REVENUE ACT OF 1938

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

SEVENTY-FIFTH CONGRESS

THIRD SESSION

ON

H. R. 9682

AN ACT TO PROVIDE REVENUE, EQUALIZE TAXATION
AND FOR OTHER PURPOSES

REVISED

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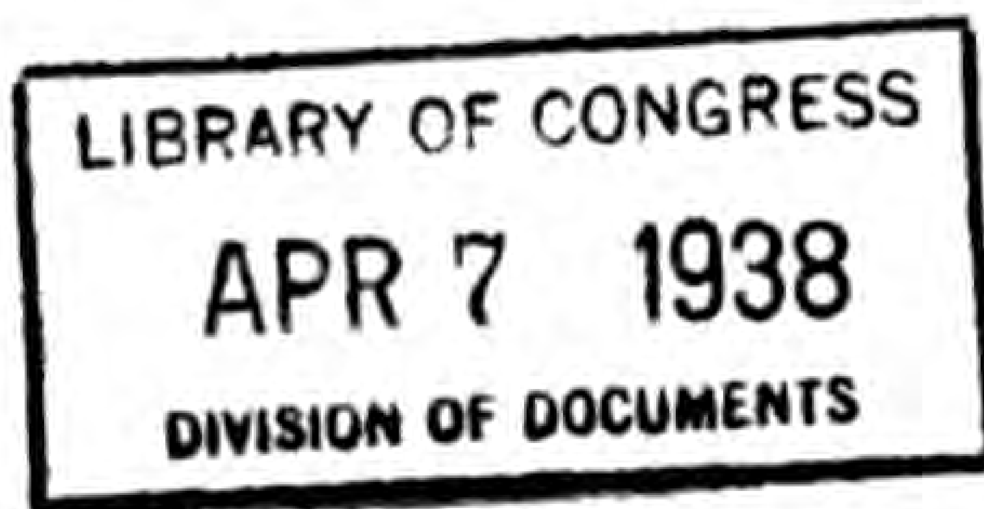

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$200,000 to $2,100,000 the percentage is doubled, or 16.1 percent. In estates of $2,100,000 to $4,100,000 the holdings represent 26.7 percent and over $4,100,000 the percentage is 44.

This large shift to tax-exempt securities and away from investments in business in order to avoid high-surtax rates, is obviously far from an end, and so long as the present rates continue business will be robbed of the capital which should be flowing into employment-making and wealth-producing enterprises.

The economists who compiled the table referred to above estimate that an additional $15,000,000,000 now invested in business securities is in danger of being gradually transferred to tax-exempt securities by holders whose incomes are of such proportions that they could obtain a higher net yield from tax-exempt securities than they now obtain from net dividends on business securities after deduction for taxes.

The present policy, viewed entirely from the standpoint of the real interests of those in the lowest income brackets or without income, is a mistaken one. Surtaxes on individual incomes most not be permitted to continue at such punitive rates as to eliminate individual incentive for enterprise and deprive the country of resulting employment-making activities.

In conclusion, permit me to speak briefly on the present opportunity of your committee and of Congress to build confidence and increase employment through the medium of a thoroughly equitable and reasonable revenue act.

As the Congress assembled last October in special session, there was being expressed in the Senate, in the House of Representatives, and throughout the country a common concern over the part played by the discredited tax policies enacted in the Revenue Act of 1936 in causing the business recession.

More than a half year will have passed before that act can be superseded by a Revenue Act of 1938. This half year will have witnessed no lessening of recognition of the great need for drastic and immediate change. Rather, that need has deepened and the recognition of it has increased as employment has dropped precipitously in the most rapid decline in business the country has ever experienced within a similar period of time.

The constructive attitude of your committe is well known. We applaud it for we know your purpose is to deal realistically with the important problems involved. If the Congress takes full advantage of its opportunity it will lead the country on a course of encouragement and hope which will enable business to renewed advance upon our great economic frontiers. It will declare against erroneous theories of overproduction and oversavings which have been and are now stultifying our national policies and drastically impeding progress. Moreover, Congress will give positive demonstration that it is firmly behind equity and reasonableness in all taxation; thus Congress will hearten the discouraged and thus it will call forth the enthusiasm and galvanize into action the combined great forces of America's savers and investors, its workers and its managers of business in the common task of achieving full employment, prosperity, and happiness for all.

The CHAIRMAN. Mr. Maurice E. Peloubet of New York City, representing the Copper and Brass Mill Products Association.

STATEMENT OF MAURICE E. PELOUBET, NEW YORK CITY, THE COPPER & BRASS MILL PRODUCTS ASSOCIATION

Mr. PELOUBET. I am Maurice E. Peloubet, a member of the firm of Pogson, Peloubet & Co., certified public accountants, of New York City. I am speaking for the Copper and Brass Mill Products Association, a group of manufacturers who produce copper and brass sheets, tubes, rods, and other shapes, principally for further fabrication by other manufacturers but to some extent for use as finished products. The members of this Association wish to have that section of the proposed Revenue Act which corresponds to section 22 (c) of the Revenue Act of 1936 so worded as to permit members of the association to use, for purposes of computing income subject to Federal income and excess profit taxes, the same accounting methods which are generally accepted as correct for reporting to the Securities and Exchange Commission, reporting to their stockholders and for other corporate purposes. This method is the last-in, first-out method of applying current costs to current sales and is not now permitted by the United States Treasury Department to be used as a basis for determining taxable income.

I appeared before this committee at the hearings on the Revenue Act of 1936 to request legislation in that act to permit the use of this method and was told that it was within the power of the Commissioner of Internal Revenue to permit the use of the last-in, first-out method and that legislation was not, therefore, required. Those whom I represented were advised that appropriate action could be obtained from the Treasury Department, but while they have been in almost continuous touch with the Department since the passage of the Revenue Act of 1936, the Treasury has continued to require the use of methods of determining income which are not generally considered to be correct for the copper and brass mill products industry.

The copper and brass mill products industry conducts its business so as to avoid loss and thereby preclude gain from market fluctuations, which is accomplished by matching purchases and sales in the following manner:

Orders are customarily taken for delivery some time in the future—generally 90 days, sometimes more. The price at which the orders are taken is a combination of the fabricating charge, generally known as the fabricating differential, and the price of the metals used in the product on the day that the order is taken. Promptly thereafter a purchase commitment is made for copper, zinc, or other metals required to fill the orders taken.

The products may not be delivered and the metal may not be received for several weeks or months, but the manufacturer knows that he can obtain metal to cover the sale he has made and that he will neither gain nor lose on the metal but will make his profit on the difference between his fabricating cost and the differential charged the customer, which is the basis on which his business is done.

The prices of copper and brass mill products are increased or lowered as the prices of copper and zinc change. Price changes on products are made within a few hours after a change in metal prices, and it is of the utmost importance to each fabricator to have a system and organization by which these prices can be changed and made effective promptly. If this were not done, heavy losses could result.

Thus, on the metal itself which is bought for and included in the products sold to customers, the brass manufacturer neither gains nor loses. It is not possible, however, to run a mill solely on the metal which the manufacturer has contracted to deliver to his customer in the form of finished products. He must, in addition, maintain a substantial inventory of metal. This inventory is in many different forms. Beginning at the casting operation, an excess of metal must be provided to allow discarding of unsound metal and dross. Similarly, in the rolling, drawing, and extrusion operations, unsound surfaces, edges, and ends must be removed. In finishing operations the product is reduced to proper dimensions by cutting off surplus material.

In other words, to produce a given quantity of a product a substantially larger quantity must be processed, the difference being mill scrap which is reclaimed and constitutes a constantly revolving inventory within the mill. Besides this, quantities of partially processed material must be kept at various points in the mill to permit economic production of the stream of orders which vary widely as to their individual quantity requirements. Altogether, therefore, the manufacturer must keep on hand an inventory which in metal content may equal several months' production. The inventory must always be kept on hand; a mill could no more operate without this inventory or so-called metals in process than it could operate without its plant or any of its equipment. And its practice, as I have explained to you, recognizes this fact. Sales are not made against this inventory; they are made against purchases of metal which occurred at approximately the same time as the sale.

In spite of this, the regulations of the Commissioner under section 22 (c) compel the fabricator to apply his current sales against an inventory deemed to be the earliest purchases when this, in fact, is exactly contrary to the fabricator's business practice. This results in inclusion in the computation of income, for income-tax purposes, profits or losses which are not the result of actual transactions.

The resulting distortion becomes particularly important in the copper and brass mill products industry because of the nature of their manufacturing operations, the relatively high cost of the metals they use, and the fluctuations in price to which those materials, particularly copper, are subject and over which the mills have no control. Their manufacturing operation is a complicated process bristling with physical and technical difficulties, and such a long period is involved that changes in price of inventory have a a maximum effect. The cost of the metal is the principal single cost of their product—often representing 60 percent or even more of the price which they receive for the product. Furthermore, copper is subject to wide fluctuations in price. During 1937, for example, copper rose from 12 cents at the beginning of the year to 17 cents, then declined again to 10⅛ cents at the end of the year. The reflection of this market fluctuation in the manufacturer's taxable income for that year might either double his actual profits for tax purposes, or result in a loss for the year, depending solely upon which his fiscal year ended. Certainly uniform and equitable taxation cannot be predicated on such an unreal base.

The taxation of fictitious incomes cannot be justified by the allowance of fictitious losses. The taxation of profits based on assumed

transactions which do not occur in periods of rising prices and expanding business forces a taxpayer, at the time when his working capital is most fully employed and most urgently required, to provide money for tax payments at effective rates double, triple, or quadruple those nominally in force. No matter how much benefit he may receive later in periods of declining prices and declining business, when through contraction of operations his needs for working capital are less and his position more liquid, he will still have no relief from his present compulsion to obtain by any means and under any terms money to pay the taxes then assessed on income assumed to have been realized. Over a period of years total income will be the same under any method of accounting consistently applied, and if taxed at a flat rate the aggregate tax will be the same.

What the members of the Copper and Brass Mill Products Association want is an amendment in section 22 (c) which will permit them to determine the cost of current sales by using the cost of the metal which they buy currently to cover such sales. This is the system which I have described as "last in, first out"—that is, metal which is sold is deemed to be the last acquired instead of the first acquired, as the Treasury Regulations now provide. This method corresponds with the mills' actual practice in conducting their business and is the method which many of them now use for their corporate accounts, although they are not allowed to use it for tax purposes. It determines all of the profit which they have actually realized, but it does not tax them upon profits or allow them losses which have not occurred as the present method does.

There can be no doubt that the last-in, first-out method is an approved accounting practice, Statements filed on this basis have been accepted by the Securities and Exchange Commission and the special committee on inventories of the American Institute of Accountants approved this method in a report dated May 7, 1936. In A Statement of Accounting Principles prepared by Professor Sanders, of the Harvard School of Business; Professor Hatfield, of the University of California; and Professor Moore, of the Yale University School of Law, the authors expressed their approval of last in, first out or similar methods. This study was prepared under the auspices of the Haskins & Sells Foundation, an organization formed for research into accounting matters, and was published by the American Institute of Accountants.

I have here letters from members of nine of the most prominent accounting firms in the United States approving the use of this method.

The members of the association which I represent do not ask for any special consideration, they do not wish any preferential treatment; they merely ask to be placed on a par with other industries which are permitted to determine taxable income on the basis of accounting methods recognized as correctly determining income in the industries in which they operate. No one inventory method is suitable for all industries, and the members of the Copper and Brass Mill Products Association merely ask that they be permitted to pay income and profits taxes on income actually realized rather than on the basis of a method which is not applicable to their particular industry, which shows profits in periods of rising prices which are not and can never be realized and which show losses in periods of falling prices which are equally fictitious.

The copper and brass mill products industry is being subjected to discriminatory treatment by the United States Treasury Department because other manufacturing industries are permitted to use their recognized accounting methods to determine taxable income and are taxed on income which is admittedly realized or realizable while the copper and brass mill products industry is taxed on unrealized and unrealizable income determined by methods not recognized by the industry.

Other industries are permitted to determine income and inventories by methods substantially similar in purpose and effect to the method the use of which is denied to the copper and brass mill products industry.

Industries dealing in a product such as cotton textiles or flour, where the conditions are similar to those in the industries described above, apply "hedging" transactions to their inventories and are thus able to get for themselves the same sort of results as the industries under discussion obtain by the use of the "last-in, first-out" method. The cotton and flour milling industries are permitted to use their "hedging" methods for tax purposes. The leather, nonferrous metal and other industries are not permitted to use an accounting method producing the same results. The entirely fortuitous circumstances of the existence or absence of an effective futures market is thus made the basis of discrimination between various taxpayers similarly situated. (See general counsel's memorandum 17,322.)

The high rates of tax which are generally considered to be inevitable for many years in the future magnify the importance of using accounting methods which reflect only such income as can actually be dispersed in taxes. A nominal tax rate of 5 percent, which by the inclusion of fictitious income becomes an actual rate of 10 percent, is unfair but will not ruin an industry. A nominal rate, however, of 20 to 30 percent levied on the fictitious income may easily become an actual rate of 40, 60, 80, or 100 percent on realized income. The members of this association do not wish to pay an effective rate of 3 or 4 times that of most industries and I cannot believe that it is the intention of Congress that they should do so.

I ask, therefore, that the section of the proposed act which deals with inventories should be so worded as to make it possible for the members of this industry to determine their taxable income on a basis which is generally accepted as that which shows as nearly as possible the actual results of operations and the actual realized income. They ask relief from the arbitrary imposition on their industry of a method which is clearly unsuited to it and which shows results which are demonstrably at variance with the facts.

To accomplish this I suggest the addition of the following language to section 22 (c) of the revenue act now under consideration:

"Goods remaining in inventory which have been so intermingled that they cannot be identified with specific invoices may be deemed to be the goods first purchased or produced during the period in which the quantity of goods in the inventory has been acquired and the cost of goods most recently sold may be deemed to be the cost of those most recently purchased or produced, if in conformity with the taxpayer's method of keeping his books or records and with the best accounting practice in the trade or business."

The CHAIRMAN. You say it is a question then of regulation by the Department?

Mr. PELOUBET. I think not, because the Department has refused to recognize an accepted method.

The CHAIRMAN. I understood that the Treasury Department, in 1936, had stated that they had the power to effect it by rules and regulations.

Mr. PELOUBET. They now say no.

The CHAIRMAN. Is that the only question you discussed in your brief?

Mr. PELOUBET. That is the only question.

The CHAIRMAN. When was the last time you had a conference with the Treasury officials?

Mr. PELOUBET. A few days ago, with no results whatever.

The CHAIRMAN. With whom did you talk?

Mr. PELOUBET. That was not a conference at which I attended personally, but I understand they spoke with Mr. Kent and with some of the other officials working under him.

The CHAIRMAN. You did not get very far?

Mr. PELOUBET. We got nowhere, I think there is no question about that.

The CHAIRMAN. I might say to you that this is not a new question. I remember it was presented in 1936.

Mr. PELOUBET. Yes.

The CHAIRMAN. The committee will inquire into it very definitely and will take your brief in connection with it. I was going to suggest, if you had not talked to these experts it might be well to bring it up to date, because we have some experts at one time and at another time we have different experts. They change them at times.

Mr. PELOUBET. We haven't gotten very far with them.

There is one thing that I might bring out. Of course we are not asking for privileges, we are not asking for anything exceptional, and there is nothing in this method which will reduce revenue over a period. As a matter of fact, in the year 1937 the revenue would have been increased if we had been permitted to use this method, for the year 1937 there would have been more taxable income in a number of industries than there are. Of course that will always happen in a period of declining prices. It works both ways. Our people are perfectly willing to take the consequences either way. The only thing is we do not want to pay taxes 2 or 3 years before we make any profits just because we must write up inventories which we cannot sell.

The CHAIRMAN. I will ask the representative of the Treasury to bring those matters to their attention.

(The memorandum heretofore referred to is as follows:)

BRIEF OF MAURICE E. PELOUBET ON BEHALF OF COPPER AND BRASS MILL PRODUCTS ASSOCIATION

The members of the copper and brass mill products industry desire to be permitted to use the last-in, first-out, or replacement method of costing inventories for purposes of computing taxable income for Federal income and excess-profit taxes. These methods are already in use by representative members of the industry for corporate purposes and it is desired to compute taxable income on this basis because it conforms more nearly to the basis on which business is actually done.

The members of the Copper and Brass Mill Products Association, which includes practically all the makers of what are known as copper and brass mill

products, that is, copper and brass sheets, tubes, rods, and extruded shapes, and similar and related products, carry on their business in very much the same way. By far the larger part of their business is made up of sales of substantial quantity and amount to other manufacturers who in turn produce the goods which go into direct consumption or to jobbers and distributors whose business it is to deal with the small user of the products of the various mills. There is, of course, a comparatively small volume of business which might be almost considered "retail," sales to small manufacturers, to individuals living in a territory not served by a distributor and the like, but the amount of such business in most mills is relatively unimportant. The first two classes of business with other manufacturers and distributors is done by means of contracts calling for delivery of substantial amounts of material over an extended period of time. Contracts calling for delivery within 60 to 90 days are probably the most frequent although it is not unusual for them to extend further.

The purchaser who is in all probability already committeed to his own customer for the price and amount of material to be furnished must know the price he will need to pay for his sheets, tubes, rods, or whatever products he requires and, therefore, enters into a contract not only to take delivery of a specified amount of material but to take delivery at a fixed price. In determining this price the copper or brass mill takes two factors into consideration: First, what the mill should charge the customer for the fabrication of the product which he ordered, and, second, what should be charged for the metallic content of the material. The first charge is determined by the usual competitive considerations, the mills' own cost and what others are charging for a similar service. This charge, which is generally known as the manufacturing or fabricating differential, does not change frequently but responds somewhat slowly to changes in wage rates and other factors affecting manufacturing cost. That part of the price representing metallic content, however, is determined promptly and definitely and without reference to any competitive considerations or to any profit or loss to be made by the sale of the metal to the customer.

The prices of copper, zinc, lead, nickel, and other metals used in the production of copper and brass mill products are quoted daily and publicly. The metal producer, the management of the copper and brass mill, and the purchaser of the mill's product all have available to them at the same time the same information on metal prices. The mill's customer, therefore, if he orders today a product which will require, say, 1,000,000 pounds of copper and 400,000 pounds of zinc will receive a contract stating that the mill will deliver to him 1,400,000 pounds of product as specified by the customer within the agreed time at a price determined by the metal prices of the day on which the order was taken and plus the fabricating differential which was in effect on that day.

Long experience has taught the members of the copper and brass mill products industry that it is more profitable for them in the long run to confine themselves to fabrication and to make their profits on the difference between the manufacturing cost and the fabricating differential charged to the customer. The fabricators, therefore, wish to avoid any possibility of loss to themselves by reason of fluctuations in metal prices and are willing to forego any possibilities of profit from this same cause. Obviously, if an order is taken today and a contract made at today's metal prices for delivery 2, 3, or more months in the future, a speculative risk would be taken by the fabricator if he failed to make certain that he would have metal available to him at the same price as that on which the order was placed at the time it was necessary to fill the order. There is, of course, but one general method of bringing this about, that is, to make a forward purchase commitment for the same amount of metal as will be required to cover his forward sales commitment and at the same price. This is the general custom of the industry and as soon as a fabricator receives an order he "covers" this by making a purchase commitment for the metal required. Obviously, every small order for a few thousand or even a few hundred thousand pounds is not covered individually but it is generally the custom to calculate the amount of metal required to fill the orders of any one day and to make purchase commitments to cover immediately.

The comparatively small amount of business which is done on what might be called a "spot" basis can generally be estimated and provided for with a considerable degree of accuracy.

Most mills have agreements with customers to buy back scrap from their own product and it is possible for those experienced in the business to estimate the amount of scrap which will be received from customers with a considerable degree of accuracy and this intake of metal is considered when de-

ciding on the amount of purchase commitments for raw metal. On the whole, it may be said that it is the constant and generally successful endeavor of the management of a copper and brass mill to protect themselves against any fluctuation in the price of the metal included in their sales and that they accomplish this by means of covering purchase commitments made with individual metal producers.

Obviously, this method, while always working towards the norm of exact coverage, will inevitably result in some lack of balance between purchase and sales commitments caused perhaps by the failure of a customer to carry out a contract, by a change in specifications, or by some condition in the metal market over which the fabricator has no control.

When metal prices change the price lists of the fabricators change at the same time and in the same proportion and it is only a matter of hours after a change in the metal price before changes in the prices of copper and brass mill products are notified to the trade.

It is obvious that the method of doing business adopted by the industry, which is designed to eliminate so far as possible profits or losses on metals, puts the fabricator, so far as metals are concerned, practically in the position of a buying agent for his customer.

If the fabrication of copper and brass mill products were a simple process completed within a relatively short period of time, the method of applying costs to sales and consequently of determining income and inventories would be of little importance and almost any recognized method consistently applied would produce a substantially correct income account. This, however, is not the case. The process of manufacture in a copper or brass mill is long and complicated and in many of the processes time is an important element. The conversion, for instance, of an ingot of raw copper and a slab of raw zinc into a brass tube where the alloy must be exact and uniform, the metal of a specified hardness, and the thickness of the walls and the inside and outside diameter accurate within a very small limit of tolerance, is a long and involved technical process and cannot be successfully completed within a short period of time. In general, the turn-over in a copper and brass mill is slow, three to four times a year being representative.

Many of the operating processes are continuous and in almost every operation it is desirable to have some material constantly in the department or in process. Every manager of a copper and brass mill knows it is expensive to carry inventories, and it may reasonably be assumed that inventories are generally maintained at the lowest practicable point and that the turn-over in the industry is as rapid as is consistent with satisfactory operations.

The practical requirement that a minimum inventory be maintained in the mill makes it necessary that each sale should be covered by a forward purchase rather than applied to stock in works already on hand. The management know that if any order were considered to be covered by stock in works, a substantially equivalent amount of metal would need to be purchased when delivery to the customer was made, and this might easily be at a higher price than the metal prices on which the sales contract was based. In a copper and brass mill the management do not consider that they may apply current sales to stock in works, but they know that they must purchase to cover their sales commitments. For this reason it is the custom in the industry to calculate income by applying current purchases to current sales without changing the metal prices applied to stock in works. This is the method known as last-in, first-out, under which it is assumed that the latest purchases are those first consumed rather than as is the case in other industries, assuming that the first purchases are the first consumed.

Obviously, the amount of stock in works required for successful operation will vary from time to time. If during a period of rising prices stock in works is increased, that is, if metal is bought for which there are no corresponding sales, such metals should be carried in the inventory at its cost. If, in a period of declining production which will, in all probability, be a period of declining prices this metal is sold, it should be applied against sales not otherwise covered. By this method the necessary flexibility of the amount of inventory required at different volumes of operation will be automatically maintained and the income of the fabricator will be affected by the liquidation of his inventory at the time this actually takes place. This is the principal difference between the "normal stock" method and the last-in, first-out method. While the results obtained by the use of a normal stock, if this method is properly applied, will frequently closely approximate the results obtained under the

last-in, first-out method, the normal stock method is, nevertheless, based on the arbitrary assumption that one unchanging normal quantity at one unchanging price exists. This can hardly be exactly true in any case and in most cases it is demonstrably incorrect. This element of rigidity and arbitrary assumption is probably the reason why the courts and the Treasury Department have not looked on the normal-stock method with favor. The last-in, first-out method has been devised to eliminate the arbitrary features of the normal-stock method and to retain at the same time those features of the normal-stock method which are based on correct theory and which corresponds to actual business practices and operations.

If a fabricator must keep in process at all times 1,000,000 pounds of copper he must maintain this amount in order to operate his business.

Accordingly, on January 1, 1937, he has on hand 1,000,000 pounds (cost 10 cents per pound).

During the year he sells 4,000,000 pounds (selling price 15 cents per pound).

In the course of the year he purchases, as he sells, 4,000,000 pounds (cost 15 cents per pound).

He has left at the end of the year 1,000,000 pounds (cost ?).

The Treasury Department's position is that he has sold 1,000,000 pounds on hand at the first of the year costing him 10 cents and 3,000,000 out of the 4,000,000 pounds purchased during the year at 15 cents; that he has, therefore, realized a profit of 5 cents a pound on the 1,000,000 pounds, but the fabricator started out with 1,000,000 and ended with 1,000,000 pounds of the identical material. He has not bargained for a profit on the commodity; his whole course of business was to avoid it. The so-called profit cannot be realized unless the 1,000,000 pounds of copper are sold at 15 cents but in order to operate his plant the fabricator must immediately replace his 1,000,000 pounds of copper at 15 cents and his profit is back in copper again. Yet this is the profit from which he must pay taxes at high rates or which he must distribute in dividends.

The question mark under the cost of the last million pounds presents the issue. Does he have on hand a new million pounds of copper at 15 cents (having realized a profit of 5 cents on the first 1,000,000 pounds) or, does he really have on hand nothing but what he originally started out with—1,000,000 pounds of copper at 10 cents? This is really the heart of the question. The more detailed examples serve to illustrate this in different situations and to varying degrees but the principle remains the same in every instance.

The following table shows the results in periods of stable rising and falling prices of the application of the first-in, first-out method to the operations of a hypothetical mill which handles, for simplicity, copper only. It is assumed that the mill has a capacity of 500,000 pounds per month and carries an inventory equal to 2 months' production. Inventory prices on the first-in, first-out method are taken at the average of the last 2 months of operation.

STABLE MARKET—CONDITIONS SUBSTANTIALLY THOSE OF YEAR ENDED DEC 31, 1935

First-in, first-out	Pounds	Cents per pound	Amount
Sales:			
Metal	6,000,000	8.8	$526,875
Fabricating differential		4.0	240,000
Total sales value	6,000,000	12.8	766,875
Cost of sales:			
Metal cost:			
Inventory beginning	1,000,000	9.0	90,000
Purchases	6,000,000	8.8	526,875
Total	7,000,000		616,875
Less inventory end	1,000,000	9⅛	91,250
Cost of metal sold	6,000,000	8.8	525,625
Manufacturing cost		3.0	180,000
Total cost of sales	6,000,000	11.8	705,625
Profit			61,250

RISING MARKET—CONDITIONS SUBSTANTIALLY THOSE OF YEAR ENDED MAR. 31, 1937

First-in, first-out	Pounds	Cents per pound	Amount
Sales:			
Metal	6,000,000	11.1	$665,620
Fabricating differential		4.0	240,005
Total sales value	6,000,000	15.1	905,625
Cost of sales:			
Metal cost:			
Inventory beginning	1,000,000	9¼	92,500
Purchases	6,000,000	11.1	665,625
Total	7,000,000		758,125
Less inventory end	1,000,000	14½	145,000
Cost of metal sold	6,000,000	10.2	613,125
Manufacturing cost		3.0	180,000
Total cost of sales	6,000,000	13.2	793,125
Profit			112,500

FALLING MARKET—CONDITIONS SUBSTANTIALLY THOSE OF YEAR ENDED DEC. 31, 1937 BUT WITH LOWER CLOSING PRICE

	Pounds	Cents per pound	Amount
Sales:			
Metal	6,000,000	13.0	$780,000
Fabricating differential		4.0	240,000
Total sales value	6,000,000	17.0	1,020,000
Cost of sales:			
Metal cost:			
Inventory beginning	1,000,000	10⅞	108,750
Purchases	6,000,000	13.0	780,000
Total	7,000,000		888,750
Less inventory end	1,000,000	9.0	90,000
Cost of metal sold	6,000,000	13.3	798,750
Manufacturing cost		3.0	180,000
Total cost of sales	6,000,000	16.3	978,750
Profit			41,250

In each case the 6,000,000 pounds of metal included in sales and the 6,000,000 pounds of purchases were made at the same price. The profit is, therefore, composed of two elements—$60,000 being 1-cent-per-pound profit on 6,000,000 pounds of production and the difference in the value of inventories as calculated on the first-in, first-out basis, although the nature and amount of the inventory was the same at all times.

Under the last-in, first-out method, the profit would amount to $60,000 in each of the three periods, as shown below:

STABLE MARKET—CONDITIONS SUBSTANTIALLY THOSE OF YEAR ENDED DEC. 31 1935

Last-in, first-out	Pounds	Cents per pound	Amount
Sales:			
Metal	6,000,000	8.8	$526,875
Fabricating differential		4.0	240,000
Total sales value	6,000,000	12.8	766,875
Cost of sales:			
Metal cost:			
Inventory beginning	1,000,000	9.0	90,000
Purchases	6,000,000	8.8	526,875
Total	7,000,000		616,875
Less inventory end	1,000,000	9.0	90,000
Cost of metal sold	6,000,000	8.8	526,875
Manufacturing cost		3.0	180,000
Total cost of sales	6,000,0000	11.8	706,875
Profit			60,000

RISING MARKET—CONDITIONS SUBSTANTIALLY THOSE OF YEAR ENDED MAR. 31, 1937

Last-in, first-out	Pounds	Cents per pound	Amount
Sales:			
Metal	6,000,000	11.1	$665,625
Fabricating differential		4.0	240,000
Total sales value	6,000,000	15.1	905,625
Cost of sales:			
Metal cost:			
Inventory beginning	1,000,000	9.0	90,000
Purchases	6,000,000	11.1	665,625
	7,000,000		755,625
Less inventory end	1,000,000	9.0	90,000
Cost of metal sold	6,000,000	11.1	665,625
Manufacturing cost		3.0	180,000
Total cost of sales	6,000,000	14.1	845,625
Profit			60,000

FALLING MARKET—CONDITIONS SUBSTANTIALLY THOSE OF YEAR ENDED DEC. 31, 1937, BUT WITH LOWER CLOSING PRICE

	Pounds	Cents per pound	Amount
Sales:			
Metal	6,000,000	13	$780,000
Fabricating differential		4	240,000
Total sales value	6,000,000	17	1,020,000
Cost of sales:			
Metal cost:			
Inventory beginning	1,000,000	9	90,000
Purchases	6,000,000	13	780,000
Total	7,000,000		870,000
Less inventory end	1,000,000	9	90,000
Cost of metal sold	6,000,000	13	780,000
Manufacturing cost		3	180,000
Total cost of sales	6,000,000	16	960,000
Profit			60,000

If the fabricator acts as the buying agent for his customer and not as a dealer in metal it should make no difference by whom the metal is bought. It is not uncommon for the larger customers of some copper and brass mills to buy their own metal and to ship this to the fabricator, paying the fabricator only his manufacturing differential. If the assumption that the fabricator is merely the buying agent is correct, and the general universal practice of the trade bears this out, then the results of a correct method of accounting where the fabricator buys the metal should be the same as the results where the customer buys the metal.

The following table is given for illustration only, as it is highly improbable that any mill would operate entirely on customers' copper:

	Pounds	Cents per pound	Amount
Sales:			
Metal belonging to customers	6,000,000		
Fabricating differential		4	$240,000
Cost of sales:			
Inventory beginning	1,000,000		
Receipts	6,000,000		
Total	7,000,000		
Less inventory end	1,000,000		
Total	6,000,000		
Manufacturig cost		3	180,000
Total cost of sales			180,000
Profit			60,000

The profits under the last-in, first-out method and the profit which would result if all metal belonged to customers are the same. These profits also represent the only profits which would be realized in cash as the remainder of the so-called profit on the first-in, first-out basis is represented entirely by changes in the valuation of inventories.

GENERAL USE AND RECOGNITION OF LAST-IN, FIRST-OUT METHOD IN THE INDUSTRY

The following members of the Copper and Brass Mill Products Association have stated through the medium of published accounts that the last-in, first-out is used by them for determining their corporate income: The American Brass Co.; Bridgeport Brass Co.; Phelps Dodge Corporation; Revere Copper & Brass, Inc.; Scovill Manufacturing Co.

A number of other members who keep statistical records on substantially this basis have stated that they would use the method in their financial books if it should be allowed for tax purposes, their reason for not using it at present in their financial books being that it was not permitted for tax purposes.

The method is recognized by the Securities and Exchange Commission, educators, and leading practicing accountants as a correct method of determining income for industries situated as is the copper and brass industry. To establish the recognition of the method by accounting authorities there is submitted:

(a) Opinions of: Paul K. Night, of Arthur Anderson & Co.; Deloitte, Plender, Griffiths & Co.; Edward A. Kracke, of Haskins & Sells; Dr. Joseph J. Klein, of Klein, Hinds & Fink; Walter A. Staub, of Lybrand, Ross Bros. & Montgomery; Samuel J. Broad, of Peat, Marwick, Mitchell & Co.; Rodney F. Starkey, of Price, Waterhouse & Co.; C. Oliver Wellington, of Scovell, Wellington & Co.; Victor H. Stempf.

(b) Excerpts from: A Statement of Accounting Principles, prepared by Thomas Henry Sanders, Harvard University Graduate School of Business Administration; Henry Rand Hatfield, University of California; Underhill Moore, Yale University School of Law; referring, on pages 15, 43, 73, and 74 to last-in, first-out, or similar methods with approval.

(c) Resolutions of committee on Federal taxation of the New York State Society of Certified Public Accountants.

(d) Data on last-in, first-out, and similar inventory methods: Corporations using last-in, first-out, or similar methods in corporate accounts; bibliography on last-in, first-out, or similar inventory methods; list of trade and other associations approving last-in, first-out, or similar methods.

LAST-IN, FIRST-OUT IS A METHOD OF DETERMINING COST

"Last-in, first-out" or "replacement" method of costing sales is merely one of several methods commonly used to determine cost for the purpose of arriving at taxable or corporate income and is, therefore, a permissible method, subject to the same regulations as any other method of arriving at cost in situations to which the various methods are adapted.

DISCRIMINATORY TREATMENT OF THE COPPER AND BRASS MILL PRODUCTS INDUSTRY

The copper and brass mill products industry is being subjected to discriminatory treatment by the United States Treasury Department because:

(a) Other manufacturing industries are permitted to use their recognized accounting methods to determine taxable income and are taxed on income which is admittedly realized or realizable while the copper and brass mill products industry is taxed on unrealized and unrealizable income determined by methods not recognized by the industry, and

(b) Other industries are permitted to determine income and inventories by methods substantially similar in purpose and effect to the method the use of which is denied to the copper and brass mill products industry. Industries dealing in a product such as cotton textiles or flour, where the conditions are similar to those in the industries described above, apply "hedging" transactions to their inventories and are thus able to get for themselves the same sort of results as the industries under discussion obtain by the use of the "last-in, first-out" method. The cotton and flour milling industries are permitted to use their "hedging" methods for tax purposes. The leather, nonferrous metal, and other industries are not permitted to use an accounting method producing the same results. The entirely fortuitous circumstances of the existence or

absence of an effective futures market is thus made the basis of discrimination between various taxpayers similarly situated. (See General Counsel's Memorandum 17322.)

To accomplish this, I suggest the addition of the following language to section 22 (c) of the revenue bill under consideration:

"Goods remaining in inventory which have been so intermingled that they cannot be identified with specific invoices may be deemed to be the goods first purchased or produced during the period in which the quantity of goods in the inventory has been acquired and the cost of goods most recently sold may be deemed to be the cost of those most recently purchased or produced, if in conformity with the taxpayer's method of keeping his books or records and with the best accounting practice in the trade or business."

[Letterhead of Arthur Andersen & Co.]

NEW YORK, *February 25, 1938.*

Mr. MAURICE E. PELOUBET,
Pogson, Peloubet & Co., New York, N. Y.

DEAR MR. PELOUBET: As representative of the Copper and Brass Mill Products Association, you have asked my opinion of the propriety of the use in the industry represented by that association of the last-in, first-out, or replacement method of costing sales and determining inventories, and you have particularly asked whether this method may be considered to be in accordance with present standards of good accounting practice.

The last-in, first-out, or replacement method of costing sales and determining inventories is appropriate in those industries which meet the following main requirements:

1. The investment in inventories is large relative to other assets.
2. The inventory consists of a few basic materials which form a substantial part of the cost of the product sold.
3. The spread between raw material prices and finished goods prices is relatively constant.
4. The turn-over is slow because of the length of the processing.

The fabrication of copper and brass appears to be an industry which meets these requirements. The last-in, first-out, or replacement method of costing sales and determining inventories is therefore applicable to this industry. It is my opinion that this method is in accordance with good accounting practice for this industry and for any other industries which have similar characteristics.

A number of important industrial companies are now using this method and have used this or similar methods for many years. Accounting authorities, both educators and practicing accountants, have, by the written or spoken word, advocated the use of this method in those industries to which it applies, and accounts prepared on this basis have been accepted by the Securities and Exchange Commission.

I see no reason why the United States Treasury Department or any other department or commission concerned should hesitate to recognize the last-in, first-out or replacement method as good accounting practice and as a method which is acceptable, both for corporate purposes and for determining taxable income, in certain industries.

Very truly yours,

PAUL K. KNIGHT.

[Letterhead of Deloitte, Plender, Griffiths & Co., United States, Canada, Cuba, Mexico, South America, Great Britain, Continental Europe, and South Africa]

NEW YORK, *March 2, 1938.*

Mr. MAURICE E. PELOUBET,
Pogson, Peloubet & Co.,
New York, N. Y.

DEAR SIR: As a representative of the Copper and Brass Mill Products Association, you have asked our opinion of the propriety of the use in the industry represented by that association of the last-in, first out or replacement method of costing sales and determining inventories and you have particularly asked whether this method may be considered to be in accordance with present standards of good accounting practice.

In our opinion the last-in, first-out method of costing sales and determining inventories is an accepted principle of accounting and could appropriately be followed, in preference to other methods, in any business where raw material forms a major part of the cost of the finished product, where minimum inventories must be maintained and where the inventory is slow. We have had no experience of the application of the last-in, first-out method to the copper and brass mill industry but the use of that method has been advocated for the oil industry by the American Petroleum Institute.

We see no reason why the United States Treasury Department or any other Department or Commission should not be prepared to recognize the use of the last-in, first-out method as being good accounting practice and as being particularly appropriate in the case of any business which has the characteristics mentioned in the preceding paragraph.

Yours very truly,

DELOITTE PLENDER GRIFFITHS & CO.

[Letterhead of Haskins & Sells, certified public accountants]

NEW YORK, *March 3, 1938.*

Mr. MAURICE E. PELOUBET,
Care Messrs. Pogson, Peloubet & Co.,
25 Broadway, New York.

DEAR SIR: With regard to the allegation that the last-in, first-out basis of inventory valuation did not conform to good accounting practice, may I refer to the conclusion reached by the special committee on inventories of the American Institute of Accountants in its report to the council of the Institute, dated May 7, 1936, in which the committee gave its unanimous opinion as follows:

Our committee, after careful consideration of the matter, has found itself in agreement in arriving at the following conclusion:

"The last-in, first-out method for the valuation of oil company inventories, as recommended by the American Petroleum Institute, constitutes an acceptable accounting principle for those companies, which, finding it adaptable to their needs and views as correctly reflecting their income, apply it consistently from year to year; it is important, however, that full and clear disclosure, in their published financial statements, be made by the companies adopting it, both as to the fact of its adoption and the manner of its application, including information as to the period adopted for the unit of time within which the goods last in are deemed to be the first out, that is, whether the fiscal year or a shorter or longer period."

The above excerpt is, of course, a summarization of the committee's findings which that report set forth in the remainder of the report in extended form.

Sincerely yours,

E. A. KRACKE.

[Letterhead of Klein, Hinds & Finke, certified public accountants]

NEW YORK, *March 2, 1938.*

MAURICE PELOUBET, Esq.,
25 Broadway, New York, N. Y.

MY DEAR PELOUBET: I am glad to respond to your recent invitation to express my personal views regarding inventorying on the basis known as last-in, first-out. Under date of February 3, 1938, the chairman of the committee on Federal taxation of the New York State Society of Certified Public Accountants, I addressed a communication to the Honorable Roswell Magill, Under Secretary of the Treasury, with reference to the same subject.

The experience of professional accountants has demonstrated that no single inventorying method serves the purpose of all types of industries. The method with respect to which you wish my opinion is in quite general use and has justified itself in connection with enterprises (1) which must maintain a constant minimum or base inventory, (2) which customarily make purchases of raw materials to fill specific orders, (3) in which the cost of the raw material constitutes the predominant element in the value of the finished product, and (4) in which the chief income is represented by the charge for

processing. In the situations under discussion, considerable periods of time frequently elapse between the taking of the order and the delivery of the finished product.

In the determination of costs of operations for the types of business which I have in mind, it has been found that most dependable results are achieved when it is assumed that the cost of the raw-material ingredient of the finished product is represented by most recent purchases. In other words, in the determination of costs, it is assumed that the most recently acquired merchandise is first consumed; hence the designation of the formula as last-in, first-out.

In practice the accountant associates the concept of cost, not only with reference to income from operations, but likewise with respect to the effect on the balance sheet. If it is assumed that raw materials are exhausted in the inverse order of their acquisition, it follows that the cost of the inventory on hand is predicated on the earliest costs. Where the base stock fluctuates little in physical quantity, the balance-sheet value of the inventory may be based on prices of many years earlier. Regardless of which inventorying method is employed, the balance-sheet valuation should in general reflect the lower of cost or market value. It follows, therefore, that, regardless of which inventorying method is employed, the inventory should not be shown in an amount in excess of the lower of cost or market value. Thus, unless the base inventory is priced as of a time when the market was low, the results from the application of the last-in, first-out method may have to be modified so as to reduce the value of the end-of-the-period inventory to the currently lower market. If this precaution is observed, it would seem to me that neither management nor Government officials should object to the use of the last-in, first-out method by industries of the type herein referred to.

Very truly yours,

JOSEPH J. KLEIN.

[Letterhead of Lybrand, Ross Bros. & Montgomery, certified public accountants]

NEW YORK, *March 8, 1938.*

MR. MAURICE E. PELOUBET,
25 Broadway, New York, N. Y.

DEAR MR. PELOUBET: At your request I am submitting herein my opinion as to the propriety of the use of the so-called last-in, first-out method of costing sales and determining inventory valuations and whether this method may be considered to be in accordance with present standards of good accounting practice.

I can perhaps most readily express my views on the general principle involved and the reasons for preferring the last-in, first-out method by quoting from my article written in the latter part of 1934, which was based on talks on the subject of Adjustment of the Balance Sheet to Present-Day Business Conditions, given at meetings of the Washington and Rockford chapters of the National Association of Cost Accountants in December 1933 and October 1934.

I append hereto a copy of that portion of the article which dealt with the subject of inventories and the costing of sales. The L. R. B. and M. Journal, in which the article appeared, is published primarily for distribution among the members of the organization at our different offices.

I first became interested in the subject almost 20 years ago when the tremendous rise in commodity prices occurred during the World War. I questioned the reality of profits which were then being shown as the result of the sales of products at greatly enhanced prices being compared with the lowest costs of materials or finished product included in the stock on hand. Unfortunately, however, there was not sufficiently general recognition at that time of the fallacy of costing sales and showing profits by the first-in, first-out method, which was suitable enough for ordinary circumstances but not, in my opinion, nearly as sound as last-in, first-out in times of wide fluctuation in prices. Also, the optimism of war times indulged in the hope that post-war reconstruction and similar influences would maintain and continue permanently the price level attained during the war.

The tremendous fall in prices in 1920 led to some recognition of the weakness of the first-in, first-out method, but, again unfortunately, the Treasury in its regulations regarding inventories adhered to the old method which had been evolved under comparatively stable conditions of pre-war times. These Treasury regulations for the administration of the 1918 Revenue Act (which was not actually passed until February 1919), and their substantial continuance under succeeding acts, had, I think, much to do with the slow recognition of the superiority of the last-in, first-out method, as businessmen were naturally

reluctant to keep their books on a different basis than that which they were required by the Treasury regulations to use for reporting profits or losses for income-tax purposes.

The rapid rise in commodity prices during the later twenties and the cataclysmic drop in prices during the depression, which completed a cycle similar to that of the war period and the post-war years of 1919–20, caused more serious consideration to be given to the subject than ever before. As you know, about 4 years ago one of the major industries of the country asked the American Institute of Accountants to appoint a special committee to confer with an accounting committee representative of the industry in an endeavor to determine the most satisfactory method of valuing inventories and consequently of determining profits. Although the industry was, naturally, most concerned with its own immediate problems, the committee of our institute obviously had to consider the question from the broader aspect of the basic principle upon which any particular method should rest. I served on that committee for a time, and urged strongly the use of the last-in, first-out method because of the superiority which I believe it enjoys as compared with the first-in, first-out method. The report of the institute committee expressed approval of the last-in, first-out method for use in that particular industry, and in my opinion it would be just as suitable for general use in the industry represented by the Copper and Brass Mill Products Association.

A number of representative companies have for years used the last-in, first-out method or its practical equivalent, and the number of such companies is, I believe, now larger than ever before. I am of the opinion that the method is in accord with good accounting practice of the present day for the purpose of determining the cost of inventories of industrial and mercantile enterprises other than in those cases where specific articles can be readily identified as used or sold and the nature of the business is such that the cost of specific articles should be used.

Very truly yours,

WALTER A. STAUB.

EXTRACT FROM ARTICLE ENTITLED "NOTES ON THE ADJUSTMENT OF THE BALANCE SHEET TO PRESENT-DAY BUSINESS CONDITIONS"

[L. R. B. and M. Journal, November 1934]

Inventories materials, goods in process, and finished product.—In the course of time the rule of "cost or market, whichever is lower," for which the public accountant profession consistently contended in season and out of season, and at a time when many businessmen did not agree with the rule, has become generally accepted by the banker, the manufacturer, the merchant, and the taxing official.

It is a rule of conservatism and safety rather than of logic. Logically, by the same token that inventories are written down to provide against potential losses not yet actually sustained but threatened by a fall of market prices below cost, it could be argued that inventories should be written up to recognize potential profits therein not yet actually realized but promised by a rise of market prices above cost. Long experience, however, has taught that the only course of safety is that of providing against threatened losses but of not counting chickens until they are actually hatched.

The time-tested principle of "cost or market, whichever is lower," is on the whole still the best to follow. But question has from time to time been raised which cost is to be applied to the goods sold and which cost is to be applied to the goods remaining on hand. Shall it be "first in, first out, or last in, first out, or average of the beginning inventory cost plus subsequent purchase or production cost (on a weighted average basis)?

This question has been receiving renewed consideration because it is of greatest importance in periods when a radical change in the price level occurs (whether up or down) as during the depression period. When the price movement is upward, as during the World War, the use of the first-in, first-out costing of sales tends to show large profits because of selling at mounting prices goods purchased at the lower price level, although if the concern is to remain in business it must immediately replace the sold goods with others purchased at prevailing higher prices.

The effect is that the valuation of the inventory is at the highest recent cost, and the profits shown on goods sold have to a large extent not been realized

in the sense that they are available for distribution but they have had to be reinvested in large part in maintaining a stock of goods no larger in quantity than that previously carried for a much smaller investment. When the inevitable drop in the price level occurs, large losses on inventory values are shown in adjusting to "cost or market, whichever is lower." In 1920 many concerns showed inventory losses which offset to a considerable extent the large profits apparently earned during the war period. Similarly, large inventory losses due to the tremendous drop in prices during the present depression have in the case of many companies absorbed profits shown during the time that a high cost was being developed for the inventory.

The question has been raised whether, assuming a starting inventory at a low enough level so that prices would hardly drop below it excepting under catastrophic conditions, the use of the formula of "last in, first out" in costing goods sold would not result in a truer picture of actual profit. The argument can be made that there is a closer relation between the prices of goods last purchased and of the goods currently sold then between the earliest purchases of goods on hand and of the goods currently sold.

In the case of industries or concerns the inventories of which are ordinarily very large in relation to other assets—as, for example, the oil industry where large quantities of crude oil may be carried in stock continuously—the last-in, first-out method of costing sales has a tendency to minimize the extremes of profits and losses. The profits shown in periods of rising prices would tend to be less than by using the formula of "first in, first out," and correspondingly in periods of falling prices such losses as might be shown in reducing inventories to lower market prices would not be as great as would otherwise have to be taken. It is to be noted that the formula of cost or market, whichever is lower, would still govern the violation of the inventory and would correct the tendency which might develop in a period of falling prices for the inventory to remain at a higher price level than the current prices at which sales would be costed.

The last-in, first-out formula is being given study by an inventory-methods committee in one of the large industries of the country at the present time. Any method which will tend to minimize the profits shown in periods of rising prices which are not actually available for distribution, because of the need for retaining at least a material portion of such profits in the business as added working capital and thus subjecting it to a business hazard which becomes greater the higher the price level rises, is worthy of careful consideration.

If such a cost formula or method were generally adopted in an industry, it would be desirable to show as a memorandum on the balance sheet the current replacement market value for the inventory. This would assist in giving a full understanding of the situation to those extending credit to a given concern or those who wish to make an intelligent comparison of the financial position of various companies in the same industry whose inventories may be carried at differing costs. Even under the present more general use of the first-in, first-out cost formula, the supplementing of the valuation at which the inventory is carried in the balance sheet by a memorandum of the approximate replacement market value thereof would be informing.

The average cost method of carrying or valuing the inventory may be said to be intermediate between the first-in, first-out and last-in, first-out methods. It is probably less used now than was at one time the case, though it is still the method generally used in at least one of the major industries of the country.

An inventory method which has somewhat the same end in view as the last-in, first-out cost formula is the base-stock method. It has the virtue of conservatism, both from a balance-sheet point of view (assuming, of course, that the base price, which remains unchanged, is set sufficiently low at the inception of the use of the method) and from the point of view of the earnings shown during an era of rising prices.

The leading exponent of this method in this country is the National Lead Co., which has clearly explained the method in its annual reports. Another of the prominent industrials of the country, the International Harvester Co., used the method for a few years at the close of the World War period but discontinued when the United States Treasury refused to accept the method for income-tax purposes. The refusal of the taxing authorities in both the United States and Great Britain to accept the base-stock method for valuing inventories has probably discouraged a more general use of it by industrial companies.

One other point in the valuation of inventories which requires especial consideration in the depression period is that only normal overhead should be

included in inventory value, even though under present conditions with greatly reduced output the actual overhead ordinarily exceeds a normal rate of overhead.

[Letterhead of Peat, Marwick, Mitchell & Co., accountants and auditors]

NEW YORK, N. Y., *March 3, 1938.*

Mr. MAURICE E. PELOUBET,
Messrs. Pogson, Peloubet & Co.,
New York, N. Y.

DEAR SIR: I refer to your recent discussion as to the propriety of the use in certain industries of the last-in, first-out method of costing sales and determining inventories, and particularly to your inquiry as to whether, in my opinion, this method may be considered to be in accordance with present standards of good accounting practice.

The commonly used basis of stating inventories is under the formula of cost or market, whichever is lower, but within that formula variations of method of determining cost and market prevail, consistency of treatment from period to period being, of course, essential whatever method be adopted. Your inquiry is directed to that method underlying cost which is designated "last in, first out."

It is well to point out, in the first place, that before determining the preferable method of computing the cost of inventory on hand there must be careful consideration of the purchasing and selling methods, rapidity of turnover of inventory, extent of inventory normally carried, and the timing of sale-price changes in relation to changes in purchase prices of materials entering into the product sold. It is impracticable and undesirable, in a period of changing cost prices for materials, to determine the cost of goods sold by following through from purchase to sale the specific materials entering into the product sold; thus it becomes necessary to appraise the merits of various methods, i. e. whether the goods sold may be regarded as having been produced from materials purchased first or from those purchased last, or from the group of all similar materials purchased and on hand within a specified period.

In a period of stable prices it would not make much difference which method is used, because all would produce substantially the same results. Such is not the case, however, where purchase costs have changed materially during a period. Thus the problem resolves itself into a question as to which method would most adequately reflect the results of the transactions and managerial policies and methods.

The average manufacturing or processing company usually has a certain amount of inventory on hand in different stages of production. Where prices have changed between the beginning and the end of a period, the use of either the first-in, first-out method or the average-cost method results in a change in the costs used for the terminating inventory as compared with the inventory at the opening date even though substantially the same amount of goods may be on hand. Particularly in the case of industries where the turn-over is slow because of the length of the processing time, either method would thus introduce into the accounts an element of profit or loss on the inventory which is to some extent speculative in nature and which may never be realized.

In some businesses an attempt is made to eliminate so far as possible the the speculative element by relating sales commitments to current costs of materials; thus, when goods are sold, substantially the required amounts of raw material are either purchased concurrently or future commitments therefor may be entered into, the principal purpose being to avoid speculation and to eliminate the effect of market fluctuations from the profits. In cases where such procedure exists it would seem entirely arbitrary to declare that only the first-in, first-out, or the average cost. method should apply, or to take the position that market profits or losses reflected in the inventory as a result of determining them on such a basis had actually occurred.

I believe that these considerations are the more important in the case of those industries in which raw material costs form a relatively large part of the total cost of the product, and particularly where the raw material involved is subject to substantial price fluctuations. Due to the element of timing as between the purchase of raw materials and the shipment of the corresponding sales, an assumption that the last goods in are the first goods shipped is also arbitrary to a certain extent. But it is my opinion that this assumption, under the conditions outlined above, most nearly reflects the actual operating conditions,

and that the last-in, first-out method can be considered in such cases as in accordance with sound accounting practice for costing sales and for determining inventories.

While I realize that so far this method has not been accepted by the Treasury Department for the purpose of determining taxable income, some substantial corporations have adopted it for their fiscal purposes, notwithstanding the added difficulty of a double determination of the inventory; and this very fact would seem to justify the assertion that they regard this method the preferable one from a business standpoint and the one which most accurately reflects the profits or losses which have been realized.

Yours very truly,

SAMUEL J. BROAD.

[Letterhead of Price, Waterhouse & Co.]

NEW YORK, *March 4, 1938.*

Mr. MAURICE E. PELOUBET,
Pogson, Peloubet & Co., 25 Broadway, New York, N. Y.

DEAR SIR: You have requested my opinion of the propriety and use of the last-in, first-out method of costing sales and whether, in my opinion, this method may be considered in accordance with present standards of good accounting practice.

The question of determining the cost of sales and of pricing inventory at cost, whether this cost be used in the balance sheet or compared with market in order to determine inventory at cost or market for balance-sheet purposes, is, I believe, a broader subject than a mere consideration of whether a last-in, first-out method is in accordance with present standards of good accounting practice.

In a report in 1936 on a proposal of the American Petroleum Institute to adopt the basis of last-in, first-out for the oil industry, the special committee on inventories of the American Institute of Accountants made the folowing observations in regard to valuing inventories "at cost or market, whichever is lower":

"The principle of 'cost or market, whichever is lower,' which constitutes the present-day, generally followed method of inventory valuation, is one of long standing and dates from the days when the balance sheet was accorded much more attention as compared with the income account than is the case today, and accounting practices naturally reflect this viewpoint. To value inventories at cost was, of course, the logical thing to do, and to take cognizance of a declining market was equally logical and conservative. The question of what constituted cost, however, in the days of simple business relations did not give rise to the involved considerations called for by present-day business complexities, and because of the much greater emphasis laid on the balance sheet of effect upon income of the diverse views which are possible in regard to cost computation did not receive much attention."

In a recent booklet published by the American Institute of Accountants, entitled "A Statement of Accounting Principles," the first-in, first-out, last-in, first-out, and average cost have all been recognized as proper methods to be used in arriving at cost in any industry for which they may be appropriate.

Fundamentally, the determination of net income for income-tax purposes should not deviate from good accounting practice, and this has been consistently recognized in the Federal income-tax statute. Section 41 specifically provides that "The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but * * * if the method employed does not clearly reflect income, the computation shall be made in accordance with such method as, in the opinion of the Commission, does clearly reflect the income."

The regulations have amplified the general provisions of the statute, and in article 22 (c) (2) two tests are provided, to which each inventory must conform: "(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) it must clearly reflect the income." The regulations are principally concerned with the "valuation of inventories," whereas, in my opinion, more emphasis should have been put on the determination of "cost of goods sold."

Among the various bases which may be used in computing cost of goods sold are the following:

The actual identified cost of the materials used in production (this basis is applicable in cases where the material can actually be identified).

The basis of average cost (many variations of this basis may be made as required by conditions. The period of time used for averaging has to be considered. In some cases an average cost for a period of a year may be used and again it may be necessary to average the cost of current production with the unsold quantity and cost of prior production).

The last-in, first-out basis which has been adopted by the oil industry and a number of other industries.

The first-in, first-out basis which is also being used by a number of industries.

The various methods of determining cost of sales set forth in the foregoing paragraph are, in my opinion, appropriate and good accounting practice for certain companies and industries.

Yours very truly,

RODNEY F. STARKEY.

[Letterhead of Scovell, Wellington & Co., accountants and auditors]

NEW YORK, *March 10, 1938.*

Mr. MAURICE E. PELOUBET,
Pogson, Peloubet & Co.,
25 Broadway, New York, N. Y.

DEAR MR. PELOUBET: As a representative of the Copper and Brass Mill Products Association you have asked my opinion as to whether the last-in, first-out method of costing sales and determining inventories may be considered good accounting practice for the industry represented by the Association.

The use of the last-in, first-out method for determining cost of goods sold and net earnings has always been good accounting practice, and, in my opinion, is particularly well adapted to an industry such as that you are representing, with whose usual operating conditions I am familiar. While the use of the first-in, first-out method of determining cost of goods sold is more general and is applicable to the conditions in many industries, there has been in recent years an increasing adoption of the principle of last-in, first-out in place of first-in-, first-out for those companies where the last-in, first-out method most clearly reflects income.

The purpose of accounting is to state operating facts as clearly and accurately as may be under the circumstances. For companies in the industry that you represent, a comparison of the metal content of sales with the cost of the metal most recently received in my opinion comes closest to the actual operating facts, and more clearly reflects income than under the first-in, first-out method, where the cost of materials sold is assumed to be those first purchased.

Fundamentally, the function of the companies in the industry you represent is the fabrication of raw materials into a finished product. The profits should be and generally are from fabrication, and the gain or loss on raw materials is incidental. A well-operated company endeavors to cover current sales by current purchases. Many of the companies, if there were a market available for hedging transactions as is the case with some other raw materials, would undoubtedly make hedges to eliminate any gains or losses on raw materials. Lacking such an opportunity, the use of the last-in first-out method corresponds most closely with business conditions under which sales and purchases are made, and in my opinion most clearly reflects income and is therefore good accounting practice for the industry.

Sincerely, yours,

C. OLIVER WELLINGTON.

EIGHTY MAIDEN LANE, NEW YORK, N. Y.,
February 25, 1938.

Mr. MAURICE E. PELOUBET,
New York, N. Y.

DEAR SIR: As a representative of the Copper and Brass Mill Products Association, you have asked my opinion of the propriety of the use in the industry represented by that Association of the last-in, first-out, or replacement method of costing sales and determining inventories and you have particularly asked whether this method may be considered to be in accordance with present standards of good accounting practice.

The last-in, first-out, or replacement method of costing sales and determining inventories is appropriate in those industries in which:

1. Operating processes are continuous.
2. Turn-over is slow because of the length of the processing.
3. Minimum inventories must be constantly maintained.
4. Raw material costs form the greatest or a substantial part of the total cost of the product.

In such industries it is the custom to make purchases of raw material at the same time and at the same price as the sale is made, even though delivery to the customer is to be made some little time in the future. Generally, in such industries the price of the finished product varies with that of the raw material, which is the principal constituent of the product. In such industries profit on converting or fabricating is the principal object, and any gain or loss on material is incidental and frequently the result of circumstances beyond the control of the management.

A method of determining costs and inventories, therefore, which has the effect of applying current costs to current sales, reflects the income more correctly than any other. A method such as first-in, first-out which disregards the fact that purchases are made to cover sales and attempts to apply entirely unrelated purchase and sale transactions, must of necessity distort the results of operations.

The fabrication of copper and brass appears to be an industry which possesses the characteristics outlined above, which indicates that the last-in, first-out, or replacement, method of costing sales and determining inventories in applicable to it. In my opinion, therefore, the last-in, first-out, or replacement, method of costing sales and determining inventories may be regarded as good accounting practice in that industry, being the method which most nearly reflects the correct income for any given period.

I do not need to remind you that a number of important industrial companies are now using this method and have used this or similar methods for many years. Accounting authorities, both educators and practicing accountants, have, by the written or spoken word, advocated the use of this method in those industries to which it applies, and accounts prepared on this basis have been accepted by the Securities and Exchange Commission.

In view of all this I see no reason why the United States Treasury Department or any other department or commission concerned should hesitate to recognize the last-in, first-out, or replacement, method as good accounting practice and as a method which is correct, both for corporate purposes and for determining taxable income, in the accounts of companies or industries which possess the characteristics outlined in this letter and which carry on their business in the manner described herein.

Yours very truly,

VICTOR H. STEMPF,
Certified Public Accountant, Member American Institute of Accountants.

EXCERPTS FROM "A STATEMENT OF ACCOUNTING PRINCIPLES"

Prepared by Thomas Henry Sanders, Harvard University Graduate School of Business Administration; Henry Rand Hatfield, University of California; Underhill Moore, Yale University School of Law, for the Haskins & Sells Foundation, Inc., published by American Institute of Accountants

(P. 15)

Such inventory policies as the base-stock method frankly abandon the usual basis of keeping inventories within the cost or market area. A long-time view is taken; a low point is chosen as the inventory base price; the ups and downs of current prices above that point are ignored with respect to the base inventory; most of the time the inventories stand in the balance-sheet at something much below either cost or market, and there results some equalizing of profits over periods of prosperity and depression.

(P. 43)

If the management wishes to go further and adopt a still more conservative policy with respect to inventory valuation, calculated to reduce the fluctuations in profits, that should be regarded as well within its province. The base or normal-stock method is a notable example. It is not, as some suppose, an artificial treatment of the figures; on the contrary, it takes cognizance of two

important facts: First, that a minimum inventory is a constant necessity to the operating company, and, second, that in times of prosperity the incipient conditions of depression are already present. The basic question is, What is the accounting period? A narrow adherence to the conditions and figures for the one year will exclude any notice of what may come after, while a recognition of the fact that the year is simply a chapter in the company's history may lead to adoption of sounder policies.

If the base or normal-stock method is clearly explained in the annual reports, especially as is sometimes done, with tables showing the adjustments, a reader can compute for himself the approximate effects of the policy, and can adjust inventory and profit figures if he chooses. If a company can show a strong current ratio with inventories on the base-stock method, the ratio would be still stronger if they were stated on the usual basis. In these circumstances the base-stock method seems to be within the bounds of proper accounting principles. The policy of the Bureau of Internal Revenue in disallowing this method, while it may simplify the determination of income for tax purposes, is probably not a wise public policy in the long run. The subject of inventory valuation is further discussed in part III, page 73.

(P. 73)

Accepting the rule stated above that the lower of cost or market is the primary guide, the accountant should apply this rule reasonably and consistently. If by different interpretations of the rule it is possible to arrive at substantially different results, then it is desirable to indicate the method employed and to follow that method consistently from period to period.

Accountants may properly arrive at "cost" on a basis of (a) first-in, first-out; (b) last-in, first-out; (c) average cost; or (d) base-stock method, as may be most appropriate for the industry. For raw-materials "market" usually means the buying or replacement market; as to work in process and finished goods, "market" means the cost of reproduction or replacement, unless the realization prices are lower, in which case they would govern.

Discussions as to the auditor's responsibility for inventories should not obscure the fact that those who read the statements will in fact rely upon the inventory figures there given as a representation by the company's accountants and auditors. The latter are, therefore, bound to take reasonable and appropriate steps to ascertain that the inventory is as reported; if they know of any circumstances likely to invalidate conclusions drawn from the inventory figures, they are bound to endeavor to preclude the drawing of such erroneous conclusions, either by changing the figures themselves, or by suitable qualifications.

Rules like the lower of cost or market were devised as an aid to prudent business management and for the protection of investors, and not for tax purposes. But under these rules, cases have occurred of wide fluctuations of material prices resulting in losses of one period, followed by profits of another period, in which the latter were taxable without proper offset. In these cases such valuation methods as base stock, or last-in, first-out, are intrinsically proper, as well as being proper from a business point of view.

LETTER FROM DR. JOSEPH J. KLEIN, CERTIFIED PUBLIC ACCOUNTANT, CHAIRMAN OF THE COMMITTEE ON FEDERAL TAXATION OF THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS, TO THE HONORABLE ROSWELL MAGILL, UNDER SECRETARY OF THE TREASURY

HON. ROSWELL MAGILL, FEBRUARY 3, 1938.
The Under Secretary of the Treasury,
Washington, D. C.

DEAR PROFESSOR MAGILL: The committee on Federal taxation of the New York State Society of Certified Public Accountants has given considerable thought to a suggestion made by the society's committee on inventory methods relative to the inventory regulations of the Commissioner.

As you know, section 22 (c) of the Revenue Act of 1936 and the corresponding provisions of the preceding acts, provide that—

"Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

You also know that General Counsel's Memorandum No. 17322 (reported on p. 151 of the Cumulative Bulletin XV-2) wisely and fairly permits industries processing certain raw materials, principally wheat and cotton, to apply the results of hedging transactions, entered into for the purpose of eliminating gains or losses on raw materials, to their inventories without the application of the limitation imposed on capital gains or losses, although such limitations are applied generally to futures transactions in these commodities.

There are, as you know, other industries producing, fabricating, or processing raw materials which are not permitted by the Commissioner to apply current costs to current sales under the replacement, or last-in, first-out inventory method. The committee on inventory methods urges that the presently unrecognized method of inventorying, under ordinary conditions, has a similar effect upon the determination of income as that produced by permissive open-market hedging transactions in commodities where effective and satisfactory futures markets exist.

As practicing accountants, the members of our committee are keenly aware of the fact that during a period of rising prices the first-in, first-out method of pricing inventories, as at present required by the Commissioner, where merchandise is commingled, results in taxing business income that is in part necessarily absorbed in increased inventories and working capital. Manifestly, the injustice of taxing such increase as a part of the income is grossly aggravated under a system of graduated taxes on income and on undistributed earnings.

It seems to us that the discrimination referred to, to the extent that it exists, is unintentional, because it is unthinkable that the tax authorities should wish to impose unlike burdens on different groups of taxpayers similarly situated in all respects except with respect to the possibility of access to an adequate futures market. The change advocated by the committee on inventory methods may be most simply made in the regulations, by including among permissive methods of computing income and valuing inventories, the method known as replacement or last-in, first-out. It may be that, for administrative reasons unknown to us, the alleged discrimination directed to your and to our attention may best be remedied by amendment of the revenue act.

This matter is brought to your notice at this time so that it may be before you in the consideration of necessary and desirable changes in the revenue act. From time to time we shall feel free to write to you about other technical matters.

Very truly yours,

——— ———,

Chairman, Committee on Federal Taxation, the New York State Society of Certified Public Accountants.

Corporations using last-in, first-in, or similar methods in corporation accounts

	Auditors	Date of first use of method
American Smelting & Refining Co	Scovell, Wellington & Co	1906.
National Lead Co	Bieth & MacNaughton	1913.
Chicago Frog & Switch Co		Previous to 1916.
Continental Can Co., Inc	Deloitte, Plender, Griffiths & Co	Do.
American Can Co	Lybrand, Ross Bros. & Montgomery	1917.
International Harvester Co	Haskins & Sells	1917.
U. S. Smelting, Refining & Mining Co	Lybrand, Ross Bros. & Montgomery	1924.
Graton & Knight Co	Arthur Anderson & Co	1925.
Anaconda Copper Mining Co	Pogson, Peloubet & Co	1927.
Anaconda Wire & Cable Co	do	1929.
Cero de Pasco Copper Corporation	Lybrand, Ross Bros. & Montgomery	1929.
The American Oak Leather Co	Ernst & Ernst	1932.
American Metal Co., Ltd	Lybrand, Ross Bros. & Montgomery	1933.
Bridgeport Brass Co	R. G. Rankin & Co	1933.
Consolidated Oil Co	Arthur Young & Co	Previous to 1934.
Vulcan Detinning Co	Loomis, Suffern & Fernald	1934.
Standard Oil Co. of California	Price, Waterhouse & Co	Previous to 1935.
Phelps Dodge Corporation	Pogson, Peloubet & Co	1935.
Revere Copper & Brass, Inc	Scovell, Wellington & Co	1935.
Gulf Oil Corporation of Pennsylvania	Price, Waterhouse & Co	1935.
Swift & Co	Arthur Young & Co	Previous to 1936.
Endicott Johnson Corporation	Touche, Niven & Co	1936.
Surpass Leather Co	Price, Waterhouse & Co	1936.
Socony Vacuum Oil Co., Inc	Arthur Young & Co	1936.
St. Joseph Lead Co	Haskins & Sells	1936.
International Paper & Power Co	Arthur Anderson & Co	1937.

This list is not complete nor exhaustive and cannot be so, as it is confined to companies which issued reports to the public or which have gone on record publicly through legal action or otherwise as using last-in, first-out or similar or equivalent methods. Companies which use these methods and do not publish their accounts cannot be included in this list nor can companies which use these methods but merely refer to them in their accounts as cost. It is impossible to estimate how many companies fall into these two classes but the probabilities are that the number is substantial. It will be observed from the dates shown above that the use of last-in, first-out or similar methods appears to be growing at an accelerated rate.

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Excess Profits Duty and Corporation Profits Tax, Roger N. Carter, M. Com., F. C. A., published by Gee & Co., Ltd., London, 1921. Contains the White Paper presented to the House of Commons, June 1917, entitled "Heads of Government Proposals upon the Valuation of Stocks for Purposes of Excess Profits Duty."

The War Finance Acts of 1914 to 1917 by "Income Tax Expert of 'The Accountant,'" second edition published by Gee & Co., Ltd., London, 1918. Covers much the same ground as the previous reference on pages 82 to 84.

The Law and Practice of Excess Profits Duty, William Sanders of the Inland Revenue Department published by Gee & Co., Ltd., London, 1918. Also contains on pages 54 to 62 the White Paper mentioned above together with a letter from A. Lowes Dickinson and other chartered accountants.

Auditing Theory and Practice, Robert H. Montgomery, Edition 5, pages 217–18. Says "base price" method has been successful, and successful business methods should be conformed to by accounting practices. Lists six objections of U. S. Treasury Department to its use.

Principles of Auditing, Kohler and Pettengill, Third edition, McGraw-Hill Book Co., Inc., N. Y., 1932, page 81. The replacement-cost method deserves serious consideration in the future as a basis for valuing inventories.

Intermediate Accounting, Taylor and Miller, Vol. 1, McGraw Hill Book Co., Inc., N. Y., 1933, pages 117–119. On pages 117 to 119 is a good discussion of the method with particular reference to its actual use by representative corporations and a description of the methods of the International Harvester Co. and the U. S. Steel Corp'n. whose methods are similar to normal stock.

Problems in Accounting Principles, R. G. Walker, A. W. Shaw Co., Chicago, 1929, pages 365–378. Discussion of National Lead Co.'s method, etc.

Present-day Problems in Inventory Valuation, M. E. Peloubet, National Association of Cost Accountants, Year Book, 1936, pages 164 to 187. Paper delivered at annual meeting of National Association of Cost Accountants, June 1936. A discussion of the situation at the present time with particular reference to the effect on taxable income and revenue of the adoption of methods applying current costs to current sales, the use of analogous methods for other purposes by the U. S. Treasury Department and the administrative changes which would be required in the Department to give effect to permission to use methods applying current costs to current sales without loss of revenue.

MAGAZINES AND NEWSPAPERS

HARVARD BUSINESS REVIEW

October 1924, Inventory Valuation and Business Cycle, by H. T. Warshow, Comptroller, National Lead Co., New York. This is a general discussion of the subject together with a description of its particular application to the National Lead Co.'s accounts.

January 1926, pages 129–137, The Role of Paper Profits in Industry, George E. Putnam. This article does not mention normal stocks specifically but is significant as it states the problem plainly.

Autumn 1936, pages 76 to 94. The Base Stock Principles in Income Accounting, Ross G. Walker. A carefully documented statement of the principles of

base-stock inventories with particular reference to financial statements for stockholders and the effect of this method in the internal administration of a business.

JOURNAL OF ACCOUNTANCY

December 1926, Some Variations in Inventory Valuations, by T. H. Sanders. This article discusses the normal stock method as applied to three representative companies and points out that it is a method sponsored by practical business men rather than accounting or economic theorists.

July 1930, Base Stock Inventories, L. G. Peloubet. A general discussion of the method with particular relation to taxation.

December 1932, Influence of Depression on Accountancy, George O. May. A portion of the article is devoted to the comparison of various inventory methods including normal or basic stock.

December 1937, Some Observations on Accounting Practice with Special Reference to Inventory Valuation, John L. Harvey. Discusses various methods of inventory valuation. No one method suitable to all industries. Recent developments in last-in, first-out method.

January 1938, Editorial, An Unintentional Discrimination. Discusses the analogy between "hedging" and last-in, first-out, and similar methods and shows the inequity of permitting hedges to be recognized when last in, first out is not permitted.

NATIONAL ASSOCIATION OF COST ACCOUNTANTS BULLETIN

Vol. XVIII, No. 13, March 1, 1937. Problems of Present-Day Inventory Valuation, Maurice E. Peloubet, page 741. Current Practices in Inventory Valuation, E. W. Graham, page 752.

Vol. XVIX (XIX), No. 3, October 1, 1937. Inventory Valuation, The Use of Price Adjustment Accounts to Segregate Inventory Losses and Gains, Clarence B. Nickerson, page 147.

Vol. XIX, No. 7, December 1, 1937. Inventory Valuation and Business Profits: The Case for a "Stabilized" Basis, Albion R. Davis, page 377. The Case for a "Cost or Market" Basis, Homer N. Sweet, page 400.

BULLETIN OF THE TAYLOR SOCIETY AND OF THE SOCIETY OF INDUSTRIAL ENGINEERS

May 1935, Principles of Inventory Valuation, Maurice E. Peloubet. This article describes various methods of inventory valuation including normal stocks and similar methods. Gives a history of the method and examples which illustrate its application. This article was reprinted in the New York Certified Public Accountant, April 1935, and in the Canadian Chartered Accountant, June 1935, in which issue an editorial appeared on the same subject.

PAPERS NOT PUBLISHED BUT PRESENTED AT MEETINGS

The Normal Stock Method of Inventory Valuation, H. T. Wawshow, Comptroller National Lead Co. (also included in year book of National Association of Cost Accountants, 1922). This is a specific description of the application of the method to the accounts of the National Lead Co.

A Practical Inventory Method for the Tanning Industry, Maurice E. Peloubet. This is a general statement of the normal stock and similar methods and an examination into the practicability of its application to the Tanning Industry.

WALL STREET JOURNAL

Inventory Losses (unsigned), February 7, 1935. Describes advantages gained by National Lead and American Can, 1917, through use of normal stock system.

Series of articles by Arundel Cotter, March 18, 19, 25, 28, April 1, 1935:

March 18.—Uses table to show "first-in, first-out," and "normal stock" differences, with a good discussion. American Smelting & Refining Co. installed system (normal) in 1903. Anaconda Copper Mining Co. is understood to have employed normal stock system until a few years ago when it changed to a "last-in, first-out" system.

March 19—Discusses "last-in, first-out" as applied to oil industry.

March 25—Gives case of American Woolen Co. Internal Revenue position discussed.

March 28—Gives case of Swift & Co. How it now sets up inventory reserve.

April 1—Reserve. Discusses tobacco inventories. Concludes normal stock should be carefully considered.

Discussing American Institute's bulletin by Arundel Cotter, January 20, 1936. Shows how meaningless "cost" is. Uses apple dealer to illustrate "first-in, first-out" and "last-in, first-out," as well as "average cost" methods. Urges fuller information from corporations on what is meant by "cost or market."

Series (3) articles on new tax proposals by Arundel Cotter:

April 29, 1936—Shows how tax, even in times of prosperity, would eventually consume cash and inventories, through tax on inventory profits.

May 2, 1936—Likens present situation to that in which German's many nails shrank to one. Gives figures of Tanners' Council to show changes in inventory value. Says non-distribution in dividends of these book profits has saved many companies, but taxation on them would be disastrous.

May 4, 1936—Points out Revenue Bureau does not recognize normal stock or "last-in, first-out" methods. Without it, however, new tax will be ruinous to many companies.

WORLD PETROLEUM

An article on the subject of normal stocks by C. C. Bailey appeared in December 1931.

LIST OF TRADE AND OTHER ASSOCIATIONS APPROVING LAST-IN, FIRST-OUT OR SIMILAR METHODS

American Mining Congress, The.
American Petroleum Institute, The.
Copper and Brass Mill Products Association.
Lead Industries Association, The.
National Association of Credit Men.
National Electrical Manufacturers Association.
Tanners' Council of America.
Trade Association for the Rope and Cordage Industry, The.

The CHAIRMAN. Mr. Victor H. Stempf, of New York City.

STATEMENT OF VICTOR H. STEMPF, REPRESENTING THE COMMITTEE ON TAXATION, AMERICAN INSTITUTE OF ACCOUNTANTS, NEW YORK CITY

The CHAIRMAN. You appeared before the House committee, I think.

Mr. STEMPF. I did not; I filed a brief with them.

The CHAIRMAN. Mr. Stempf, you represent the committee on taxation of the American Institute of Accountants?

Mr. STEMPF. Yes. My name is Victor H. Stempf, a resident of Larchmont, N. Y. I am a certified public accountant, a partner in the firm of Touche, Niven & Co., New York, N. Y. I am appearing as chairman of the committee on Federal taxation of the American Institute of Accountants. My associates on the committee are Mr. William L. Clark, of Tulsa, Okla.; Mr. James A. Councilor, of Washington, D. C.; Mr. Clarence L. Turner, of Philadelphia, Pa.; and Mr. Leon E. Williams, of New York, N. Y.

I request the privilege of filing, on behalf of the American Institute of Accountants, a memorandum dealing with revision of the revenue laws, with special reference to the bill recently passed by the House of Representatives. The report deals particularly with questions of an accounting nature and stresses—

(1) Outright repeal of the tax on undistributed profits;

(2) Further modification of the capital-gains section;

(3) Opposition to the reintroduction of the surtax on closely held corporations advocated in title B of the House bill;

(4) A sound broadening of the base of income taxation;
(5) The restoration of consolidated returns;
(6) The determination of fixed principles of income taxation; and
(7) The modification of rates generally in the belief that lower rates will induce business activity and result in equal or improved revenue yield.

The CHAIRMAN. Why do you say that?

Mr. STEMPF. I think that the history of our Revenue Act has demonstrated the fact that lower rates, by the reason of the incentive which they give to business, create business activity, greater profits, and thereby yield greater revenue at lower rates. I think that you yourself, Mr. Chairman, have admitted the application and the effect of the law of diminishing returns in statements that you have made, which I think are very properly applicable.

There are also included recommendations relating to technical revisions of existing provisions.

The CHAIRMAN. Does that statement apply to capital gains as well as the high surtax rates?

Mr. STEMPF. Most definitely so.

The CHAIRMAN. It does not apply to undistributed profits, does it?

Mr. STEMPF. I am unalterably opposed to the principle of the undistributed profits tax.

The CHAIRMAN. You do not know whether you can do justice by it?

Mr. STEMPF. Because I feel it is absolutely contrary to the fundamentals of sound corporate finance. There are also included recommendations relating to technical revisions of existing provisions; including a proposal to defer for an additional 30 days the filing date of returns. It is believed that some change in this respect is needed urgently to alleviate the growing difficulty of taxpayers to comply with existing requirements, due to the increasing complexity of the law and the more exacting attitude of the Bureau of Internal Revenue relative to extensions of time for filing returns.

In compliance with the wishes of your committee, I shall refrain from presenting any of these matters in further detail at this time; and offer the Institute's detailed memorandum which you and your technical assistants may consider in due course.

Senator LONERGAN. Mr. Chairman, I would like to ask the witness a question.

The CHAIRMAN. Senator Lonergan.

Senator LONERGAN. You say you are opposed in principle to the undistributed profits tax. What would be your remedy where a corporation intentionally withheld the distribution of profits?

Mr. STEMPF. I have included in my memorandum in support of that a statement recently made by Maurice Wertheim, in the Harpers Review, in which he says 102 is there in the act and he cannot believe that American ingenuity has gotten to the point where it cannot put teeth in that section. That is the remedy. Frankly, I have no suggestions to make as to strengthening that section. I do not believe it has been applied as fully as it might have been. There has been too much compromise in most of those cases, but I think that is the proper remedy for the improper retention of surplus.

Senator LONERGAN. We would be glad to get any suggestions that you and your associates might have.

Mr. STEMPF. I have discussed the thing at some length, but I have not arrived at any conclusions. I might say that this memorandum was prepared over night on Wednesday. This hearing came about 10 days sooner than we expected.

The CHAIRMAN. We do not work as slowly as some other committees.

Mr. STEMPF. I think you have done an excellent job.

The CHAIRMAN. You are the head of the American Institute of Accountants?

Mr. STEMPF. I am chairman of the committee on taxation.

The CHAIRMAN. How many members do you have?

Mr. STEMPF. We have approximately 5,000 members throughout the country.

The CHAIRMAN. Are they composed of certified public accountants?

Mr. STEMPF. All certified public accountants, and included in our group is an advisory council of State society presidents who, in turn, represent all of the certified public accountants within all of the States of the country.

The CHAIRMAN. Are there any of the members of your institute in the employ of the Treasury Department?

Mr. STEMPF. I would not doubt that there are, Senator.

The CHAIRMAN. I expect so.

Mr. STEMPF. Yes.

The CHAIRMAN. All right, thank you.

(The memorandum submitted by Mr. Stempf is as follows:)

MEMORANDUM FILED WITH THE SENATE FINANCE COMMITTEE BY THE COMMITTEE ON FEDERAL TAXATION OF THE AMERICAN INSTITUTE OF ACCOUNTANTS REGARDING THE PROPOSED REVENUE ACT OF 1938 (SUBMITTED MARCH 18, 1938)

NEW YORK, N. Y.,
March 18, 1938.

SENATE FINANCE COMMITTEE,
Washington, D. C.

SIRS: The committee on Federal taxation of the American Institute of Accountants respectfully submits its recommendations for revision of the revenue laws, with special reference to the provisions contemplated by H. R. 9682 as adopted in the House of Representatives, and at the outset stresses particularly that this memorandum:

(*a*) Approaches the subject of income-tax revision solely from the standpoint of sound principles of taxation, without regard to social or political aspects, and deals particularly with questions of an accounting nature.

(*b*) Urges outright repeal of the tax on undistributed corporate profits.

(*c*) Strongly recommends further modification of the capital-gains section.

(*d*) Opposes unqualifiedly the restoration of the "third basket" provisions, advocated by the Ways and Means Committee of the House.

(*e*) Supports a sound "broadening of the base" of income taxation, coupled with effective withholding at the source.

(*f*) Urges the requirement of consolidated returns as conforming to recognized sound business practice.

(*g*) Again favors the creation of a qualified nonpartisan commission to conduct the research required for the unbiased determination of fixed principles of Federal income taxation; and

(*h*) Advocates that taxation for revenue is best served at moderate rates which encourage enterprise, stimulate activity, increase employment, and produce more revenue than high rates which stifle initiative, freeze the service of capital, and retard employment.

Reference is also had in the data which follow to other matters which, although important from the viewpoint of sound administration of the revenue act, do not partake of the broader aspects of income taxation present in the foregoing items.

(*a*) Taxation should be based upon fixed principles having a closer relation to sound accounting procedure and conservative business practice.

This committee has stated repeatedly that taxation has become a major problem in business planning by reason of its repeated shifting in form and incidence. Our Federal income tax should have a long-range viewpoint, which would remove much of the uncertainty by establishing fixed principles at flexible rates to fit the needs of Federal revenue without change in the character of the tax or its application.

The creation of a popular belief that a taxing statute is impartially and equitably administered is essential to the ultimate success of any revenue program. Reassure the business community of a determined purpose to fix and abide by established rules of Federal income taxation and much will have been done to restore confidence. Taxation has become almost inscrutable, forcing upon business a policy of timid "hand-to-mouth" planning, a policy which cannot be changed until the effects of taxation upon operations may be reliably gaged on the basis of rational unchanging principles.

The ever-widening breach between "tax accounting" and "business accounting" has developed as a result of the attempt to refine the definitions of taxable income and allowable deductions, in the fallacious belief that these definitions should be applied inflexibly; with the unfortunate result of creating a labyrinth of exceptions incomprehensive to the average taxpayer. The law and regulations should be purged of these refinements, with a concurrent reversion to the simple fundamentals that "standard methods of accounting will ordinarily be regarded as clearly reflecting income" and that "each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose," with a mandate that these provisions be liberally construed. Without the latter, emphasis upon these fundamentals is futile. In any equitable tax law income and allowable deductions should be defined in broad terms, and liberal recognition should be accorded accounting procedures regularly and consistently employed by taxpayers with less opportunist stress upon the year in which an item belongs. Tax administration should give more weight to the consistency of successive returns instead of stressing the nearsighted and usually doubtful advantage of immediate revenue.

The renewal of confidence and the related stimulation of business activity and employment which would emanate from such settled policies of tax administration would have a salutary effect upon the Federal revenues.

(*b*) This committee remains unalterably opposed to the undistributed-profits tax, and urges outright repeal. Likewise, while there is distinct merit in the drawback principle, when properly applied, it too is wholly objectionable unless it be purged of the existing inequities in the undistributed-profits tax by the repeal of the latter, and unless related to business profits as distinguished from taxable income.

The Institute's committee opposed the enactment of the tax on undistributed profits in its memorandum filed with the Senate Finance Committee on May 7, 1936, summarizing its objections in item XIV of that memorandum, as follows:

"(1) That the potential revenue to be derived from the proposed legislation is conjectural;

(2) That the objective of simplification has not been attained, and that the provisions of the bill are in fact extremely complex;

(3) That the proposed form of taxing undistributed income will create a new field of problems of accounting and corporate finance which will aggravate the existing difficulties of determining the tax liability;

(4) That the administration of the act by the Bureau of Internal Revenue will be far more difficult than at present with attendant increased costs;

(5) That the proposed act will inflict undue hardship upon a large group of moderate-sized corporations having meager reserves, many of which are struggling to overcome the burden of accumulated deficits."

These reasons remain valid today. The basic principle of the undistributed-profits tax is unsound, violating as it does the rudiments of corporate finance and jeopardizing the stability of corporate enterprise.

In principle the harshness of the existing law has been modified to some extent in H. R. 9682 by the adaptation of the "drawback" method suggested as a compromise by this committee in May 1936. In the words of the report submitted by the House Committee on Ways and Means, March 1, 1938 (page 4) "the tax should not be framed as a penalty surtax on undistributed profits but should be designed on the basis of a flat tax rate with a tax credit which will give reasonable encouragement to the distribution of dividends."

However, in our opinion, the House bill does not accomplish this end because there remain in the law all of the complications of the old undistributed-profits tax and the objectionable inconsistencies in distinction between "taxable income" and "business income." Under proposed conditions, a corporation may have to pay not only normal income tax but also the surtax when it actually has no income measured by recognized principles of accounting ordinarily and consistently applied in commercial practice. A striking example of this remains uncorrected in the case of a corporation with an operating deficit at the beginning of the year, ordinary taxable income of $100,000, and a capital loss of the same amount. By reason of the $2,000 limitation on capital net losses, the corporation would pay not only a normal tax but, because of its inability to distribute a dividend, would also be liable to an unwarranted surtax. Even though such a corporation were to make a distribution to the full extent of its adjusted net income, it would get no dividends-paid-credit in view of the fact that the distribution would not be a taxable dividend under section 115 (a). By way of contrast, this inequity is recognized in section 102 relating to the surtax on improper accumulation of surplus.

(c) Further modification of the capital-gains section is strongly urged.

The report of the committee on Federal taxation, of the American Institute of Accountants, submitted to the Senate Finance Committee on September 23, 1937, stated:

"There is probably justification for the position that realized capital gains should bear their just proportion of taxation, instead of shifting the entire burden to those carrying on commerce and the professions, and complete elimination would aggravate rather than correct the existing differences between 'tax accounting' and 'business accounting.'

"It is recommended that capital gains and losses be segregated in a separate schedule from other income, taxable at a moderate, flat rate, without subjection to percentages depending on the period during which the asset was held. The $2,000 limitation on net capital losses should be removed, and the right to carry over net capital losses as an offset to gains for a period of 5 years should be established.

"Relief in taxation of capital gains would reopen the flow of capital transactions and the profits and employment that go with such transactions, which are now inhibited by inordinate taxation.

"Capital assets should be redefined to exclude land and depreciable assets used in the business."

H. R. 9682 has excluded property subject to depreciation from the definition of capital assets for purposes of the capital-gains section. We commend this provision. However, we strongly urge that land used in trade or business be likewise excluded from the statutory definition. There are no logical grounds for holding that buildings used in trade or business, and the land upon which the buildings stand, belong in different categories. The inclusion of land and buildings in different classifications would raise needless difficulties in the administration of the law, as it would necessitate the division of the proceeds from the sale of improved real estate, between the portion applicable to the land and the portion applicable to the buildings. Furthermore, a situation of this kind lends itself to tax evasion, as it would be possible to stipulate, in a sales contract, the division of sales proceeds between land and buildings most advantageous to the seller. The bill also makes a logical distinction between "short-term" or "speculative" profits and "long-term" capital gains. The former are properly placed on a basis comparable to ordinary income. As to the latter, however, we do not believe that adequate relief has been extended.

In this connection, we quote from recent editorial comment:

"Dr. Carl Snyder has reported that as the result of his own researches, it appears that the average investment in industry in this country is about $12,000 per man; and that comparing one country with another the wages of labor in industry are directly proportionate to the capital investment per man. Dr. Snyder also points out that the average rate of increase of industrial production in this country has been about 4 percent per annum compounded, and that the gain in capital supply required to produce this increase has been a little higher, around 5 percent per annum. This investment was supplied almost wholly from the industries themselves or from their owners and not from the savings of the people via the savings banks and the insurance companies, which invest primarily in mortgages and safe bonds and not in the equity position. This, Dr. Snyder points out, was up to 1930, since when there has beeh an abrupt reversal."

Unquestionably, this country needs the restoration of an abundant flow of equity capital. No one thing will do more to restore activity, employment, and prosperity. An overwhelming proportion of informed opinion believes that the capital-gains tax is one of the principal deterrents to this flow of capital. Why be niggardly in the revision? The report of the Ways and Means Committee points out that during the time capital gains were subjected to a flat 12½ percent the revenue from this source amounted to approximately 50 percent of the total income-tax collections from individuals, whereas, in 1934 and 1935, it made up but 3 and 13 percent, respectively. The law of diminishing returns has had its inevitable effect during the latter years of high capital-gains tax. Remove the deterrent effectively and the lower rate will produce increasingly greater revenue.

There is a natural reluctance to seeing those who enjoy true capital gains escape the heavier tax burden; but this must continue to be one of the rewards of equity risks if commerce is not to be stultified.

We urge again:

(A) That capital gains and losses be segregated in a separate schedule from other income; (B) taxable at a more moderate flat rate, say 12½ percent; (C) without subjection to percentage calculations depending on the period held; (D) that the $2,000 limitation on capital losses be removed entirely; and (E) that the carry-over provision should be extended to 5 years instead of 1.

Under such circumstances it will be impossible to make an equitable distinction between "short-term and long-term" capital gains. The speculative element in the stock market is an essential lubricant to the play of supply and demand; and as a necessary adjunct to the adequate release of capital, transactions may justifiably be granted the status of capital gains and losses, as in the past. There should be no major objection to an arbitrary 1-year rule, if the distinction be deemed essential.

(*d*) The third-basket tax recommended by the House Ways and Means Committee, but rejected by the House, imposes an arbitrary and unjust penalty upon legitimate business enterprises and should not be restored to the proposed revenue bill.

We are strongly opposed to the tax on closely held corporations contemplated by title 1B. Corporations of the type covered by title 1B are the very corporations which should be given protection and encouragement. By forcing closely held operating corporations to distribute their incomes, owner-management is being unjustly discriminated against in favor of absentee ownership. Family business concerns will be put at a competitive disadvantage with widely held organizations.

Nearly all successful businesses originate as one-, two-, or three-man affairs. Usually by the initiative and sacrifices of a small group, a large enterprise is developed and new employment opportunities created. Such enterprises must retain their income for expansion and for added working capital. They have limited credit lines which may be increased only by growth of capital arising through earnings retained in the business. To force these closely held corporations to distribute their net income is discriminatory, and places an oppressive burden on legitimate business enterprises. The title 1B tax is unsound and opposed to the best interests of industrial growth and the employment of labor.

While we oppose restrictions of any kind upon the retention of current earnings for expansion or other legitimate business purposes, we recognize the existence of abuses through the unreasonable accumulation of surplus. Mr. Maurice Wertheim, in Harpers Magazine of February 1938, said:

"I refuse to believe that American ingenuity or its legal talent is at so low an ebb that section 102 cannot be so redrawn as to make it work properly and cover completely the abuse of improperly accumulated earnings. It is not necessary or sound public policy to tax thrift in business in order to reach malefactors."

We, too, advocate the setting up of new administrative machinery to study cases coming within the purview of section 102 of the existing revenue act, with a view toward minimizing tax avoidance through improper surplus accumulations.

(*e*) We support a sound broadening of the base of income taxation, coupled with effective withholding at the source.

It seems desirable to broaden the base of income taxation by the reduction of personal exemptions, graduation of normal taxes, and otherwise, facilitated by an extension of the principle of withholding at the source. This proposal has

been made repeatedly since 1918, if not before, "so that a substantially large proportion of voters would become direct taxpayers and take a keener interest in government."

More important would be the substitution of such broadening of the base in lieu of existing indirect "nuisance" taxes, which, it is claimed, fall more heavily, dollar for dollar, on the low-income class of our population.

(*f*) Consolidated returns should be made mandatory. Such procedure conforms to ordinary business practice, enables the Treasury Department to deal with a single taxpayer instead of many, and eliminates the necessity for examining the bona fides of innumerable intercompany transactions.

Inasmuch as subsidiary companies are often organized merely to comply with the requirements of various State laws or to minimize risk in opening up new territory or establishing a new line of business, it is erroneous to treat them as entities distinct from the parent corporation. For all practical purposes they are branches or departments of one enterprise. Therefore, as the Treasury Department pointed out to the House Ways and Means Committee when it was considering the Revenue Act of 1934, the simplest way to secure a correct statement of income from an affiliated group is to require a consolidated return, with all intercompany transactions eliminated. This conforms to recognized, sound business practice. By requiring separate statements of income, as under the present law, nonexistent income is often taxed, profits and losses may be shifted from one subsidiary to another in such a manner that the Commissioner's power to reallocate income is ineffectual, and the earnings of particular units are not accurately presented. Moreover, administration of the income-tax law is simpler with the consolidated return, as it conforms to ordinary business practice.

Likewise, from the standpoint of the taxpayers, in cases in which corporations follow the consistent practice of preparing consolidated financial statements, the preparation of related tax returns is simplified if done on a consolidated basis. Accordingly it is urged that consolidated returns be required.

(*g*) Congress could do nothing of greater importance to assure the future stability of business than to bring about the creation of a qualified, nonpartisan commission to establish fixed principles of income taxation and related administrative procedure.

This committee has repeatedly urged the creation of such a body, latterly in its memorandum of September 23, 1937, filed with the Senate Finance Committee. The year-to-year revision of tax laws is an abomination, bred of political expediency. Fixed principles of taxation are needed to enable taxpayers to face the future with greater confidence based on known factors.

Permanent principles should be established, subject only to changes in rates to meet the requirements of the Federal Budget. Business can adjust itself to changing rates of taxation, but common sense decries a repeated shifting in the general scheme and incidence of taxation, which must be construed anew from year to year.

(*h*) The tax burden should be equalized, and the Federal revenue stabilized by the adoption of moderate rates of taxation which encourage enterprise, and thereby increase employment.

This committee has previously urged the principle of taxing corporate income on the basis of average earnings for 5 years, believing it to be inequitable to exact heavy taxes upon the full profits of successful years without relief in respect of unprofitable years which inevitably follow. By the same token, a basis of average earnings would assure less fluctuation in the level of revenues. It is recognized that this principle of averaging income entails some administrative difficulties, but these are not insurmountable. However, the simplest recognition of the principle may be obtained by restoring provisions for carrying forward losses as offsets to taxable income of subsequent years. We urge the enactment of such a general provision, permitting the forwarding of losses for 5 years.

The post-war period demonstrated the fact that progressively lower rates of taxation brought increasing revenues, through the release of capital into private enterprise with attendant enlargement of the market for labor in productive employment, whereas it is generally recognized that excessively high rates of tax have discouraged business expansion and have thereby adversely affected employment.

Although based upon authoritative statistical factors, the estimates of the Treasury Department relative to the adverse effects upon revenues of the elim-

ination of certain provisions, consistently predicate such conclusions upon current revenues at existing rates. We submit that such conclusions ignore the salutory effect upon revenues inherent in the reduction of rates demonstrated by the post-war experience previously referred to. We support the claim, broadly held, that "lower rates bring more revenue than higher rates." Excessive rates are nonproductive. Lower rates induce the release of capital into productive employment. Higher rates have the opposite effect, and in the face of declining national income might ultimately prove disastrous to the revenue.

(*i*) If the capital-stock tax be retained the adjusted declared value should be reduced by Federal income taxes and excess capital net losses.

Many business leaders look upon the capital-stock tax and related excess-profits tax as "Siamese twins" which are unconscionably speculative and vicious, and advocate repeal of these sections of the law. However, if the way cannot be opened to outright repeal, we advocate that one amendment particularly be made. Under the present and proposed laws, no reduction in the adjusted declared value is permitted for Federal income taxes or for excess capital net losses. This treatment tends to create artificial situations whereby the adjusted declared value increases more rapidly than the actual net worth and, in many instances, increases while the actual net worth decreases. The adjusted declared value of capital stock should be brought into line with actual conditions by permitting deductions for Federal income taxes and excess capital net losses.

(*j*) The excess-profits tax, if retained, should be based upon predictable ordinary business net income and should exclude capital gains and losses.

The excess-profits tax as provided by section 602 of the proposed bill, if retained, should be modified in one important respect. When a corporation realizes a large unforeseen capital gain, it may be subjected to an onerous excess-profits tax. In some instances, the profitable disposition of a capital asset might be discouraged because of the high excess-profits tax. It is urged therefore, that capital gains and losses, because of their unpredictable nature, be excluded from net income subject to the excess-profits tax and that the tax be based solely upon ordinary net income.

(*k*) This committee endorses the "consent dividends credit," but objects to certain inequitable provisions relative thereto embodied in H. R. 9682.

Section 28 is intended to provide a method whereby corporations in a poor cash position, unable to distribute taxable-stock dividends or dividends in their own obligations, may secure a dividends-paid credit by obtaining "consents" from stockholders to include portions of the undistributed corporate net income in their own net incomes. Obviously, this expedient will be practicable only in the case of closely held corporations; whereas financially embarrassed corporations, with widely scattered stockholders, will be unable to take advantage of the proposal.

Effective use of section 28 will require planning in advance to obtain "consents" from cooperative stockholders and paying off recalcitrant stockholders before the end of the year. As most organizations are not in a position to determine the amount of their net income until after the close of the taxable year, widely held corporations will not be able to make all the necessary preliminary arrangements incident to obtaining the "consent dividends credit." In practice, therefore, section 28 can be availed of only by closely held corporations.

A point that requires adjustment is involved in determining the holding period of the "consent" stock for the purpose of computing the recognized gain or loss in the event of a subsequent sale or taxable exchange. Will the holding period date from the original purchase of the stock, or will there be several holding periods, one for the original purchase of the stock and others for the amounts of the "consent" dividends added at various times to the cost of the stock?

As the proposal now reads, where a shareholder signs a "consent" the amount specified in the "consent" is taxable to him in its entirety, whether or not such amount, if distributed to him in cash, would have been in whole or in part a taxable dividend. Such amount is then added to the basis of the stock in the hands of the shareholder, but only in an amount which represents a taxable dividend (i. e., is out of earnings or profits) and is allowed as a "consent dividends credit" to the corporation. Thus, a holder of 1 share in a corporation "consents" to include $100 in his gross income as a dividend. It develops that for the taxable year the corporation has net income of $100

per share but at the end of the year has accumulated earnings or profits of only $50 per share. In this case, the "consent dividends credit" of the corporation would be limited to $50 per share, while the shareholder would be obliged to include the entire $100 in his gross income. Moreover, the shareholder would be allowed to increase the basis of his stock by only $50 (the amount allowed to the corporation as "consent dividends credit"), the remaining $50 apparently vanishing into thin air.

The foregoing situation will undoubtedly arise frequently, as in a great many instances corporate executives will find it difficult to estimate accurately the net earnings before the end of the year. In such cases, there will always be the danger to shareholders that they might sign "consents" in excess of the corporate net earnings and, therefore, will be taxed on amounts which do not represent earnings of the corporation. To avoid this inequitable condition and to encourage shareholders to cooperate with corporate executives where conditions warrant, it is recommended that shareholders be taxed only on such amounts of their "consents" as would represent taxable dividends if paid in cash. Alternatively, if shareholders are to be taxed on the full amount of their "consents," they should be permitted to add such amount in full to the basis of their stock, and not only the portion allowed as a "consent dividends credit" to the corporation.

The definition of "consent stock" (sec. 28 (a) (1) could be improved by being changed to read as follows:

"*Consent stock.*—The term 'consent stock' means the class or classes of stock entitled, after the payment of preferred dividends (as defined in par. (2)), to an unlimited proportionate share in the distribution (other than in complete or partial liquidation) within the taxable year of all the remaining earnings or profits."

(*l*) Expenses incurred in the production of taxable income should be allowed as deductions, even though such income does not arise from a trade or business.

Section 23 (a) of the proposed bill and the corresponding section of the present and prior laws provide for the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. This provision should cover the deduction of expenses paid or incurred in the production of taxable income, even though such income does not arise from the taxpayer's trade or business. In some instances, the Commissioner has disallowed expenses of this character, and has attempted to place an unduly narrow interpretation on this section of the law.

The failure to allow such deductions is contrary to sound accounting concepts and the reasonable intent of the law, and results, in many cases, in the taxation of gross, instead of net income. Accordingly, it is recommended that section 23 (a) be amplified to permit the deduction of all ordinary and necessary expenses paid or incurred during the taxable year in the production of taxable income.

(*m*) This committee endorses the recognition of the "normal stock," and "last in, first out" or replacement methods of costing sales and determining inventories in pertinent cases.

Section 22 (c) of the Revenue Act of 1936 and of the proposed bill, provides that:

"Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income." General Counsel's Memorandum No. 17322 (reported on p. 151 of Cumulative Bulletin XV-2) wisely and fairly permits industries processing certain raw materials, principally wheat and cotton, to apply the results of hedging transactions, entered into for the purpose of eliminating gains or losses on raw materials, to their inventories without the application of the limitation imposed on capital gains or losses, although such limitations are applied generally to futures transactions in these commodities.

There are other industries producing, fabricating, or processing raw materials which are not permitted by the Commissioner to apply current costs to current sales under the "replacement" or "last-in, first-out" inventory method. These latter inventory methods are appropriate in industries in which (a) operating processes are continuous, (b) the period of processing is relatively long, (c) minimum inventories must be maintained constantly, and (d) raw materials represent a major part of the total cost of the products. Moreover, these

methods have substantial acceptance in industry, are endorsed by accounting authorities, and have been recognized as appropriate by the Securities and Exchange Commission.

During periods of rising prices the "first-in, first-out" method of pricing inventories results in taxing business income that is in part necessarily absorbed in increased inventories and working capital, and is unduly onerous in industries which entail long processing periods.

The "normal stock" and "last-in, first-out" or "replacement" methods clearly fall within "approved standard methods of accounting" and are "best suited to the needs of certain businesses." They should, accordingly, be granted recognition.

(*n*) We urge the repeal of section 802, requiring the filing of returns as to formation, etc., of foreign corporations. It imposes unnecessary burdens on accountants, inasmuch as such information can best be obtained from officers, directors, stockholders, and attorneys directly concerned.

Section 802 of the proposed bill provides for comprehensive returns of information in connection with the formation, organization, or reorganization of any foreign corporation. This section affects the accounting profession vitally.

The proposed bill, as well as the Revenue Act of 1937 and T. D. 4773 promulgated thereunder, impose an unreasonable burden upon accountants. Entirely apart from the principle of the matter, these provisions relating to information returns to be submitted by accountants and others are particularly objectionable due to their ambiguity and breadth.

The language of the law itself is ambiguous. Prior to the promulgation of the regulations under the 1937 act, there remained a doubt as to whether such information was required only if the foreign corporations were actually in existence or merely proposed. The regulations imply an extension of the requirements to include information relative to discussions of proposed foreign incorporations.

The regulations and Form 959 require answers to hypothetical questions, calling upon accountants to interpret the intent of clients. The Bureau itself refuses to answer hypothetical questions concerning tax matters. Is it not unreasonable to expect accountants to do so? Does the acceptance of an engagement on the part of an accountant to calculate the effect which the formation of a foreign corporation would have upon taxation involve "aid or counsel" in matters relating to the formation of foreign corporations? Such engagement does not necessarily warrant the conclusion that the formation of a foreign corporation is even proposed.

Decided doubt remains as to the meaning of "reorganizations" of foreign corporations. Does reorganization contemplate the statutory concept or the commonly accepted meaning of that term? Recent Supreme Court decisions have overthrown interpretations of that term which have prevailed for some years past. Does writing up the accounts of a foreign corporation constitute the character of "aid or counsel" contemplated by the act? Does advice to foreign clients through offices abroad, relative to the formation of corporations in the normal and legitimate conduct of affairs, come within the definition of "aid or counsel" under the act?

The foregoing examples are typical of many ambiguities which exist because the provisions of the law are not sufficiently limited. Where does mere conversation end and advice begin?

The relationship between the accountant and client is one of confidence. Assurance of sound procedure demands that this relationship be fostered for the good of all concerned. The provisions of section 802 stultify the accountant and rear a reluctance on the part of clients to confer with accountants respecting the formation of legitimate foreign business companies, and may have the further effect of driving taxpayers to seek the services of accountants and lawyers in foreign countries.

It would seem that provisions requiring such information to be filed by those directly concerned—i. e., officers, directors, stockholders, and attorneys—should suffice, without resorting to reports of indirect informants, who merely have casual acquaintance with the matter in hand.

Therefore the repeal of this provision is strongly urged.

(*o*) The time for filing Federal income-tax returns should be extended to the fifteenth day of the fourth month following the close of the taxable year.

Under section 53 of the proposed bill, income-tax returns are required to be filed, as heretofore, within 2½ months following the close of the taxable year. The Commissioner is empowered, by the same section, to grant reasonable extensions of time.