

TO PROVIDE REVENUE FOR WAR PURPOSES

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE UNITED STATES SENATE

SIXTY-FIFTH CONGRESS

SECOND SESSION

ON

H. R. 12863

TO PROVIDE REVENUE, AND FOR OTHER PURPOSES

THURSDAY, SEPTEMBER 26, 1918

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PART 2



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TO PROVIDE REVENUE FOR WAR PURPOSES.

THURSDAY, SEPTEMBER 26, 1918.

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

The committee met pursuant to call, at 10.30 o'clock a. m., in the committee room, Senate Office Building, Senator F. M. Simmons presiding.

Present, Senator Simmons (chairman), Williams, Robinson, Jones, Gerry, Nugent, Penrose, Lodge, McCumber, Smoot, and Dillingham.

The committee had under consideration H. R. 12863, an act to provide revenue, and for other purposes.

The CHAIRMAN. There are some gentlemen here representing the Aircraft Board who desire to present to the committee a matter connected with the production of aircraft as affected by the revenue bill. We will hear from any of you gentlemen who desire to be heard upon that subject. First to be heard will be Mr. W. W. Montgomery.

STATEMENT OF MR. W. W. MONTGOMERY, JR.

Mr. MONTGOMERY. Mr. Chairman, Maj. C. C. Campbell and Maj. Robert H. Young are with me representing the Bureau of Aircraft Production, of which Mr. W. C. Potter is the acting director in the absence of Mr. Ryan, who is now abroad. The subject in which we are interested is one which I think concerns the whole Army, and probably all the branches of the Government which have anything to do with construction work, or with the purchase of supplies of any kind. However, we, of course, only undertake to speak for ourselves.

We have found that the question of amortization, or the extraordinary depreciation of manufacturing industrial plants, has been one of increasing importance. As you all know, costs of construction are enormous now, probably two or three times as great as they are in normal times.

Senator NUGENT. Are you speaking of the construction of aircraft?

Mr. MONTGOMERY. No, sir. I speak of the construction of plants and machinery and facilities of all sorts—manufacturing particularly I refer to. They are probably two or three times as great as they are likely to be after the war; although that is a matter of speculation. Furthermore, one subject which is very apt to be lost sight of is that the industries of the country are called upon to erect plants for war purposes on an enormous scale, probably several

times as great as any demand for their products, or any other demand for which those plants would be adaptable, after the war. The consequence is that there is going to be, as far as anyone now can foresee, an enormous depreciation in the market value of those plants.

It becomes necessary, in Army contracts made directly with the Government, to make allowance in some way to reimburse the contractor for the depreciation which he is bound to suffer. That has been done in several ways, sometimes by undertaking to estimate it in advance, and agree to a certain rate of depreciation or amortization. In some cases it is done by providing that after the war, or at the termination of the contract, as the case may be, there shall be an appraisal of the market value again, and the contractor shall be allowed, as depreciation, the difference between his actual cost and the then market value.

But under the revenue laws as they now exist, the contractor is allowed for depreciation only a fair allowance for wear and tear, and ordinary obsolescence, but nothing for ordinary depreciation.

The CHAIRMAN. Do you mean to say the department is now entering into agreements to pay contractors a certain amount for amortization?

Mr. MONTGOMERY. All the departments of the Government—

The CHAIRMAN. We are dealing only with an allowance for the purpose of deduction.

Mr. MONTGOMERY. Yes, sir.

The CHAIRMAN. But I infer from what you have said that the department is entering into some agreements with them to make them an allowance?

Mr. MONTGOMERY. Not affecting taxation.

The CHAIRMAN. Not affecting taxation at all?

Mr. MONTGOMERY. No, sir.

The CHAIRMAN. That is what I want to know, what you are doing, and to what extent you are doing it?

Mr. MONTGOMERY. It is done necessarily to a very large extent. In fact, there is not a contract made in which that is not taken into consideration. If a flat-price contract is made, you necessarily figure in advance what the depreciation is going to be, and then you spread it over the whole contract. In a cost-plus contract usually it is provided for separately. The General Staff have taken the position, which seems to me an entirely logical one, and are putting into effect a regulation to apply throughout the Army, as I understand it, that this subject of depreciation is in all contracts—flat-price as well as cost-plus—to be made a matter of separate stipulation, in order that you shall not leave the contractor to include in his estimate or his bid a speculative element, because the factor of safety which the contractor figures in making his estimate is always going to be so high that he can not possibly take a loss, and the result is that it is rather extravagant from the Government's point of view. Therefore their theory is—and it seems to me it is very logical—that this amortization should be treated as a separate item, in which the Government takes whatever speculation there is and pays the actual depreciation suffered.

In England they have found it a matter of such vital importance, as I understand it, although I do not state this as a positive fact, as absolutely accurate, with all their war-munitions plants they are

providing for amortization to the extent of 100 per cent of the actual cost of construction. So far we have not found it necessary to do that, except possibly in plants erected for some specialties, where there is obviously going to be no use whatever for them after the war.

Therefore, as I say, this question of amortization really enters directly or indirectly into every Government contract. But the subcontractor who is manufacturing munitions of war and putting up plants especially for it, but not contracting directly with the Government, has no such protection. I have not the figures, but I suppose the number of men who are making supplies for direct contractors with the Government probably in the aggregate is several times as great as the number of direct Government contractors. The result is that we are finding that those people are unwilling to undertake to erect plants and install facilities for the manufacture of those things which we must have, because they can not see their way out. They are bound to suffer a great loss.

The CHAIRMAN. I understand you now to say that there are two methods by which you provide for reimbursing for amortization purposes. One is that you agree to pay a flat sum, some percentage of the cost of the plant. The other is that you include it in your contract price?

Mr. MONTGOMERY. Yes, sir.

The CHAIRMAN. Which method do you most generally adopt?

Mr. MONTGOMERY. I do not know that I could answer.

Maj. CAMPBELL. The spreading of it over the cost of the contract.

Mr. MONTGOMERY. Maj. Campbell thinks that the spreading of it over the cost of the contract has been the most frequently used.

The CHAIRMAN. Putting it in the price?

Mr. MONTGOMERY. Putting it in the price; yes, sir.

The CHAIRMAN. This is important in connection with what you are going to ask us to do, and I would like to know if you can give the committee an idea of what you allow for that in your contract price?

Mr. MONTGOMERY. We could get for you any figures that you want. But that can not be answered by any short answer, because it varies tremendously with the kind of plant. For instance, in chemical plants the rate of depreciation will be very much greater than in certain other kinds of plants. Things which require tools and machinery of a certain sort, which are designed and constructed to make a certain article, are useless except for a scrapping value after the war. That is not so with all kinds of machinery. So that you see to answer your question definitely would really require a very elaborate answer, and giving you a good many statistics, which we can not get.

The CHAIRMAN. It would require some classifications?

Mr. MONTGOMERY. Yes, sir; considerable.

The CHAIRMAN. Can you not furnish us later an answer, not dealing with it accurately, because I do not think you can do that, but approximating as near as you can, about the percentage that you allow?

Mr. MONTGOMERY. We will get you up the most accurate figures we can; yes, sir.

Senator SMOOT. In that connection I want to ask you a question. You say the plan of spreading it over a certain number of years, and

paying for the same by an increased price paid for the article purchased, is the one that has been most usually adopted?

Mr. MONTGOMERY. Spreading it not over a period of years, but spreading the amortization allowance over all the articles, the number of tons, the number of feet, or whatever it may be that are being ordered.

Senator SMOOT. Do you mean to say that you take care of that amortization in one year?

Mr. MONTGOMERY. We take care of what is estimated to be the fair amortization, not necessarily a hundred per cent of the cost, but what we estimate ought to be apportioned to that.

Senator SMOOT. I judged that to be the case. Suppose the war should end in a year. In that case what would you do? Would you make the balance up, or does the contract provide that the balance should be made up on the part of the Government in case the amortization allowed does not cover the increased cost?

Mr. MONTGOMERY. In some cases it does.

Senator SMOOT. It must in all cases.

Mr. MONTGOMERY. No. The difficulty is that in spreading it over the price of the article, there is a speculation as to how long the war will last, and that is where the extravagance, to my mind, from the Government point of view, comes in, because the contractor is going to be safe in that in every case.

Senator SMOOT. That is what I was getting at. It seems to me in that case the only thing to do would be to spread it over a number of years, but have it understood by the contractor that if the additional cost is not covered during the time of the war, then of course the Government would make up whatever difference there was, and in that case I have not any doubt but what the Government would save from the contractor an immense amount of money.

Mr. MONTGOMERY. It seems to me so. I know that is the opinion of the Judge Advocate General, who is strongly opposed to agreeing to definite allowances in advance, but feels we are speculating on the future, and that we do not know.

Senator SMOOT. And you know the contractor will not speculate on it. He will not take any more chances than he has to.

Mr. MONTGOMERY. Exactly.

Senator JONES. I gathered from what you said that where the Government awards a contract for a fixed quantity of any material, necessitating the erection of a new plant, the contractor will figure into the entire quantity of the article the cost of the plant; or, rather, what he would consider a loss on the plant.

Mr. MONTGOMERY. Yes, sir.

Senator JONES. And that amortization is cared for, not in terms of years or time, but in terms of articles to be furnished?

Mr. MONTGOMERY. Yes. That is what I tried to explain.

Senator SMOOT. I understood that. But it seems to me that as long as that plant is made for a special purpose, and the Government has to pay for it, it should not be covered in the first order, because if the war continues very long, they will receive additional orders and it ought to be covered in whatever is produced from that plant for the Government.

Mr. MONTGOMERY. As a result of the experiences of the past year and a half, we have all learned a good many things, and the Gen-

eral Staff is trying to put into effect throughout the Army, and is putting into effect, a uniform practice of contracting and uniform forms of contracts. As a matter of fact, I was chairman of a committee, representing the different bureaus of the Army, which worked very hard on that subject for two months this summer, and made recommendations, which have since been overhauled by the director of purchases, storage, and traffic of the General Staff and his board, which is called the superior board of review.

As a result largely of the recommendations which our committee made, the General Staff is adopting this policy, as I understand, that this amortization shall be taken care of in this way, that every contract shall provide that there shall be allowed for depreciation, to be paid at the termination of the contract, an amount to be arrived at in this way, that an appraisement is then to be made of the fair market value of the plant at the end of the contract, and the contractor is to be allowed the difference between the actual cost of facilities expressly provided for this contract—nothing else—and the fair market value at that time. Or, in cases where there is no fair market value, and the contractor himself is the only person who can be a purchaser, because they are mixed into his plant so that they can not be separated, then the fair additional value to his plant by reason of those facilities.

That, it seems to me, will work in this way—that if at the termination of the contract the war is still going full blast, the probability is that the plant will be of great use, of great value, to that contractor, or somebody else who would like to take it from him, either to supply us with munitions of war or to supply the allies. Therefore, if that is the case, the Government certainly is entitled to the benefit of that market value. That condition will be represented in renewal contracts, and eventually it will all wash out at the end, because it seems to me, automatically that will be the result.

I think that an order has gone out, one of the series of orders which are designated "Supply Circulars," from the General Staff—if it has not, it is about to go out—which is going to put into effect throughout the Army that method of dealing with this subject of depreciation. If so, it will carve out, as I understand, from all flat-price contracts, any estimated allowance to be put into the price per ton, per pound, or per foot. To my mind it is much more accurate and logical, and avoids that element of speculation.

Senator McCUMBER. Do these contracts of which you speak all contain the cost-plus provision?

Mr. MONTGOMERY. Oh, no, sir; that is only used now where there is no other way to do it. It has served a very useful purpose, in my judgment, and no doubt cost-plus contracts will always be necessary to some extent. But of course, with the greater experience and greater knowledge of the cost of manufacture of different things, and all that, as it is worked out now, and the advance payment provision, which was in the urgent deficiency bill last October, the situations which made the cost-plus contract imperative in a great number of cases before have been reduced to a minimum.

Senator McCUMBER. You think, then, you are eliminating to some slight extent the robbery of the Government that has obtained so far under the cost-plus system?

Mr. MONTGOMERY. To my personal observation, I am not convinced that the robbery has existed, but if it has, we are eliminating it so far as we can.

Senator PENROSE. Put it "wastefulness" instead of "robbery"; and disturbance of the labor market.

Mr. MONTGOMERY. That, too, is not an inherent difficulty in the cost-plus contract as such. There are provisions in the cost-plus contracts now to meet that subject.

Senator PENROSE. I am not going into an argument with you about cost-plus contracts. I only want to say that in Pennsylvania there has been a great deal of disturbance in the labor market because the 10 per cent man can pay anything for carpenters and other laborers, and take them away from others.

Mr. MONTGOMERY. In the bureau of aircraft production there have been, I think, not more than half a dozen contracts which were let on the basis of cost-plus percentage. All of them have been cost plus a fixed profit, with a bonus for saving below an estimated cost. So that it eliminates, I think, the objection to which you refer.

The CHAIRMAN. I do not know how rigidly you supervise the expenditures that enter into the item of cost. But I would assume that if the Government lets a contract upon the cost-plus basis, the Government would maintain constantly some sort of supervision over the prices that the contractor was paying, both for labor and materials, and see that the price was a bona fide one, and that it was not excessive.

Mr. MONTGOMERY. I think we have met that.

The CHAIRMAN. I would like to have you state whether that is so or not.

Mr. MONTGOMERY. Yes, sir; that is done.

The CHAIRMAN. Because there is a general impression throughout the country—and I am afraid the Senator from Pennsylvania participates in that—that the Government just lets the contractor under this scheme of compensation pay any price that he pleases for labor, and pay any price he pleases for material, adding, thereby, of course, if it is an excessive price, to his commission. I wish you would explain to what extent the Government does provide supervision to protect itself against that sort of exploitation.

Mr. MONTGOMERY. The condition you suggest is not so in our bureau. It exists, so far as I know, in no case, and we met it in three ways. In the first place, the profit is a fixed one. If the estimated cost, which we estimate in advance—and which we among ourselves call the "bogey" price—is exceeded, there is no advantage to the contractor. His profit does not go up. If he saves, and gets below the bogey price, he gets 25 per cent of the saving that he makes, and the Government gets 75 per cent. There is thereby a direct incentive to the contractor to keep down his costs. We may guess wrong in fixing our bogey price. If so, we are this much better off than we would be in a flat price contract, that if we made an error in fixing our bogey price, we lose to the contractor only 25 per cent of our error, whereas if we make an error in a flat-price contract, he gets a hundred per cent of our error.

In addition to that, we have in our bureau—and the general staff is establishing it, following our practice, in all the bureaus in the Army—what is called an approval section. We have a staff of men who are

what are supposed to be men qualified in prices, in construction work, in manufacturing, in cost of machinery, in cost of material, and all that sort of thing, and I think I am correct in saying that every item is supervised, and every expenditure of the contractor is O. K'd by us.

Senator McCUMBER. The question of material is not the principal element of cost to the Government. It is the matter of labor, and it is not a question of how much you pay that labor but what you get out of that labor. For instance, you take the construction of these buildings around on these vacant lots surrounding us. We know that the laborers are not producing more than $3\frac{1}{2}$ per cent of what a laborer ought to produce within the hour, and we know that you are adding $66\frac{2}{3}$ per cent to the labor cost of that construction, and the Government has to pay it.

Mr. MONTGOMERY. Yes, sir. But let me suggest this thought to you: The contractor, under a flat-price contract, knows he has to meet that situation, and the result is that his estimate covers that very feature. We do not get away from that under any kind of a contract.

Senator SMOOT. You say that is the case with your bureau. That was not the case when they were building the cantonments, when they were paying \$5 or \$6 for boys to pack water, and taking away from employers I know of here, negro men who were receiving \$60 a month, and paying them \$9 or \$10 a day for carpenter work; and they never had a hammer in their hands, I suppose, more than half a dozen times in all their lives. Your department may not have done this, but when the cantonments were first built that was the case.

Mr. MONTGOMERY. I have heard that said. I have never personally scrutinized the operation of their contracts. I have scrutinized their contracts with some care.

Senator McCUMBER. I have scrutinized the operation in their work.

Mr. MONTGOMERY. I think I can safely say that if there have been any abuses of that kind in our bureau, it would be hard to discover them. I can not answer for the others.

I want to say this, too, that in our contracts we have always had a provision, which was really suggested by the War Industries Board a year ago last August, that no increase in the rate of wages should be paid by any contractor under our cost-plus contracts beyond the rate prevailing for similar labor in his community without the permission of the Government. A slight amplification, I think an improvement of that clause we have been using is now being put into effect by the General Staff in all cases where the cost-plus contract plan is used.

Senator PENROSE. Have you known cases where these 10 per cent contractors have put in their subscriptions to the Red Cross as part of the expenses for the work, and got 10 per cent on them?

Mr. MONTGOMERY. I have read of those in the papers. But that has not been so with us, because we have not had any of these 10 per cent contracts.

Senator PENROSE. That is a case cited by the accountant for the Hog Island shipyard, who has written an article in the Forum on the subject, which I hope to show the committee.

Mr. MONTGOMERY. Yes; by Perley Morse. I read it with a good deal of interest, because I had made some study of the cost-plus

contracts, and it seemed to me that his argument was a collection of abuses which are possible, not as a result of using a cost-plus contract, but of an improperly drawn cost-plus contract, and I think I can say with entire conviction, so far as I am concerned that the cost-plus contract which will be used hereafter, and used only when there is not any alternative will eliminate practically every one of the difficulties to which Mr. Morse calls attention in that article. I may be wrong, but I am thoroughly convinced that is correct.

Senator PENROSE. I can see how in the future careful supervision and a more careful phraseology in the contracts will eliminate many of these abuses. I am talking more as to the experience of the past.

Mr. MONTGOMERY. Yes, sir. Out of fairness to ourselves, who have had a good deal of contracting to do, we have learned a lot.

Senator SMOOT. The only justification I could ever think of for this cost-plus contract was that the construction of the building or the article itself was of more importance to the Government than money.

Mr. MONTGOMERY. Of course, that is the great justification in many cases. But there are two other considerations which were imperative, or have been in the past were certainly a year ago, that is, that in many articles nobody—neither manufacturers or Government officials—knew what the cost of that manufacture was going to be.

Senator ROBINSON. What is your suggestion with reference to this bill? Let us get down to something this committee has jurisdiction of. Do you desire to present amendments to the bill or do you support provisions in it?

Mr. MONTGOMERY. I will present a matter of amendment.

Senator WILLIAMS. Mr. Chairman, I would like to ask the witness a question. Mr. Montgomery, have you any amendment drawn up that you propose to offer to the committee?

Mr. MONTGOMERY. Yes, sir.

Senator WILLIAMS. I suggest we hear it and have it explained.

Mr. MONTGOMERY. A part of this is practically a quotation of the bill as it was passed by the House. Other parts are quite new.

(Mr. Montgomery thereupon presented and read the following proposed amendment to the committee:)

(A) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April sixth, nineteen hundred and seventeen, for the production of articles contributing to the prosecution of the present war, there ~~may~~ shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities as has been borne by the taxpayer, but not again including amounts otherwise allowed under this title for depreciation, exhaustion, or wear and tear. ~~At any time within three years after the termination of the present war with the Imperial German Government as declared by proclamation of the President, the commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the necessary adjustment of the taxes for the year or years affected shall be made, and the amount of tax due upon such readjustment, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section two hundred and fifty two. In the case of a nonresident alien individual this deduction shall be allowed only as to facilities within the United States. In no case shall the deduction allowed under this paragraph exceed 25 per centum of the taxpayer's net income as computed without the benefit of this paragraph or paragraph (11).~~

In the case of any such buildings, machinery, equipment, or other facilities, constructed, erected, installed or acquired by any taxpayer for the purpose of performing any contract with the United States of America made subsequent to April sixth, nineteen hundred and

seventeen, in which contract provision shall have been or shall be made for the allowance or payment to the contractor of any sum or amount for depreciation or amortization of the cost of such facilities, such sum or amount shall be allowed as a deduction under this paragraph in computing net income: Provided, That if the performance of such contract shall in fact extend over any part of two or more separate taxable years the commissioner may equitably apportion such allowance for depreciation or amortization among the several taxable years during which such contract shall be performed.

At any time within one year after the termination of the present war with the Imperial German Government as declared by proclamation of the President, the commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the necessary adjustment of the taxes for the year or years affected shall be made, and the amount of tax due upon such readjustment, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section two hundred and fifty-two. The recommendations of the Advisory Tax Board upon any matters submitted to it under this paragraph shall be binding upon the commissioner and the Secretary of the Treasury.

Senator PENROSE. That compulsory feature is a pretty strenuous provision.

Mr. MONTGOMERY. It is, of course. Our reason for that was this: I may say that I think this is in general satisfactory to the Treasury. I did talk it over in general with Dr. Adams some time ago. But I had not seen him until this moment here in the committee room. He has not seen this phraseology.

The CHAIRMAN. Let me suggest that you submit it to Dr. Adams after you get through.

Mr. MONTGOMERY. Yes, sir. In answer to Senator Penrose's comment, may I say this? We find that there is a feeling among the manufacturers throughout the country, whether they are contracting directly with the Government or not, that when they submit themselves to the decision of the tax collector they are taking a tremendous gamble, and there is a reluctance—and I am afraid, with the high rate of taxation, there will be a refusal—on their part to go into any extensive construction or equipment development of their plants, or increase of their plants, or the erection of new plants, for the purpose of making munitions.

We felt that this advisory tax board, which is provided for by the act, is a board whose personnel are appointed by the President. They are given very complete powers to investigate, to summon witnesses, and all that, but when they have come to their conclusions, all they can do is to recommend. I suppose that all of us would probably feel that in a vast majority of the cases the commissioner or the Secretary would regard the recommendations of that board as practically conclusive—not necessarily so, but in most cases they would so regard them. Probably it is hardly fair to suppose that the manufacturers throughout the country are going to take the same view. It seemed to us that this board, for this one purpose, should be regarded as a separate tribunal. It exists, not by appointment from the commissioner or Secretary, but from the President, and in this one respect its findings would be conclusive. It would be a separately constituted tribunal, independent of the tax collector, which would settle this vitally important matter. We have been unable to see why the interests of the United States would in any way be sacrificed by such an arrangement. It does seem to us that it would add a feeling of confidence to the people of the country generally, and it would probably bring about the conditions which we certainly need, their entire willingness to go ahead and put up the

facilities which are necessary to supply the allies with what they must have for the conduct of the war. If we do not have something of the kind, I am afraid it will result in the Government itself having to take over manufacture. It is almost impossible to say from what sources or on what basis the industries of the country can finance themselves, because even if we agree to reimburse them for their amortization, that they must have in some form or other, inasmuch as the tax law will result in allowing them something very much less than the damage which they have actually suffered, anything over the amount which the tax law permits them to deduct for the purpose of determining net income would come in as an item of profit, and some large percentage of it, running up to perhaps 80 per cent, would be taken away from them, and it would mean in many cases absolute insolvency. The Government would not gain by that policy.

Senator SMOOT. Have you made any estimate at all as to the effect of this on the amount of revenue collected for the year 1918?

Mr. MONTGOMERY. I do not think it would affect it, as a matter of fact. But I can not say that I have made any estimate in figures. I do not think it would affect it, because in some way or other the Government has to pay for this thing. If it gets it back in taxes, it must pay out in some way, even if it thus protects the plants.

Senator SMOOT. That would be true in the end, but what I wanted to know was whether you have made any estimate of the effect it would have on this present year's taxes? It seems to me that if we undertake to adopt your provision, it is going to affect this year's taxes. But in the end it would not.

Mr. MONTGOMERY. I have not made any such estimate. I do not know whether such an estimate can be arrived at. We would not have the data to make such an estimate. I do not know whether the Treasury Department or the War Industries Board might have the data to make it.

Senator JONES. Would you make the decision of that board conclusive upon the taxpayer also?

Mr. MONTGOMERY. I do not see why not.

Senator SMOOT. I think the wording of it does.

Senator JONES. I thought it only included the Treasury Department. You say it would be binding.

Mr. MONTGOMERY. That is true. That is the way I have worded it. My idea was to provide that that one decision should be by the board and not by the commissioner, but reserve to the taxpayer any rights of appeal which the present law or any other law may give him. That was my idea.

Senator JONES. In other words, you make the decision of the board conclusive so far as the Government is concerned, but not so far as the taxpayer is concerned?

Mr. MONTGOMERY. I think it would have that effect; yes, sir. Undoubtedly it would have that effect.

Senator ROBINSON. To whom would appeal from the board lie in the case of a taxpayer.

Mr. MONTGOMERY. I am not quite sure how that would be under the present revenue laws. This law provides no new machinery in that respect.

Senator ROBINSON. I mean under the special provision you have presented.

Mr. MONTGOMERY. I suppose there is an appeal now to the United States courts. But this law does not provide any change. All this would do would be to substitute the decision of that board, so far as the taxpayer is concerned, for the decision of the commissioner, leaving the taxpayer all rights of appeal, if any, which he now has, and giving him nothing new, his appeal simply being from the board instead of from the commissioner.

Senator SMOOT. Did I understand you to say that the War Department was in favor of this, or only the bureau that you represent?

Mr. MONTGOMERY. I think it is perfectly proper for me to say that the War Department is. I will not say I represent the War Department, but I represent our own bureau. We have no authority to represent anybody else. I have talked it over at length with Gen. Johnston, who is director of purchases and supplies, representing the General Staff, and his Superior Board of Review, and the general principles which we are now advancing they regard as important.

Senator SMOOT. Have you submitted this to Gen. Johnston?

Mr. MONTGOMERY. No, sir; but I think it ought to be submitted to him. Unfortunately, the matter was handed to me to attend to too late to do that, and for that reason I have not had a chance to talk with Dr. Adams, which I certainly should have done, because I discussed the proposition with him in general outline earlier.

The CHAIRMAN. Have you any further statement you desire to make?

Mr. MONTGOMERY. So far as I know, I have covered it. If I can answer any questions in any way, I will be very glad to do so.

Senator McCUMBER. Generally, your idea in making your contracts is to make them in such a way that by the time the war is over you will have paid back any loss to the contractor that would result from inability to dispose of his extensive shops, machinery, etc.?

Mr. MONTGOMERY. Exactly.

Senator SMOOT. Ordered by the Government?

Mr. MONTGOMERY. Ordered by the Government, or necessary for work to be done to go into munitions, not necessarily under contract by the Government, and then to frame the revenue law in conformity with that.

Senator McCUMBER. The contractor gets paid as he goes along with his contract?

Mr. MONTGOMERY. Yes, sir.

Senator SMOOT. In some cases?

Mr. MONTGOMERY. He gets paid for it by the time he gets through. Usually it will be a lump-sum payment at the end of his contract. I say usually because I think that is the system of contracting that the General Staff wants to put into effect.

The CHAIRMAN. And you want the amount that is paid allowed as a deduction?

Mr. MONTGOMERY. Subject only to revision in the way I suggest here.

The CHAIRMAN. You think you ought to have a special board, then, as I understand it?

Mr. MONTGOMERY. I do not ask to have a special board, but simply to have that jurisdiction given to the advisory board, which is

already provided for in the act. As the act is now drawn, it does not give them the right to make a definite decision, but merely to recommend. You will find in the latter part of the bill, I think, a provision for a board called an advisory tax board, to be appointed.

The CHAIRMAN. We all understand that. I thought you were advocating a special board outside of that and independent of it. You misunderstood me. I was out for a moment when you were reading your amendment. I was under the impression that you were asking for the creation of a special board, instead of leaving the matter to the board created by the act.

Mr. MONTGOMERY. No, sir. I would leave it to the board created by the act, but give them final, definite jurisdiction to make a decision in that one particular.

Senator SMOOT. If the committee does not agree to establish that board, have you any suggestions as to what agency should have that power—I mean an agency which is already in existence in the Treasury Department?

Mr. MONTGOMERY. I am afraid that I am not sufficiently familiar with the organization of the Treasury Department to enable me to answer your question. If you are willing to go outside of the Treasury Department, it would be entirely logical to make the War Industries Board the one. The objection to that would be that the War Industries Board does not exist by virtue of an act of Congress, and its jurisdiction and its existence may be changed by an Executive order. My only point on that is that it seems to me that there would be a great feeling of confidence created among the industries of the country if they felt that the decision of this vital question was to be made, not by the person whose duty it is to collect taxes, but by somebody who will have in that respect a judicial capacity and be independent.

STATEMENT OF MR. CHARLES PIEZ, VICE PRESIDENT AND GENERAL MANAGER OF THE EMERGENCY FLEET CORPORATION.

Mr. PIEZ. Mr. Chairman, I believe I am down here on very much the same errand as the gentlemen who proceeded me. I did not hear all of his statement, but the Emergency Fleet Corporation is constantly in difficulties in negotiating contracts by reason of the questions that the contractors raise concerning the amortization of extensions or additions to plants. We have in hand at this time a statement of one of the important shipbuilding companies in connection with vessels that were requisitioned. In determining the costs of those vessels, this company claims that they ought to be able to write off at least 50 per cent of their plant, a plant that was very largely constructed since the beginning of our war, against the costs during the next three years. According to the terms of this bill as it passed the House, the amortization, I understand, is limited to 25 per cent of the profits. In most of the cases in which amortization is asked the industries are new. It is very difficult in advance to determine what the profits are going to be. But the contractors are interested very much as to what allowance for amortization we are going to permit as an element of cost. And so I came down here to ascertain from the committee whether, in the case of new indus-

tries, or industries in which the expansion has been very large in proportion to the existing investment, discretionary power should not be lodged in somebody else, so that that restriction of 25 per cent could be removed. If that is not done, I feel most distinctly that the Government has simply to finance all extensions from now on, and I favor financing by private individuals, because as a rule the investment and the construction is not as elaborate when individuals take the risk as it is when we ourselves are held responsible for it. I have felt that perhaps the committee might be entertained by the experiences we have had connected with the making of contracts that involve this particular point.

Senator PENROSE. And when the Government does it, it is of no use to the Government after the war.

Mr. PIEZ. Absolutely not.

Senator PENROSE. If it is of any use to anybody, it is of use to the individual adjacent to whose concern the improvement is made.

Mr. PIEZ. Yes, sir.

Senator SMOOT. You heard the suggestion offered by the representative of the Aircraft Board?

Mr. PIEZ. I came in just as he was about in the middle of it. I did not hear all of it. But I appreciate that it is probably the same question.

Senator SMOOT. The same question has arisen, and he offered this suggested amendment. I was going to ask you if you have suggested an amendment covering the subject from your standpoint?

Mr. PIEZ. No, except that I felt discretionary powers should rest at least with the Commissioner of Internal Revenue, or an appointed agent of the Treasury. But we have this restriction.

The CHAIRMAN. You mean the restriction of 25 per cent?

Mr. PIEZ. Yes.

Senator SMOOT. That is entirely out in his amendment. He excludes that 25 per cent.

Mr. PIEZ. I think it ought to be excluded.

Senator SMOOT. I think his amendment covers exactly your idea.

Mr. PIEZ. It is a very serious thing with us. We are constantly being pressed for decision on this very vital point, and we have taken the position that we can not of our own accord introduce terms in a contract that are not in accordance with the revenue act.

The CHAIRMAN. Mr. Montgomery has presented the committee a concrete amendment, and we have asked Dr. Adams, representing the Treasury Department, to examine that amendment. Would you have any objection to going over it with those gentlemen?

Mr. PIEZ. No; I would be very glad to.

The CHAIRMAN. I think it would be well for you to do it.

Mr. PIEZ. Probably it would save the time of this committee to do that.

Senator PENROSE. Go ahead with your statement, Mr. PIEZ.

Mr. PIEZ. I have not very much else to say, except that we were confronted with this problem almost daily, and it looked to us as if some provision had to be made, or the Government would have to finance the proposition.

Senator ROBINSON. How have you handled it up to date?

Mr. PIEZ. We have simply dodged it, and that has not been satisfactory. It is very essential that some of the plants should make additions in order to round out their capacity.

Senator JONES. The contractors have not dodged it, have they? They have estimated that element in making their contracts.

Mr. PIEZ. In many of these cases we have had to place contracts at cost plus a fee, and the question then arises with our auditors as to whether amortization is properly an element of cost; and, if so, what percentage. These plants will largely serve as a temporary purpose. The contractor wants the amortization not only for the extra war cost, which is probably two or two and a half times the ordinary cost, but he also wants amortization for a partial liquidation of his original investment.

Senator WILLIAMS. Is it not true that each case would have to be determined upon its own merits?

Mr. PIEZ. Very largely. It is very difficult to lay down any particular rule, and therefore there ought to be discretionary power vested in some board or some person.

Senator McCUMBER. Does your contract allow amortization as an element of cost?

Mr. PIEZ. It does not, in our ordinary ship contracts. In some of the contracts for dry docks we have agreed that the contractor shall have the right to purchase on an appraised value, and we have limited the amount of write-off to a certain percentage of the original cost. That we have done.

The CHAIRMAN. The gentlemen who just appeared before us said that they had been providing for this amortization by two processes. Sometimes they provided for it in the price that the Government paid. Sometimes they provided for it by agreeing that at the termination of the war, or at some fixed time, the Government would allow a certain percentage of the cost of the additional plant by way of amortization and would assume the indebtedness.

Mr. PIEZ. I think the first alternative is the better one, because that absorbs the cost as you go on. If there is an amortization, it ought to be charged against the cost of the product you turn out rather than be taken care of by an allowance at the end of the period, and I would much prefer the first process, because that charges it immediately into the cost of the ships, and if there should be any sale later on, it would be taken care of in that sale, because it would be covered in the price.

Senator PENROSE. My recollection is that the gentleman who just testified preferred the other way.

Senator SMOOT. Yes; he preferred the other way. But I think there is quite a difference between ships and the building of machinery that would be used afterwards only to a limited extent. I think both the gentlemen are right.

Senator PENROSE. Whichever method is preferable is largely dependent on the nature of the article?

Mr. PIEZ. Yes. Here is a product of continuing value, and the cost, I think, ought to be charged against the product.

Senator JONES. But is it not more difficult to ascertain that cost in advance than it would be at the end of the transaction?

Mr. PIEZ. I do not think so. I think most contractors would be content with a fairly modest allowance for amortization over the next two years.

Senator JONES. What I had in mind was this: We can not tell how long the war is going to continue, and we can not tell how many articles are going to be produced at a given plant.

Mr. PIEZ. No.

Senator JONES. Therefore it seems to me that it would be wiser, perhaps, not in all cases, but in a majority of the cases, to have this adjustment at the conclusion of the transaction.

Mr. PIEZ. The difficulty then is that if the amount to be allowed for amortization is uncertain, it is very difficult for the contractor to finance his operations.

Senator JONES. What I had in mind was this: I got an impression, for instance, that the Hog Island Shipyards were built assuming a given number of ships to be constructed at the yards, and it may be, and I think quite probable, that after that number of ships are constructed, we will want to construct others at the same plant. But if you write off the cost of the plant against the number of ships already contracted for, you will have a plant then which stands as absolute profit as to the next contract.

Mr. PIEZ. That would not be an unmixed evil, because you will probably reach competitive conditions at that time, so that your vessels would have to come down in cost, and would not carry quite as big a write-off as they would carry to-day.

Senator JONES. I was rather impressed with the fact that we should not assume any greater burden at the present time than was absolutely necessary.

Mr. PIEZ. It is not assuming a burden. It is simply putting it in a different form. I think unless we make a decision, and make a decision as to the percentage of reasonable amortization to be permitted, the burden on the Treasury is going to be heavier.

Senator JONES. The burden, of course, must be borne at some time.

Mr. PIEZ. Yes.

Senator JONES. We are all agreed on that.

Mr. PIEZ. Yes, sir.

The CHAIRMAN. You are not asking us to provide for amortization to be made by the Shipping Board. You are simply asking us to provide a plan of amortization for deductions in order to ascertain the net income?

Mr. PIEZ. Yes. We may decide upon a reasonable percentage of amortization, but if it is not sustained by the Treasury, we have broken faith with our contractors.

The CHAIRMAN. In other words, you want us to harmonize, as far as we can, the revenue laws to your practice?

Mr. PIEZ. To our own practices growing out of our necessities.

Senator PENROSE. I think it would be well if Mr. Piez would confer with Dr. Adams and with the airplane representatives, and agree on an amendment that will cover these cases.

The CHAIRMAN. I think that would be well, and we have this amendment offered by Mr. Montgomery as a starting point.

Senator PENROSE. I think it would be better for the individual contractor to be permitted to go ahead than for the Government to spend hundreds of millions for material that would be only junk after the war. There has been too much Government construction already.

The CHAIRMAN. I understand Mr. Joseph S. Auerbach wants to give some testimony in addition to what he has said at a former hearing on this bill. You may proceed, Mr. Auerbach.

STATEMENT OF MR. JOSEPH S. AUERBACH, REPRESENTING THE WOOLWORTH CO. AND OTHER CORPORATIONS—Resumed.

Mr. AUERBACH. Mr. Chairman, in order to economize your time I have prepared a statement which contains all at the present time that I think it is worth while to submit to you. I suppose as time goes on there will be abundant opportunity, when the conference committee gets together, to make further suggestions. I am only going to call attention colloquially very briefly to some things which this memorandum contains, so that I may answer any questions you care to ask.

This bill has been passed by unanimous vote in the House, and the report of the Ways and Means Committee which advocated its passage contains this statement [reading]:

The definition of invested capital in the existing law, while rewritten in the proposed bill in the interest of clearness and while changed slightly in order to apply a more liberal rule in a few cases where the existing law has in operation been found to produce certain inequalities, but has not been changed in any important particular.

I think that this committee is going to find it very difficult to reconcile that statement with the changes in the existing law, particularly in the definition of invested capital.

The CHAIRMAN. Mr. Auerbach, I want to say to you that the Treasury Department has sent me a number of proposed amendments, or suggested amendments, as to that section. I went over them last night rather hurriedly, but I was very much impressed with some of them.

Mr. AUERBACH. Undoubtedly I should be, too.

The CHAIRMAN. That is a subject which the committee will want to thoroughly consider. Personally, that is my own view.

Mr. AUERBACH. Do you mean that you do not want a further statement from me now?

The CHAIRMAN. No, we want to hear you; but I was just suggesting that.

Senator SMOOT. Do I understand that in your brief you have suggested any amendment?

Mr. AUERBACH. No; but I should be glad to submit amendments covering my suggestions.

The CHAIRMAN. If you have any amendments you want to suggest to us with reference to this, you may do so.

Mr. AUERBACH. So far as this memorandum goes, it makes all the preliminary suggestions I care to volunteer.

The CHAIRMAN. What I was trying to suggest to you was that we would not be bound by the action of the House, and the Treasury Department has sent some suggested amendments as to that definition.

Mr. AUERBACH. Inasmuch as a great deal of emphasis is put upon the fact that the bill was passed unanimously by the House I am not able to reconcile the argument in favor of the bill with the fundamental changes that are made in the bill in the matter of definition of invested capital.

Of course you may recall from the brief I, along with other counsel, submitted and the statement I made last year before you that I was not entirely reconciled to the final definition of invested capital

even as agreed to in conference committee. I think, of course, it ought to have been actual value. That value could be ascertained, and I thought it ought to be the full value not only of tangible property but of good will, properly defined.

But inasmuch as war conditions had arbitrarily changed prices, there was a suggestion made in the brief that was filed before the conference committee that a date should be selected before those advances in value had taken place, and in this memorandum January 1, 1914, was suggested as a very natural date. I do not wish to claim any credit for it, for it was a very natural date for one to select. You deliberated fully over the whole matter, the conference committee deliberated over it, and now this bill proposes to measure invested capital by cost and not by value. What kind of allowance of 10 per cent on invested capital is it when you do not even permit the values of January 1, 1914, to be allowed? Take again, for instance, intangible property. The committee says that no changes shall be made except in the interest of clearness, etc., yet patents have been taken out of that paragraph which permitted them to have exemption on the basis of cost value. Now they are classified as good will, and only 20 per cent can be allowed. How can you reconcile the argument for the bill with the provisions which bill contains?

Take again the question of the consolidated returns of federated corporations which the bill proposes to prohibit. I understand that it is said that the regulation was availed of by corporations not according to the spirit of the regulation, yet we all know why this regulation was promulgated by the Treasury.

Let me give you an illustration of how it applies. The Woolworth Co. can not do business in Pennsylvania as it wishes to do business, because the laws of Pennsylvania prohibit certain foreign corporations, of which it is one, from holding real estate.

Therefore it organizes a corporation in Pennsylvania. It can not properly do business in some other community. Therefore it organizes a local corporation, because the local community favors a local corporation. This is true of its subsidiary company in Canada. Instead of prohibiting such a regulation, at least permit it in cases where the subsidiary corporations do not show a loss from operation, which would reduce the income returns of the parent corporation. What possible objection would there be to that? Yet the House arbitrarily prohibits it the right to have such a regulation because it finds one instance where it may have worked an injustice to the Government.

It is not necessary for me to argue and reargue ad nauseum this question of cost. This idea that "cost" is easy of ascertainment is lacking in seriousness. You should fix a date when invested capital shall be valued—say January 1, 1914—or if there is any magic about March 1, 1913, then at least March 1, 1913. For in this bill, as it came from the House, you have to find the value, if there be a sale, because the difference between the value as of March 1, 1913, and the price at which it is sold is income which is taxed. Are you going to have one theory for taxing income and another theory for allowing exemptions on capital?

See what results from the provision as it now stands. You go back to original cost. Yet you can not think that 10 per cent on cost is 10 per cent exemption on invested capital. No; I can give

you an illustration where it will not not be an allowance appreciably less. I am not saying anything about what you should or should not allow by any exemption on the tax imposed. Of course, that is for you to say what part of the war expenditures should be paid by taxation. What I am urging upon your attention, Mr. Chairman and gentlemen, is, do not "keep the word of promise to our ear and break it to our hope." Do not let us have an alleged exemption of 10 per cent and have it represent an exemption in almost every case throughout the United States of any corporation that has been in existence for a reasonable time appreciably less than that.

I think there are one or two definitions that ought to be made clear, which are referred to in the bill.

Senator SMOOT. Have you figured out at any time the percentage of expense of the war that is being raised by England by direct taxation since their last revenue act was passed?

Mr. AUERBACH. I do not know exactly. I asked Mr. McCoy the other day and I think he said 15 or 16 per cent. But I do not know that I am even right about that.

Senator SMOOT. Mr. McCoy, have you figured it out?

Mr. AUERBACH. What percentage of the war expense was paid by direct taxation in England?

Mr. MCCOY. Not quite 15 or 16 per cent.

The CHAIRMAN. Do you mean now, or the average?

Mr. MCCOY. I mean now.

Mr. AUERBACH. Of course, I do not know what we are paying. It has been said that we are paying something like a third. But of course that does not take into account the amount we are loaning to the various Governments.

The CHAIRMAN. On the basis of actual expenditures last year we paid nearly 50 per cent.

Mr. AUERBACH. I made a suggestion in the statement submitted that if you came to the conclusion, under a right theory of this bill, that you can not raise, without injurious effects to the individual and to industry, \$8,000,000,000, there is a very easy way for you to provide for the difference—by some short-time war certificates, convertible into a bond thereafter.

When I made this suggestion originally to some one about a less amount to be imposed as taxation and more by bond issues, so as to conform somewhat to the practices of other countries, the reply was made that a larger issue of bonds would still further depress existing prices, which are appreciably below par.

Senator SMOOT. In your statement presented to the committee do you handle the question of issuing bonds?

Mr. AUERBACH. Yes; I refer to a way in which the prices at which they are selling might be improved through the operation of a sinking fund.

Senator SMOOT. That is, in a serial bond?

Mr. AUERBACH. In a serial bond, or however it might be characterized. Of course, when you come to take up that question, in all probability other considerations would occur to you which would improve the selling price of these bonds.

The primary thing you have to consider here is whether you are going back to the old question of the cost to establish invested capital, on which you shall calculate an exemption. If you do, I

think the consequences to industry are going to be at least very serious. And I think whatever the exemption is, it should be a real exemption upon invested capital, properly defined, and at least as of March 1, 1913, for the reason I have outlined.

Senator ROBINSON. Do you undertake to define "invested capital"?

Mr. AUERBACH. No; the definition of invested capital is a pretty workable thing as you had it last year, as of January 1, 1914, though, as I say, if there is any magic about the date, put it back to March 1, 1913. As to patents, only 20 per cent of cost is allowed for good will. They are classed with good will. I urge, and a good many people do, that good will should be allowed for at a fair value, whether it has been bought or not. For developed but not purchased good will you do not allow for at all. But to take patents and copyrights out of invested capital, where they allowed for cost, and class them with good will, where they allow only 20 per cent is indefensible. There is no reason for it in the report of the House committee. In fact, as I have said, the report of the House committee says there has been no change in the substance, yet if it is not a substantial change, a change only of definition, for the purpose of clarity, to take patents out of where they were and putting them under good will, and to changing the definition of "invested capital," and say it shall be at cost and not as of the value of January 1, 1914, it would be difficult to give an example of a substantial change.

The CHAIRMAN. We have not reached that item in the bill, and the lines of thought upon it have not been developed in the committee.

Mr. AUERBACH. But you had the same question up before. This same question we worked over and prayed over. The result of it all was that in your wisdom not only you, but the conference committee, said January 1, 1914, and put patents so that they were allowed for at cost. Now the whole thing is in a position where it must be thrashed over again.

Of course, there are some things in the bill to be commended. The small corporation, whose earnings may be large in comparison to their capital, do not get into the high brackets. I said so in the brief I submitted last year, because there the earnings are attributable, not to invested capital, but to the individual effort and ability of the men who run them. Then you permit losses to be taken into account included in a venture that is not immediately connected with the taxpayer's vocation. I think this is wise. In those particulars the bill is to be commended.

The CHAIRMAN. Do you not think some of the regulations made by the Treasury Department relieve to a very considerable extent against the rather too drastic definition of capital?

Mr. AUERBACH. I do, very emphatically so. I think it a kind of benediction that those regulations were promulgated, nor were they in derogation of the act, but in furtherance of it, and I refer particularly in my preliminary statement to that. Many of those regulations contain "saving" provisions, and the services of the advisory board, of which Dr. Adams, who is I see here, was a member, can not be too highly commended. It is a misfortune that the House has struck out the authority for one of those very important regulations permitting consolidated returns. At least, confine the prohibition to cases where it would operate improperly to reduce the income of the Government. If a man has a venture which is paying a large

return and he has another venture which is a loss, an entirely independent unrelated venture, the spirit of that regulation, as I understand it, was not that he should offset one against the other, but it was to apply to a case like the Woolworth Co., and numerous other companies, where, for the necessities of business and the requirements of local laws, some such subsidiary company was necessary.

The CHAIRMAN. While you are expressing a willingness to have these cases of losses by subsidiaries eliminated, what is your opinion as to the equity of such an elimination? Do you think it ought to be made?

Mr. AUERBACH. I am not clear about it, though in some cases where the corporations are properly related when the consolidated report might well be authorized, even in cases showing losses. I do not, however, represent any of those corporations. But an officer of the Government told me that there were cases which did not work out with proper results to the Government under the spirit of those regulations. I said I thought it was unfortunate to take away from industry that which, in the opinion of this advisory board, they were entitled to and which everybody must agree they were entitled to.

The CHAIRMAN. You are, then, just suggesting that as a possible way of meeting some of the objections to the consolidated returns, without expressing any opinion as to whether those cases ought to be eliminated?

Mr. AUERBACH. Yes; I have no decided opinion about them other than that which I have expressed, because I do not represent those companies.

(A supplemental statement was submitted by Mr. Auerbach, and is here printed in full, as follows:)

STATEMENT OF JOSEPH S. AUERBACH.

Inasmuch as what I shall say maybe the subject of discussion and colloquy by members of the committee, I thought it would economize your time if I prepared and submitted my preliminary statement in writing and merely summarized it in oral argument.

Let me say at the outset that my suggestions are not made in the selfish interest of any particular industry, as opposed to the interests of industry generally and, further, that such suggestions are intended to take into full consideration a patriotic desire that the country secure the best revenue bill possible.

In the report of the Ways and Means Committee to the House of Representatives is contained the following:

"PART VI. INVESTED CAPITAL.

"The definition of invested capital in the existing law, while rewritten in the proposed bill in the interest of clearness and while changed slightly in order to apply a more liberal rule in a few cases where the existing law has in operation been found to produce certain inequalities, but has not been changed in any important particular."

On the contrary, radical and sweeping changes in the substance of the bill both as to tangible and intangible property are proposed.

AS TO INTANGIBLE PROPERTY.

Under subdivision (a) of section 207 of the existing law it is provided that "the actual cash value of patents and copyrights paid in for stock or shares in such corporation or partnership, at the time of such payment, shall be included as invested capital, but not to exceed the par value of such stock or shares at the time of such payment."

The provision of the present bill, subdivision 5, section 326, is:

"Patents and copyrights bona fide paid in for stock or shares on or after March third, nineteen hundred and seventeen, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate twenty per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest."

AS TO TANGIBLE PROPERTY.

In the case of tangible property the invested capital on which the exemption of 10 per cent is allowed should be measured by actual value, not by original cost. But, if the committee are not of this view, certainly corporate interests are entitled at least to the protection of the provision of the previous bill, subdivision (b), section 207:

"But in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen."

This was little enough to concede to the corporations, for the reason that full actual value, more properly, should be the basis of exemption; otherwise the 10 per cent is not allowed upon invested capital.

The actual value, or value as of January 1, 1914, or at least as of March 1, 1913, should be allowed not only for the reasons given, but for the further reason that under the present bill in sales of property the difference between value as of March 1, 1913, and the price realized is taxed as income. There should not be two standards of value of tangible property established by the law, one for the purpose of measuring income and another for the purpose of measuring invested capital.

As it now stands, the provision of exemption of 10 per cent of invested capital is misleading, for in scarcely any instance is such exemption really an exemption of 10 per cent in view of the fact that invested capital is confined to cost and not value.

Moreover, the unfairness of fixing upon the cost, rather than upon the actual values of corporate assets as the basis of exemption is apparent at a glance for another reason.

While a corporation has been defined as an artificial being and a legal entity, the fact is, as a well-known text book writer has very properly said—and this represents the present-day view of the courts:

"The word 'corporation' is but a collective name for the incorporators or members that compose an incorporated association; and where it is said that a corporation is itself a person, or being, or creature, this must be understood in a figurative sense only."

With this thought in mind, it is clear that, although a corporation may not, as a corporate transaction, have resold any of its property since the original acquisition, it may properly be said that the undistributed interests in the assets of the corporation have been the subject of sale over and over again, to the extent that, and as often as, the capital stock has changed hands.

The cost of this property, therefore, to the corporation in such a case may properly enough be regarded not as the original cost to its original members or owners, but as the cost to its present members or owners, which in many instances may be, or approach to being, its actual value.

It is apparent, therefore, that both as to tangible property and intangible property there is not really an exemption of 10 per cent on the fair value of invested capital, whereby the resulting percentage of taxation is much greater than is apparent from the phraseology of the bill.

Again, one of the most desirable regulations adopted by the Secretary of the Treasury pursuant to the act authorized consolidated returns by affiliated corporations. It is now proposed to forbid this. The reason for such change seems to be that the effect of such returns has been, in some cases, to diminish the revenues of the Government by setting off against the earnings of a profitable venture in one locality the losses resulting from similar ventures conducted in other localities. It does not seem to me that these cases come within the spirit of the existing regulation. The regulation was aimed at permitting a consolidated return where the business of the subsidiary company was incidental to the main business.

I suggest, as an adequate protection to the revenues of the Government, that consolidated returns be permitted or required from affiliated corporations under such regulations as the Secretary of the Treasury may prescribe, but that in no case shall the aggregate income subject to taxation be reduced by reason of the fact that any corporation joining in such consolidated return has sustained a net loss from the operations of the taxable year.

In the majority of cases, subsidiary companies are organized for convenience in transacting business, or where local laws require this to be done. Take, as an illus-

tration, one of the corporations I represent. It does not directly do business in Pennsylvania, on account of the statute prohibiting foreign corporations from holding real estate there. It must operate, therefore, through a local corporation organized under the laws of Pennsylvania. In Canada, also, where this corporation has been obliged to organize a separate company, the laws favor the local corporation.

IN GENERAL.

It is difficult to see how it is possible to justify the feature of the bill which provides two schemes of taxation—the excess-profits scheme and the war-profits scheme. It should be one or the other. There ought not to be one scheme which will apply to only a small number of corporations and not apply to the majority of corporations.

It is to be borne in mind that we are providing by taxation for a greater proportion of war expenditures—even including loans to our allies—than is done in any other country. It is to be borne in mind, also, that the burdens both on corporate and private interests must be increased year by year during the war if the present proportion of war expenditures is to be met by taxation.

SUGGESTION AS TO FUTURE BOND ISSUES.

If the committee are in accord with these views, any less amount of taxes—by reason of changes which are essential if the 10 per cent exemption is to be calculated upon a fair value of invested capital and not cost—can be met by the authorization of short-time war certificates to be convertible at the option of the Government into future bond issues, inasmuch as for the present it is doubtless too late to change the amount of bonds proposed to be issued. In future issues, however, of bonds and the enactment of revenue bills, the present proportion between issued bonds and moneys raised by taxation can be appropriately changed.

OBJECTIONS CONSIDERED.

An objection to the issue of additional bonds may be made on the ground that, inasmuch as Government bonds are now selling at a depreciated price, an increase in the amount of them would necessarily be reflected in a still lower value than that at which they are now selling.

SUGGESTION AS TO SINKING FUND.

The obvious reply to this objection is that the bonds should be issued under conditions which will affect favorably the market price of the bonds. For instance, the present depreciation in price would not exist if there were a substantial sinking fund provision in the bonds requiring them to be drawn periodically at par or slightly above par, say, at 100 $\frac{1}{4}$. For not only in normal times but in times of panic, as a rule, bonds of even private corporations—to the issue of which there is attached a reasonable sinking fund—sell at or close to par, when otherwise there would be practically little or no fair market value for them.

At present it is common information that subscriptions to any of the new bonds will represent a loss of the difference between the price paid and that at which they will in all probability sell. On the other hand, with a sinking fund such as suggested, bonds would not be sold at a depreciated value, because of the certainty that some of the bonds would periodically be drawn by lot at par, or even very slightly above par. All previous issues could, if so desired, be convertible into the new issue, so as to secure the benefit of the sinking fund provisions.

That the Government recognizes the desirability of keeping the price of the former issue as close to par as possible is apparent from the authority conferred upon the Secretary of the Treasury of the right of investment in existing bond issues of funds of the Government up to a given sum and by a like authority conferred upon the War Finance Corporation. The two amounts thus available aggregate \$1,000,000,000. Yet the result of recourse to these funds has not had and is not likely to have the desired or contemplated result. And it is to be borne in mind that by reason of the present market price of the bonds the Government itself may at will invest, and doubtless does invest those discretionary funds in the purchase of bonds by the Government at a depreciated price, which may have just cost the owner par. A mere glance at section 15 of the third liberty loan act, or section 11 of the War Finance Corporation act, will make it abundantly clear that the authority conferred to purchase bonds is no substitute for a definite sinking fund.

The provisions of the special act as to the exemption of \$30,000 from taxation is wise; and, undoubtedly, when the question of improving the market price of the bonds is taken up, suggestions supplementing that of the sinking fund will be forthcoming.

The sinking fund can be provided for, in whole or in part, out of the taxes under the revenue bill itself. And even though it be not larger than the amount now authorized to be invested under the provisions of the third liberty loan act, and of the powers of the War Finance Corporation, its stabilizing effect on the price of bonds would be reasonably certain.

To the sinking fund, which should be continued for the period of the war and a reasonable period thereafter, should be added any excess of interest received from loans to our allies over the amount paid on bonds subscribed for by the American people.

It is suggested that in the future bills which provide for the issue of bonds and for revenue should be considered together.

While it is not now possible to change the character of the new bonds, a mere announcement by the committee and the Secretary of the Treasury that in future issues of bonds—into which the present issues could be converted—such a sinking fund would be favored and would undoubtedly be a great stimulus to their sale.

CONCLUSION.

Let me say, also, that the revenue bill now before your committee, as it comes from the House of Representatives, represents in some respects an improvement over the present revenue act, and to that extent is to be commended. This is true as to the provisions authorizing deductions from net income of losses in ventures not identified with the particular business of the taxpayer; though if I were called upon to make any suggestion concerning this, I should say that the provision should apply to losses for last year as well as the present year.

Then, too, the bill is just in permitting corporations having earnings which are absolutely small, but relatively large, when the amount of invested capital is taken into account, to have special consideration. In a brief which, with other counsel, I filed before the conference committee last year, such a provision was advocated with this statement:

“For when a corporation with a small capital has comparatively large earnings, it is clear that the earnings are to be attributed, not to the amount of capital employed, but to the industry and intelligence of the management of the members of the corporation.”

In some other respects, however, the bill is open to criticism, particularly as to the definition of invested capital.

The CHAIRMAN. This will conclude the hearings, and the committee will now adjourn.

(Thereupon at 12.05 o'clock p. m. the committee adjourned, subject to the call of the chairman.)