PROCEEDINGS OF
A SYMPOSIUM ON
INDUSTRY AND NATIONAL DEFENSE

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MR. LEWIS H. BROWN (President, Johns-Manville Corporation, and Chairman, The Tax Foundation, Inc.): Gentlemen: We will call this conference and symposium to order and get started, so that we can finish, we hope, on schedule.

Let me say first that this conference started out at the request of some of the officers of the larger corporations of the country, who said that we were in a tangle and needed to clarify the thinking of industry about some of these national defense problems. And we expected to have about twenty-five experts sit around a little table and spend a day in discussion of this subject.

Now, the matter apparently was of such great interest that one corporation after another said they would like to have representation, and we finally had over two hundred acceptances and had to enlarge our idea of the little conference table discussion and move into a larger room.

We are very happy, however, to have so many representatives here to take part in this discussion. It is going to be informal in nature. There are no reporters present. It is a symposium of industry at which we want you to take part in the discussion. We have arranged for a certain number of speakers to set the basic outline of the problem, but we are going to have discussion from the floor and we want you to feel free to raise questions of any character that have a bearing on this main point, and to ask the Chairman or any of these experts to express viewpoints that may help to clarify your thinking.

I think it is generally understood by industry that this problem is of great importance, and I think as evidence of that is the fact that you men have come from all over the country in hot August weather, away from your vacations in many instances, in order to take part in this important discussion and, if possible, to make a contribution of the thinking of the country as to what we should do about it.

First I would like to say just a word as to why the Tax Foundation has called this meeting. It was at the direct request of many of the Foundation's members, even though it falls somewhat outside the scope of the Foundation's purposes. The Tax Foundation has been engaged for the past two years or more, as many of you know, in a rather specialized study of problems of taxation as
these affect the future of industry and the national economy. And for the
benefit of those who may not be familiar with its work, let me add that the
approach to these problems on the part of the Tax Foundation is completely
objective, non-partisan, and non-political, and is supported as a public service
that is intended to be thoroughly constructive in character.

The Foundation is primarily a coordinating agency. It is striving to
bring some kind of order out of the present chaos that has arisen from the taxing
activities of 175,000 different governmental units which, taken together, are
now spending close to 30 per cent of our entire national income. It is assisting
local and state organizations and many different volunteer citizens' groups,
helping them to establish, state by state, county by county, community by
community, at the very grass roots of our national life, more efficient adminis-
trative procedures and sounder fiscal policies which are now recognized as being
vital in safeguarding America's economic future.

With activities spread over this wide front, the Foundation has until
now not concerned itself with that other equally important half of the tax
problem, Federal finances. However, during recent weeks, as a result of the
national defense crises, this situation has been profoundly altered. Congress
is being called upon to make unprecedented appropriations of more than ten
billions to strengthen the national defense. It is estimated that before this
program of national defense is completed, the original cost of equipping this
country and the cost of maintenance will, over a period of the next ten years,
cost us perhaps fifty billions of dollars. The economic consequences of these
huge expenditures are bound to have sharp repercussions upon our national
economic future.

One of industry's present tasks is to analyze and prepare for such
future eventualities. Our main objective is to help this country prepare, and
that is the main problem. Now, these problems appear to me to consist of
about four elements.

First, a sudden expansion in the Government's requirements of indus-
trial products for national defense. And this includes the necessity for
determining just what products are wanted, what the specifications of those
products are, and what quantities will be required.

Second, the necessity for industry to convert or provide with great
expedition the necessary production facilities in order to turn out these
requirements of the Government.
Third, a reasonable and equitable division of responsibility between Government and industry before the program is undertaken, so that there may result a realistic solution to the huge financing problem imposed by the expenditures required, which concerns both the furnishing of funds and the control of expenditures once the program gets under way.

And fourth, the assumption by Government and industry of the responsibilities and risks that properly fall within the area of each.

I think in this program there are certain dangers to industry that need to be considered. The new taxes which Congress is now considering to finance this gigantic rearmament program will fall primarily upon industry. More than ever, it is vital that these taxes should not unduly penalize or handicap industry, for the defense bill, huge as it is, can only be paid out of an expanding economy, out of a greater national income, which in the last analysis it is up to industry to provide. And it would seem obvious that to expand the economy and to provide this greater national income, business must be given a green light to go ahead.

In an economic system based upon free enterprise, it now becomes doubly important to remove, as far as possible, those deterrents to the profit incentive on which the system depends for its real motive power. Unfortunately, those who determine the nation's fiscal policies too seldom recognize that industry is already paying in one form or another virtually 75 per cent of the nation's total tax bill, Federal, state and local. And under the national defense emergency that percentage is bound to be increased.

For example, the proposal recommended by the Subcommittee of the House Ways and Means Committee, and now being considered by the Joint House and Senate Committee, will take from a corporation's income, once it is subject to the 40 per cent excess profits tax, 52 cents out of each additional dollar of profits earned. This means roughly that if a typical average company is to even maintain for 1941 the same net profit that it had in 1940, it must increase its income before taxes by from 10 to 30 per cent over its best year in the 1936-1939 period—in other words, the base period to be used in computing excess or normal profits.

In other words, what industry is concerned with is not the problem of making profits; it is concerned with the problem of avoiding losses.

Now, it is not my purpose to explain how these taxes will affect industry or the national economy, for certainly I am not a tax expert but merely
a business man like yourselves, confronted with this problem. And I shall leave
the explanation of these technical points to the experts on today's program,
which I shall turn over in a moment to Mr. Ellsworth Alvord, one of the outstand-
ing experts in this country in taxation, who will be Chairman of this meeting
for the balance of the day.

What I would like to do is confine myself to commenting briefly on
certain general phases of the present situation which seem to me to be exceed-
ingly grave. The first of these is the possibility of inflation. We must avoid
at all costs being projected into a new inflationary cycle, for which there are
now at hand all the necessary ingredients. And certainly we remember our
experience in the last war, when the price index of commodities mounted to 250,
and where we had all the problems of rising prices, rising costs, rising wages,
to go through, and then the readjustment that was necessary after the war. We
certainly want to avoid that if we possibly can in this period that lies ahead.
And yet, there are on hand at the present time the elements that might well
make such an inflationary cycle, which would be very serious to the future of
this country.

In addition to the present deficit financing by the Government, the
armament program alone will inject into the economy additional Federal expendi-
tures which for an indefinite period will total more than four hundred million
dollars a month, on top of what we have been spending. And furthermore, many
of the taxes which are now being levied upon industry can only be regarded as
taxes on production. They add to the industrial costs, and thus they must be
passed on to the consumer in the form of higher prices. Advancing prices
cause manufacturers to hedge contracts and prospective sales by increasing
inventories. And likewise disrupted and in an uncertain position are raw
material supplies drawn from belligerent and other foreign countries.

Unprecedented bank reserves make possible an unlimited credit expansion
based upon Government contracts to industry. And, notwithstanding the fact
that WPA funds are being increased from one billion to a billion four hundred
million to provide for a prospective rise in unemployment this fall, there is
today, particularly in many skilled trades, a growing labor shortage which can
quickly be translated into demands for higher wages.

Not only must we recognize the presence of these factors which tend
towards inflation, but equally the important fact that under existing Government
regulatory controls industry is no longer able to deal with these forces
effectively. Government supervision over business activities has already reached
the point where industry cannot control its own production costs, labor costs,
or, in many instances, even the prices of its products, and these are all within
the new orbits of governmental action; while, under the tax measures now pending,
even the legitimate profits of industry are being questioned and are to be made
to conform to what are nothing less than arbitrary legislative yardsticks.

The result is that our national economy, which was formerly elastic
and flexible in meeting rapidly changing conditions, is tending to become more
and more rigid and difficult to adjust to the ebb and flow of the business tide.
As industry's dependence on Government has grown, it has become more rather than
less vulnerable to influences that are political rather than economic in character.

The present controversy in Washington over the recovery of costs by
industry in connection with the establishment of emergency armament plants,
and over what shall be the dividing line between normal and excess profits,
illustrates the point that political rather than economic factors are determining
what we should do to bring about a proper solution to this defense problem.
And it should not be political factors. We should keep our mind definitely on
the end result, which is quick and adequate defense.

Now, these factors, from the standpoint of industry, are two separate
problems which are only incidentally related; yet Washington insists on joining
them as if they were Siamese twins. The question of recovery of costs through
amortization affects only companies which must expand their facilities in
order to meet the requirements set up by the Defense Advisory Commission. It
would seem only common sense that the cost of the plant built especially to
produce war supplies should be just as much a part of the defense expenditure
as the guns or tanks or other equipment it is designed to manufacture. The
excess profits tax, on the other hand, affects all business irrespective of
defense contracts. The vast majority of industrial companies will benefit
only indirectly as the Government's increased spending expands consumer purchasing power.

We are naturally concerned over the delays which have arisen as a
result of the insistence of Administration officials that these two situations
be joined in the pending tax bill. But what is much more serious, in my view,
is the possibility that in an election year an attempt may be made to blame
industry for this production slowdown simply because business men have been
anxious that their relationships with Government should be placed upon a practical, common sense business basis, and because business men have been determined to try to avoid the economic inflationary tendencies of the last war, with the subsequent danger of another depression breakdown that may well spell the end of the free private enterprise business system.

On these matters, which we are to examine into today, it is important that the position of industry be made thoroughly clear to the public. There must be no room for either misunderstandings or possibly later recriminations, or for any revival of that ancient Army practice of "passing the buck."

There is no question about industry's willingness to cooperate. All that industry asks today is a clear-cut formulation of the rules under which it can cooperate in the defense program. Once these are reduced to tangible and practical form, industry will turn in a performance record which will shatter all previous precedents.

No business man with an ounce of patriotism wishes to profiteer at the expense of the nation's necessity. All that business seeks in the way of compensation is that minimum of return which will produce the maximum effective functioning of the enterprise system. Limitations on profits under contracts awarded by the Army and Navy Departments have been cheerfully accepted by business, and so have the terms of the Vinson-Trammell Act. Many business men may feel that the profit percentages set by the Government are not commensurate with the risks assumed, but they have been accepted without protest, for the simple reason that every American business man today regards it as his primary duty to do everything in his power to make America impregnable to any foreign attack, whether from European dictators or other quarters. And for these reasons industry today accepts the necessity of an excess profits tax, even though it believes that the principle of such a tax is in itself a deterrent to full business recovery.

The question has been magnified, in my opinion, out of all proportion to its true relationship to the defense program. This is shown by the fact that one of the Treasury's leading experts, when testifying before the Joint Committee hearings at Washington last week, conceded that the 1941 yield from this tax would fall short of three hundred millions, a mere drop in the bucket against what the nation is setting out to spend to achieve military and naval security.

If the taxation program attempts to confiscate an abnormal portion of profits, there has been destroyed the incentive to lower costs and improved
operating efficiencies. And once this incentive has been lost, we have lost one
of the prime automatic controls of the competitive system, and have gone a long
way in the direction of destroying the basic elements of the free private enter-
prise business system.

What is the alternative? Well, we hear a lot from the bureaucrats in
Washington who threaten that, unless business will immediately take contracts
without adequate provision for amortization or financing, or take contracts
through a mere letter without even having prices determined or any other of the
conditions, Government will take over business and operate the plants to make
munitions for defense. Now, that is the kind of silly, childish talk that
threatens to hold up indefinitely our defense program.

What we need is great national unity, with Government and business each
assigned to its task to do its part, and with an understanding on both sides as
to how the system must work in order to get effective results. In other words,
we must make the first order of business the bringing about of adequate defense,
and everything else must move aside in favor of that.

Even Mr. Hitler, the Munich paperhanger, understood that first things
must come first. He kept his eye on the objective of getting supplies for his
army. He certainly had the power to take over and operate industry over there,
but he knew that industry had the "know how" and that his Nazi Party men did not
know how. If the Government were to build munition plants, the Government would
of course have to pay for them. Instead, he got industry to do the job by
letting them charge off the cost of the plants as amortization in as short a
time as they wished, and then, having quickly gotten the plants into production
and the flow of supplies for his army coming out of them, he levied increasingly
heavy taxes on all but the most nominal of profits.

Here in this country, however, we hold up production for defense for
three months, and maybe more, so that we can impress everyone with the sad news
as to how heavy the excess profits taxes are going to be, and to make it very
clear that there is not going to be any profit incentive in war work, thus
effectively removing the carburetor from our free private enterprise machine.
And thus again those petty prejudices against business in high places work to
prevent the accomplishment of the main objective, which is preparedness for
national defense.

The real bottleneck at Washington, as is generally recognized, arises
from the various proposals advanced for amortization of costs of emergency

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armament plants. Here industry has merely asked that it be protected against capital loss. That would certainly seem to be a reasonable request. The proposal that the cost of plants which have a temporary military value and cannot be converted to subsequent industrial peacetime use should be charged off within the period of their productive life, would appear to be both practical and fair. The alternative suggested, that a company be permitted to reopen its tax returns for preceding years, during which time it may have had either no profits or subnormal profits, in order to write off unamortized capital investments, would appear to set up undue hazards and penalties which are handicaps to that quick expansion of production which is now so necessary for national defense. And I think in addition, in the minds of a good many business men that went through the period of the last war, is the recognition that this reopening of returns or trying to deal with Government officials on a matter of this kind after the war, is a rather sorry experience.

Finally, I would like to emphasize the basic difference between the ordinary commercial business undertaken by the average industrial concern and the type of business undertaken under the defense program. It is only by a clear understanding of these differences that the benefits and economies of the present free enterprise system can be utilized. It must be understood that the role of the purchaser, usually performed by hundreds of thousands of individuals throughout the nation, is here entirely within the hands of one agency, the Government. The Government's responsibility essentially is to secure what is wanted in the most economical way and to assess the costs of the program to the various parts of the national economy fairly and equitably.

The part that individual industrial concerns should play is not to assume the tremendous hazards involved in making plant outlays for a huge current production, regardless of the continuation of such requirements. Their part is rather to assume the risks and hazards involved in meeting promises to provide the required products on the most economical basis from a cost standpoint. There is plenty of hazard and risk in the latter to challenge the most alert business men.

The national government must determine what manufactured articles are required and in what quantity, in order to assure that individual industrial concerns will provide the facilities to produce these articles. And they should also make certain that the finished articles will be provided at a minimum of cost. Particularly in the latter respect is it desirable for the Government to
create a procurement policy that will permit adequate reliance upon the profit motive in keeping down production costs, for the latter is more certain and powerful than the reliance upon patriotism alone. This involves a very delicate balancing between the safeguards that will keep individual negotiated contract prices within reasonable limits and, at the same time, that will give the industrial manager a real incentive to apply his usual peacetime ingenuity and skill in devising the most economical way of meeting the problem.

And finally, we come to industry's part. Normally capital and management do three things. They provide the necessary capital and facilities to produce the product. They provide the talent required to manufacture and sell the product. And they take the risks inherent in both the financing and production of the product.

Private capital is undoubtedly ready, in most instances, to furnish these necessary special facilities, if the Government will take a reasonable position in indicating the extent to which it, as the sole purchaser, will utilize these facilities for a reasonable period, or at any rate permit their costs to be recovered. Industrial management can be depended upon to produce the product economically and expeditiously, if it can be allowed to concentrate upon this problem and secure a normal minimum return for its function.

As to the risks, there are plenty of risks for the individual enterprise to assume in meeting the promises inherent in the signing of contracts that promise to produce goods at a given price and within a given time. If management can be assured of a minimum return for this function, plus some part of any cost savings that can be brought about through increased efficiencies, then it seems clear that the program can go forward on a reasonably expeditious basis.

And, in my judgment, there is nothing more important than trying to make clear not only to the people in Washington but to the American public the fact that American business is not concerned in this matter with the making of profits, it is concerned with the problem of trying to avoid capital losses. And, above all, it is trying to get this defense program under way so that we in this country, in the months or years that lie ahead, will not find ourselves in the position of France, inadequately prepared to meet the conditions that may confront us, and as a result lose everything that is precious to the American people and to all of us.

And now, without further words, I would like to introduce Mr. Ellsworth
Alvord, one of the outstanding tax experts of the country and a former adviser to the Government in Washington, who will act as Chairman of this meeting, will introduce the other speakers and conduct your program.

Mr. Alvord! (Applause)

CHAIRMAN ALVORD: Gentlemen: I am personally more concerned with broad problems than I am with the provisions of any particular tax measure, including the one that is now pending in Washington. A national defense program, we all know, is a very serious, huge undertaking. From the technical military aspect, I know nothing. From the financial aspect, I suspect I know nothing.

Broadly speaking, I suppose that a national defense program would be classified about as follows:

First, we need an adequate military, naval, and air force, adequately equipped and fully manned.

Second, we need an industrial production which will produce all the requirements of the adequate military, naval, and air force and maintain it.

Third—and this problem hasn't been discussed very much, if at all—we need some means by which those not directly engaged in the national defense program can carry on in what we might call peacetime activities, because that is the group that is going to pay. If that group diminishes, payment must be sought from other sources.

From a financial point of view, I would divide our problems about as follows:

First, we must finance the cost of acquisition of our fully equipped, fully manned army, navy, and air force.

Second, we must finance the cost of maintaining our fully equipped and fully manned army, navy, and air force.

Third, we must finance those facilities which will contribute to the national defense program and those facilities which are not so directly involved in the national defense program.

I will merely give you a few figures. So far the Congress has appropriated $14,700,000,000 in an effort to acquire the national defense army, navy, and air force.

There have been no official estimates that I have seen with respect to cost of maintenance. I have made some guesses that are necessarily rough, but if I have erred, I think I have erred on the side of conservatism, which is probably on the wrong side. But my guess is, after you have acquired your completed army,
navy, and air force, and if you continue on with your present Government non-
defense expenditures, your annual budget will be about fifteen billions of
dollars.

In my fifteen billion dollar estimate I have done the same thing which
Washington has done in its fourteen billion seven hundred million estimate; I
have omitted those matters which we all know will come in the future, but which
have not yet been asked for. I mean, for example—and this is only one example
of many—the $14,700,000,000 appropriation, or series of appropriations, calls
for twenty-three thousand airplanes. We have heard frequent references to an
air force of fifty thousand planes. I don't know where the rest of the program
is or what it is, and I don't know where the financial program is or what it is.

Of one thing I am very certain, that some day very soon somebody must
sit down and attempt to plan just how we are going to finance the national
defense program, how we are going to finance its maintenance, and how we are
going to finance the expansion of private industry. I suggest that that program
might well take into consideration a threefold era which I think we are facing.
We now are certainly facing the first two stages. We see ourselves being
converted from a peacetime economy into an armament economy. Then we know there
will be a period of time in which the armament economy prevails; how long, we
don't know. Then, I hope there will come a time when we are again converted
from an armament economy into a peacetime economy. Certainly whatever financial
program we devise now ought to be weighed with a reasonably keen appreciation
of its effect upon each of those three eras,

Coming more immediately to the excess profits tax, I suspect that there
is no one here, including myself, who has much of an idea what the excess profits
tax bill will contain. We have a few general statements. We have a few general
purposes.

Last Friday, a report of the Subcommittee of the Committee on Ways
and Means was made public at 10 o'clock in the morning. At exactly the same
time the hearings began. The proposals were threefold: (1) A provision for
amortization; (2) an excess profits tax; and (3) the suspension of the Vinson-
Trammell Act.

The Government officials appeared on Friday, and I can generalize
their position. It was about like this.

The Treasury said, "First, we must get revenue from this excess
profits tax."
Now, they didn't say so publicly, but it has been generally rumored in Washington that the Treasury had a program under which it expected to raise through an excess profits tax a maximum of two billion dollars. Their minimum proposal, according to newspaper reports, was, I think, seven hundred and fifty million.

Treasury pronouncement number two: "We must not interfere with private enterprise."

This they didn't say: "Whether we like it or not, we have got to rely upon private enterprise to play a very important part in the national defense program." Nor did they say that "We think that private enterprise should be financed privately."

The officials charged with the national defense program then appeared. I merely summarize what I got out of their appearances; and I may quote them inaccurately, in my attempt to summarize briefly.

Number one: "We cannot go ahead on our national defense program until industry becomes advised specifically with respect to amortization."

Number two: "We think industry will not go ahead unless they know with reasonable certainty before they enter into national defense contracts what their liabilities will be under the proposed excess profits tax."

Number three: "We do not blame Government departments, we do not blame industry, we do not blame Congress for the delays that have been encountered. We are merely stating facts."

Certainly they can't blame Congress, at least with respect to the excess profits tax, because about eight weeks ago the Committee on Ways and Means announced that there would be an excess profits tax enacted at the next session of Congress which might be applied retroactively; whether it should be or not, they would decide next January.

About seven weeks ago, the Secretary of the Treasury announced that this program met with the approval and the pleasure of the President.

About six weeks ago, the conferees on the Revenue Act of 1940, which, as you gentlemen know, was designed, the Treasury told us, to finance the national defense program as it had then been prepared, announced that "We have instructed the experts of the Congress and the Treasury to prepare an excess profits tax and report back to the Committee on Ways and Means and the Committee on Finance on the first of October."

Now, that takes care of the situation eight weeks ago and six weeks...
ago. And then, about five weeks ago, came an announcement from the White House saying a steeply graduated excess profits tax must be enacted at this session of Congress. That statement was made notwithstanding the fact that just two weeks before that—my periods of time might not be accurate to the day—the Secretary of the Treasury announced to the Committee on Finance that he was authorized to state that the program of having the experts prepare an excess profits tax and report back in January of next year, had the President's approval and the President was very happy about it.

So Congress now finds itself—the reasons for its position haven't been proclaimed—confronted with the necessity of preparing, drafting, considering the intricate policies and problems of an excess profits tax, and completing the impossible task in probably three weeks' time.

All I know is that if the job of drafting that excess profits tax devolved in part upon me, I couldn't do that job in three weeks' time, even if somebody had long before prepared all the answers to the innumerable specific questions of policy.

I am not going to explain the details of the proposal. I will just outline them to you, and I think their details will be revealed as we proceed. If they are not revealed sufficiently, it is either because they are not known or because the speaker has not had an opportunity or because you gentlemen have been too modest. You can shoot all the questions at us you want. I always reserve the right to confess I don't know.

I will give you just a little more history. The original Treasury program, according to the newspapers, was to compute "normal profits" solely with reference to invested capital.

You see, the big job in an excess profits tax is to determine what are "normal profits." If we can agree upon normal profits, then, so far as I am concerned, the tax can take a terrific slice of excess profits.

The Treasury proposed to determine normal profits by computing the pre-war rate of return upon invested capital. I use the word "pre-war" ill-advisedly, I hope. They called 1936-37-38-39 a base period, with 1940 being the first taxable year.

They said, "If your rate of return was in excess of ten per cent, we will cut you down to ten. If it was less than four, we will take you up to four. And if you fall in between ten and four, we will let you get what your experience proved."
It happened that the staff of the Joint Committee didn't think that that was a fair measure of normal profits, and they prepared a plan to determine normal profits substantially as follows: Take the actual earnings of the four years 1936-37-38-39; realize that '38 was a substantial lose year, and strike an average of three out of the four years. That average will be considered normal profits.

Further, they said, "For those corporations which in fact didn't exist or didn't realize normal profits during that four-year period, we will prepare an alternate yardstick for normal profits. We will let them compute their invested capital and give them an eight per cent return on it."

The Treasury and the staff of the Joint Committee were deadlockcd for a few days. I think it is generally known that the Subcommittee report represents — in fact, it so states— a compromise between those two plans. Under the Subcommittee report it is proposed to use pre-war earnings as one yardstick, but the average of the entire four years 1936-1939, even though '38 was a bad year. Then, as an alternative this yardstick has been devised. We will take those profits in the pre-war period and find out what return they gave on invested capital, and, despite the fact that this duplicates the average earnings method, we will take that return if it falls between ten per cent and four per cent of invested capital. We cut them down to ten per cent of invested capital if they earn more than that, although of course, if they did, they would take the pre-war earnings basis. We raise them up to four per cent (six per cent up to $500,000 invested capital) if it is less than that, obviously because we think four per cent is a fair return.

"So," say the Treasury, "we shall disregard all history, we shall not pay much attention to what we learned in the war years, and we shall embark upon the policy of writing a new definition of invested capital. We have eleven times in the last eight years revamped the definition of net income, and we shall revamp it a little bit further. We shall avoid innumerable administrative problems by taking short-cut methods. We shall solve all the criticisms of all the prior excess profits taxes by being arbitrary."

I think our best procedure will be to continue on through the scheduled program, and then I hope we shall have time before lunch for you to ask whatever questions you may wish with respect to the excess profits tax proposal.

We naturally have three basic problems. One I have referred to—economic problems. The second, yardstick problems. The third, administration.
Our program this morning is designed to present, I suspect, not the answers, but at least the problems in those three fields.

I am very happy indeed to present Professor Buehler, of the University of Pennsylvania, as your first expert.

Professor Buehler! (Applause)

DR. ALFRED G. BUEHLER (Professor of Public Finance, University of Pennsylvania): Mr. Chairman, Gentlemen of the Conference: I find that the remarks made by the two preceding speakers and some of my remarks may possibly overlap. Taking the language of the movies, I might say that any references here to remarks made by preceding speakers are purely coincidental; they were not planned that way.

It seemed to me, in considering the problem of the conference, that perhaps I, as an economist, could make my contribution to best advantage if I presented some of the economic fundamentals. I would like to start out with a brief resume of recent financial events.

The fiscal and economic aspects of our emergency armament program must be related to the present fiscal position of the Federal Government especially, and also to the financial problems of the state and local governments. The Secretary of the Treasury estimated the other day that Federal expenditures during the present fiscal year will be approximately twelve billion dollars. Revenues will be about six billion seven hundred million dollars, and the deficit about five billion three hundred million dollars. By the end of the year, the Federal debt will have climbed to about forty-nine billion dollars. In view of the unsettled condition of world affairs today, of course, the estimates are obviously highly tentative.

The Federal financial picture has grown darker year by year. The fiscal year 1940 closed with a deficit of three billion six hundred million dollars, and a debt of forty-four billion dollars. Expenditures were nine and a half billion dollars, and revenues a little under six billion. Year after year, since 1931, the deficits have accumulated and the debt has mounted.

Taxes at best have been only six billion dollars a year, while expenditures have recently been around nine billion dollars or more a year.

In the new Revenue Act approximately a billion dollars in new taxes are provided. The chief sources of the new revenue will be: The corporation income tax increases, about two hundred million dollars; the individual income tax increases, three hundred seventy-five million dollars; gasoline and oils,
about one hundred twelve million; alcoholic beverages, one hundred twenty-two million.

Fundamental Factors

As the United States endeavors to recover the ground lost on the economic front during the early nineteen thirties and to advance a program of social reforms, she finds herself an unwilling participant in the struggle between the totalitarian and the democratic powers. In attempting to evaluate the alternative methods of financing national defense, and their effects upon the economic organization, it is well to keep certain fundamental factors in mind.

1. The armament program is for the benefit of all, and all of us should share equitably in its cost. The word has gone from one section of the country to the other that the conscription for defense must be universal, with men, materials and machines coordinated in a mighty effort to defend the nation against all aggressors. In organizing the defense program, shall the nation appeal to our patriotism, to our purses, or to both? War has not yet become a business for the American people. Labor, capital, and enterprise should be rewarded fairly but not excessively for their services. Those in active military service should not be compelled to undergo greater sacrifices than those who engage in non-military pursuits, nor should they be forced to accept lesser rewards.

2. Armament expenditures are essentially an outlay for consumption. War is not productive in itself. It may protect a nation's resources and preserve its economic, political, and social organization, but it tends to exhaust the resources of the combatants. During the war one nation may rob another of its lands and its wealth, and the vanquished may be coerced into the payment of oppressive indemnities, but the wealth of society is not thereby increased. In like manner, while some of the makers of armaments and certain of the producers of non-military commodities may exploit the commonwealth, while some individuals may receive excessive rewards for their services, and war veterans and their dependents may obtain generous bonus and pension payments, the society as a whole does not prosper because of war. National defense is, indeed, vitally necessary. Yet it is primarily a consumptive, rather than a productive, employment of men and materials.

3. Today's armament costs must be met from today's resources, so long as national defense is financed internally. Whether we resort to borrowing, paper money, forced labor, or to taxation to obtain our armament, it will be
necessary to arm with our present resources. We cannot fight today's battles with tomorrow's soldiers and tomorrow's guns. By the resort to expedients other than taxation, it may be possible to conceal the costs of armament and to avert particular taxes upon particular groups. But these expedients will not make it possible to arm today with resources not yet created. It is wise, therefore, to face the situation intelligently and frankly and to meet as large a part of the armament costs as possible from taxation.

4. The national income should, if possible, be increased sufficiently to meet the heavy costs of armament without the sacrifice of our traditional necessities and conveniences. America has vast potential productive capacities. If these productive capacities can be organized effectively, it is conceivable that we might carry the additional outlays for national defense without giving up other indispensable commodities and services.

Unfortunately, the armament program cannot wait for increases in the national income, if the lights of democracy are to burn on through the dark nights of world chaos. We cannot, moreover, be too sanguine about the possibilities of living more luxuriously while we fortify our continent. If, however, armament production does initiate a general business boom and industry in general does prosper, it is to be hoped that the costs of armament will not be so heavy as to compel sacrifices of other essentials. As we gird ourselves for the battle with the foes of democracy, we should strain every energy to provide an adequate national defense and at the same time maintain the health, both physical and mental, of the nation.

So far as it be possible, we should increase our productivity and construct a mighty economic bulwark for ages to come. The productivity of the nation, that is, the income produced, is the result of business enterprises. Since the taxes must be paid from capital or income, upon business rests the responsibility of creating the resources required for national defense, as well as the commodities needed for our everyday existence. If business is repressed by unwisely chosen taxes or other governmental restraints, the national income suffers and the sources of taxation disappear. Governments should therefore make certain that the taxes they impose and the services which the taxes finance will bring not gains to society rather than net losses, and that they will not handicap our productive organization.

During the last several years, the nation has lived in relative comfort and has watched the Federal deficits accumulate without grave apprehensions. The
time has come, however, for us to admit the gravity of our situation. Taxes have already been increased. They must be increased still further. When wars have been imminent in the past, or have actually broken out in their fury, it has been customary to adopt a few additional taxes and to raise by far the greater part of the funds required for armaments by borrowing. The loan policy postpones the day of unwelcome taxes and seems to lay the costs of armament upon future generations. The disadvantages of free and unrestricted borrowing or the issue of paper money should, however, be apparent after a little thought. The public debt may pass out of control and the printing presses may flood the countryside with worthless paper money. Because the debt cannot be paid off, it may be carried as a perpetual burden, it may be repudiated, or it may be cancelled by inflation.

The unhealthy boom of war prosperity which is nourished for a time by inflation, must in time be followed by financial, economic, and perhaps political and social disorganization and collapse. Heavy taxation will minimize inflation, indicate to the people the costs of armament, and permit them to share equitably in those costs. The danger is not that too much of the expenses of armament will be met by taxes; rather, it is that too much will be met by borrowing.

The purpose for which any tax is to be raised," the Constitution declared, "ought to appear clearly to the Legislature to be of more service to the community than the money would be if not collected."

Any public expenditure for armament or other purposes is justifiable only when the social advantages from the expenditures are greater than the social costs. At a time when expenditures are bound to soar upward and the tax load becomes more burdensome, it is imperative that waste, inefficiency, and graft be eliminated in the expenditure of public money. Economies in spending will apparently not avert heavier taxation, but they will lessen the amount of new taxation required.

At a time of national emergency, the tax system must above all else be adequate to provide the revenues required to keep the budget in a healthy condition. Past experience has shown that it is not enough to meet merely the interest
on the debt incurred for national defense. If future credit sources are to be preserved and if the budget is to be kept within control, a large part of the costs of armament must be covered by taxation. In spite of all the lessons which might have been learned from past wars, the leading nations not only a minor part of their expenditures during the World War by taxation. Taxes in England and the United States were 25 per cent of the total expenditures during the period of conflict, 13 per cent in France, and only 10 per cent in Germany.

In recent years there has been much discussion of the problems of the Federal tax system and needed reforms. It should now be possible to lay the broad basis of the tax system which could provide increased revenues as the national needs mount. The defense program will be hastened if a fair and definite tax policy can be formulated so that taxpayers can estimate their tax liabilities with certainty. So far as possible, the often repeated yet often ignored principles of equity, certainty, simplicity, convenience, and adequacy, should be observed. Federal, state, and local financial and revenue programs should be coordinated more effectively. Since all taxes must, in the last analysis, be paid out of current capital or income, it should be recognized that new taxes are only different ways of tapping the old revenue sources.

Many theorists have suggested that more reliance upon a personal income tax, to be collected for the benefit of the federal and state governments by the former, would go a long way toward making tax payments more direct and obvious, more simple, and more equitable. The exigencies of war finance may hasten the advent of the day when tax administration in the United States will be rationally unified for the greater convenience of governments and taxpayers.

For the present, it may be expected that the Federal and state governments, in particular, will follow the principle which governments long ago adopted, the principle of a diversity of revenues. The history of taxation reveals that many of our important taxes originated in times of war. During the World War, individual income and business profits taxes were extended. General sales taxes were introduced and commodity taxes multiplied. The hasty search for new revenues went on with renewed vigor after the war, as the nations vied with each other in laying one tax after another upon the backs of the groaning taxpayers.

The outlook of the immediate future in the United States is that new taxes will probably be adopted as Congress struggles with the worries of national defense.
At the moment, the most discussed tax proposal calls for a new impost upon the excess profits of corporations. Such a tax is suggested by the experience of the United States and other nations during the World War, when war and excess profits taxes were rapidly developed to provide handsome revenues. Recently there has been a revival of the excess profits tax in various countries. The mushroom growth of the tax during the World War must be attributed to its relatively large revenues during the war boom, when the administrative difficulties of the tax were more or less disregarded in the patriotic fervor attendant upon waging a war. After the war, the tax collapsed as its yield fell off because of depression conditions, administrative complexities, inequalities in burden, and evasion and avoidance. The tax was accepted as a wartime emergency and was subsequently rejected shortly after the cessation of hostilities. That was a general worldwide movement.

There was much discussion of the excess profits tax as a normal peace revenue after the World War and during the nineteen thirties, but the tax was generally considered to be impracticable as an ordinary revenue. The recent discussion of the tax is to be related to the memories of its role during the World War. It is admitted in many quarters that an excess profits tax may be tolerated in wartime, even though its inherent administrative weaknesses may rule it out in times of peace. The tax has been favored as a method of striking at monopoly profits and as an instrument of indirect price control. Some observers also feel that the rate of the return upon business investments is the most logical guide to the capacity of business enterprises to pay taxes. To be sure, the profit ratio will not indicate the economic status of the individual stockholders of corporations, and a tax which may seem fair when it is levied impersonally upon business may prove to be inequitable when it is related to the personal status of the owners of the business corporations.

The theory of a heavy tax upon excess profits, especially in war periods, has proved most alluring to many persons, some of whom may feel that it is wicked to earn any profits and that it is particularly sinful to obtain high profits. It is also believed by many persons that an excess profits tax could yield large revenues, although the returns of the present makeshift excess profits tax were only twenty-seven million dollars in 1939, when the rates were six and twelve per cent on the corporate profits in excess of ten per cent of the value of the capital stock as declared by corporations.
The war and excess profits taxes of the World War period were more productive than this, since the rates were very high and quite substantial profits were obtained in many industries during the war boom. One must keep in mind, however, that the rates of the personal income tax and the normal profits tax are now higher than the rates of these taxes in the earlier period. The aggregate tax collections are also greater, and a higher percentage of the national income is being taken in taxes today than during the era of the World War. Thus, in 1919 Federal taxes were four and a half billion dollars and the total Federal, state and local taxes were seven and a half billion dollars, or 11 per cent of the national income, while Federal taxes in 1938 were six billion dollars, the total Federal, state and local taxes were about fourteen billion dollars, and the tax load was equivalent to 22 per cent of the national income, just twice the percentage of 1919.

It is difficult to estimate the present possibilities of the excess profits tax as a source of revenue, because of the uncertainties concerning future profits and the features which might be enacted in the tax law. The estimates of the Secretary of the Treasury for one of the proposals now being considered are that three hundred million dollars might be obtained in the first year and five hundred million dollars thereafter. Without disputing his estimates, which have already been questioned, one may agree that important revenues could be obtained without admitting that these revenues would be ample to finance an armament program involving outlays of five billion dollars a year or a sum even much larger than this.

An inherent and as yet insuperable difficulty in excess profits taxation under present administrative limitations, is that of separating excess from ordinary profits. If the rate of the return upon business investments must be determined, how shall those investments be valued with reasonable accuracy and at a reasonable cost of appraisal? If the profits of one year or a period of years are taken as normal profits, as the period 1936-39 inclusive, in order to expedite the administration, it will always remain a question, were the profits during that period normal profits? A given base period may be quite favorable to some corporations and very unfavorable for other corporations.

During the World War, the English plan of excess profits taxation was essentially one of comparing the total profits in the taxable year with those in the base period. Opinion was quite general in England after the war
that the fairer and more logical method of ascertaining excess profits was by determining the rate of return upon the investment. While the principle of comparing profits in the tax year with those in the base period is followed in the 1939 English law, investments of new corporations are to be valued to discover whether profits exceed the rate of return permitted. In this country, we are proposing to abandon our previous theory of a tax levied according to the rate of return for a tax which may be related to the income earned in the base period. A true excess profits tax can be imposed only if business investments are valued yearly, unless the value of investments, which is seldom the case, remains constant. The rates of return upon investments fluctuate considerably for many concerns and also very greatly among concerns at a given time. Unless a period of several years is taken as the basis for determining the profit ratio to the investment, an excess profits tax will penalize concerns with variable earnings and will be especially onerous upon risky ventures where investments may return losses or only uncertain profits in many years.

The highly perplexing problem of amortizing investments when plant expansion is demanded by a government to produce war materials and the type of armaments is changing and the quantity needed is uncertain, must also be faced. This problem is not altogether peculiar to excess profits taxation, however, since it may also be found in the application of other profits taxes. Here again, as in the valuation of investments and in the definition of excess profits, a decision which may be fair for one corporation may be quite unfair for another, if allowances are not made for particular circumstances in each case. The adjustment of an excess profits tax to each individual case, however, renders the administration most difficult, if not impracticable.

An excess profits tax is essentially an emergency device to raise needed tax revenues quickly in a boom period. Even in an emergency, however, the long run effects of tax policies should be weighed carefully. Excess profits may arise during the prosperity of peace as well as during a war boom. They are not peculiar to war industries, but may be found here and there throughout the field of industry. While they may be the fruits of monopoly prices, they may also arise when the fortunes of a business alternate from failure to success, and they may follow venturesome investment at high rates of risk. The long continued excess profits of a monopoly should be distinguished from the occasional high profits of a corporation with unstable earnings. If a government is to play the game fairly, its excess profits tax at a high rate
should be imposed only upon the excess of profits over costs and losses over a period of several years.

Assuming that an excess profits tax is employed with due moderation, that it is as fairly administered as possible, and that it reaches only true excess profits, it may be justified as a wartime revenue, and it may also have some advantages in curbing monopoly profits and in limiting the gains of the profiteers. Until its baffling problems can be solved satisfactorily, however, the excess profits tax can be defended only as a revenue makeshift.

If the tax is adopted, it should apply to the whole field of industry and should not be confined simply to armament making. In view of the high rates of the personal income tax which apply to the undistributed as well as to the distributed income of non-corporative enterprises, the excess profits tax should apply only to corporations. One may suggest here that if it were possible to treat the undistributed as well as the distributed earnings of corporations as individual income and to tax them in that manner, an excess profits tax would be uncalled for as long as the individual income tax were levied at steeply graduated rates.

An excess profits tax will obviously not provide enough revenue to finance an armament program. But it may be employed as an emergency impost to supplement the basic normal profits tax.

Other Taxes

The present system of graduated rates in the normal profits tax is arbitrary and illogical, and it should give way to a flat rate tax at a rate consistent with revenue requirements and the effects of the tax. Rate graduation according to the total net income indicates confusion concerning the assumed ability of corporations to pay taxes. Ability to pay is an attribute of the individual rather than of the corporation. If one wishes to assume that corporations have a capacity to pay taxes, it would probably be measured best by the rate of return upon the investment if it could be determined, rather than by the total profits.

The individual income tax is also indispensable in the Federal tax system. We may anticipate the further lowering of the personal exemptions, the lowering of the credits, and the advancement of the rates upon the lower and the middle incomes.

The tax rates on the higher brackets should be raised only if it is found probable that higher tax rates would produce more revenues, which many
of course would deny.

Commodity taxes may also be expected to supply greater revenues. The demand for gasoline, tobacco, alcohol, coffee, sugar, and other commodities, is rather inelastic, and high rate taxes may be collected to advantage if bootlegging can be kept under control. The exemptions of the death and gift taxes and advances in rates in some of the brackets would provide additional revenues.

A most important revenue which was developed during and after the World War was the general sales tax. In one form or another, it has been imposed in many countries and also in many of our states. England, a country which had long held out against a general sales tax, has apparently capitulated and is reported to be initiating joining this relatively regressive and much criticized impost.

It has recently been estimated that a Federal manufacturers' sales tax at a rate of 2 per cent, with exemptions for food, clothing, and drugs, would produce eight hundred million dollars annually; without exemptions, still more revenue could be obtained.

The tax outlook in the United States is indeed gloomy. The heavy spending during the nineteen thirties and the still heavier spending which will apparently accompany the nineteen forties, in view of the present armament requirements and the demands of the immediate future, call for an increasing stream of taxes for an indefinite period. We should plan now for the tax requirements of the nation, for both the immediate and the more distant future. The crushing burdens of taxation may be alleviated by a judicial selection of the sources of revenue and the proper methods of administration, even if increasingly heavy taxation may not be averted.

(Appause)

CHAIRMAN ALVORD: Thank you very much, Dr. Buehler.

You certainly have given us a very accurate picture of our economic and financial situation. But since what you have suggested is based on common sense, the chances are your remarks will not be heeded.

Professor Buehler has also indicated several rather important issues. I trust that some time in the course of the day we may have a discussion as to what is the true purpose of an excess profits tax. Professor Buehler says the raising of revenue. In my opinion, the less revenue raised, the better your economic condition.
Second, he suggests the use of invested capital as the ideal base. It strikes me that in practically every industry invested capital as such is of lesser importance in the production of profits than, let me say, management, brains, ability, ingenuity, labor. Quite true, in many industries we need invested capital, but our experiences in the past, I think, very clearly show us that invested capital as such is not a guaranty of profits, nor is it absolute insurance against insolvency.

But he is quite correct, in my opinion, in suggesting that one of the important parts of an excess profits tax is the determination of normal profits. For example, if we use invested capital and if there were a wise man available, given adequate power, he probably could determine for each taxpayer in the country just what rate of return that fellow should get in order to produce normal profits.

The partners of Price, Waterhouse, in the days of the War and immediately following, were very instrumental, very helpful, very influential in the framing and the administration of the old excess profits taxes. We are very happy to have one of their successors with us today. He is listed as discussing "Appropriate Yardsticks for Determining Normal Profits."

In accordance with the temper of the times, following true democratic precedent and procedure, I will announce that it has been moved and seconded and unanimously carried that we amend his subject by striking out the word "appropriate"—so that he can discuss the yardsticks proposed in the Subcommittee report.

Mr. Byerly! (Applause)

Mr. F. P. BYERLY (Price, Waterhouse & Company):

Gentlemen: I am very glad Mr. Alvord made that explanatory remark, because that fitted in with my intention anyway.

The issuance a few days ago of the Subcommittee report of the Committee on Ways and Means gives a practical reason just now to concentrate our study on its proposals and not spend time just at the moment in theorizing on what might be some ideal form of measurement of normal earnings.

As Mr. Alvord also briefly explained, (though I imagine most of you gentlemen have read the Subcommittee report), the proposal is to allow alternative methods of measurement, one of which involves invested capital not at all, except in so far as changes in invested capital may occur during the excess profits taxable year, and the other of which provides for determining a percentage of earnings in relation to invested capital and therefore involves
the use of invested capital figures for the base period—which ought to be quite a help to us accountants. (Laughter)

There are a number of rather important things on which the Subcommittee report is silent, and others on which it seems to be either ambiguous or defective. I had the opportunity this week to appear before the Committee on Ways and Means and put in a statement calling attention to a few of those points, and I think my remarks now might be largely the same as there, as they related chiefly to the topic which had been assigned to me.

I believe that perhaps the most important thing to submit as a criticism of this Subcommittee report in proposing an excess profits tax is the failure of the Subcommittee to include any recommendation regarding consolidated accounts. The history of the war profits taxes twenty years or more ago is that consolidation was then compulsory, and I understand there was some rather hectic discussion on that subject in Washington along in late 1917 and early 1918, when the 1917 Act was being completed and regulations framed. The authorities in Washington were then convinced, after the Act itself had been passed, that consolidation should be required for computation of excess profits taxes and therefore by regulation so required, although the Act had nothing on the point. The 1918 Act, as you probably all recall, included it in mandatory form.

Then we had a series of post-war years where it was to some extent optional. The '34 Act withdrew the privilege of consolidated returns for most companies, I believe, making an exception with respect to railroads.

The Treasury Department in the past has been very much convinced of the desirability of consolidated returns, not simply in the interests of fairness, but to minimize or reduce possibilities of evasion. There are certain sorts of cases, with which you are probably all familiar or which you can readily imagine, where special inter-company arrangements might be made of a somewhat artificial nature which would serve to reduce excess profits taxes, if the Treasury Department couldn't have them thrown out as simply devices or artifices which the courts wouldn't recognize.

From the point of view of the taxpayer, the obvious advantage of consolidation is the averaging of profits and losses of the whole business and determining a relationship between income and capital that would have some economic significance for the enterprise as a whole.

Another point that I might mention is that the Subcommittee report
fails to provide for the inclusion of predecessor earnings. If a company, say, between the beginning of the base period, January 1, 1936, and the beginning of the excess profits taxable year, 1940, acquired some other going concern through some form of tax-free merger or reorganization, or possibly by liquidation of a subsidiary, the earnings from that newly acquired business would presumably be reflected in the 1940 earnings, and therefore they would not be fairly comparable with the base period earnings of the taxpayer corporation alone.

If a provision for inclusion of such predecessor earnings is written into the bill, of course a parallel provision should go in with respect to invested capital of the base period in similar cases.

There is some lack of clarity in the Subcommittee's report as to whether, in arriving at the average earnings of the base period, the loss of a loss year or years would be deducted; that is, whether you would take the algebraic sum of the income account, say, for the four base years and divide by four, or whether you would do as provided in the Canadian law recently enacted, take the total number of base years but add up only the profits, ignore the losses, if any, and divide the sum by the number of base-period years.

As to Method Two of the Subcommittee report, which is the one dependent on invested capital (under which you get a percentage of earnings of the base period on the invested capital of the base period, then apply that percentage, within limits, to the taxable year invested capital to determine the normal earnings for that year), the report provides that deficits in earnings should be deducted in the base period computation. They don't seem to have a similar provision where you are using Method One, simply base period earnings without regard to the base period invested capital. It is not entirely clear whether this apparent difference was intentional.

There is a further complication in interpreting how loss years would work out in detail, because excess profits income is recommended to be based upon normal tax net income, presumably as defined in the 1939 Act or in the Code as amended by that Act; and that Act, as you know, contained a provision for net loss carryovers. Now, it doesn't seem conceivable that if in the base period a company had losses, say, in 1936 and 1937, but larger profits in 1938 and 1939, it would have to carry those losses forward and diminish the 1938 and 1939 excess profits income and also, on top of that, deduct the losses of the years 1936 and 1937 as such. Incidentally, the net loss carryover
Deduction provision has some rather tricky features in it, and it is not a simple calculation in itself, whereby you merely carry forward the net loss, but the net loss deduction is net losses of previous years diminished by a number of other factors that may have to be brought into account.

However, such questions as that will no doubt be worked out by the legislative draftsmen when a bill is actually framed. It is really more a matter of detail and not the sort of thing you would expect the Subcommittee to go into in the preliminary report.

I think I might proceed now to read (or paraphrase) certain portions of the statements that I made before the Ways and Means Committee.

As to the determination of base period earnings to be used as a measure for normal earnings of the taxable year, whether you are using Method One or Method Two, it is obvious that the bill should provide that the earnings of the base period and of the taxable year should be so computed as to be fairly comparable. The Subcommittee report proposes to eliminate from the determination of excess profits income for both the base period and the taxable year, any realized long-term capital gains or long-term capital losses upon sale or exchange of depreciable or nondepreciable assets. But there are in many cases a number of other extraordinary items of the sort commonly described as non-recurring. Non-recurring, of course, does not mean items of a nature that may never recur, but items of major importance which do not recur annually or at longer intervals with some regularity.

Examples of such items are:

1. Substantial gains or losses realized from sale or exchange of capital assets, including depreciable assets, that may have been held for not more than eighteen months (the Subcommittee report already having proposed to eliminate such gains and losses with respect to items held for more than eighteen months).

2. Losses on abandonment or destruction of property.

3. Taxable profit realized upon the purchase at a discount by a corporation of its own bonds or other outstanding evidences of indebtedness.

4. Deductible loss incurred by a corporation upon the purchase at a premium (or at an amount in excess of the principal amount less the related balance of unamortized discount at the time of purchase) by a corporation of its own bonds or other outstanding evidences of indebtedness.

Those last two items of extraordinary gain or loss are usually substantial when a corporation has carried through a refunding operation, and
might not call for any special adjustment in the case of acquisition of bonds simply from time to time through some sinking fund or similar routine operation.

It is my recommendation that such extraordinary profits and losses of substantial amount, if any, realized by a corporation during the base period or the excess profits taxable year, should be eliminated in determining the excess profits credit and the excess profits income, but need not be eliminated for normal tax purposes.

On the subject of consolidated returns, I just made these remarks:

"The business of a number of corporations is conducted on such a scale that it is often necessary or desirable, because of state laws, temporary exigencies of financing, and sometimes for other special reasons, to have some of the departments, operations, or geographical divisions of the business conducted by subsidiary corporations. From the economic standpoint, however, the enterprise is a unit, and the interest of the investing public is wholly or principally in the securities issued by the parent company.

"Under an excess profits tax, whereby the tax is determined in part by reference to invested capital, artificial duplications of invested capital may exist to the injury of the revenue in a group of affiliated companies if the accounts are not made up on a consolidated basis. In consolidated accounts the investment of the parent company in the stock and securities of the subsidiary companies is eliminated, but in the absence of consolidation no such elimination occurs, and the same net operating assets may be represented in the equity securities of two or more corporations of the group, subsidiary and parent. The provision in the Subcommittee's report for an adjustment in respect to inadmissible assets would not necessarily serve to cure such duplication, since that adjustment is reduced by application of the ratio which the equity or invested capital bears to the total assets.

"Consolidated accounts are more equitable to taxpayers in that the operating results of the whole enterprise are combined in arriving at the amount of net income.

"On the basis of consolidated accounts, the ratio of income to invested capital is a weighted average for all the separate corporations of the affiliated group, and the artificial peaks and valleys that may exist in such ratios for the separate corporation divisions are leveled off. Under the system of a separate return for each corporation, it would be quite possible for the effective tax rate on one enterprise to be more than a hundred per
cent under a law which asserted a maximum nominal rate of only forty per cent, or even lower.

"Without consolidation ambiguities would often be encountered as to the status of inter-company open accounts. The question would arise as to whether such accounts represented indebtedness or capital and how they should be treated in determining statutory invested capital."

Although the Subcommittee, you recall, made some allowance for indebtedness to be included in invested capital, their recommendation is limited to debt represented by outstanding evidences of indebtedness and apparently would not have any application to an open book account such as we often find in inter-company records.

"Such complications," I concluded, "might put taxpayers under temptation to rearrange their corporate structures and relationships so as to minimize duplication of taxes and thus might tend to retard progress in the direction of simplification of corporate structures."

There was another point not quite so obvious as some of those I have mentioned, which came to the attention of some of us two or three days ago, that might in some cases seem to be unfair to taxpayers. The Subcommittee report concludes with a short recommendation that the Internal Revenue Code be clarified in order that the unrecognized gain or loss upon the sale or exchange of property by a corporation not be reflected in its earnings and profits. If that recommendation were adopted, it would presumably be applicable in determining earnings or profits in the computation of invested capital, and also for computations of earnings and profits to ascertain the tax status of corporate distributions or dividends.

In this connection the tax law regarding liquidations of subsidiaries might work out unfairly if that was not specifically excepted. In a supplementary statement filed with the Ways and Means Committee, I said:

"The tax law, commencing with the Revenue Act of 1936, has provided that under specific conditions the complete liquidation of a subsidiary company does not result in recognized gain or loss to the parent company. A parallel provision of the law states that the basis of assets so acquired by a parent company shall be the same as the basis to the subsidiary. The Subcommittee report recommends a general rule that assets be included in invested capital at their income tax basis. In conformity with this principle, it should be made clear in the bill that this general rule applies to assets"
acquired by a parent company upon liquidation of a subsidiary company under Section 112 (b)-(6), regardless of whether such liquidation resulted in an unrecognized gain or loss.

"Supplementary to such a provision, the rule to be included in the bill with respect to the determination of earnings or profits for purposes of invested capital should explicitly recognize the principle established by the Sansome decision (CCA-2, 1932—certiorari denied) and applied since that time in the administration of the income tax laws, viz., that the earnings and profits of a corporation should include the amount of the earnings or profits of a predecessor company acquired by a reorganization, merger, or liquidation which was a tax-free transaction under the income tax law effective for the year in which it occurred."

It seems to me that such a provision as that and as the one recommended with respect to 112 (b)-(6), would be entirely consistent in principle with a requirement or permission for filing returns on a consolidated accounting basis.

Consolidated accounts, properly made up and carried through for the base period and the taxable period both—and, let me say, recognizing consolidation accounting even in interpreting, for purposes of invested capital of the base period or the tax period, transactions that may have occurred in prior years when possibly the corporation did not or could not file consolidated returns—would in many cases eliminate complicated problems of intercompany situations and transactions that would certainly arise and be very difficult to deal with on a separate corporation return basis.

Thank you, (Applause)
where your corporation didn't exist in the past. The second is where your corporation has earned admittedly abnormally low profits, in the past. Other yardsticks have to be devised to take care of those two situations and past history, trends, risks, and nature of business are probably important factors. The complications can be piled on top of each endlessly.

We are going to give you time to express your views. I think you will find basically the difference between the views expressed by Professor Buehler and myself is this. What is it you are trying to do? Are you trying to get revenue, or are you trying to promote, permit, protect normal profits and prevent excess profits? That seems to me to be the basic issue.

But, regardless of the objective, regardless of the purpose of the tax, it has to be administered. It might seem strange that we should call upon a lawyer to discuss administrative problems. But Bob Miller was on the firing line during the war; he merely changed camps after the war, and stayed on the firing line. I know of no one better qualified to discuss administrative problems than Robert N. Miller, of Washington. (Applause)

MR. ROBERT N. MILLER (Former Solicitor of Internal Revenue and past Chairman, Committee on Taxation of the American Bar Association): Mr. Chairman, Gentlemen: What we have all heard is so apt and so comprehensive that I would feel very much embarrassed if I were going to talk about the same phase of taxation, but, as you have heard, my assignment is something different—that is, the administrative phases of excess profits tax laws.

I have tried to put myself in the place of the Government and see what administrative considerations the Congress should be giving weight to in drafting the law, in the Government's own interest, and especially in the Government's interest of getting a workable law. It is, of course, true that taxpayers want a workable law; but the Government needs a workable law even more than taxpayers do.

My remarks will have to do mainly with the past, that is, the more serious difficulties which the Bureau of Internal Revenue actually met with in administering the World War high rate taxes based on income, imposed by the '17 Act, the '18 Act, and the '21 Act. Of the hundreds of hard problems which were of vital importance to some groups of taxpayers, and hence to the Bureau, the ones I am about to speak of appeal to me as the most important just now, when we are drafting a bill.
Purely Administrative Difficulties

Before I speak of any single technical problem or difficulty of that period, let me say that there has gradually developed in me over the years the conviction that, however numerous and serious were the problems of determining questions of law and of fact in connection with those World War taxes—that is, the problems that would exist with an ideal personnel, ideally directed and free from fear of criticism—there were other causes, probably more important, interfering with reasonably prompt and satisfactory administration of these taxes—causes which had little to do with the detailed text of the law as written by Congress.

I am convinced, indeed, that the greatest difficulties of administration which the Government meets in getting its money, and getting it promptly, were then and will be under the new law, if it has high rates, not these very real difficulties involved in the Government's task of making an audit and writing a deficiency letter, but the difficulties involved in so handling each tax case that the Government and the taxpayer come with reasonable promptness to a condition of equilibrium as to the amount of tax involved in the controversy, instead of taking years to reach that condition of equilibrium. In other words, real tax administration demands a great deal more than getting up a deficiency letter which embodies the Government's position on the various topics or problems of the case in hand; more, even, than inviting the taxpayer to whittle away according to the taxpayer's ability at each one of the many points of the case where the Government's position may be subject to attack. The Government's real job is to get the case actually finished. In other words, the Treasury has a selling job as well as a deciding job, and Congress has a job of giving the Treasury something that the Treasury can sell without being ashamed of it.

An official study, in which I have great confidence because our Chairman participated in it when he was in the Government mill, was made in 1927—dealing only with taxes for the four years 1917, 1918, 1919 and 1920—to see how many of the cases were still in the administrative phases, and how much tax they involved. It showed that there were still in administrative controversy more than $160,000,000 of taxes. That amount seems worth considering, when we hear how relatively low the probable yield of this new tax is expected to be. The survey showed that more than three thousand cases of a substantial character involving the years mentioned were still pending near the end of 1927.