TREASURY DEPARTMENT

Washington

(The following address by Randolph E. Paul, General Counsel for the Treasury, before the American Institute of Accountants at the Waldorf-Astoria Hotel, New York, is scheduled for delivery at 2 P.M., Central War Time, Thursday, October 21, 1943, and is for release at that time.)

BUSINESS RESERVES FOR RECONVERSION

Introductory

It is a distinct privilege to appear before the distinguished membership of your organization. It is particularly a pleasure to discuss with you the subject of reconversion costs. I believe I can count on your sincere interest, even though at times our discussion may have to embrace subtle technicalities. You pioneered the subject in your Research Bulletin No. 13, "Accounting for Special Reserves Arising out of the War." This study has been a valuable contribution to a subject which is still in what the President calls the "discussion stage", but which is becoming more important every day. In this and other ways your research staff and members of your organization have generously aided the Treasury in our study of the problem.

Businessmen often say to me that the hardest part of their life is its uncertainty. They do not know their tax liability for past years. They do not know what the latest tax statutes mean. They do not know what policies will be announced from many quarters the next day. They find it difficult to plan intelligently. I can sympathize very genuinely with these feelings. They are vague, but they are real. To the extent that we in the Treasury can remove obstacles to business planning, it is our desire to do so. On the other hand, there is a limit beyond which our power to give certainty does not reach. A large degree of uncertainty is inherent in the critical period in which we live. Neither you nor I can tell what tomorrow will bring; there must be for all of us an area of uncertainty. It would be presumptuous of us to attempt exactness in a field involving such a large element of prophecy. If we tried we should get nothing more than a delusive certainty that in the end would do more harm than good.

We do know that heavy work lies ahead. Sometime in the future we shall have to reverse the job industry has been doing for the last two years, -- the conversion of a peacetime economy to intensive wartime production. Taken all in all, that job was done with remarkable speed and with results that are speaking for themselves on the military front. We do not know when, but we do know that a time will come when we must do this job in reverse. We shall have to reconvert a war economy to a peace basis. Not the least part of that job will be to insure conditions under which peacetime production can furnish many goods and services people have been unable to buy during the war years, and to provide employment comparable to the employment level of today.

Reconversion Reserves

What are reconversion reserves? You accountants know better than I the meaning of the term "reserves". I have had a good deal of association with the word in many years of tax practice, but I have not had the daily contact you have had. I speak humbly, therefore, when I remind you that reserves are divisible into two types: (1) valuation reserves, including liability reserves, and (2) surplus reserves. The former type represents a cost which must be deducted before true net income can be determined. The latter type is an entirely different animal. It represents a part of surplus which is set aside as an aid in conserving the funds of an enterprise to meet some future expenditure. It need not be deducted to arrive at true net income. It is nothing more, and nothing less, than a subdivision of surplus. It is surplus earmarked for an expenditure which directors presently think may be necessary at sometime in the future. They may change their minds at any time, in which event the reserve account goes over to surplus.

There can be no disagreement among informed persons as to the meaning of the term "reserve". But it is appropriate to call attention to the looseness with which the word "reconversion" is frequently used. People employ the term constantly without precise thought as to its meaning. There are at least two schools of thought on the subject of what constitutes reconversion. One school would limit the concept of reconversion to postwar costs directly related to wartime income. The other school views reconversion in its broadest sense, thinking of the term as including all expenditures made in the immediate postwar period whatever their purpose and character. This is a rough classification, but I think it may serve the purpose of clarifying what I have to say later.

To this audience I think I may dogmatically state that reconversion costs, in the sense of costs directly associated with the earning of wartime income, should be charged against that income. This is a principle to which I am sure most accountants would readily subscribe. But in accounting, as in law, general propositions do not decide concrete cases. It is a long step from the enunciation of a principle to its practical application. This is particularly true when the facts of the concrete case have not yet made their appearance on the horizon.

The difference between the general and the specific has acute relevance when we add another consideration to the equation. It becomes a matter of intense concern to the Government when the suggestion is made that a deduction be allowed for reserves for reconversion. The question is no longer simply what informed directors report to stockholders. Not all stockholders read balance sheets too carefully. Those who read carefully know that reserves mean what the directors intend them to mean. Reserves on a balance sheet are, therefore, little more than a notice, -- a record of the directors' guess as to the shadow of coming events. The thing anticipated happens, or it does not happen, and a book entry does not change the course of events. Net income remains what the future lets it be. The stockholders' inchoate interest in the corporate profits remains what it would have been if no entry had ever been made.

But it is a very different matter when a deduction is allowed for tax purposes. The Government takes less -- the corporation keeps more. The ultimate corporate profits after taxes remain higher. Stockholders' equities stay at a higher level. Stockholders may even be vouchsafed more dividends. The question is not merely one of checking the accuracy of the directors' prophecies. It becomes the serious matter of earnings remaining after taxes, which involves governmental revenue at a critical time and perhaps the competitive position of firms in the same industry.

This makes the question of reserves for reconversion a matter of pressing concern to the Government. We might, though you would not, be cavalier about a bookkeeping reserve. We dare not be cavalier about a deductible reserve. Rigorous tests must be applied to determine whether Government interests suffer and what the effects on industry will be. We have to ask the question whether, in the largest orbit of the public interest, an arbitrary tax adjustment may not do more harm than good.

Assuming that the responsibility involved in the determination of a deductible reserve is accepted, other problems remain. How shall we charge reconversion costs to the income with which they are properly to be associated? What costs shall be allowed? These questions are much more easily asked than answered, even though we use the term "reconversion" in the narrow sense of postwar costs directly related to wartime income.

Method of Charging Reconversion Costs

First, let us consider the methods of charging reconversion costs against wartime income. History may be a good teacher here. In the 1942 Act Congress enacted a two-year carryback of net operating losses and unused excess-profits credits. The purpose of this provision was to make adjustments against wartime income for postwar costs directly related to the war, as well as to average income over the war period. The extent to which this indirect allocation of postwar costs will result in tax savings equivalent to a direct allocation depends on many factors now indeterminate. In the main, the extent of the relief afforded by the provision will depend upon the pattern of income, both in the war years and the period of reconversion, as well as the tax structure over this entire period. Since another speaker is to discuss this specific adjustment, I gladly yield the field to him. In passing, however, I would like to call your attention to the implication of the present carry-back provisions when stated as reserve plans. They represent a potential reserve of 100 percent of two years' income.

The carry-back provision has received little attention. The reserve technique has many vocal adherents. This in spite of the fact that the carry-back procedure requires no adjustment in current income and no difficult anticipation of reconversion costs. It provides the simpler technique of charging postwar costs to wartime income at a time when the costs are known or definitely ascertainable.

The reserve approach has seductive appeal, since it appears to be a simple matter to create a reserve through deductions from current income against which specified postwar costs may be charged at a later date. It is urged that such a procedure is entirely safe because any unused balance can be returned to taxable income in later years. How can the Government be harmed under such circumstances?

The reserve technique requires in a period of intense uncertainty anticipation of the cost of reconversion at a date no one yet knows. No one can make a reasonable estimate at the present time of the magnitudes of such costs. They may be large; they may be smaller than most of us anticipate. The reserve method requires us now to make a reasonable precise guess as to the unknown future.

Since none of us can safely predict the details of the future, the amount of any reserve established today must of necessity be arbitrary. This leads to the reasonable requirement that estimates of future reconversion costs must be subject to some limitation. Limitations are crude instruments. They would create hardships for those firms with eligible postwar costs in excess of the limitation employed. They would make available excessive deductions to those firms with few or no eligible postwar costs. Under this technique no one would have security.

But it is smoothly argued that limitations will do no inequity because any unused balance in a reserve account will be returned to taxable income in later years. This leads to the third objection to the reserve approach. A taxpayer in future years has a large unused balance in his reserve account. Will it be easy for such a taxpayer to avoid thinking of that balance as his own? Will he readily recognize that the portion of the reserve which represents remaining taxes belongs to the Government? I think most taxpayers, even most corporate taxpayers, are more human than that. Their natural reaction will be to forget the original purpose of the reserve deduction and to attempt to broaden the charges against the reserve beyond those which we might now agree were appropriate. Such an extension of deductible expenses might well be a greater step away from improvement in the wartime tax base than the original reserve deduction would have been toward such improvement.

This possibility is no straw man. I need only refer to some of the proposals to the Ways and Means Committee. Some of these proposals lose sight of the fact that reserves are a method of refining taxable income. In fact, one plan has pushed the broadening of reserve charges to its logical extension, and required no charges against the reserve. The harmful results of such a procedure I shall discuss later.

I am trying to give you as simply as I can the reasons why we believe that further adjustments can only come by way of a further refinement in the carry-back techniques. Of course, any such refinements will have to pass the test of administrative feasability. We make this suggestion not because we wish to deny appropriate relief, but rather because we are looking for a method which will give equitable and sufficient relief.

Reconversion Costs to be Charged Against War Income

Even with a decision made in favor of that technique, the road is far from clear. We immediately encounter difficulties in the specification of war costs properly related to wartime income.

Costs of Reconverting Facilities

Take first the case of cost connected with reconverting plant facilities to peacetime production. Outlays for readapting, re-arranging, dismantling, and reinstalling plant and equipment would have to be segregated from other expenditures, and further classified into capital expenditures and deductible expenses. The distinction between expense items and capital outlays is an old friend to those of you who have been concerned with tax law for the last few years.

The next difficulty is also one of classification. Re-arrangement expenses do not necessarily constitute proper charges against war revenues. Some of them may be proper charges against peacetime revenues. How shall we tell in the case of particular items of expense whether they are properly chargeable against one type of revenue or the other? The answer to that question, as it arises in respect to specific items, is easier for the client than his adviser who probes below the surface of things. For example, suppose that a firm does not return to its identical prewar productive pattern.

. Or suppose that it does not go on producing the same prewar product. Are reconversion expenses in such cases necessarily chargeable against war production? Or should the answer to this question differ according to whether the shift to a new product was war induced or was the culmination of prewar plans. How can cases of this kind be satisfactorily separated?

What treatment shall be given to facilities presently owned by the Government but purchased and converted to peacetime production by private industry? Should the conversion of facilities amortized under certificates of necessity be offset against war income? Surely the conversion of such facilities represents a capital outlay to be charged against income from peacetime products and not against war revenues. Of course, the cost of dismantling and scrapping facilities amortized under certificates of necessity are war costs; but if such facilities are used in peacetime production, then complete amortization against wartime revenues has represented too large a charge against such revenues in view of their true economic life. The definition of wartime income would hardly be improved if further deductions connected with these facilities were allowed.

Deferred Maintenance

There has been much fluent talk, and much ink has been spilled, in an attempt to prove that deferred maintenance should be included as a reconversion cost in the general sense that I have been using it. We have studied this problem carefully, but we have failed to find any method or formula which will satisfactorily recognize differences between industries and give proper effect to changes in the price level, changes in the volume of production, and changes in the relationship between maintenance outlays and production. If any of you can suggest an adequate formula, I should be delighted to have it.

Difficulties with the problem of deferred maintenance do not end at this point. The term over-maintenance is not frequently used, but there is such a thing. It distorts war income just as much as does under-maintenance. One may be permitted some doubt as to how serious and extensive under-maintenance may accurately be said to be. All of you have seen it in the case of specific machines and particular equipment. But it would be imprudent to generalize from specific items of under-maintenance to the broad area of the entire business of a firm or over a whole industry. Under-maintenance of certain assets may be more than balanced by over-maintenance of other assets.

Even in the case of the railroads — the most generally cited example of significant under-maintenance — authorization by the Interstate Commerce Commission in 1942 of charges for deferred maintenance did not give rise to substantial deductions. With Interstate Commerce Commission approval, only 28 companies charged $11 million for deferred maintenance in 1942. This amount may be compared with total maintenance expenses in 1942 of Class I railways of slightly over $2 billion or 1/2 of 1%. Although 15 companies have been authorized to charge $7 million for deferred maintenance in the first seven months of 1943, additions to deferred maintenance reserves in 1943 have been less than the charges against the 1942 reserves. In other words, the making good in 1943 of 1942 under-maintenance is in excess of deductions claimed for under-maintenance in 1943.

In interpreting these figures, it must be remembered that they are not accepted for tax purposes. However, it is a common practice to show reserves on balance sheets which are not tax deductions.

Dismissal Wages

If I could leave this subject at this point, I am sure that we could all go home with a comfortable feeling that the problem, while difficult, is not insuperable. We could feel that somehow answers would cross tables as the debate unfolded. But machines, whether over- or under-maintained, do not run themselves. In the postwar period, as now, they will have to be operated by many of the men and women who are working at them today. There will be a hiatus in which these workers will have no machines to operate. Some of them will have moved to expensive defense areas. They will be people with a thin margin of security for a period of unemployment. Perhaps they will need dismissal wages.

You will say that the administrative problems in determining dismissal compensation are relatively simple when compared with the problems involved in the re-arrangement of facilities. Dismissal wages can be easily segregated. But I remind you that the problem is more subtle than appears upon the surface.

If we would prevent abuses, it will be necessary to adopt certain restrictions and limitations. We may be obliged to place a limitation upon the number of weeks of wages or salary to be paid to any one employee. This, on the theory that only a reasonable payment to carry the dismissed employee over a period of readjustment may be recognized as a war cost. We may have to adopt some non-discriminatory provision which will prevent the selection of favorite or higher paid employees as the recipients of dismissal compensation. Finally, because the problem of relocation and adjustment may be most severe for the lower paid employees, it may be necessary to impose some limitation upon the total amount which may be paid to any one employee.

You will, of course, have in mind that such restrictions would not prevent any individual firm from making larger payments to employees if it desires. The limitations apply only to any special treatment to be accorded to these types of payment.

The costs of returning plants to their pre-war condition and dismissal wages do not exhaust the possible postwar costs which might be included under the heading of reconversion. However, as we extend the list we soon enter a twilight zone. Cases arise in which the context of postwar events becomes obscure. Who knows that context now? And who does not know that it will vary from firm to firm? I cannot answer these questions today. My purpose this afternoon is to state problems which you can evaluate better than I.

The Broader Meaning of Reconversion

So much for the problem of reconversion costs in the narrower sense of that term — costs which relate to war income. As I said earlier, there is a school of thought which views reconversion more broadly, and includes in the term all expenditures made in the immediate postwar period. In justification of this attitude it is said that wartime taxes take away such a high proportion of wartime income that taxpayers cannot accumulate in the war sufficient earnings for postwar expansion and growth. Another group, acknowledging the adequacy of corporate earnings, believe that lower wartime taxes are necessary to insure the liquidity of these accumulated earnings after the war. It is also argued that tax savings resulting from the deduction of all types of expenditure from wartime income will enable a higher level of employment after the war by stimulating these expenditures.

Adequacy of Net Income After Taxes

These arguments are made for the most part by interested persons and should be washed in what Holmes called the "cynical acid of distrust." Take first the argument that it has been impossible during the war for corporations to accumulate earnings for postwar expansion. The argument simply does not hold water. I call your attention to certain data submitted to the Ways and Means Committee on October 4, 1943, and appearing on page 103 of the unrevised report of the hearings before that Committee. The figures in the unimpressive columns on these pages are little short of sensational. Net income (excluding dividends received) has reached the estimated level of $22 billion for the calendar year 1943. The estimate for 1944 is $24 billion. These figures are comparable to the figure of $5 billion for the year 1937, which was one of the most prosperous years of the Thirties.

Some of you will say that taxes have also risen and that we should regard not total net income, but net income remaining after taxes. I agree, taxes have risen; they have been multiplied many times. Total corporate liabilities for income and excess-profits taxes, amounting to slightly over $1-1/4 billion for 1937, have climbed to $13-1/2 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 billions, 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!

Nor have our high war taxes substantially affected dividends paid. 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!

The figures I have given you are the profits of all corporations, including the deficits of those with losses. You will find from the record of the Ways and Means Committee that the figures for corporations with net income are even higher. From our analysis of a sample of 650 corporations, prepared by the Department of Commerce, we have found that increased corporate earnings have been widely distributed. It is true that some businesses are suffering as a result of the war, while others are securing a relatively large share of increased war profits. However, of this sample, three-fourths report more net income after taxes in 1942 than in 1939, and over 40 percent doubled their 1939 level of earnings after taxes. The year 1939, you will recall, was generally a better year than either 1936 or 1937.

Viewing this period of unrivalled prosperity of corporate enterprise when measured by net income after taxes, it would be an indictment of our enterprise system if tax reduction were required to create its share of postwar jobs. Corporations may well need contract cancellation relief, but the deduction from wartime income of unrelated postwar expenditures would be nothing more than a subsidy program at the very time when industrial prosperity is at its greatest in history.

Liquidity of Business Enterprise

I now come to the second argument made by those who favor the inclusion in reconversion costs of all expenses of the immediate postwar period. Their argument is that the vast corporate accumulations of which I have spoken are not in liquid form. They are invested in plant and equipment, inventories, and accounts receivable. As such they cannot be used to pay obligations certain to mature immediately upon the cessation of hostilities. Cash available will be insufficient for the payment of dismissal compensation and immediate reconversion costs. Corporations will face serious cash shortages which may in many cases be ruinous.

I grant that there is this danger for many corporations. But I say that this is not basically a tax problem. It is a problem on a much broader front than the tax front. Some procedure will have to be developed for meeting this situation. All the reserves in the world will not help corporations out of this difficulty. The question must be tackled in connection with the termination of war contracts, and devices will have to be employed to keep our corporations on the job of producing postwar goods and giving postwar employment. One such device which has been developed is the Government-guaranteed loan under Regulation V issued by the Board of Governors of the Federal Reserve System.

I have said this was not basically a tax problem, but if prompter refunds of taxes to which firms are entitled can be made, then the tax structure can make a substantial contribution in easing this transitional period. In the years in which losses are being incurred, corporations are now required to make quarterly payments on their preceding year's tax liabilities. These payments are required even when the following March 15 will find the corporation suffering losses or declines in income with a credit balance in the Treasury.

To reduce this cash drain, the Treasury suggested to the Ways and Means Committee that a postponement of prior year's taxes be granted when corporations anticipate losses. This postponement could equal the potential refund resulting from the loss. A final reckoning could be made the following March 15. I believe this approach can more adequately meet the cash problem of those corporations with real need than any reserve plan which has yet come to my attention. It would immediately free the liquid assets that corporations have accumulated for payment of their tax liabilities, but does not grant them any more total refund than their legitimate claim. There would be no subsidy element in such a proposal.

Postwar Employment Stimulation

The last argument on behalf of the wholesale deduction of postwar reconversion expenses from wartime income is that employment after the war may be stimulated by such a device. I should be the last person to assert that our wartime tax structure is perfect. But I do say that the arbitrary reduction of the wartime tax base on account of postwar expenditures not related, in an accounting sense, to wartime revenue would not improve the situation any. Such a remission of taxes, which would otherwise have been levied on wartime income, would represent Government subsidies of the most discriminatory character.

The Government would be underwriting the postwar capital expenditures of a corporation making excess profits during the war more heavily than a corporation earning only normal profits during the war period. Two types of concerns would receive little or no benefit from such a treatment of postwar expenditures — the war casualty concern and the new postwar concern. The postwar industrial competitive structure would be enormously biased in favor of the existing profitable corporation.

Another unfortunate result would follow from the indiscriminate deduction of postwar capital outlays from wartime income. It is the function of our capital markets to place the liquid savings of individuals at the disposal of corporations with the highest prospective return upon investment. If corporate funds are to be provided by the remission of wartime taxes, it becomes impossible to secure this best investment of individual savings. These subsidies would be completely unrelated to need, or to the postwar prospects of the industry to which they were paid. The direction of investment customary in the capital markets would be warped, and the function of the capital markets would be sharply curtailed.

The Treasury, therefore, has opposed the deduction of postwar capital outlays from wartime income, as well as other arbitrary reductions in the wartime tax base. I am sure that the major part of our business leadership does not believe that after four consecutive years of industrial prosperity Government subsidies in the guise of postwar reserves are either necessary or wise. Refinements in the income-tax base are, of course, quite another matter.

It would be a masterpiece of understatement to say that history has never recorded anything like the times in which we live, and the times in which we shall live when victory is won. Was there ever such instability or insecurity? Change "with its long arm, its disturbing touch, its decree of events not yet manifest", has come to all the folkways of business. Invention was never so fertile. The pace of events is terrific. The tempo of the 19th Century has gone forever. The old order has perished.

At the same time the responsibilities of the businessman were never so great. Not the least of his difficulties is the coming transition period. This involves more than most of us can clearly foresee. But some outlines appear in the distance. We know that depleted world supplies and vast accumulated savings may well present a peacetime demand for goods such as the businessman has never known. We know that when peace comes, he will be dealing with employees who have recently had the satisfaction of full employment and who will be restless if there is too much slack. We know, and the businessman knows, that his whole future is at stake.

But we need not end on a pessimistic note. The businessman who converted from peace to war can convert from war to peace. For a time there may be loss of momentum. But I predict that speed will return to the machine as the challenge of the undiscoverable future is accepted. And I venture the prophecy that in the end the businessman will be glad that he did the job himself, that in a crisis business enterprise did not fail to perform its historic function, and that in the process the businessman kept Government assistance at a minimum.