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RECONVERSION COSTS IN RENEGOTIATION

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With the outbreak of World War II came a strong determination on the part of the Federal Government to curb war profiteering as sharply as possible. While it is true that the Federal Government had already established, through increased Federal income and excess profits taxes, a means of recouping a substantial portion of any profits made by manufacturers and others, such regulations, alone, were not considered sufficient to prevent the earning of excessive profits on Government contracts. Nor were the only two statutes limiting profits on government contracts, in existence at the time hostilities commenced in December, 1941; namely, the Vinson-Trammel Act of 1934, and the Merchant Marine Act of 1936, as respectively amended, adequate, either alone or jointly, for the Government's avowed purpose of obviating the possibility of excessive profits. The reasons for this were twofold: they applied only to contracts for vessels and aircraft and they required payment to the Government only of profits in excess of a fixed percentage of the contract price.

In analyzing the problem with which it was faced, in the early months of World War II, the Government realized that a flat profit limitation would not serve its purpose for the reason that it would not control costs as well as profits. It was clear to the Government that excessive costs would be as detrimental to the effective prosecution of the war as would be excessive profits.

The answer to the problem of limiting costs as well as profits came in the form of the principle of renegotiation. Renegotiation attempts to review the profits on war contracts in the light of the varying conditions which enter into the production of war material. Some of the varying conditions which will be given consideration during the renegotiation process are the efficiency of the contractor's operations including the effective use of machinery on hand, the ecective use, by the contractor, of manpower, and the adequacy of his personnel program and policy. Renegotiation, in effect, is a form of bargaining between the Government and the contractors. Under this system, the contractor submits adequate data as to actual costs and profits on the basis of which the amount of excess profits to be refunded to the Government is determined.

The principle of renegotiation was enacted into law as Section 403 of the Sixth Supplemental National Defense Appropriation Act on April 28, 1942. This section is generally referred to and known as the Renegotiation Act. Major amendments to the basic Act were enacted on October 21, 1942, July 1, 1943, and July 14, 1943. On February 25, 1944, the Renegotiation Act was amended by provisions included as part of the Revenue Act of 1943 (Public Law No. 235, 78th Congress). It is interest-

ing to note that there has been no determination, as yet, as to the constitutionality of the Act.

For the most part, the Renegotiation Act has served its purpose of limiting excessive profits on Government war contracts adequately. However, the cessation of hostilities and the conversion of many plants to peace-time production, have created major problems which face contractors as well as Government renegotiators today. Uppermost in the minds of most contractors is the question — will reconversion costs be allowed against profits on Government war contracts?

It is clear, from regulations issued recently, that the Government intends to examine very closely any so-called reconversion costs submitted in connection with renegotiation proceedings for the year 1945. In a new section, 384, added recently to the Renegotiation Regulations by the War Contract Price Adjustment Board, it is stated, under paragraph 384.2 titled "Costs in Connection with the Discontinuance of Renegotiable Business," subparagraph I: "The costs of establishing or re-establishing peacetime operations are not costs of performing renegotiable contracts or subcontracts and are not allocable to renegotiable business regardless of whether such costs constitute deductions or exclusions under Chapters 1 and 2E of the Internal Revenue Code. However, certain costs in connection with the discontinuance of renegotiable business, are allocable to renegotiable business. Such costs and the extent to which they are allocable to renegotiable business are set forth in the following subparagraphs of this paragraph 384.2."

While the foregoing regulation appears to be a simple, direct statement of fact, careful scrutiny and analysis make it obvious that it is fraught with considerable danger to the contractor unless he fully understands what costs may be considered, on renegotiation, in connection with the discontinuance of renegotiable business. Because of the gravity of the problem under consideration, it has been thought wise to quote, in toto, the new subparagraphs added recently to paragraph 384.2 of the Regulations, as mentioned above. They are:

"Paragraph 384.2 (2) Inventory Losses: Losses established through the write-down, abandonment or sale of inventories acquired for the purpose of performing renegotiable business and reasonably necessary to the performance of such business are allocable thereto. Costs of protecting and handling of such inventories to the extent that such costs are not reflected in losses so established on such inventories are likewise allocable to renegotiable business.

"Paragraph 384.2 (3) Losses from Sale, Exchange or Abandonment of Facilities Used in Performing Renegotiable Contracts and Subcontracts: Losses from sale, exchange or abandonment of facilities used in performing renegotiable contracts and subcontracts are allocable to renegotiable business in accordance with the provisions of paragraphs 385.4 and 385.5. Notwithstanding the method of computing such losses for Federal Tax purposes, (i) the costs of moving, dismantling, demolishing, protecting and storing such assets will be taken into account in determining whether losses have been sustained and in computing the amount of such losses for the purpose of renegotiation; and (ii) depreciation incurred with respect to such assets during a period between the end of their use in the performance of renegotiable business and their sale or other disposal will be disregarded in computing such losses.

"Paragraph 384.2 (4) Other Costs and Expenses: In addition to the losses described in paragraphs (2) and (3) with respect to inventories and depreciable or amortizable property, certain other costs incurred in connection with the discontinuance of renegotiable business are also allocable to such business even though incurred after renegotiable business has ceased. Such costs are, in general, items for which the contractor became obligated in connection with the performance of renegotiable business, which were reasonably necessary to such performance and for which he is obligated notwithstanding the cessation of his renegotiable business. Such items include those set forth below.

(a) Severance Pay: Amounts paid by a contractor to his employees in connection with their separation from his employment for which he is obligated by reason of law, contract or the custom of his business are allocable to renegotiable business to the extent such amounts relate to the services performed by the employees in renegotiable business. Generally such amounts are allocable to renegotiable business in the proportion which wages paid with respect to renegotiable business bear to the total wages paid during a

period (ending with severance) equal to the average tenure of employment for all employees on the payroll immediately prior to the severance. Where, however, by reason of the difference in location or the nature of work, employees used in one operation are not interchangeable with those used in the other business of the contractor, the principles of the foregoing sentence will be applied to such operation seperately rather than to the entire business of the contractor.

(b) Rent and other Obligations in Connection with Property: Items such as rents, royalties or other such costs which the contractor is required to pay by law or by contract in connection with the use of property belonging to another where the obligation arose in connection with and was reasonably necessary to the performance of renegotiable business but continues after such business has ceased, are allocable to renegotiable business to the extent warranted by the facts of the particular case. In determining the extent to which such items are allocable to renegotiable business, consideration will be given to the use the contractor made of such property during the performance of renegotiable business and to the use he has made or may make of it during the period between the cessation of such business and termination of the obligation.

(c) Depreciation: Inasmuch as subparagraph (3) of this paragraph 384.2 excludes, in computing losses, depreciation on assets used in renegotiable business sustained during the period between the end of their use in performing such business and their sale or other disposal, depreciation during this period will not be allowed as a cost of performing renegotiable business. If such assets are retained for future use in non-renegotiable business depreciation thereon will be allowed as a cost of renegotiable business to the extent otherwise properly allocable to the end of the month immediately succeeding that in which the end of their use in the performance of renegotiable business took place provided that they are not sooner devoted to civilian production.

(d) General Overhead Expenses: Certain continuing expenses, such as executives' and officers' salaries, maintenance wages, light and heat, and insurance paid or incurred subsequent to the cessation of renegotiable business, may be allocated to such business in amounts considered fair and equitable in light of the circumstances of the particular case. In no event will such costs ge so allocated if incurred more than a reasonable time beyond the discontinuance of renegotiable business. In determining the time which is reasonable for the purposes of this subparagraph, consideration will be given to the time that would be required to eliminate all such expenses in an orderly liquidation of the organization set up for war production, without considering any requirements of the contractor's peacetime production."

Insofar as inventory losses are concerned, as mentioned in subparagraph (2) above, most contractors follow the procedure of including losses on inventories acquired for renegotiable business in termination claims. If they follow this procedure, no substantial inventories should remain once the termination claim has been settled. On the other hand, should any of the inventory costs be excluded from the termination claim by reason of the fact that certain purchases are deemed excessive for the purposes of a particular contract, such costs should be allowed, under this subparagraph, on renegotiation if the inventory in question was acquired by the contractor for war production. If a contractor prefers not to include his inventory in a termination claim because he can use it for peacetime production, but he sustains a loss by reason of a decrease in present prices, such loss also should be allowed.

Under subparagraph (3), cited above, the amount of loss from the sale, exchange or abandonment of facilities used in performing renegotiable contracts which may be claimed, on renegotiation, is limited. Some of the limitations, especially those relating to the amount to be segregated as between renegotiable and non-renegotiable business, are set forth in paragraph 385.4 of the Renegotiation Regulations. The latter paragraph provides, in part, in subparagraph (1) that "If, as a result of the sale or exchange of tangible property used in performing renegotiable contracts. . . . a contractor sustains a loss, there will be allowed as an item of cost. . . . an amount equal to that portion of such loss which bears the same ratio to the whole of such loss as the aggregate amount of deprecia-

tion or amortization on such property allocable to renegotiable business for all fiscal years of the contractor to the date of such sale or exchange bears to the total amount of depreciation or amortization allowed or allowable on such property. . . ." Thus, if a facility were acquired in 1940, and were being amortized on the basis of 10% per annum, approximately 50% of its value would have been charged off by the time of its sale in 1945. Consequently, under subparagraph 385.4 (1), only such portion of the loss sustained as a result of such sale would be allowed, on renegotiation, as would be equal to the percentage of the use made of the facility for war production, unless the contractor could prove either that he was engaged wholly in war production or that the facility in question was used, during its ownership by him, exclusively on war contracts. In such cases, the entire amount of loss would be allowed. Since large numbers of our war contractors will find themselves in the position of taking losses on the sale of facilities used for both renegotiable and non-renegotiable business, during the war period, which facilities may not be adaptable for peacetime use, it becomes clear that careful consideration should be given to this paragraph in preparing the segregation of losses between renegotiable and non-renegotiable business.

It is interesting to note the restrictive language used throughout subparagraph (4) in connection with other costs and expenses. For example, subparagraph (4), second sentence, states, in part, "Such costs are, in general, items. . . . which were reasonably necessary to such performance. . . ." The question immediately arises, what does "reasonably" mean? Again, in subparagraph (4) (a), on severance pay, the regulation states, "Where. . . . employees used in one operation are not interchangeable with those used in the other business of the contractor, the principles of the foregoing sentence will be applied to such operation separately rather than to the entire business of the contractor." In general, it will be most difficult if not impossible for the contractor to segregate his severance pay costs in such a situation. If he is unable to prove his costs in this connection, they may be entirely disallowed as not being "reasonably" necessary. In subparagraph (4) (b), the word "reasonably" is again used in connection with rental costs. Moreover, the subparagraph indicates that in determining the extent to which rent and other such obligations in connection with property are allocable to renegotiable business, consideration will be given to the use the contractor made of such property during the performance of the renegotiable business and to the use he has made or may make of it during the period between the cessation of such business and the termination of the obligation. The facts in each instance will determine what the contractor may claim.

Unquestionably, the provisions of subparagraph (4) will be the source of greatest confusion and difficulty to contractor and government renegotiator alike. There is a decided question as to how much of officers' salaries may be included against renegotiable business during the reconversion process. Moreover, the question, as to whether maintenance, wages, light and heat, insurance, and other such continuing expenses, paid subsequent to the cessation of renegotiable business may not be considered so-called reconversion costs, remains unanswered at this time.

In the past, contractors who engaged both in renegotiable and non-renegotiable business usually determined, on some basis agreeable to their respective Renegotiation agencies, the allocation of general and administrative expenses. Such allocations may not be allowed for 1945, on an annual basis, because of the effective date of the cessation of hostilities. It will be necessary for contractors seeking the allowance of the expenses enumerated in subparagraph (4) (d) which were incurred after the cessation of hostilities as a charge against renegotiable business to make a very careful study and segregation of such expenses for renegotiation for 1945.

The profit factor allowed to corporations during the war years will no doubt not be used as a basis for 1945 renegotiations because of the many problems of reconversion and the possible allowance of additional costs for the current year's operations. Renegotiation, in the past, has presented many problems in the matter of allocation of expenses. In the current year, these problems have been magnified becase some contractors have had substantial terminations while others may still be working on the completion of certain so-called war contracts. Still others have no reconversion problems whatsoever and may be able to start on peacetime production immediately. These and other factors should be given careful consideration both by the contractor and the Government renegotiator in setting profit allowances for year 1945.