

LIMITATION OF WAR PROFITS

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The large profits made by manufacturers of war materials¹ disclosed in the recent Congressional investigation² have shocked the public. The high salaries and handsome bonuses³ reported are in sharp contrast to the wages of the men in our armed forces. The resulting pressure on Congress for some limitation upon war profits has resulted in a number of proposals and several bills. Before considering these, it may be well to take a look at pre-war legislation limiting the profits which contractors could make on contracts for ships and airplanes.

VINSON-TRAMMEL ACT

The Act of March 27, 1934, known as the Vinson-Trammel Act,⁴ provided that the Secretary of the Navy should not let contracts in which the award exceeded \$10,000.00 for the construction of naval vessels or aircraft, or any portion thereof, unless the contractor agreed to pay into the Treasury all profit in excess of ten per cent. of the total contract price. The ten per cent. profit was the profit after income taxes were paid since credit was allowed for income taxes for the same period. The Act provided that if the excess profit was not voluntarily paid the Secretary of the Treasury might collect it by methods usually employed for collecting income taxes.⁵ A report to the Secretaries of the Navy and Treasury showing net income and its percentage of the total contract price was required. No contract could be let unless the contractor agreed to make no subdivision of the contract for purposes of evasion, to permit the inspection of his books and plant, and to make no subcontracts unless the subcontractor agreed to all of the conditions to which he had agreed.

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1. E. g., Jack & Heintz, Inc., verbatim record of proceedings of the Committee on Naval Affairs of the House of Representatives.

2. Committee on Naval Affairs and Committee on Military Affairs of the House.

3. Statement of Representative Albert Gore of Tennessee, *Hearings before Committee on Naval Affairs on H. R. 6790 (The Smith Bill)*, 77th Cong., 2d Sess. (1942) 2625-2626, 2670-2681. See also note 1.

4. 48 STAT. 503, 505, § 3 (1934), 34 U. S. C. A. § 456 (Supp. 1941).

5. The Internal Revenue Code of 1939, enacted Feb. 10, 1939, provides in Chapter 2, §§ 650, 651, 53 STAT. 112 (1939), 26 U. S. C. A. §§ 650, 651 (1940), that the Secretary of the Treasury "shall" collect excess profits not voluntarily paid as required by the Vinson-Trammel Act, and that all provisions of the Revenue Act of 1934, 48 STAT. 683 (1934), including penalties are applicable.

The Act was amended on June 25, 1936,⁶ to make the profit in excess of ten per cent. payable in the income taxable year in which the contract was completed, to relieve the surety on the contract from responsibility for the payment of the excess profit, and to provide that net losses on similar contracts completed in the preceding income tax year might be deducted in determining the excess profit.

The provisions of the Act were incorporated in the Merchant Marine Act of 1936⁷ so as to cover contracts for the construction of merchant ships let by the Maritime Commission. One of the clauses in the Merchant Marine Act was new. It provided that no salary of more than \$25,000.00 per year should be considered a part of the cost of building a ship in computing the excess profit and that the Commission should scrutinize construction costs and overhead expenses to determine that they were fair, just, and not in excess of reasonable market prices.

In the Act of April 3, 1939,⁸ the provisions of the Vinson-Trammel Act were extended to contracts for Army aircraft and it was amended again by increasing the profit which might be retained from ten per cent. to twelve per cent. and by providing that a net loss or deficiency in profit, due to failure to earn the permitted twelve per cent., in any income taxable year might be deducted during the next four income taxable years in ascertaining the excess profit.

In the Act to Expedite National Defense⁹ the statute was amended to make the excess profit that in excess of eight per cent. of the total contract prices of contracts completed within an income taxable year or eight and seven tenths per cent. of the total cost of performing such contracts, whichever was lower¹⁰ (in lieu of ten per cent. and twelve per cent.), and to limit the application of the Act to contracts in which the award exceeded \$25,000.00 (in lieu of \$10,000.00).

Regulations for applying the Act were prepared jointly by the Treasury, Navy and War Departments.¹¹

The provisions of the Vinson-Trammel Act as amended were suspended by the Second Revenue Act of 1940¹² for all contracts en-

6. 40 STAT. 1926 (1936), 34 U. S. C. A. § 196 (Supp. 1941).

7. 40 STAT. 1985, 1998, § 505 (b), (c), (d) and (e), (1936), 46 U. S. C. A. § 1155 (Supp. 1941).

8. 53 STAT. 555, 560, § 14 (1939), 34 U. S. C. A. § 496 (Supp. 1941).

9. 54 STAT. 676, 677, §§ 2b, 3 and 4 (1940), 41 U. S. C. A. prec. § 1 note. (Supp. 1941).

10. See Internal Revenue Treasury Decision 5000, 76 T. D. No. 7 (Aug. 15, 1940) 10, 17.

11. Internal Revenue Treasury Decisions 4906, 4909 and 5000, 74 T. D. No. 52 (June 29, 1939) 101, 75 T. D. No. 1 (July 6, 1939) 14, 76 T. D. No. 7 (Aug. 15, 1940) 10.

12. 54 STAT. 974, 1003 (1940), 34 U. S. C. A. § 496a (Supp. 1941).

tered into after December 31, 1929, or uncompleted on that date by contractors or subcontractors subject to the general excess profits tax imposed by Title II of the same Act.¹³ The similar provisions of the Merchant Marine Act of 1936 were also suspended, but only for contracts entered into after December 31, 1939, by corporate subcontractors unaffiliated with a corporate principal contractor.

THE SMITH BILL

Sections 302 and 303 of a bill introduced by Representative Smith of Virginia on March 16, 1942,¹⁴ purports to be an amendment and re-enactment of the Vinson-Trammell Act. It is, however, relatively simple as compared to that Act. It requires "every naval contractor", the contract price of whose naval contracts completed in any one fiscal year exceeds \$10,000.00, to pay to the Secretary of the Navy all net profits in excess of six per cent. of the total cost of performance of those contracts. The net loss on the aggregate of all naval contracts completed during the preceding fiscal year may be deducted in ascertaining the net profit. It requires a report to the Secretary of the Navy showing contracts completed in the fiscal year, their aggregate contract price and the total cost of completing them, to be ascertained in a manner approved by the Secretary of the Navy. A clause is added which is intended to make applicable the regulations of Treasury Decision 5000.¹⁵ While the bill as framed applies only to naval contracts, it was apparently contemplated that an amendment would be offered making it applicable to all war contracts.¹⁶

Hearings on the bill were held by the Naval Affairs Committee of the House.¹⁷ All who testified, including leading administrative officials of the Government, opposed the bill except Vice Admiral Samuel M. Robinson, Chief of the Office of Procurement and Material of the Navy Department. Admiral Robinson said that the Vinson-Trammell Act handicapped the Navy's procurement by putting it at a disadvantage in competing with other departments of the Government. He saw no objection to the principle of the Smith Bill if it was made to apply to all war contracts.¹⁸ He criticized the bill for not exempting contractors who completed less than \$50,000.00 worth of contracts in

13. Also known as the Excess Profits Tax Act of 1940.

14. H. R. 6790, 77th Cong., 2d Sess. (1942).

15. 76 T. D. No. 7 (Aug. 15, 1940) 10.

16. Representative Carl Vinson, Chairman of the House Naval Affairs Committee, instructed witnesses to assume this in discussing the bill.

17. Reported in *Hearings before Committee on Naval Affairs on H. R. 6790, 77th Cong., 2d Sess. (1942)*, hereinafter cited as *Hearings*.

18. *Hearings*, 2574-2575.

any one year,¹⁹ and for freezing the regulations of Treasury Decision 5000 by incorporating them in the law.²⁰

The reasons for opposing the bill given by Robert P. Patterson,²¹ Under Secretary of War; James V. Forrestal,²² Under Secretary of the Navy; Donald M. Nelson,²³ Chairman of the War Production Board; Randolph E. Paul,²⁴ Tax Adviser to the Secretary of the Treasury; Representative Willis Robertson²⁵ of Virginia, member of the House Ways and Means Committee; and William P. Witherow,²⁶ President of the National Association of Manufacturers, may be summarized as follows:

1. The limitation being based on the cost of completing the contract would leave a profit which would in many cases bear no reasonable relation to capital invested. Contracts might take a long time or a short time to complete and the total cost of completion of contracts completed in any one year might be a fraction of the invested capital or several times the amount of invested capital. If the total cost of completing the contracts completed in one year was one-third of the invested capital then the profit would be only two per cent. of the investment. If the total cost was four times the invested capital then the permitted profit would be twenty-four per cent. of the capital.²⁷

2. The one year carry-over of losses is not sufficient.²⁸

3. There is no carry-over of deficiencies in profits. Thus if the profit in one year is two per cent. and in the next, six per cent., the average for the two years will be four per cent.²⁹ The second and third objections are likely to cause contractors to demand guaranteed profits in the form of cost-plus-fixed-fee contracts with resulting lack of incentive to keep costs down.³⁰

4. The bill itself removes incentive to keep costs down by making the permitted profit a percentage of cost. Larger profits can be retained if the costs are padded to the point where they equal the contract price.³¹

19. *Id.* at 2568.

20. *Id.* at 2568, 2569.

21. *Id.* at 2473 *et seq.*

22. *Id.* at 2493 *et seq.*

23. *Id.* at 2576 *et seq.*

24. *Id.* at 2740 *et seq.*

25. *Id.* at 2825 *et seq.*

26. *Id.* at 2840 *et seq.*

27. *Id.* at 2474 (Patterson), 2578 (Nelson), 2743 (Paul), 2842 (Witherow).

28. *Id.* at 2743 (Paul).

29. *Id.* at 2744 (Paul).

30. *Id.* at 2475 (Patterson), 2493-2494 (Forrestal), 2578 (Nelson), 2744 (Paul).

31. *Id.* at 2744 (Paul).

5. The \$10,000.00 exemption is too small. A contractor completing contracts in a year, the cost of completing which would be \$30,000.00, would be permitted to retain only \$1,800.00 profit. This would hardly be sufficient incentive to justify undertaking the risk.³²

6. The six per cent. profit which the contractor would be permitted to keep is six per cent. before normal income and surtaxes have been deducted. After deducting income and surtaxes at present rates the contractor would have left a profit of one and seven tenths per cent. of cost of completion at present tax rates, or seven tenths of one per cent. at tax rates which the Treasury proposes to put into effect.³³

7. The profit limitation does not apply to contracts other than war contracts. This would provide an incentive to manufacturers to supply normal customers in preference to the Government.³⁴

8. Subcontractors and materialmen are not included, which will create an inducement to prime contractors to sublet most of the work especially if they can contrive to have an interest in the subcontracting firm.³⁵

9. The difficulty of securing a sufficient number of competent accountants to do the auditing, and the expense to contractors and the Government.³⁶

Those opposed to the bill stated that contractors should not be permitted to make large profits out of the war. Most of them thought that a higher general excess profits tax would be a better remedy.³⁷ The Treasury Department suggested an excess profits tax which in the highest bracket would take seventy-five per cent. of profits in excess of \$500,000.00. When combined with a normal income and surtax rate of fifty-five per cent. on such a profit, the combined maximum rate would be eighty-eight and three-fourths per cent., apart from a possible post-war rebate under certain conditions of eight and three-fourths per cent.³⁸ Representative Willis Robertson suggested a general excess profits tax of ninety per cent. after which normal income and surtax rates should apply.³⁹ Mr. William E. Witherow, President of the National Association of Manufacturers, suggested a ninety per cent. excess profits tax to be imposed on the balance after an income

32. *Id.* at 2475 ((Patterson), 2568 (Robinson), 2578 (Nelson).

33. *Id.* at 2744 (Paul), 2842-43 (Witherow).

34. *Id.* at 2742 (Paul).

35. *Id.* at 2742-2743 (Paul).

36. *Id.* at 2475 (Patterson), 2495 (Forrestal), 2743-2744 (Paul), 2842 (Witherow).

37. *Id.* at 2475 (Patterson), 2614-2615 (Nelson), 2741-2742 (Paul), 2828 *et seq.* (Robertson), 2842 (Witherow).

38. *Id.* at 2741-2742 (Paul).

39. *Id.* at 2828.

tax of forty per cent.⁴⁰ Representative Melvin J. Maas suggested that all [excess?] profits be taken and twenty-five per cent. returned after the war to serve as a cushion which would enable industry to convert plants for peacetime production.⁴¹ In England the Government takes all excess profit, of which twenty per cent. is returnable after the war.⁴² Mr. Witherow also favored the cushion idea.⁴³ He thought too, that something should be left for stockholders because the income of widows, orphans and institutions like insurance companies and universities depended on dividends.⁴⁴ Mr. Patterson thought that excessive profits could be prevented by a clause in the contracts providing for the renegotiation of prices whenever profits were deemed to be excessive. He stated that he had had such clauses inserted in War Department contracts.⁴⁵

THE SIXTH SUPPLEMENTAL DEFENSE BILL

When the Sixth Supplemental Defense Bill passed the House, it contained Section 402A providing that no part of the appropriation should be available for the final payment of a contract for war material to a contractor who failed to file a statement of his costs and an agreement to renegotiate the contract and pay back all profits in excess of six per cent.⁴⁶

The Senate Committee on Appropriations proposed a substitute for the provision limiting profits.⁴⁷ The Secretaries of War and Navy and the Chairman of the Maritime Commission, in making contracts for amounts in excess of \$100,000.00 were authorized to insert provisions (1) for renegotiation of the contract price when the profits could be determined with reasonable certainty; (2) for the withholding from the contract price, or the recapture of the excess profits so determined; and (3) requiring the contractor to insert similar provisions in subcontracts for amounts in excess of \$100,000.00, and exempting the contractor from liability on subcontracts for subcontractors' excess profits as determined by the Government and withheld from payments due contractors. The authority was granted for contracts already made, although they contained no provision for renegotiation. It was provided that in determining excess profits, excessive and unreasonable

40. *Id.* at 2482.

41. *Id.* at 2595.

42. L. J. STAT. (1940) c. 29, § 26, p. 193, amending, L. J. STAT. (1939) c. 109, § 12, p. 1319; L. J. STAT. (1941) c. , § , p. 221. Referred to by Representative Robertson, *Hearings*, 2839.

43. *Hearings*, 2857.

44. *Id.* at 2863.

45. *Id.* at 2475.

46. H. R. 6868, passed March 28, 1942, 88 CONG. REC., March 28, 1942, at 3202, 3231 (1942).

47. 88 CONG. REC., April 6, 1942, at 3441-3442 (1942).

salaries, bonuses and other costs should not be allowed. Authority was granted to demand statements of costs from contractors and a criminal penalty provided for refusing to furnish such statements or for making false and misleading statements. Subsection (f) of the proposed substitute provided that the Secretaries and the Chairman jointly or severally should prescribe regulations which would indicate in advance the profits which would be deemed excessive insofar as practicable. In any event, profits were not to exceed maximum rates fixed in the following schedule:

10%	of the first \$100,000.00 of the contract price
8%	on the next \$400,000.00 of the contract price
6%	on the next \$500,000.00 of the contract price
5%	on the next \$5,000,000.00 of the contract price
4%	on the next \$15,000,000.00 of the contract price
3%	on the next \$30,000,000.00 of the contract price
2%	on so much of the contract price as exceeds \$50,000,000.00.

The percentages were applicable to costs in cost-plus contracts. Subsection (f) was adopted by a Committee vote of eight to eight.

The Senate struck out the House provision⁴⁸ and adopted the Appropriations Committee substitute⁴⁹ without subsection (f).⁵⁰ As so amended, the Sixth Supplemental Defense Bill passed the Senate,⁵¹ and went to a Conference Committee of the House and Senate. The Conference Committee adopted the Senate's proposal with some minor changes and the House,⁵² on April 21, and the Senate,⁵³ on April 23, agreed to the report of the Conference Committee. The President signed the bill on April 28, 1942.⁵⁴ On April 30, 1942, the House Naval Affairs Committee voted 13-12 to table the Smith Bill.⁵⁵

The adoption of the Senate amendment does not foreclose the possibility of a sharply increased excess profits tax. The President, in his message to Congress on April 27, 1942,⁵⁶ recommended that an excess profits tax be imposed upon all business which would recapture all excess profits for the Government. He left Congress to define excess profits. He also recommended that individual income be limited to \$25,000.00 a year after taxes, all above that to go to the Government.

48. 88 CONG. REC., April 7, 1942, at 3481.

49. *Id.* at 3506.

50. *Id.* at 3502.

51. *Id.* at 3511.

52. 88 CONG. REC., April 21, 1942, at 3696, 3710.

53. 88 CONG. REC., April 23, 1942, at 3762, 3782.

54. 88 CONG. REC., May 14, 1942, at 4352.

55. The Evening Star, Washington, D. C., April 30, 1942.

56. New York Times, April 28, 1942, p. 12.