THE 1943 REVENUE BILL'S RENEGOTIATION PROPOSALS

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This article, originally planned as a general survey of legislative proposals for amending the Renegotiation Act, has been completely recast as a result of the turn of events of the past few weeks. It is now being rewritten while Congress is in a three-week Christmas recess and is almost entirely devoted to proposals contained in the Revenue Bill of 1943. This bill has run the gauntlet through the House. Just before the recess the Senate Finance Committee completed its hearings and made its recommendations. Thus, before the bill goes to the President for his signature, it remains to be passed by the Senate, the differences between House and Senate must be ironed out in conference, and the action of the conferees endorsed by both Houses.

No one had been so sanguine as to anticipate that renegotiation changes fully acceptable to the Price Adjustment Boards would glide smoothly through the halls of Congress. No statute in recent years has caused so violent an emotional explosion as has the Renegotiation Act. The bitterness and excoriation heaped on renegotiation has mounted steadily in intensity during the past year and the voices of opposition have found an increasingly sympathetic audience in a Congress in which the influence of the Administration has considerably waned.¹ The political swing to the right, foretold by all the omens, has increased the strength of the opposition.

On the other hand, it was not believed that the renegotiation statute would be so severely manhandled by this Congress. The overwhelming majority of the electorate stands firmly behind renegotiation. It is recognized as one of the strongest pillars of the Administration's procurement and economic stabilization program. A platform of taking the profits out of war is one that enjoys unassailable popular support. Reflecting that sentiment, it is inconceivable that Congress would vote to repeal the renegotiation statute in the face of irrefutable evidence that war contractors would reap unconscionable profits were it not for a method of subsequent recapture.

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¹ REPORT OF RENEGOTIATION OF WAR CONTRACTS, SEN. REP. NO. 10, 78th Cong., 1st Sess. (1943) Part 5 (Truman Committee); *Hearings before Committee on Naval Affairs pursuant to H. Res. 30*, 78th Cong., 1st Sess. (1943); H. R. REP. NO. 73, 78th Cong., 1st Sess. (1943) (Report of Committee on Naval Affairs); *Hearings before Committee on Ways and Means on H. R. 2324, 2698, and 3015*, 78th Cong., 1st Sess. (1943).

If renegotiation is to be retained, then logically the only changes that can be made, short of outright repeal, are procedural changes, designed to afford greater protection to the contractor, as by right of appeal. Renegotiation is fundamentally a bargaining process requiring the judgment and discretion of the renegotiators and that discretion cannot be readily fettered by a priori legislative commandments, unless the intent were clearly to shatter the operation of the law. During many closed sessions of the House Ways and Means Committee and the Senate Finance Committee, members of Congress groped vainly for a uniform formula to govern all renegotiation determinations, but finally had to admit that such an attempt to find a solution by formula was completely futile.

The changes proposed by the House Ways and Means Committee and passed by the House did not cut deep into the vitals of the Act. They consisted mostly of refinements in procedure, and gave a right of appeal; the only major change was a broadened exemption covering subcontracts for items which did not constitute a component part of the final military product. The Senate Finance Committee, however, ripped the statute apart and voted changes which would destroy renegotiation as we know it. Mandatory exemptions, principally for standard commercial products, would shrink renegotiation to less than two-thirds of its former size. The function of renegotiation as a pricing mechanism might be nullified by the duty imposed on the renegotiators to determine excessive profits after taxes. Renegotiation would not only be outlawed in future, but it would be declared illegitimate *ab initio* for certain items and contractors hitherto shorn of excessive profits totaling at least \$500,000,000 for those items could claim restitution as if for illegal exactions for the sums repaid as excessive profits.

This is not reform—it is repeal. If 50% of the coverage by articles of renegotiation is cut away, that is 50% repeal. If 50% of excessive profits are declared immune from recapture, that, too, is 50% repeal. To label the changes recommended by the Senate Finance Committee as renegotiation revision is a misuse of terminology, a disguise to becloud the real issue, when the palpable effect is one of repeal. Members of the Senate Finance Committee during Committee hearings openly expressed their aversion to renegotiation as a whole. There is a well-informed belief that the Committee, cognizant of its inability to drive repeal through Congress, decided as an alternative on outright emasculation.

If the vitality of renegotiation is to be preserved, then the Senate version will have to be "toned down" to conform to the lines laid down by the House bill. The Administration will exert every influence toward that end, using the potent threat of veto. The testimony of industrialists favorable to renegotiation will be cited in its support. Among the enlightened business community there has developed a recognition that renegotiation repeal is unwise since it removes from the brow of business its wartime crown of thorns, its sole claim to martyrdom and equality of sacrifice. According to this view, it is wiser for industry to endure the travail of

renegotiation for a short period during the war than to carry for an indefinite post-war period the stigma of profiteering.

This article will discuss the changes proposed by the House and the Senate Finance Committee under three sections:

1. Limitations on the scope of renegotiation.
2. Substantive changes in the actual techniques of renegotiation.
3. Procedural and administrative changes.

NARROWING THE SCOPE OF RENEGOTIATION

Scope of Existing Renegotiation

Under existing law, contracts or subcontracts are subject to renegotiation if they satisfy these four tests:

(1) Do they cover goods other than raw materials, or raw materials in their first stage of processing? A contract or subcontract for the output of a mine, oil or gas well or other mineral or natural deposit, or timber is exempt from renegotiation provided the raw material has not been refined, processed or treated beyond the first form or state suitable for industrial use.

(2) Are the goods to be purchased ultimately by the War, Navy, Treasury Department, Maritime Commission or the Reconstruction Finance subsidiaries—Defense Plant Corporation, Metals Reserve Company, Defense Supplies Corporation, and Rubber Reserve Company?

(3) Are the aggregate sales to the Government, either directly or ultimately, in excess of \$100,000?

(4) Was final payment made or is it to be made after April 28, 1942?

The Army, Navy, Maritime Commission, Reconstruction Finance Corporation, and Treasury are directed to insert renegotiation clauses only in contracts for an amount in excess of \$100,000. However, contracts or subcontracts for these agencies are subject to renegotiation even without the existence of any renegotiation clause, unless they do not exceed in the aggregate \$100,000 for the contractor's fiscal year. If the contractor's aggregate sales plus the aggregate sales of all persons under his control or under common control (i.e., subsidiaries) on contracts or subcontracts with the Army, Navy, Maritime Commission, R.F.C. and the Treasury do not exceed \$100,000 for his fiscal year, he is then exempt from renegotiation.

These are the mandatory exemptions under the present Renegotiation Act. In addition, the Department head in his discretion may exempt from some or all of the provisions of the Act either individually or by classes or types the following contracts or subcontracts:

1. *Geographic limits*—Contracts or subcontracts to be performed outside of the territorial limits of the United States or in Alaska.

2. *Short-term contracts*—Contracts which can be performed within a period of thirty days.

3. *Stock items*—Where the actual costs are known and the profits can be determined with reasonable certainty at the time a firm price is set (as in the case of contracts for personal service, purchase of real property, perishable goods, commodities for which a minimum price has been set by a public regulatory body, leases and license agreements, etc.).

4. *Other protection against excessive profits*—Contracts providing for revision of prices on the basis of experience, and contracts providing for sharing of reduction of costs between the Government and the contractor, are examples. Such contracts include those which provide for forward pricing. It would also cover cost-plus-fixed-fee contracts and those lump-sum contracts which contain price redetermination provisions requiring a price adjustment by formula.

Virtually every subcontract and sub-subcontract is subject to renegotiation. Every tier of subcontractors, no matter how far removed from the prime contractor, can be reached. Subcontracts are broadly defined to include any purchase order or agreement to perform all or any part of the work or to make any article required for the performance of another contract or subcontract. Thus, the term includes any services and articles supplied, including "any materials, part, assembly, machinery, property, or other personal property." It includes catalysts, lubricating oils, abrasives, and similar supplies. It includes even small supply contracts for less than \$1,000 if the seller's sales for use on Government contracts aggregate \$100,000. Contracts for machine tools and similar capital equipment are subject to renegotiation.

Raising the Floor to \$500,000

Both the House and the Senate Finance Committee have recommended an amendment exempting specifically from the Renegotiation Act all contractors and subcontractors whose renegotiable sales are under \$500,000 a year—at the present time the ceiling is \$100,000 a year. The War and Navy Departments have endorsed this proposal.

This amendment, if passed, will not mean that a single contract standing by itself of less than \$500,000 will be exempted from renegotiation; all contracts or subcontracts held by a single contractor are added in the aggregate to determine whether they come within the exemption.

Under the present law, the Army, Navy, Maritime Commission, and Treasury are directed to insert renegotiation clauses only in contracts for an amount in excess of \$100,000. However, contracts or subcontracts for these agencies are subject to renegotiation even without the existence of any renegotiation clause if they exceed in the aggregate \$100,000 for the contractor's fiscal year. The contracts and subcontracts are added up on a horizontal basis. Thus a company may be a prime contractor at \$75,000, a subcontractor at \$15,000, and a sub-subcontractor at \$20,000. Since the total of the Government contracts and subcontracts held by the individual total more than \$100,000, all these contracts are subject to renegotiation even in the absence of a renegotiation clause.

There are two arguments advanced in favor of the exemption.² In the first place, it would greatly reduce the administrative load since it is estimated that 17% of all contractors now subject to renegotiation would be excluded. In the second place, renegotiation works a particular hardship on small businesses which are not readily able to bear the burden of renegotiation. Companies with dealings of \$10,000 a week or so generally do not have accounting and legal staffs of any size set up; consequently, segregation of renegotiable sales and costs of their sales cannot be readily checked. On the negative side of the proposal, however, it has been pointed out that small contractors might deliberately turn down a contract which would carry them over the \$500,000 mark and thus expose their profit picture to surveillance with a view to possible recapture. Again, the exemption, if enacted, might work an unfair discrimination against the large contractor since inordinately large profits may just as readily result from small contracts as from large ones.³

² In favor of the exemption, see the testimony of Under Secretary of War Patterson, *Hearings before Committee on Ways and Means, supra* note 1, at 798 (Part 9). Against the exemptions, see H. R. REP. No. 733, *supra* note 1, at 12.

³ Another approach to the setting of a higher floor for renegotiation has been advanced in a bill (S. 1366, 78th Cong., 1st Sess. 1943) introduced by Senator Hatch, Chairman of the Truman Committee which investigated renegotiation some months ago, which adds an exemption by formula to the present exemptions. To qualify for this flexible exemption, a contractor must meet two tests: (a) His profits before deduction of Federal income and profit taxes must not exceed 8% of his total sales; and (b) his total sales must not be more than three times his average total sales during the base years 1936 to 1939 inclusive. While recognizing that no exact formula for computing the proper amount of renegotiation refunds is equitable or possible, Senator Hatch argues that experience shows that such an exemption formula will expedite renegotiation and at the same time free businessmen from much existing uncertainty in formulating business policies and plans. The formula is based on the experience of the past year and a half. The 8% minimum profit was selected since the profit realized after renegotiation generally has exceeded this figure. Similarly, the "three times average base period sales" exception covers most of the cases in which profits were renegotiated to a figure below 8%.

An analysis was made of the 683 War Department cases cleared prior to July 29, 1943, without recapture of any excessive profit. Four hundred and sixty-nine of the 683 cases involve profits of 8% or less on all sales, including non-renegotiable as well as renegotiable sales. Three hundred and thirteen of these cases likewise would have met the "three times average base sales" test so that under the formula almost half of this "non-recapture" group of contractors could have determined this fact in advance. At the same time, an analysis of more than 3,000 War Department cases in which recaptures were effected was prepared which shows that only in 163 of these were the contractors left after renegotiation with less than an 8% profit on total sales. Only 30 of these 163 cases would have avoided renegotiation by reason of total sales being less than triple the average realized during the base years and all of these 30 were small contractors. The total recovery from all 30 was \$847,500 and the maximum from any one \$90,000. According to Senator Hatch, 75% of the \$847,500 would have been recovered under the Excess Profits Tax Law, but the Army Price Adjustment Board estimates this figure at between 60% and 70%.

Contractors who have started business since 1936 will find the profit exemption of little benefit. If they commenced business after December 31, 1938, they are not entitled to the exemption. Although entitled to the exemption, moreover, contractors and subcontractors who began business between December 31, 1935, and January 1, 1939, probably in the vast majority of cases will not come within the exemption since the base period is from the date business was actually commenced to December 31, 1939. A new business takes time to get rolling and even in a normal market a substantial yearly increase in sales could be expected.

Under the Hatch Bill, no change is made in the present exemption extended to contractors whose prime and subcontracts aggregate less than \$100,000, for the fiscal year. The 8% profit exemption is superimposed over this. In other words, there would be two exemptions: (1) Contractors with aggregate sales of less than \$100,000 for the fiscal period; and (2) contractors with profits of 8% or less

Exemption for Standard Commercial Articles

The House passed a provision granting discretionary authority to the War Contracts Price Adjustment Board, a new Board set up under the 1943 Act to exempt from renegotiation standard commercial articles, if, in its opinion, normal competitive conditions existed affecting the sale of such articles. This was a weak compromise on this controversial proposal since the Price Adjustment Boards, standing in firm opposition to such an exemption, would rarely, if ever, choose to exercise the privilege. The Senate Finance Committee, however, has recommended that the exemption be made absolutely mandatory on the Boards, thereby reducing the orbit of renegotiation by at least a third.

The term "standard commercial article" is defined in this manner under the House bill:

"(A) Which is not specially made to specifications furnished by a Department or by another contractor or subcontractor,

"(B) Which is identical in every material respect with an article which was manufactured and sold, and in general civilian, industrial, or commercial use prior to January 1, 1940.

"(C) Which is identical in every material respect with an article which is manufactured and sold, as a competitive product, by more than one manufacturer, or which is an article of the same kind and having the same use or uses as an article manufactured and sold, as a competitive product, by more than one manufacturer, and

"(D) For which a maximum price has been established and is in effect under the Emergency Price Control Act of 1942, as amended, or under the Act of October 2, 1942, entitled 'An Act to amend the Emergency Price Control Act of 1942, to aid in preventing inflation, and for other purposes,' or which is sold at a price not in excess of the January 1, 1941, selling price. An article made in whole or in part of substitute materials but otherwise identical in every material respect with the article with which it is compared under subparagraphs (B) and (C) shall be considered as identical in every material respect with such article with which it is so compared."

The Senate definition struck out paragraph (A) so that an article especially made to specifications of the contracting department would nonetheless be considered as a standard commercial article.

The range of commodities encompassed within the definition is not too definite. It would clearly cover manufactured textiles, lumber, shoes, operating tables, sterilizers, artificial teeth, X-ray equipment, etc., which are in general civilian use. It

whose sales are less than triple the average base period sales. If Congress sees fit, the provisions of the Army-Navy sponsored bill—H. R. 2324—raising the \$100,000 exemption figure to \$500,000 can be written into the Hatch Bill.

might also apply to many tools, most plates, shapes and forms, many engines, welding equipment, and thousands of the component parts like bearings and nuts which go into finished war products. For example, a motor in a jeep may very well be a standard commercial product to the same extent as a toothbrush.

Two reasons are given by the advocates of a provision to grant mandatory exemption for all standard commercial articles:

1. Costs of such standardized articles are so well known that contracting officers are able to work out contract prices which avoid excess profits. These articles were produced long before the war and peacetime competition compelled standardization of production costs.

2. OPA price ceilings which are imposed on such commercial articles are sufficient to prevent a contractor from reaping undue profits.

Opponents of the amendment are quick to make the rebuttal. In reply to the first point, they state that the huge volume of production necessitated by war demands has tobogganed unit costs so that production costs now bear little resemblance to what they were before the war. With shifting labor and material costs, amid all the uncertainties of war production, a contracting officer cannot predict with any certainty what unit production costs are going to be for standard commercial articles based on the arithmetic used in the past history of the firm.

In answer to the second point, the Government spokesmen point to the fact that the OPA price ceiling is ineffective to limit the huge profits of the low-cost, efficient producer. Under the bulk-line principle of pricing, which was used in the last war and is the approach applicable today, the ceiling is placed at the level of the highest cost marginal producer whose output is necessary to maintain the minimum war or essential civilian supplies. As unit costs drop, the producer obtains a windfall profit as the ceiling stays intact—in the absence of a differential pricing method the price ceiling actually guarantees a return, dollar for dollar, for any reduction in production costs, dependent or independent of the contractor's efforts.

The price ceiling sets the maximum for which the producer can sell the commodity. The OPA advises him that he is permitted to sell below the ceiling, but this encouragement is thrown to the wind. In a seller's market, few producers will sell below the ceiling price. In a peacetime market with competition the price is driven close to cost. In a wartime market, any resemblance between the ceiling price and the cost to the producer selling within the ceiling is purely coincidental.

The following figures show the excessive profits which have been realized in certain standard goods industries. These companies, it should be noted, are engaged principally in subcontracting and are substantially all of those in these classifications which have been renegotiated by the War Department. These cases represent what has happened in standard product businesses as a result of the war and are examples of the profit results of volume increases before taxes.

[000 omitted]

	1942	Average 1936-39	Increase	Percent increase
Perishable tools, 19 companies:				
Sales.....	\$172,011	\$29,418	\$142,593	485
Profit before renegotiation and taxes.....	\$62,010	\$5,025	\$59,985	1,134
Percent profit.....	40.0	17.1	22.9	128
Woolen textiles, 25 companies:				
Sales.....	\$237,782	\$98,030	\$139,752	143
Profit before renegotiation and taxes.....	\$31,985	\$3,245	\$28,740	885
Percent profit.....	13.5	3.5	10.2	309
Lumber, 10 companies:				
Sales.....	\$106,677	\$42,228	\$64,449	153
Profit before renegotiation and taxes.....	\$25,908	\$4,991	\$20,917	419
Percent profit.....	26.1	11.8	14.3	121
Cotton textiles, 53 companies:				
Sales.....	\$548,633	\$207,185	\$341,448	165
Profit before renegotiation and taxes.....	\$76,209	\$8,467	\$67,742	800
Percent profit.....	13.9	4.1	9.8	239

As a specific example, one company, and not by any means the most unusual, did an average volume of business from, 1936 to 1939, of \$16,500,000. It earned an average dollar profit, before income taxes, of \$1,220,000, at the rate of 7.4 percent on sales. In 1942, its sales were nearly \$50,000,000, its profit before tax \$12,500,000, and its earning rate 25 percent on sales. It would be difficult to conclude that this manufacturer of a standard product under Office of Price Administration price ceilings was not benefiting from the war to an unreasonable degree.

Under the Renegotiation Act, the Secretaries of the Army, Navy, Treasury, or the Chairman of the Maritime Commission have full discretion to exempt contracts for stock items where the actual costs are known and the profits can be determined with reasonable certainty at the time a firm's price is set. Exemptions have been allowed for contracts for perishable goods and for certain contracts and subcontracts with public utilities and common carriers. Price Adjustment Boards have indicated their complete willingness to extend this exemption to any production where, on the basis of the facts presented, it seems administratively wise. However, they resist any blanket exemption beforehand by statute. Such a procedure would open the door to a competition between various industries to put the most political pressure on Congress to include them within the exemption and would be like a tariff logrolling contest all over again.

Note the fact that under this provision for exemptions within the discretion of the Secretaries of the various departments, the forward pricing method has been adopted. A contractor who wishes to get a fixed price for future deliveries not subject to renegotiation and who can establish his costs with reasonable certainty can obtain the dispensation of forward pricing free from renegotiation. Producers of standard commercial articles can take advantage of this opportunity. The contractor must, however, fix his price on a comparatively narrow margin of profit,

because, based upon his own statement, his costs are definite and his risks are therefore negligible.

Exemption for Subcontracts for Non-Component Parts

The House bill narrowed the scope of the present Act by eliminating from renegotiation auxiliary contracts, that is, contracts for articles or services not going into an end product or a component thereof. This change was accomplished by defining subcontract in Subsection (a)(5)(A) as follows: "Any purchase order or agreement (other than a contract with a department) to make or furnish or to perform any part of the work required for the making or furnishing of a contract item or a component article." The bill then defined a component article as: "Any article which is to be incorporated in or as a part of a contract item." Under the House bill, this change was confined to fiscal years closing after June 30, 1943. The Finance Committee bill, however, made this provision retroactive to April 28, 1942, annihilating the effect of the law altogether for these articles. This would require refunds totaling over \$500,000,000 to industries such as machine tools, factory and mill supplies, construction equipment, cranes, hoists, and other industries operating under contracts or subcontracts for auxiliary articles.

In a limited study of 60 relatively small subcontracts, the Army Price Adjustment Board estimated that \$72,883,000 of recoveries would have to be refunded, re-establishing margins of profit ranging all the way from 17.7 cents on each dollar of sales to 54.2 cents on each dollar of sales. After giving effect to taxes, net refunds to these subcontractors would amount to \$13,228,000. None of these companies is very large. It has not been determined what would have to be refunded to subcontractors such as General Electric, Western Electric, General Motors and other large subcontractors.

Additional Exemptions Under the Bill

1. *Agricultural Commodities.* The House bill made mandatory an exemption for agricultural commodities on the same basis as the previous exemption for raw materials. The exemption reads as follows: "Any contract or subcontract for an agricultural commodity in its raw or natural state, or if the commodity is not customarily sold or has not an established market in its raw or natural state, in the first form or state, beyond the raw or natural state, in the first it is customarily sold or in which it has an established market, or any contract or subcontract for canned, bottled, or packed fruits or vegetables (or their juices) which are customarily canned, bottled, or packed in the season in which they are harvested. The term 'agricultural commodity' as used herein shall include but shall not be limited to—

"(i) Commodities resulting from the cultivation of the soil such as grains of all kinds, fruits, nuts, vegetables, hay, straw, cotton, tobacco, sugar cane, and sugar beets;

"(ii) Saps and gums of trees;

"(iii) Animals such as cattle, hogs, poultry, and sheep, fish and other marine life, and the produce of live animals, such as wool, eggs, milk and cream."

The Finance Committee continued the House exemption of agricultural commodities, but added to the list of such commodities as contained in the House bill: "Any contract or subcontract for a canned, bottled, packed, or processed dairy product or any product, the principal ingredient of which is a dairy product."

The Price Adjustment Boards are opposed to the exemption for seasonal canned, bottled or packed fruits and vegetables and for dairy products. However, the exemptions as a whole give legislative ratification to the present practice of Price Adjustment Boards which have issued a long list of exempt agricultural products. In granting such exemptions, the Boards acted on highly tenuous grounds. Although they assumed to act under the provision authorizing the Secretary to exempt contracts where the profit was definitely determinable in advance, it was doubtful that their action fell technically within the statutory provisions. In view of the fact that the legislative exemption follows closely the administrative practice, the Departments recommended that the exemption be made retroactive to April 28, 1942, and this suggestion was adopted in the bill.

2. *Charitable Institutions.* The House and Senate bills exempted any contract or subcontract with an organization exempted from taxation under Section 101(6) of the Internal Revenue Code. The Departments have recommended that this exemption be made retroactive and the bills so provide.

3. *Public Utilities.* The Finance Committee bill exempts from renegotiation, effective for fiscal years closing after June 30, 1943, contracts or subcontracts with a public utility to furnish gas or electric energy or with a common carrier to furnish transportation, when made at published rates or changes fixed or approved by a public regulatory body. This provision is in accord with present practice of the Boards.

4. *Construction Contracts.* The Finance bill exempts contracts with a Department, awarded as a result of competitive bidding, for the construction of any, building, structure, improvement or facility.

5. *Production Directives.* The Finance bill exempts any contract or subcontract for an article made or furnished in obedience to a directive of the War Production Board at or below ceiling prices. This provision is made retroactive to April 28, 1942.

6. *Exempted Contracts.* Any subcontractor directly or indirectly under a contract or subcontract which is exempted from renegotiation by virtue of the Act is also made exempted.⁴

⁴Present bills do nothing to enlarge the areas of renegotiation despite some pressure to encompass a greater area within the renegotiation framework. The largest of these areas is the purchasing activities of the Department of Agriculture. Its contracts between March 12, 1941, and March 31, 1943, amounted to \$1,661,318,152.32. To some of its purchases, such as its parity, soil conservation and subsidy programs, renegotiation cannot be applied. On the other hand, renegotiation would be readily applicable to purchases of commodities like dehydrated foods, dried eggs, concentrated citrus juices, meats and other commodities. In many of these contracts, the Government has built facilities for the contractor, the

SUBSTANTIVE CHANGES IN RENEGOTIATION

Standards in Determining Excessive Profits

The new Renegotiation Act will set forth the standards which are to guide the Price Adjustment Boards in determining excessive profits. The House bill contains the following standards:

1. Efficiency of the contractor, with particular regard to the attainment of quantity and quality production, reduction of costs, and economy in the use of raw materials, facilities and manpower.
2. Reasonableness of costs and profits, with special regard to the volume of production and to normal pre-war earnings.
3. The amount and source of public and private capital employed, and the net worth.
4. The extent of the risk assumed, including the risk incident to reasonable pricing policies.
5. The nature and extent of the contractor's contribution to the war effort, including contributions and cooperation with the Federal Government and with other contractors in supplying technical assistance.
6. The character of the business including the complexity of manufacturing technique, the number and extent of subcontractors, the rate of turnover, and the potential financial burden to reconvert to peacetime production.

The Senate bill changed the second standard to read as follows: "Reasonableness of cost and profits with particular regard to volume of production and normal pre-war earnings and comparison of war and peacetime products." This change

costs of operation were unknown as the contracts were entered into, and in the execution of the contract became later ascertainable. According to the Vinson Bill, the Secretary of Agriculture would be specifically authorized to renegotiate such contracts. In determining the existence of excessive profits, however, he will not act where the determination would conflict with the purpose of any program or regulation relating to prices of agricultural commodities or commodities processed in whole or in part from them.

The House Naval Affairs Committee has recommended that the Act be broadened to cover Lend-Lease contracts, since a survey made by the Committee discloses that large profits—in some cases as much as 100% in relation to cost—were made by American contractors on these contracts. Many of these contracts are on the same footing as domestic contracts since the "take-over" agreements entered into between the War Department and the British and Netherlands Governments at the start of the war provided for a purchase by the United States from the foreign governments of the articles covered by the contracts at the prices fixed by contracts which those governments had with American contractors.

The Committee also favors the renegotiation of all contracts made by Government agencies, even though not specifically covered by the Act, if the head of any department believes that a contract made by that department will yield excessive profits, the task of renegotiation will be assigned to the Secretary of the Treasury in the same manner and with the same authority as if the contract had been entered into with the Treasury. Thus, contracts let by the central administrative services of the Office of Emergency Management, the Office of War Information, National Housing Agency, the Office of Economic Warfare and the Office of Strategic Services would be included within the Act. However, to avoid confusion if each of these agencies were permitted to carry on renegotiation, the task would be entrusted to Treasury. This provision is included in the pending Vinson Bill. The House Naval Affairs Committee additionally has recommended that the Renegotiation Act be clarified so as to indicate its applicability to all contracts entered into by the Treasury Department and not merely those for Lend-Lease account. The General Counsel of the Treasury Department has administratively removed from renegotiation purchases made by Procurement Division of Treasury for other agencies such as War Production Board, War Manpower Commission, Office of Price Administration, etc.

was made at the request of the Price Adjustment Boards. It would enable the Boards to hold down profits to the same comparative level as during peacetime. However, it would not bind the Boards to use peacetime profits as a guide for a firm whose production had radically changed so that its peacetime and wartime production are in no way comparable. Additionally, it emphasizes the fact that a contractor is entitled to a higher profit rate if he has converted peacetime machinery to turn out war goods for the Government. Contractors who use converted machines are apt to incur higher costs, produce at a slower rate, turn out poorer quality and use more materials. If these adverse factors can be explained by cooperation with the Government objective to make full use of existing equipment, Price Adjustment Boards will make a suitable extra allowance to the contractor to compensate for the disadvantages he has suffered in converting to war production.

The Senate Finance Committee also added two standards which are discussed immediately below.

Determination of Excessive Profits After Taxes

In renegotiation the profit allowed is a profit before taxes rather than after taxes. Price Adjustment Boards will not adjust profits upwards to take care of war taxes. If, however, the weight of taxes would practically wipe out profits, or leave inadequate funds to meet working capital needs, or obligations falling due, some consideration may be given to the profits-after-taxes picture. It is worthwhile for a contractor to bring it up in a renegotiation proceedings although it is doubtful that it will be any substantial kind of a determining factor. It is, however, the policy of the Price Adjustment Boards to scrutinize the position of the contractor after taxes in order to provide where necessary reasonably deferred installment payments to reduce the burden of the contractor in satisfying the obligation imposed by renegotiation.

There has been tremendous pressure from industry to swing over from the criterion "before taxes" to that of profits "after taxes" as a basis of determining excessiveness of profits in war business. The Disney Subcommittee of the Ways and Means Committee recommended to the full Committee a provision that Price Adjustment officials be instructed to consider the effect of renegotiations on profits after taxes. However, the full Committee voted against this proposal thus approving the position of the Price Adjustment Boards that excessive profits are to be determined without regard to the taxes that are payable with respect to those profits.

The Senate Finance Committee reversed the picture. It added a clause that in determining excessive profits, the Price Adjustment Boards shall take into consideration: "Whether the profits remaining after the payment of estimated Federal income and excess profits taxes will be excessive."

A genuine after-taxes basis would operate by allowing taxes as a full-fledged cost item. The Price Adjustment Boards would first set a figure representing a fair

profit allowance by the general approach in which the starting point is a comparison of percentage of net sales during the renegotiated year and the percentage of sales during the base period 1936 to 1940. Various modifications and variables would then be employed either to increase or decrease the profit allowance or as a check on reasonableness. After arriving at this figure, the Boards, on an after-taxes approach, would allow a sufficient amount to that after Federal taxes are paid, the contractor would be left with the profit allowance completely free and clear of the tax burden. Thus, if the Board determined that a firm making \$100,000 profit for the year was entitled to a reasonable profit of only \$20,000, it might allow as profit \$50,000 if the firm had to pay out 60% of the \$50,000 in taxes. Thus, the difference representing the excessive profits on a before-taxes approach would be \$80,000, but on an after-taxes approach would be only \$50,000. The renegotiators on that basis would be paying out \$30,000 to the contractor as a cost item to balance out his taxes. If another contractor had a heavier tax rate, and required \$60,000 in order to have \$20,000 free of taxes, the Board in that case would be paying out \$40,000 to the second contractor. The Price Adjustment Boards would obviously be equalizing the tax burden as between different contractors by allowing as a cost a larger amount to the firm paying the larger tax.

If the Finance Committee had intended that taxes should be treated as a cost item or that profits should be calculated free and clear of taxes, that intent could have been clearly effectuated by an explicit statement to that effect. On the contrary, however, it was not so stated, but it was merely listed as one of the standards to guide the Boards in determining excessive profits. These standards are used as compensatory factors to inflate or deflate a basic preliminary figure which is arrived at by comparison of percentage of net sales in the pre-war and war years. It is impossible to treat the after-taxes instruction in the way it is phrased as a factor only to be used to increase the basic figure in the same way as efficiency of the contractor, extent of his risk, his contribution to the war effort, etc. If the approach were definitely that taxes were to be treated as a cost, a firm earning \$50,000 if it had to pay \$30,000 out in taxes could not be renegotiated further if \$20,000 were a sum commensurate with a fair profit allowance. On the other hand, if the after-taxes rule is to be treated merely as a guide affecting the final profit allowance, the Price Adjustment Board would be free to treat a figure around \$20,000 as a reasonable profit margin, and then increase that figure because of the taxes that the contractor must pay. However, it is difficult to see any justification for increasing the \$20,000 for taxes other than to pay the taxes on the \$50,000. This would put the Board back to a thorough after-taxes basis. Thus, despite the fact that the after-taxes provision is stated merely as a guide to the Boards, it seems inconsistent with any position other than as a prime determinant as to whether any excessive profit remains for renegotiation, and if it does, then a mandatory requirement that a sufficient allowance be added to the reasonable profit so that the contractor can receive it in full without further deductions.

Industry states its case for the use of the "after taxes" standard in this way: Businessmen never think of profits before taxes; profit to a businessman is net realization—it is not net profit or profit after taxes, since taxes are regarded like wages or material costs as part of the expense of doing business. When the Government determines that a sum is proper as a profit allowance, and uses a sum before taxes, it is using a figure which is completely arbitrary and fictitious. Businessmen complain that any survey of earnings figures will show a dip in 1942 below 1941 and there will probably be an even greater dip for 1943 because of the increase in tax rates. They claim that they are working longer and harder and netting less because of the failure of the Price Adjustment Boards to consider the "after taxes" picture, thus helping to promote a gross inequity.

To the plea of industry, Price Adjustment officials turn a deaf ear and present an imposing array of arguments in defense of their position:

1. If it were true that contractors are realizing a net profit less than in 1941 or even in a year prior to 1941, they would have no legitimate complaint. The loss of the right of making money is comparatively a slight sacrifice to ask of a citizen in wartime. If profit were calculated after taxes, business would in effect receive special treatment since it would be exempted from the added burden that each taxpayer must absorb in wartime. Business in effect would be given a bonus in order to pay taxes.

2. Renegotiation after taxes would hamper the functioning of Price Adjustment Boards as part of the procurement agencies. It is the duty of the Boards to reduce contract prices to amounts which are reasonable; the reasonableness of a contract price does not depend upon the amount of taxes the contractor must pay.

In his testimony before the Ways and Means Committee Under Secretary of War Patterson gave a graphic illustration to show how calculation of profits after taxes would render the renegotiation process impotent in many cases. Suppose there are two contractors, A and B, each making the same article, for example a rifle sold to the Government at a price of \$100 per rifle, and each contractor having the same unit costs with the single exception of Federal taxes. Assume that the costs before taxes in each case amounted to \$70 per rifle but that in the case of Contractor A the Federal taxes on the \$30 profit realized on each rifle amounted to \$12 and that in the case of Contractor B the Federal taxes amounted to \$24.

Under the present practice, assuming that a 15 per cent margin over cost represented a reasonable profit, both Contractor A and Contractor B would be allowed a profit before taxes of approximately \$10 and would be required to reduce their prices of future deliveries to approximately \$80 per rifle. On the other hand, if renegotiation were to be based upon profit remaining after taxes and an equal amount should be left to each contractor, if Contractor A were to be given a price of \$80, leaving him a profit of approximately \$10 before taxes and \$6 after taxes, it would be necessary to allow Contractor B to continue his present price of \$100,

giving him a profit before taxes of \$30 and a profit after taxes of \$6, the same as that received by Contractor A.

3. The Price Adjustment Boards in an "after taxes" basis would become tax boards. A switch to an "after taxes" basis would involve the juggling of tax rates and the equalization of taxes between contractors. This is the function of Congress and not the Price Adjustment Boards. Such a procedure would result in having the Government pay the contractors' wartime income taxes and would relieve them from the additional taxes which Congress has imposed on them. The Government would thus be chasing itself around the circle.

4. The effect of an "after taxes" basis would vitiate the will of Congress as expressed in the excess profits tax with respect to the varying impact of tax rates on taxpayers entitled to different excess profits credits. Congress proclaimed the policy of considering excess profits before taxes by the terms of the Revenue Bill of 1941 which changed the prior tax law allowing the income tax as a deduction in computing the excess profits tax. The Committee on Ways and Means at the House in its report on the bill stated: "It seems unfair to allow that part of the income tax which is computed on income which is not subject to the excess profits tax to reduce the excess profits net income. This Committee has therefore deemed it advisable to return to the 1918 ruling and has disallowed the deduction of income taxes both in the base period and in the taxable year in computing the excess profits tax."

The varying tax bases under the Excess Profits Tax have been one of the chief spurs to the movement to base renegotiation after taxes. On that approach, the Price Adjustment Boards would be equalizing the tax law by making a greater allowance to the firm which has to pay the greater tax. Renegotiation would thus be partial to firms which are handicapped under the tax law. A corporation with a small amount of invested capital and smaller earnings in the base years pays a higher tax on the same amount of profit than does a corporation which in its base years had a larger amount of invested capital and earnings. Thus aircraft companies which were not mass producers and had little invested capital and earnings in the pre-war years get a smaller profit per plane than do the established companies with a more favorable tax base. However, this is exactly what the Revenue Act intended, since Congress wanted to put a higher tax on profits which were the outgrowth of war production.

Maurice Karker, Chairman of the War Department Price Adjustment Board, explained how the "after taxes" approach would hamper the operation of the excess profits tax: "Federal taxes, and particularly the excess profits tax, have peculiarities derived at least in part from the alternative basis allowed for figuring the amount of the tax. The tax currently paid by a corporation is dependent not only on its earnings for its current year, but substantially upon its earnings during its base years or upon its invested capital. Its current tax may likewise be substantially modified or entirely eliminated by loss carry-over from a prior year. Changes in

ownership or management or increased efficiencies with present outstanding contribution to the war effort, might, nevertheless, if renegotiation considered earnings after taxes, fail to receive comparative reward in renegotiation as against a company with a high earnings record and present inefficiencies. A company which manufactured a patented product or an item made under a secret process or otherwise produced under a peacetime monopoly, with resultant extreme profits during the past years, would be allowed inordinate profits on production for war, even though the nature of its present production might be entirely different from its peacetime production and even though extravagance and waste mark its current operations. The inequalities and inequities of pricing, whether initially or in renegotiation, based upon the taxes paid by the contractor, thus are obvious."

5. It is recognized that use of the "before taxes" method is a valuable aid in curbing inflation. If a contractor can raise his price to cover increased taxes it is as if Congress with its right hand were setting up a pricing and procurement agency and at the same time with its left hand establishing a tax law which operates to counteract or nullify the purpose of the price and procurement agency. Following this principle, OPA has consistently followed a "before taxes" rather than "after taxes" approach in setting industrywide ceilings and similarly has refused to countenance an individual price increase in order to offset the heavy tax burden.

6. The "after taxes" approach would make it impossible to carry on renegotiation because the correct tax for the fiscal year involved may not be known for some time. Thus the excess profits tax law has carry-back provisions, general relief provisions, inventory adjustment provisions, and the provisions allowing revision of tax returns on termination of the war for the purpose of modifying the amortization allowance under Certificates of Necessity. Because of these provisions, the true excess profits tax may not be known for several years. Additionally, even if they were definitely known at the end of the year, it would be impossible for the price adjustment official to carry on the forward-pricing method under the statute.

A more complicated question arises in connection with the recognition of the effect of state taxes on renegotiated profits. The question is whether the renegotiation boards should give a credit for the amount of state taxes paid on profits which have been shaved off on its review. The policy of the boards is to allow full credit for state taxes only where the state will not make a refund after renegotiation; in all cases an actual credit is given to the contractor but where it is possible under state law to obtain a refund from the state treasury, the renegotiation agreement will contain a provision that the contractor must apply within ten days and then turn the refund back to the Federal Government. This practice is opposed by the National Association of State Tax Administrators which has petitioned Congress to set up a uniform procedure. There is a lack of uniformity in the practice of various states. Arkansas does not permit a refund of corporate taxes and therefore the full amount paid is treated by renegotiation officials as a non-

recoverable expense. New York, however, permits refunds to be claimed within a reasonable period. Connecticut allows refunds resulting from renegotiation to be claimed if the contractor cannot secure credit from the Federal Government for the taxes. Thus in no case is the burden put upon the contractor but it operates harshly, it is claimed, on states like New York in which taxes have frequently been spent, since the state acts as a collection agency for local communities and distributes a substantial portion of its corporate taxes to these communities upon collection. The difficulty and costliness of making refunds threatened to induce all states to protect themselves by provisions refusing refunds.

It has been proposed by the National Association of State Tax Administrators that the states be required to make refunds only for "current" renegotiation not for "retroactive" renegotiation. Thus renegotiation affecting profits for 1943 completed before December 31, 1943, should be given effect by the states; but if 1943 profits are adjusted after that date renegotiation should give the contractor full credit for state taxes paid or accrued on the basis of 1943 income before renegotiation. The price adjustment officials oppose such a change on the ground that it would amount to a subsidy. State governments can make a rough prediction in advance as to the inroads on income that will be made by renegotiation—they can be guided to some extent by revenues of pre-war years. Moreover, a method can be adopted for the settlement of accounts between the state and local governments to facilitate refunds where necessary.

The new bill as approved by the House and by the Senate Finance Committee provides: ". . . but in determining the amount of excessive profits to be eliminated, proper adjustment shall be made on account of the taxes so excluded other than Federal taxes which are attributable to the portion of the profits which are not excessive." Thus the Price Adjustment Boards would apply a uniform procedure in the case of all state taxes, whether or not the state makes refunds, where profits have been reduced by renegotiation. Credit would no longer be allowed for state taxes paid on profits recaptured as excessive, but the burden would be on the contractor to get his own refund. The Treasury Department claimed in Committee hearings that in 43 or 44 states there are no state taxes on corporate income, or the state law affirmatively provides that state taxes will be levied on income as adjusted in renegotiation; or the law is reasonably clear that the result will be the same. A consistent position that the renegotiators will recognize taxes only on adjusted income will put pressure on all states to adopt a uniform practice of granting refunds.

Recognition of Reconversion Costs in Renegotiation

The Senate Finance bill provides that in determining excessive profits the Price Adjustment Boards shall take into consideration the financial provisions of reconversion. Again, as in the case of provision for consideration of profits after taxes, the meaning of this provision is ambiguous. The renegotiators are enjoined to give

consideration to financial problems of reconversion, but the factors of reconversion are not stated nor does the provision indicate how much weight should be given to reconversion problems. The inclusion of the provision as merely one of the standards to guide determination of excessive profits makes it an elastic and flexible guide. The Price Adjustment Boards are by no means bound to recognize post-war reconversion *reserves* as costs. They may increase the profit allowance to a firm in recognition of its physical reconversion prospect because the firm has no other resources with which to undertake reconversion. On the other hand, the Renegotiation Board might determine that adequate relief is given by the carry-back provisions of the Excess Profits Tax or by the 10% post-war refund. It may decide that adequate reserves have already been set up by the contractor which will be sufficient to meet his future working needs. It may decide that capital needs can be adequately met in the future by floating securities in the private market.

The Board may confine its concept of reconversion to an actual physical change-over. According to answers filed with the National Industrial Conference Board, only four out of every ten firms engaged in war production plan a complete conversion of all of their present capacity to peacetime production. Between two and three companies need no reconversion, since their war and peace products are identical. The remaining three or four companies out of every ten plan partial conversion, but apparently only about one-sixth of this number expect to convert more than a half of their existing capacity. Sumner Slichter has estimated that the actual cost of physical change-over will be less than \$500,000,000. Physical reconversion of itself the Boards may not find a tremendous financial problem.

There is universal agreement that many industries will have to cope with great financial burdens in reconverting to peacetime demands that will put a strain on their working capital. Some plants will have to be re-equipped to switch from wartime to peacetime production; machinery which has undergone accelerated depreciation due to intensive war use will have to be replaced—and even if the machinery is in good condition, it may have to be replaced to take advantage of radical improvements developed during the war. Maintenance and repairs, delayed due to production pressure, will have to be made at a greater expense. Inventory losses will be heavy. Lost markets and distribution channels will have to be recaptured, sometimes in the face of new competition attributable to the Government's entering the field during the war or subsidizing new competitors. Added on to all of these burdens will be the duty, legal or moral, of making separation or severance pay allowances to employees no longer needed.

Although there is agreement on the peril that these charges entail to financial solvency after the war, the difference of opinion arises as to the proper method of meeting the problem now, well in advance of the emergency. Specifically, the question boils down to whether financial reserves created out of profits for meeting post-war contingencies should be recognized as proper deductions for tax pur-

poses, and as a corollary position should be recognized as a proper and legitimate item of cost in renegotiation.

The first problem is one for the Treasury. The second is one for the Price Adjustment Boards. The answer of both agencies to a recognition of these items during the war years is a flat "No!"

The link between the decisions of the Treasury and Price Adjustment officials is more than accidental. The Renegotiation Statute provides that Price Adjustment officials ". . . shall recognize the properly applicable exclusions and deductions of the character allowed under Chapter 1 and Chapter 2E of the Internal Revenue Code." Price Adjustment Boards have construed this to mean that they are bound to recognize "exclusions and deductions" of the same type as allowed by the Treasury though not necessarily the same amount. However, since the Treasury does not recognize post-war contingencies in any amount, similarly, Price Adjustment Boards are free from any legal obligation to take such reserves into account.

Since the policy of the Price Adjustment Boards is contingent on the definition of Treasury policy, the statement of Randolph Paul concerning Treasury policy toward post-war reserves on October 21 before the American Institute of Accountants is significant. Paul stated that the carry-back provisions of the 1942 Revenue Act, representing a potential reserve of 100% of two years' income, provides a simple technique of charging post-war costs to wartime income. The reserve technique requires anticipation of the cost of reconversion at a date no one now knows and of an amount that no one now can possibly guess. Thus the amount of any reserve established at this time would have to be set at an arbitrary figure. Under the carry-back technique, however, the costs are calculated at a time when they are known or can be definitely ascertained. When the cost of reconversion occurs, the taxpayer will be able to obtain his deduction through the carry-back medium. Thus, taking his position against the present recognition of post-war reserves, Paul argued for provision for "seed money" by further refinement in the carry-back provisions.

Paul proposed a prompter refund of taxes to which firms are entitled—in that way the tax structure could make a substantial contribution in easing the transitional period. Additionally, Treasury has suggested to the Ways and Means Committee a special "Ruml" plan for corporations. This plan would let corporations file a tentative estimate of anticipated losses as soon as they see a bad year coming. Companies would file application for refund on a tentative basis along with their regular returns on the previous year's income; then they could offset the refund against taxes due and keep the difference to meet expenses.

At the present time Price Adjustment Boards are not legally bound to recognize reconversion reserves to any amount whatsoever as costs. If there is a change in the tax law to include certain of such reserves as tax deductions, then the Boards will be bound to accept them as cost items.

At the present time renegotiation officials defend their refusal on their own responsibility to treat reserves as cost items on four grounds:

1. Such special treatment for corporations with sufficient surplus to set up reserves would be grossly inequitable to other kinds of business.
2. Renegotiation and tax procedures have not impeded setting up of adequate corporation reserves.
3. Recognition of post-war reserves is highly impracticable from an administrative standpoint.
4. Congress has provided suitable means of carrying industry over the treacherous shoals of war-to-peace conversion.

On the ground of inequity, Price Adjustment Boards point out that this proposal for post-war reserves will help manufacturers whose facilities were suitable for war production and who were fortunate enough to make an excessive profit out of which extra funds could be segregated. It would be of no help, however, to businesses which were closed down because of shortages or who limped through the war because they were unable to get priorities. Moreover, members of the industry who charged high prices to the Government would be able to build up high reserves. On the other hand, those members who charged lower prices would in effect be penalized.

Publicly and privately, renegotiation officials have expressed their opinion that the plea for special Governmental action on post-war reserves is spurious—that industry possesses reserves even after taxes which may be adequate for the task ahead. Paul has given the following figures: Total corporate liabilities for income and excess profits taxes, amounting to slightly over \$1¼ billion for 1937, have climbed to \$13½ billion for the year 1943. But taxes, even of this magnitude, have not kept pace with rising earnings. Corporations in 1942 will have left after taxes \$8.1 billion, and in 1943 more than \$8.5 billion, sums more than double the \$3.9 billion left after taxes for the year 1937, and equal or greater than the \$8.1 billion of income after taxes in 1929. Moreover, the average of dividends paid for the years 1936 to 1940 was \$4.1 billion, reaching the high figure of \$4.8 in the year 1937. For the years 1941, 1942, and 1943, dividends are estimated at \$4.5 billion, \$4.1 billion, and \$4.0 billion respectively. Even after taxes and dividends paid, corporations will have accumulated for the years 1942, 1943, and 1944 a total of nearly \$14 billion of undistributed corporate profits.

It has been pointed out that the representatives of such giant corporations as General Electric and the Aluminum Company of America have stated in their testimony at Congressional hearings that their own existing reserves are ample to tide them through the period of reconversion. As an alternative to setting aside funds, companies are amply able, it is contended, to get access to private capital through floatation of stocks and bonds on the private market. Government officials point out, moreover, that the dilution of the present owner's equity is preferable to outright Government subsidy entailed through a recognition of post-war reserves.

Officials point out also that even under present renegotiation practice a company can help to ensure its own post-war future:

1. The cost of extensive research and engineering related to the war effort is an allowable expense both for tax purposes and renegotiation.
2. The maintenance of the executive staff and production personnel during the war as important to subsequent operations is fully recognized.
3. Institutional good will and industrial advertising will be treated as a proper charge against the contract if they are not out of proportion to the size of the company and its past advertising budget.

From an administrative standpoint, the renegotiation officers have objected to the inclusion of post-war reserves on several grounds. They advance the argument that the amount of reserves at the time when the burden will be incurred, the amount of the burden and the sector of industry upon which the most severe burden will fall cannot be foreseen. It would, moreover, be difficult to assure that these reserves would be readily available since without strings the contractor can distribute or invest the funds at his own discretion.

Again, if renegotiation recognized the reserves, but they were not allowed as tax deductions, it would be necessary for the Boards to allow four or five dollars of reserve for every dollar available to the company after taxes.

The final focus of attack for the opponents of the post-war reserve proposal is the action which has already been taken by Congress to facilitate post-war adjustment:

1. Section 250 of the Revenue Act of 1942 imposes what is tantamount to a compulsory accumulation of a post-war reserve; it provides for a post-war refund of 10% of the excess profits tax paid after December 31, 1941.
2. Accelerated depreciation permits a company to free from taxes and renegotiation its capital invested in plant and machinery.
3. Section 153 of the Revenue Act of 1942 permits a two-year carry-back or carry-forward of losses, thus mitigating the effect of losses. The corporation which does not use all its excess profits tax credit in any one year can carry back the unused part for two years, adding it to the credit it had in the reclaimed years and reducing the tax correspondingly. Similarly, a company that has a deficit in a year can refigure its taxes for the two preceding years, subtracting the deficit from the taxable income.
4. Congress has provided the three-year period after the war in which to replace inventory and secure a tax refund based upon the difference in replacement costs if higher than the current year in valuation. This in effect covers companies which switched to "lifo" and were thereby stuck when they liquidated peacetime inventories.

Senator Hatch has urged a different method of attack on the problem which has the support of Senator George. He urged as the most practical method of handling this problem a recent proposal to amend the tax law to provide that re-

serves claimed by taxpayers in amounts not exceeding 20% of taxable income be deductible as an operating expense in computing income and excess profits taxes, provided: (1) That the amount set aside in such reserves be invested in public issue of non-negotiable, non-interest-bearing Government bonds redeemable at any time prior to a date eighteen months after the cessation of hostilities; and (2) that simultaneously upon the liquidation of such securities the taxpayers must return the amount derived from such liquidation to his taxable income for the year of liquidation.

This scheme might appeal to the Administration because all current income would be taxed at some time, either this year or when securities are liquidated. Furthermore, the plan would be easy to administer, and at the same time has an appeal to business. The probability that the Excess Profits Tax will be repealed shortly after the war means that the 20% set aside now would be hit by lower taxes when cashed in later.

Miscellaneous Substantive Changes

Both the Senate and the House bills provide that all items allowable as deductions and exclusions under Chapters 1 and 2E of the Internal Revenue Code (excluding taxes measured by income) shall to the extent allowable to such contracts and subcontracts be allowed as items of cost. At the present time Price Adjustment Boards are bound to recognize items of the same character as those recognized for tax purposes, but can use their own judgment as to how much shall be admissible as costs. Thus Price Adjustment Boards in recognizing income tax deductions have allowed less, particularly as regards executive salaries, than would be allowed by the tax authorities. This provision, it would seem, would compel recognition of the same amounts. The same rule would apply to amortization. At present, normal depreciation only is recognized as cost. The difference between that amount and the 20% amortization under a certificate of necessity is to be set aside as non-renegotiable profit which will not be considered in determining excessive profit. The post-war commercial value of such facilities is considered in paring down renegotiable profit. This provision which makes cost treatment identical might have a hampering effect on renegotiation operations since it might compel re-opening of the renegotiation agreement two or three years afterwards when the books of a contractor are audited finally for tax purposes.

The bill both in House and Senate provides for a fair cost allowance at the exemption line in the case of integrated companies and that this exemption be made retroactive. The bill provides as follows: "In the case of a contractor or subcontractor who produces or acquires the product of a mine, oil, or gas well, or other mineral or natural deposit, or timber, and processes, refines, or treats such a product to and beyond the first form or state suitable for industrial use, or who produces or acquires an agricultural product and processes, refines, or treats such a product to and beyond the first form or state in which it is customarily sold or

in which it has an established market, the Board shall prescribe such regulations as may be necessary to give such contractor or subcontractor a cost allowance substantially equivalent to the amount which would have been realized by such contractor or subcontractor if he had sold such product at such first form or state."

PROCEDURAL AND ADMINISTRATIVE CHANGES

Establishment of Joint Price Adjustment Board

The House bill set up a War Department Price Adjustment Board consisting of five members, representatives of the War Department, Navy Department, Treasury, Maritime Commission, and Reconstruction Finance Corporation. The Finance Committee bill added a representative of the War Production Board, thereby making it a six-member board. A Joint Price Adjustment Board has already existed, but under this provision it would for the first time be given statutory life.

The bills give the contractor an absolute right to require review by the newly created Board and the Act provides that the Board may not delegate "the power, function, and duty to review orders determining excessive profits." The Joint Price Adjustment Board has expressed its reluctance to accept the new responsibility thrust upon it. The function of the Board hitherto has been to set up uniform purposes, principles, policies and interpretations. The requirement of review would now mean that the Board would have to set up a substantial administrative staff and carry on duties interfering with its regular responsibilities.

Right of Judicial Review

Any contractor or subcontractor aggrieved by an order of a Price Adjustment Board may within 90 days file a petition for a court review. According to the House bill, the court of review would be the Tax Court of the United States; according to the Senate bill, the Court of Claims. In view of the jammed calendar of the Tax Court, the overwhelming probability is that the House will accept the Senate suggestion. The court will have exclusive jurisdiction to determine the amount of excessive profits, if any, and this determination will not be reviewed or redetermined by any other court or agency. This court proceeding to finally determine excessive profits will not be treated as a proceeding to review the determination of the Board, but as a proceeding *de novo*.

This latter provision departs from the traditional procedure adopted in connection with administrative review. The court of review will start from scratch and all persons would have a right of recourse. The right of review and the scope would not be confined to the question as to whether the determination by the Board was the result of a mistake of law, fraud, arbitrary or capricious action, or was so grossly erroneous as to imply bad faith.

The most objectionable feature of the review is its retroactivity to blanket all prior determinations made under the Renegotiation Act, including voluntary agreements. This renders subject to court review thousands of voluntary bilateral agreements and renegotiation settlements totaling \$5,000,000,000. The Court of

Claims will be swamped with litigations as few firms will be able to resist the pressure to review past agreements. As Under Secretary of the Navy Forrestal said: "Retroactive reopening of these agreements would put the contractors who have entered into them in an uncertain and perhaps embarrassing position. Officers and directors of the companies have made settlements on account of excessive profits, which they consider to be in the best interests of their corporations. If these agreements are now to be thrown open to review, the board of directors of each of these companies would be faced with the problem of appealing, so as to discharge its duty to its stockholders, even though it believed that the renegotiation settlement was entirely fair and just. This provision is a mandate for mutually undesirable litigation."

Statement to Contractor

The new bill provides that whenever the Board makes a determination with respect to the amount of excessive profits, whether by an order or by voluntary agreement, it must at the request of the contractor prepare and furnish him with a statement of the determination, the facts used as a basis therefor, and all its reasons for the determination. This statement cannot be used in the Tax Court or the Court of Claims in connection with the redetermination of excessive profits. The Boards look with distaste on this requirement since it will be necessary to set out in writing to the contractor a statement of the facts and factors, unfavorable and favorable, of his efficiency, ability, contribution to the war effort, risk and other elements necessary in the determination of excessive profits. This material cannot be flattering in all cases. The criteria may be understood in informal discussion and yet may produce great dispute and dissent when set down in writing. It will certainly impair the informal atmosphere in which renegotiation proceedings are at present conducted.

Statute of Limitations Provisions

Under the House bill, no proceeding to determine the amount of excessive profits can be commenced by the Board more than one year after the close of the fiscal year in which the excessive profits were received or accrued; or one year after financial statements are filed by the contractor or subcontractor, whichever is the later; otherwise liabilities for the excessive profits for the fiscal year will be discharged. Under the Senate Finance bill, however, the end period for determining excessive profits is one year after the close of the fiscal year in which the excessive profits were received. In order to expedite the disposition of the case after a proceeding has been commenced, the bills provide that the liabilities for excessive profits with respect to which such proceeding was commenced will be discharged if a determination by agreement or order is not made within one year following the commencement of the renegotiation proceedings. This limitation does not apply to a review by the Board of an order by the Secretary. The one-year period of limitation may also be extended by agreement between the parties.