

TAX PROBLEMS OF WARTIME PLANT EXPANSION

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At the outset of the defense program, in 1940, providing the physical facilities necessary for war production was a critical problem. Three plans were developed to meet this need by members of the Advisory Commission to the Council of National Defense.¹ The first involved the construction of new plants wholly with private funds. In order to encourage the use of this plan, it was proposed that taxpayers providing facilities under it be permitted to deduct the cost of such facilities, for tax purposes, over a five-year period. The second plan involved the use of private funds at the outset, with the builder thereafter being reimbursed directly by the Federal Government for his expenditures, in periodic payments over a five-year period. After the war, the facilities were to belong to the Government unless the builder chose to buy them back. The third plan provided for direct and complete financing by the Government, with full government ownership at all times. Facilities constructed under this plan would be leased to private companies for management and operation.

These three plans have provided the basis for all wartime plant expansion. They are commonly referred to, respectively, as the "Amortization" plan, the "Emergency Plant Facilities" plan, and the "Government Ownership" plan.

Contrary to general expectations, private capital has not shouldered the heaviest load. As of December 31, 1942, total commitments for industrial facilities expansion amounted to \$19 billions, of which approximately \$4.3 billions was privately financed, with the aid of amortization or Emergency Plant Facilities contracts.²

To what extent tax difficulties have contributed to this result remains a matter for speculation. Each of the plans involves tax problems, which will be considered herein.

I. AMORTIZATION

The Second Revenue Act of 1940 added a new provision to the Internal Revenue Code, Section 124, designed to implement the amortization plan by permitting tax-

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¹ See *Hearings before the Senate Committee on Finance on H. R. 10413*, 76th Cong., 3d Sess. (1940) 181, 186.

² These figures are obtained from unofficial sources. Figures as of Oct. 31, 1942, are published by the U. S. Office of War Information, in 4 *VICTORY*, No. 4, p. 17 (Nov. 29, 1942).

payers to deduct, over a 60-month period, the cost of facilities constructed or acquired in the interest of national defense during the emergency period.

It is perhaps desirable at the outset to consider briefly the necessity for a statutory provision. The tax laws have always granted a deduction for the depreciation of buildings, machinery and other business property.³ The probable useful life of the property is estimated, and its cost is spread over this period. However, the Treasury Department and many taxpayers felt that the probable useful life of a facility devoted to war purposes could not readily be determined under existing law.⁴ Such a determination would require an estimate of the probable duration of the emergency and also an estimate of the probable usefulness of the facility after the war—both highly uncertain factors. Accordingly, it was determined that a statutory provision should be enacted.

Both the Treasury and taxpayers had unhappy memories of their experiences with amortization during and after the World War. The Revenue Act of 1918 contained a provision permitting taxpayers to deduct the loss of useful value of facilities erected after April 6, 1917, for the production of articles contributing to the prosecution of the war.⁵ This provision presented two very difficult problems: (1) Whether the particular facility was necessary for the prosecution of the war, and (2) what was the remaining value of the facility after the war. These problems resulted in confusion during the war and in extended litigation for years after the war.

Section 124 was drafted to avoid, so far as possible, the pitfalls of the earlier act. The section expresses a basically simple policy in complicated statutory language. The basic policy is to determine the necessity for a war facility in advance, and to substitute a five-year period for the indefinite period of depreciation otherwise prescribed by statute.

The mechanics by which this policy is carried out are as follows: The taxpayer must obtain a certificate (called a "Necessity Certificate") from either the Secretary of War or Navy that the facility is necessary in the interest of national defense during the emergency period. Applications for such certificates ordinarily must be filed within six months from the beginning of construction, or the date of acquisition, of the facility.⁶ Having obtained a Necessity Certificate, the taxpayer may elect to take the amortization deduction over a period of 60 consecutive months, beginning either with the month following completion of the facility, or with the first month of the succeeding taxable year. This election is exercised in the tax return for the year in which the taxpayer desires to begin the amortization deduction. Once having elected

³ INT. REV. CODE §23(1).

⁴ See statement of the Hon. John L. Sullivan, Asst. Secretary of the Treasury, *Joint Hearings on Excess Profits Taxation, Amortization, and Suspension of the Vinson-Trammell Act*, 76th Cong., 3d Sess. (1940) 74 *et seq.*

⁵ Rev. Act of 1918, §§214(a)(9), 234(a)(8).

⁶ There are certain exceptions to this rule. Applications with respect to facilities completed or acquired after Dec. 31, 1939, and before June 11, 1940, by a corporation, or after Dec. 31, 1939, by an individual or partnership, must have been filed before April 22, 1943. Rev. Act of 1942, §155(e)(2). Applications filed after the expiration of the six-months period are timely with respect to the part of the facility constructed within six months prior to the filing date. *Id.* §155(d).

amortization, the taxpayer must continue to take the deduction on a monthly basis, unless, prior to the beginning of any month, he notifies the Commissioner of Internal Revenue that he desires to discontinue the deduction. If the amortization deduction is discontinued, it cannot thereafter be resumed. If, however, the war emergency is declared at an end prior to the expiration of the 60-months period, the taxpayer may elect to recompute the deduction, using the shorter period of the emergency instead of the 60-months period. This he may do although he has previously elected to discontinue amortization, or although, after receiving a Necessity Certificate, he has never elected amortization. The right of recomputation may be exercised even though it involves reopening returns otherwise barred by the statute of limitations.

On the whole, these provisions are obviously beneficial to the taxpayer. The major difficulties encountered in the administration of the 1918 Act have been avoided. However, amortization has proved to be a hydra-headed problem. In place of the problems disposed of by the legislation, new problems of interpretation have sprung up.

(1) *Depreciation or Special Allowance?*

The earliest, and perhaps the most violent controversy concerned the nature of amortization. Amortization was regarded by some as a government subsidy to industry, a reimbursement of the cost of war plants to the extent of the tax deduction. This viewpoint was rather widely held during the early consideration of the amortization provision, and influenced Congress to insert a special provision in Section 124 dealing with "reimbursement."⁷ This provided, in substance, that if the taxpayer were being reimbursed by the United States for the cost of a facility, amortization would be denied unless the contract providing for reimbursement adequately protected the United States with reference to the "future use and disposition" of the facility. To enforce this provision, the service departments were directed to issue two types of certificates with respect to individual contracts with the United States of taxpayers claiming the amortization deduction: A "certificate of non-reimbursement," that the contract did not provide for reimbursement by the United States, or a "certificate of Government protection," that the contract adequately protected the Government's interest. In the absence of one or the other of these certificates, the taxpayer was left in the uncomfortable position of having to prove to the Treasury Department that none of his contracts with the United States reimbursed him for any part of the cost of any facility subject to amortization.

There is considerable evidence that the legislative committees of Congress intended to confine the application of this provision to the Emergency Plant Facilities type of contract, where the reimbursement by the United States is direct and specific, and to those supply contracts where the parties, by agreement, "loaded" the price with the cost of the facilities required to perform it.⁸ The provision was early interpreted,

⁷ Second Rev. Act of 1940, §302.

⁸ See, H. R. REP. No. 1207 on H. J. Res. 235, 77th Cong., 1st Sess.; and *Hearings before the House Committee on Ways and Means* on H. J. Res. 257, 77th Cong., 2d Sess. (1942).

however, to require the examination of every supply contract to determine whether, in fact, it contained a charge in excess of "normal" depreciation. As so interpreted, the administration of the provision was a hopeless task, since every supply contract showing a profit was open to suspicion. The service departments were remanded to a consideration of the elements of a "reasonable" profit, without any standards for guidance. A series of "clarifying" amendments failed to remove the difficulties,⁹ and the provision ultimately was repealed.¹⁰

Since the questions are now academic, the subject does not warrant an extended discussion. It is sufficient to observe here that the belief that amortization is some form of subsidy arises from confusion as to the nature of the deduction. The only way in which the cost of any productive facility is ever recovered is through the proceeds of sale of the product. The tax laws have always permitted a portion of such proceeds to be recovered tax-free, through the allowance of a deduction for depreciation. The depreciation deduction is not regarded as a subsidy, or as a "double reimbursement" of cost. Amortization is merely a deduction in lieu of depreciation. If the facility actually is operated after the expiration of the amortization period, no depreciation deductions will be allowed. No part of the cost of any facility may be recovered more than once. In return for increased deductions over a five-year period, the taxpayer gives up all deductions thereafter. The aggregate amount of deductions is not increased. There is no "subsidy" in such an allowance, although, in common with many other deductions, it may result in a tax benefit.

The question has arisen whether, since the repeal of the "non-reimbursement" provisions, a charge for amortization of war facilities may be made in supply contracts, either of the "fixed-price" or the "cost-plus" type. It is submitted that this question has no logical connection with the amortization deduction. The proper charge for depreciation in a supply contract depends on the judgment of the contracting parties regarding the probable useful life of the particular facilities involved. It may be that a charge equivalent to the amortization deduction is justified, if the facilities will not be useful after the war. But this question cannot be answered by reference to the tax statutes.

A similar question may be expected to arise in connection with various statutory or contractual provisions which permit the Government to purchase or requisition various types of property at "depreciated cost."¹¹ If the property is subject to amortization, should the payment be based on cost less depreciation or cost less amortization? This question, too, should be resolved without recourse to the tax law. The object of such provisions is to set a fair value upon the property, which is normally measured by the actual physical depreciation sustained and not by the basis used for tax purposes. Of course, it necessarily follows that the excess of the purchase price

⁹ Act of Oct. 30, 1941, 77th Cong., 1st Sess., c. 464 (H. J. Res. 235).

¹⁰ Act of Feb. 6, 1942, 77th Cong., 2d Sess., c. 41 (H. J. Res. 257).

¹¹ See, e.g., Emergency Plant Facilities Contract, Draft of Oct. 10, 1940, art. III, §2(a); Merchant Marine Act, 1936, §802.

over amortized cost will be regarded as taxable income at the time of purchase or requisition.

(2) *Problems of Certification*

The primary determination under Section 124 is the necessity of the facility for war purposes. The statute provides no criteria for this determination, except that the facility must be "necessary in the interest of national defense during the emergency period."¹² The determination is made by the War and Navy Departments, under joint regulations approved by the President.¹³ The discretion of the service departments probably is not reviewable.

In practice, decisions are made by a staff of reviewers in special sections of the War and Navy Departments, principally on the basis of reports rendered by the appropriate procurement branches of the services, and by the War Production Board. Applications for an amount in excess of \$250,000 must be reviewed by a Tax Amortization Committee of the WPB.¹⁴ In the War Department, novel or difficult questions may be referred to a Special Panel composed of disinterested persons not connected with the Department.¹⁵

Under the policies developed by the Tax Certification Sections, both the article to be produced and the facilities to produce it must be demonstrated to be essential to the war effort. The article to be produced is necessary if it is essential to the armed forces, lend-lease nations, or civilian defense.¹⁶ Civilian supplies may be necessary if they contribute directly to the operation of a war facility, or if they release supplies needed for war purposes.¹⁷ For example, air-conditioning of a laboratory in a war plant might be necessary, while air-conditioning of offices in the same plant would not be.

The facilities to produce necessary articles will be certified only if there is a shortage of capacity to produce such articles in the industry as a whole.¹⁸ The situation of the individual company is immaterial. Thus, if there is idle capacity in other plants, or if the applicant has other facilities which can be converted to war work, or if the production can be subcontracted, a Necessity Certificate will not be granted. Exceptions are sometimes made, based on geographical considerations preventing the use of theoretical capacities or on special qualifications of the taxpayer requiring use of his facilities despite the existence of apparently adequate capacity.¹⁹

The time when a shortage of capacity is determined may be of vital importance. The Regulations state that the shortage may be either existing or prospective, and will be considered either at the time of the expansion or at the time of the issuance of

¹² §124(f)(1).

¹³ Joint Regulations have been prescribed. 7 FED. REG. 4233 (June 4, 1942).

¹⁴ *Id.* §4b. There is no statutory authority for this Committee. On the contrary, the Advisory Commission to the Council on National Defense, to which the War Production Board has succeeded, was eliminated as a co-certifying agency by H. J. Res. 235, *supra* note 9.

¹⁵ This Committee is not mentioned either in the statute or the regulations. An advisory committee, it also exercises what amounts to an appellate jurisdiction within the Department.

¹⁶ *Id.* §3a.

¹⁷ *Id.* §3b, i(1).

¹⁷ *Id.* §3a, iii.

¹⁸ *Id.* §3b, ii.

a Certificate.²⁰ However, the Tax Certification Sections have denied a Certificate in several cases where the expansion preceded the development of a war need. These cases appear to belie the Regulations and are difficult to explain except on the ground of the applicant's motive for the expansion, which should not be material. In the converse case, where the facilities are clearly necessary at the time of expansion, but subsequently lose their value to the war effort, Necessity Certificates have been granted. This result seems obviously just, although it may be inadequate if the taxpayer does not have other income against which the cost of the prematurely useless facilities may be amortized. However, after a Necessity Certificate has been granted, the taxpayer may apply at any time to the War or Navy Departments for a certificate that the facilities are no longer necessary for national defense.²¹ If the latter certificate is granted, the taxpayer may recompute the deduction for amortization over the period from the completion of the facilities to the date specified in such certificate,²² or, if the facilities have not been completed, from the beginning of construction to the date stated in the certificate.²³ These provisions recognize the growing number of cases where changes in the war program have forced the cancellation of projects formerly deemed essential.

The transfer of facilities from one taxpayer to another has caused a great deal of difficulty. Where the facilities have not previously been certified, the general policy of the Tax Certification Sections has been to deny a Necessity Certificate, unless the taxpayer can show that the facilities have an "increased usefulness for national defense" in his hands.²⁴ This treatment is a corollary of the proposition that the Tax Certification Sections are concerned solely with the net increase of industry capacity, and not with the situation of the individual taxpayer. "Increased usefulness" may be shown by evidence that the facilities were idle in the hands of the prior owner or were used by him for a non-war purpose. Frequently, however, the taxpayer does not have adequate knowledge of the prior use. Moreover, in the case of machine tools, railroad equipment, ships, and other vital war material, the taxpayer will find it difficult to prove that the equipment is more necessary to the war effort in his hands than it was to the prior owner. In view of the increasing difficulty of obtaining new equipment, and the need for wider utilization of existing productive capacity, a re-examination of this policy would seem to be desirable.

The transfer of facilities covered by a Necessity Certificate also creates problems. The Treasury Department has ruled in several instances that assets subject to a Necessity Certificate may be transferred in a tax-free reorganization without obtaining a new Certificate.²⁵ No such assurance exists in other types of transfers, and, as a practical matter, most taxpayers have sought new Certificates. This has the result of starting a new amortization period, regardless of how long the prior owner has

²⁰ *Id.* §3b, i.

²¹ INT. REV. CODE §124(d)(1).

²² *Id.* §124(d)(4).

²³ *Id.* §124(d)(6).

²⁴ JOINT REG. OF THE SEC'Y OF WAR AND THE SEC'Y OF THE NAVY, §3c, iii (hereafter cited as "Jr. REG."). Transfers between related taxpayers are, of course, closely scrutinized, and seldom have been certified.

²⁵ The rulings are unpublished.

held the emergency facility. It also creates, in most instances, a new basis for amortization. There are obvious possibilities of manipulation in this situation. The simple and logical rule, which the service departments are understood to favor, is that the Certificate attaches to the facilities in all cases and is automatically transferred with them. This would be consistent with the Government's position that it is the facility and not its owner which is important to the war effort.

Replacements of existing facilities are also controversial. After a period of indecision, the Tax Certification Sections decided that replacements would not be certified if it is established that they would have been made under normal peacetime conditions.²⁶ This is a sound rule, but its application requires some degree of clairvoyance. There are many types of replacements, and full depreciation or obsolescence is seldom the sole contributing factor. Replacements may be made to modernize plant, to remove "bottlenecks" in a production line, to eliminate hazardous conditions, to prevent break-downs, to restore property destroyed. Which of these types of replacement would have been made, under "normal peacetime conditions?" Furthermore, even if depreciation or obsolescence is the primary cause, this does not settle the problem. Three-shift operation required in wartime may have hastened depreciation, or wartime technological improvements may have rendered the property obsolete. The replacement may be of better design or larger size than the old equipment, so that plant capacity is increased. The replaced asset may not be retired but may be shifted in the plant to lighter or less precise work. The Tax Certification Sections have struggled with these problems as they arose, deciding each case on its own facts. Perhaps the difficulties are inherent; but a clearer policy is badly needed.

Land occupies a unique position, since it is subject to amortization but not to depreciation.²⁷ It is understood that the inclusion of land was dictated by the difficulties encountered during the World War in inducing the acquisition of land for shipbuilding purposes, and by the desire to encourage the construction of airports, channels and similar facilities.²⁸ Despite this legislative history, the Regulations provide that land will be certified only if it is directly connected with necessary production facilities.²⁹ Nevertheless, airports have been certified; also, storage areas, parking lots and waste disposal areas. Farm land has been denied certification. The purchase of land in excess of immediate production needs will not be certified, except where the taxpayer is compelled to buy on an "all or nothing" basis. Oil and mining property subject to the depletion allowance provided by Section 23(m) of the Code will not be certified, since the statutory deduction for amortization is "in lieu of the deduction (for depreciation) . . . provided by Section 23(l)."

²⁶ JT. REG. §3c, v. Note the phrasing of this regulation, which suggests that the Government has the burden of establishing the peacetime character of the replacements.

²⁷ U. S. TREAS. REG. 103, §19.23(l)-2. Land is specifically included in the definition of an "emergency facility," INT. REV. CODE §124(e)(1).

²⁸ See H. CONF. REP. NO. 3002, 76th Cong., 3d Sess. (1940) p. 58.

²⁹ JT. REG. §3c, ii.

(3) *Problems of Interpretation*

The functions of the Tax Certification Sections begin and end with the determination of "necessity." Since Section 124 is a part of the Internal Revenue Code, the primary responsibility for its interpretation rests with the Treasury Department. But few rulings have been published, and it is too early for litigation. As a result, many important problems remain unanswered.

For example, the definition of a "facility" has never been settled. This is perhaps the most fundamental determination the taxpayer is called upon to make. He must decide what the "facility" is, in order to file a timely application for a Necessity Certificate; to identify the subject-matter of the Certificate with sufficient precision to satisfy the Commissioner upon audit of his return; and to determine when to begin the amortization deduction.

The statute defines an "emergency facility,"³⁰ somewhat tautologically, as "any facility, land, building, machinery, or equipment, or part thereof, the construction, reconstruction, erection, installation or acquisition of which was completed after December 31, 1939, and with respect to which a certificate . . . has been made." The definition indicates that land, buildings, and machinery, which are separately enumerated, are probably separate facilities. It also indicates that work performed, such as reconstruction or installation, may be a facility separate from the asset itself. Thus, the purchase of machinery and its installation may be two distinct facilities within the meaning of the statute.

Many taxpayers have adopted the view that each depreciable asset constitutes a facility. While this theory does not entirely square with the statutory definition, it seems to be the most logical approach, since amortization was intended as a substitute for depreciation. It is certainly the most convenient for record-keeping purposes. Under this approach, for example, the purchase and installation cost of a machine (and perhaps also the cost of constructing foundations) would be treated as a single facility, since they are normally combined for depreciation purposes. There is also a broader view, which has its supporters, that it is the entire group of assets making up a complete plant or productive unit, which constitutes the facility.

If the analogy to depreciation is accepted, it does not necessarily follow that every depreciable asset must be described in the Necessity Certificate. On projects of any size, Certificates are normally issued before or during construction, when complete identification of the facilities is a virtual impossibility. The Tax Certification Sections urge taxpayers to furnish supplemental detail, as soon as complete data are available, which they will transmit to the Commissioner as a supplement to the Certificate. This is obviously a wise precaution. Even in the absence of such data, however, the taxpayer should be permitted reasonable latitude both in description and enumeration. The Certification Sections are not equipped to consider the necessity of an expansion program down to the last nut and bolt. If the taxpayer clearly describes the project and its major components, the identification should be adequate, provided the facilities

³⁰ INT. REV. CODE §124(e)(1).

actually installed can subsequently be related to the Certificate through authorization numbers, asset numbers, or other accounting data. It is also generally agreed that minor variations in actual costs from the costs estimated in the Certificate are immaterial, since it is the facilities and not the cost thereof which are certified to the Commissioner. The principal hazard involved in variations, either in description or costs, is that they may indicate substantial changes in, or additions to, the program after certification. The statute expressly requires that any expenditure attributable to a facility after certification shall not be added to the amortization basis, but shall be certified as a separate facility.³¹

Other troublesome phrases in the statute are the "beginning of construction," the "date of acquisition," and the "date of completion."

A Necessity Certificate has no effect unless the application therefor was filed within six months after the beginning of construction or the date of acquisition of a facility.³² The harsh effect of this provision, however, has been mitigated by an amendment in the Revenue Act of 1942 which permits amortization of the part of a facility constructed within the six-months period, regardless of the filing date.³³

The difficulties may be illustrated by the construction of a building. The "beginning" of such construction might be the date of drawing plans and specifications, awarding the construction contract, clearing the site, excavating for the foundations, or erecting steel. There seems to be no disposition to treat "paper" work in advance of physical operations as the beginning of construction. Whether operations on the site or foundation work will be so regarded may depend on the taxpayer's depreciation practice. If the taxpayer depreciates these expenditures with the building cost, it is quite likely that the date when they were commenced will be treated as the beginning of the building.

In order to fix the starting-point for the amortization deduction, the taxpayer must also ascertain the date when the facility was "completed or acquired."³⁴ In general, "completion" involves two possibilities: The date of physical completion or the date of beginning operations with the facility. In the normal case, where physical completion and operation are reasonably close together, the taxpayer probably can select either date if he follows it consistently.³⁵ However, if the facility is not used for a long period after physical completion, the latter should be controlling. A taxpayer who constructed a building in 1940, should not be able to claim amortization by putting the building into service in the current month, unless the delay was due to lack of raw materials, or other causes beyond his control.

The date of "acquisition" of a facility presents some special problems, because of the additional factor of passage of title from a prior owner. An "acquisition" might occur on (a) the date on which a firm order or binding contract was executed, (b) the

³¹ *Id.* §124(f)(2).

³² *Id.* §124(f)(3).

³³ Rev. Act of 1942, §155(d). Strictly speaking, no application can now be filed more than six months after the beginning of the "facility," as that portion constructed within six months preceding the filing date is defined by this amendment as a separate "facility."

³⁴ INT. REV. CODE §124(a).

³⁵ There are unpublished rulings to this effect.

date when title passed to the purchaser, (c) the date of physical receipt, or (d) the date of actual use or operation.

It seems very improbable that the execution of an order or a contract will be considered an acquisition. Nor is it likely that the Treasury Department will insist upon technical refinements of the law of sales, such as the passage of title upon delivery to the carrier, etc. Under a practical administration of the law, in line with depreciation practice, the same test should be used for acquisition as for completion, that is, the date of beginning operation with the facility—again assuming that there is no unreasonable time lag between receipt and actual use. It should be noted, in this connection, that acquisitions of steel, lumber, and like materials accumulated in inventory for construction purposes would not ordinarily be considered “facilities” since they are not depreciated until charged to construction. Where such materials are actually used within a reasonable time, their cost should be amortizable upon the completion of the construction.

The acquisition date of land is also difficult to determine. The date of acquisition would not appear to be earlier than payment of the purchase money, since the taxpayer would have no investment in the property prior to that date. If the taxpayer pays part of the purchase money and takes possession, acquisition probably occurs despite the seller's retention of a security title. If payment precedes both title and possession, a more difficult question is presented. Probably the taxpayer has not acquired property unless he has at least the right to immediate possession.

After identifying the facility and determining the starting date for amortization, there remains the question of the proper basis. Normally, of course, the amortization basis is the same as the basis otherwise determined, that is the basis prescribed in Section 113(a) of the Code, with the adjustments prescribed in Section 113(b). However, Section 124(f) further limits the basis to the amount “properly attributable to such construction, reconstruction, erection, installation, or acquisition after December 31, 1939, as either the Secretary of War or the Secretary of the Navy has certified as necessary in the interest of national defense during the emergency period. . . .” Thus, if construction began before December 31, 1939, and ended after that date, only the part of the cost which is attributable to construction after that date is subject to certification. Furthermore, the Tax Certification Sections may certify that only a specified percentage of the cost incurred after the basic date is necessary for national defense—for example, where the taxpayer constructs an unnecessarily expensive building, or where the facility will be used only part time for war purposes.

The Tax Certification Sections have held that the proper method of allocation of costs before and after the basic date should be determined by the tax authorities. The Treasury Department Regulations, however, throw no light on this problem.³⁶ The phrasing of the section suggests that the distribution should be made on an engineering basis, with regard to the physical construction actually occurring after the basic date. Since this is usually impracticable, most taxpayers have distributed

³⁶ U. S. TREAS. REG. 103, §19.124-6.

costs before and after the basic date on the basis of costs accumulated on the books, or on work orders kept while construction was in progress. Another possibility is a distribution on the basis of actual expenditures, although this method unduly favors the taxpayer if payments are not made promptly after performance of the work.

Wherever a portion of the basis is excluded from certification, the excess is subject to normal depreciation.³⁷ The regular adjustments to basis prescribed in Section 113(b) must be made, and allocated between the depreciable base and the amortizable base, where both deductions are applicable.³⁸ An adjustment for normal depreciation must also be made for any period prior to the election of amortization.³⁹

A special situation arises where the taxpayer elects amortization with respect to a facility before he has received a Necessity Certificate. Here, the Treasury Department has ruled that no deduction for amortization may be taken for any month prior to the year in which the Certificate is actually issued, but that the amortization period nevertheless starts with the month specified in the election, even though it falls in a prior year.⁴⁰ Thus, a premature election may have the surprising result of increasing the monthly deduction for amortization while shortening the amortization period.

(4) 1942 Amendments

Two other important amendments to the amortization provisions were adopted in the Revenue Act of 1942. The deduction was extended, retroactively, to individuals and partnerships, where it had previously been limited to corporations.⁴¹ The basic date for amortization was regressed from June 10, 1940 to December 31, 1939, thus permitting certification of essential defense installations made prior to the first public announcement of the amortization policy.⁴² Applications for certification of such facilities must be filed before April 22, 1943, and Necessity Certificates therefor must be issued prior to October 22, 1943.⁴³ Taxpayers establishing their right to amortization of costs incurred in this period will be able to obtain refunds of 1940 and 1941 income and excess profits taxes, without interest.⁴⁴ The cost incurred between December 31, 1939, and June 10, 1940, is treated as a separate facility.⁴⁵ Hence, if a corporate taxpayer has failed to apply for certification of a facility completed after June 10, 1940, only the portion of the cost incurred before that date may now be certified.

II. GOVERNMENT REIMBURSEMENT

The Emergency Plant Facilities Contract was an attempt to provide a dual method of financing under which private capital would provide the initial funds, subject to reimbursement by the Government over the assumed period of the emergency. This contract was designed for the type of expansion with a high degree of capital risk, such as powder plants, tank factories and similar facilities with no post-

³⁷ INT. REV. CODE §124(g).

³⁸ U. S. TREAS. REG. 103, §19.124-6, Example (2).

³⁹ *Id.* 103, §19.124-2, Example (3).

⁴³ *Id.* §155(d), (e).

⁴⁴ *Id.* §155(j).

³⁹ *Id.*, Example (1).

⁴¹ Rev. Act of 1942, §155(a).

⁴³ *Id.* §155(e)(2).

⁴⁶ *Id.* §155(e).

war utility. The facilities required for the expansion are listed in detail in the contract. Upon completion of the project, the Government agrees to reimburse the contractor for the cost of such facilities in 60 consecutive monthly payments. Title to the facilities is in the contractor during this period. The contract can be terminated by the Government at any time, or by the contractor under specified conditions. Upon termination, the facilities must be conveyed to the Government, unless the contractor exercises an option to buy them at cost less depreciation or at an agreed price. If the facilities are intermingled with the contractor's facilities, the Government may be required to remove them.

This method of financing has never received wide acceptance. Direct government ownership proved to be more practical for this type of expansion. As of November 30, 1942, only 128 plants had been built with the aid of EPF contracts, involving a total expenditure of \$336 millions.⁴⁶ Nevertheless, they involve an interesting tax problem, which concerns the nature of the reimbursement payments.

The Treasury Regulations⁴⁷ provide as follows:

Amounts received by a taxpayer in connection with its agreement to supply articles for the national defense, though denominated reimbursements for all or a part of the cost of an emergency facility, are not to be treated as capital receipts but are to be taken into account in computing income, and are therefore not to be applied in reduction of the basis of such facility. . . .

Thus, the taxpayer is required to include EPF payments in gross income. As an offset, he may obtain a Necessity Certificate for the expansion, which, in theory, permits him to take a deduction for amortization each month equal to the amount of the reimbursement payment. Actually, the deduction may not be correlated with the income since the term "completion," as used in EPF contracts, appears to refer to the entire expansion, while the amortization deduction, as previously noted, may begin with the completion of individual facilities. To avoid this distortion, the Treasury Department has ruled in some instances that the "facilities" described in the EPF contract may be amortized as a group, thus gearing the deductions to the EPF payments.⁴⁸

The Treasury's position that the EPF contract is not a contract of sale requires some explanation. It is understood that the Treasury feels that the usual EPF contract provisions with respect to ownership of the facilities are ambiguous. The contractor owns the facilities during the period of the contract. The Government does not acquire them unless the contract is terminated, and no specific termination date is prescribed. In some cases, the Government may not be able to obtain the facilities except by removing them, and removal may be impossible or may require destruction of the facilities. In view of this doubt as to ownership, the Treasury Department believes that the substance of the transaction is a payment for war material rather than a purchase of facilities.

⁴⁶ These figures were obtained unofficially from records of the Tax Certification Sections.

⁴⁷ U. S. TREAS. REG. 103, §19.124-6.

⁴⁸ The rulings are unpublished.

Even if this ambiguity exists, it is still difficult to reconcile the Treasury Regulation with a long line of cases holding that a government contribution to the capital of a taxpayer, to be used for the completion of a plant or as reimbursement for similar capital expenditures, is not income to the taxpayer. The leading case is *Edwards v. Cuba Railroad Company*,⁴⁹ in which the Cuban Government contributed money and property to a railroad to aid it in constructing and operating a line over specified routes. Similar cases involve payments by shippers to railroads to obtain the construction of spur track,⁵⁰ contributions by rural residents to utility companies for the extension of electric power lines into their community,⁵¹ and contributions by boards of trade or other public groups to induce new industries to settle in their district.⁵² In none of these cases did the donors of the contribution or subsidy obtain title to the facilities when constructed.

The Treasury Department apparently distinguishes these cases on the ground that the payments for emergency facilities are made primarily to obtain supplies needed by the Government, and thus have the character of payments for goods or services. EPF contracts, almost without exception, are made in connection with supply contracts, and sometimes may be physically incorporated in the same document. Reliance is thus placed on cases in which government payments were held to be operating subsidies or additional compensation rather than capital contributions.⁵³ The soundness of the Treasury's position seems questionable in view of the fact that EPF payments are carefully segregated from supply payments and are expressly conditioned on construction work performed, and the further fact that supply concessions or other preferential treatment to the donor were involved in *Cuba Railroad* and other cases.

Recently, however, there has been some indication that the doctrine of *Cuba Railroad* may be whittled down, at least insofar as it applies to government payments.⁵⁴

⁴⁹ 268 U. S. 628 (1925).

⁵⁰ *Great Northern Ry.*, 8 B. T. A. 225 (1927) *aff'd*, 40 F. (2d) 372 (C. C. A. 8th, 1930), *cert. den.*, 282 U. S. 855 (1930); *Texas and Pacific Ry.*, 9 B. T. A. 365 (1927); *Atlantic Coast Line R. R.*, 9 B. T. A. 1193 (1928); *Kansas City Southern Ry.*, 16 B. T. A. 665 (1929), *aff'd* and *rev'd* on other points, 52 F. (2d) 372 (C. C. A. 8th, 1931), *cert. den.*, 284 U. S. 676 (1931); *Midland Valley R. R.*, 19 B. T. A. 423 (1930), *aff'd*, 57 F. (2d) 1042 (C. C. A. 10th, 1932); *Kansas City Southern Ry.*, 22 B. T. A. 949 (1931), *rev'd* on other issues, 75 F. (2d) 786 (C. C. A. 8th, 1935); *Kauai Ry., Ltd.*, 13 B. T. A. 686 (1928).

⁵¹ *Detroit Edison Co.*, 45 B. T. A. 358 (1941), *aff'd*, C. C. A. 6th, Nov. 30, 1942, 1942 CCH Tax SERV. par. 9778; *Tampa Electric Co.*, 12 B. T. A. 1002 (1928); *El Paso Electric Ry.*, 10 B. T. A. 79 (1928); *Wisconsin Hydro-Electric Co.*, 10 B. T. A. 933 (1928); *Rio Electric Co.*, 9 B. T. A. 1332 (1928); *Liberty Light & Power Co.*, 4 B. T. A. 155 (1926), *Acq.* VI-1 C. B. 4.

⁵² *Arkansas Compress Co.*, 8 B. T. A. 155 (1927); *Holton & Co.*, 10 B. T. A. 1317 (1928), *Acq.* VII-2 C. B. 18; *G. C. M.* 16952, 1937-1 C. B. 133. *Contra*: *A. R. R.* 3513, II-2 C. B. 83 (1923).

⁵³ *Texas and Pacific Ry. v. U. S.*, 286 U. S. 285 (1932); *Continental Tie and Lumber Co. v. U. S.*, 286 U. S. 290 (1932); *Helvering v. Claiborne-Annapolis Ferry Co.*, 93 F. (2d) 875 (C. C. A. 4th, 1938); *Lykes Bros. Steamship Co., Inc.*, 42 B. T. A. 1395 (1940); *cf.* *Boston Elevated Ry.*, 131 F. (2d) 161 (C. C. A. 1st, 1942).

It is interesting to note that if the contractor exercises his option in the EPF contract to purchase the property at cost less depreciation, there is, in effect, a reimbursement to the extent of depreciation sustained, which is a current operating expense.

⁵⁴ See, e.g., *Baboquivari Cattle Co.*, 47 B. T. A. 129 (1942), holding that AAA soil conservation payments, reimbursing a ranch owner for physical improvements to the property, should be included in gross income. Section 19.124-6 is cited in this opinion in support of the result.

If there is a trend in this direction, the Treasury rule may be justifiable in that it encourages the taxpayer to apply promptly for amortization benefits which might otherwise be forfeited by delay.

Perhaps a further reason for the Treasury's insistence that reimbursement for facilities should be treated as income was the possibility that the taxpayer might also be entitled to depreciation (assuming, of course, that the taxpayer retains title). This possibility was foreclosed in the EPF contract by a provision under which, if the payments are held not to be includible in gross income, the taxpayer agrees to exclude the amount of the payments from the basis of the facilities and from the computation of invested capital for excess profits tax purposes. In the absence of a specific agreement, however, the taxpayer contended for the allowance of depreciation, despite the reimbursement.⁵⁵ If the transaction was treated as a gift of the facilities, the taxpayer invoked Section 113(a)(2) which provides that the donee shall take the donor's basis for the property. Or, if it was regarded as a contribution to capital, Section 113(a)(8) provides for the use of the transferor's basis. The Regulations under this section do not limit its application to capital contributions of shareholders but refer to contributions by "any person."⁵⁶ The Government, on the other hand, argued that this result should be avoided by the application of Section 113(b)(1)(A) requiring an adjustment to basis for "receipts . . . properly chargeable to capital account." This dispute has now been resolved by the Supreme Court in the *Detroit Edison* case,^{56a} denying the taxpayer's claim to a depreciation allowance on rural electric facilities for which it was reimbursed by its customers.

III. GOVERNMENT OWNERSHIP

By far the largest share of wartime plant expansion has been made directly for the account of the Government. Within this category are the "cost-plus-fixed-fee" type of construction contracts, the "no profit" contract (usually for equipment installations) and the Defense Plant Corporation contracts. In all of these contracts, the contractor is described as an "agent" of the United States, and purchases are made in the name of the United States. Ownership of the facilities is stated to be in the United States at all times.

Despite the characterization of the contract as an agency, it is doubtful whether such a relationship actually exists. In *Alabama v. King and Boozer*,⁵⁷ the Supreme Court held that a cost-plus-fixed-fee contractor was an independent contractor, and, as such, was subject to a state sales tax on the purchase of lumber for a government construction project. In this instance, the contractor purchased the lumber with his own funds and for his own account (subject to approval of the purchase order by a government contracting officer) and was reimbursed by the Government upon sub-

⁵⁵ The *Detroit Edison Co. v. Commissioner*, No. 675, May 3, 1943.

⁵⁶ U. S. TREAS. REG. 103, §19.113(a)(8)-1.

^{56a} *Arundel-Brooks Concrete Corp.*, 129 F. (2d) 762 (C. C. A. 4th, 1942), holding that the entire cost, including the contribution, may be depreciated by the donee.

⁵⁷ 314 U. S. 1 (1941).

mission of the invoices. While the form of contract has been changed since this decision, so that purchases are no longer made in this manner, the substance of the relationship has not been altered. For this reason, the Treasury Department is inclined to regard government contractors as independent contractors.

Furthermore, the Treasury regards the transaction as a sale of assets used in the trade or business, rather than a sale of capital assets. Under this interpretation, the amounts received from the Government should be treated as ordinary income, and the cost of performing the contract should be taken as a deduction. Again, the Treasury's interpretation seems rather strained, since most war contractors are not in the construction business, and do not themselves construct the facilities. If they are not in fact agents of the Government, they seem rather to be brokers or intermediaries in a casual sale of capital assets. As a matter of fact, the Commissioner ruled, as late as 1940, that a taxpayer realized no income as a result of the receipt of funds from a foreign government to construct facilities which became the property of a corporation wholly owned by the foreign government.⁵⁸

However, it is frequently to the taxpayer's advantage to treat the transaction in the manner favored by the Treasury Department. Some items of overhead which are deductible for tax purposes are not allowable as costs in performing a government contract. If, as a result of such disallowed costs, the taxpayer sustains a loss on the job, it is obviously preferable to treat it as an ordinary loss, not subject to capital loss limitations.

There has also been considerable uncertainty regarding the proper treatment for tax purposes of agreements for operating government plants after construction. The agreements are usually designated leases and provide for rental payments which are ordinarily equivalent to the normal physical depreciation of the property. In many cases, however, the lessee has an option to purchase the property, and the rentals paid are credited upon the purchase price. There may also be a provision for a "cut-off" of the rent when the payments equal the cost of construction. Moreover, the rental payments may be set at a high figure so that payment of the entire cost is reached within a five- or seven-year lease term. In view of these factors, some of the so-called leases closely resemble sales on installment. The question then arises whether the periodic payments are deductible or whether the taxpayer has a capital investment which should be depreciated or amortized. There are several cases on somewhat similar facts which lend support to the conclusion that many such leases are in reality sales.⁵⁹ Nevertheless, it is understood that the Commissioner has entered into closing agreements in several instances that the annual payments will be allowed as current deductions, provided the taxpayer agrees to return as income the excess of the market value of the property over the option price when the option is exercised.⁶⁰ The

⁵⁸ I. T. 3409, 1940-2 C. B. 38. See, also, I. T. 3349, 1940-1 C. B. 11.

⁵⁹ *Watson v. Comm'r.*, 62 F. (2d) 35 (C. C. A. 9th, 1932); *Rankin v. Comm'r.*, 60 F. (2d) 76 (C. C. A. 6th, 1932); *Jefferson Gas Coal Co. v. Comm'r.*, 52 F. (2d) 120 (C. C. A. 3d, 1931); *Goldfields of America, Ltd.*, 44 B. T. A. 200 (1941); *Helser Machine and Marine Works*, 39 B. T. A. 644 (1939); *Robert A. Taft*, 27 B. T. A. 808 (1933); *Alexander W. Smith, Jr.*, 20 B. T. A. 27 (1930).

⁶⁰ These rulings are unpublished.

Commissioner has further ruled that no income is realized by a taxpayer operating a plant owned by a foreign government without payment of any rental.⁶¹

Recently, both the War and Navy Departments have denied applications for Necessity Certificates covering the cost of acquiring facilities from Defense Plant Corporation through the exercise of purchase options in lease agreements. The basis for the denial of such applications is that once the facilities are installed at Government risk and expense, it is not necessary to national defense to transfer them to private ownership. From a fiscal point of view, this result is unfortunate. Furthermore, the reasoning appears unsound if the option is exercised within a reasonable time after completion of the facilities. In such a case, the Government occupies a position not essentially different from that of any building contractor who constructs facilities for the taxpayer. A different case is presented if the option is not exercised until the end of lease term, or when it becomes obvious that the end of the war is close at hand.

CONCLUSION

It is probably optimistic to suppose that the tax problems of wartime plant expansion will result in less litigation after this war than the last. Nevertheless, the Tax Certification Sections and the Treasury Department have made valiant efforts to prevent repetition of some of the errors of World War expansions and to reduce the area of future disputes. In general, the amortization provisions have been liberally construed and fairly administered. In many instances, the administrative agencies have leaned backwards to avoid hardship and inequitable results. Despite minor differences of opinion, some of which have been reviewed herein—perhaps with too much emphasis—taxpayers have every reason to be grateful for the earnest consideration and assistance they have received in the War, Navy and Treasury Departments in connection with their expansion programs.

⁶¹ I. T. 3407, 1940-2 C. B. 36.