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Joint statement by the War, Navy and Treasury Departments and the Maritime Commission : purposes, principles, policies and interpretations under section 403 of the Sixth supplemental national defense appropriation act, 1942 (Public,528, 77th Congress), approved April 28, 1942, as amended by section 801 of the Revenue act of 1942 (Public, 753, 77th Congress), approved October 21, 1942. March 31, 1943

United States. War Department

United States. Navy Department

United States. Department of the Treasury

United States. Maritime Commission

JOINT STATEMENT BY THE WAR, NAVY AND TREASURY DEPARTMENTS AND THE MARITIME COMMISSION

PURPOSES, PRINCIPLES, POLICIES, AND INTERPRETATIONS

UNDER

Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942 (Public, 528, 77th Congress), approved April 28, 1942, as amended by Section 801 of the Revenue Act of 1942 (Public, 753, 77th Congress), approved October 21, 1942

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JOINT STATEMENT BY THE WAR, NAVY, AND TREASURY DEPARTMENTS AND THE MARITIME COMMISSION OF PURPOSES, PRINCIPLES, POLICIES, AND INTERPRETATIONS UNDER SECTION 403 OF THE SIXTH SUPPLEMENTAL NATIONAL DEFENSE APPROPRIATION ACT, 1942, AS AMENDED

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I. FUNDAMENTAL PURPOSES OF SECTION 403

1. **Section 403 evolved from legislation limiting profit to a statutory percentage.**—The first law since World War I relative to a control of profits on armament was the Vinson-Trammell Act, enacted in 1934. Under this law profits on naval construction contracts for vessels and aircraft were limited to 10 percent of the contract price. In June of 1936 the act was amended to permit the offsetting of losses on one contract against profits on another by extending the 10 percent profit limitation to aggregate contract prices for all contracts completed during each taxable year. In addition, the amendment permitted the offsetting of net losses of one taxable year against net profits of the succeeding taxable year. In the same year (1936) the Merchant Marine Act provided for a 10 percent limitation on profits on contracts for ships built for the Maritime Commission. In April of 1939 the Vinson-Trammell Act was amended to provide that the 10 percent limitation on profits be applied only to contracts for naval vessels and that on contracts for Army and Navy aircraft a maximum profit of 12 percent of contract price be allowed. All of these enactments related to peacetime procurement, since the country was not yet preparing for war.

In the next year, on June 28, 1940 an act was passed changing the allowable profits on naval vessels and Army and Navy aircraft to 8 percent of the contract price. This act, coming as it did after the fall of the Low Countries and France, is really the beginning of war profit legislation in the United States. This act extended to subcontractors the provisions of the Vinson-Trammell Act and reduced the profit limitations imposed thereby to 8 percent of contract prices or 8.7 percent of allowable costs of contracts other than prime contracts made on a cost-plus-fixed-fee basis. The Second Revenue Act of 1940, approved October 8, 1940, suspended as of December 31, 1939, the profit limitation statutes applicable to military and naval contracts and subcontracts whenever the contractors and subcontractors were subject to excess profits tax. Pursuant to the Second War Powers Act, approved March 27, 1941, the President by Executive Order 9217, issued April 10, 1942, designated the War Production Board, the War Department, the Navy Department, the Treasury Department, the Reconstruction Finance Corporation and the Maritime Commission as the governmental agencies authorized to inspect the plants and audit the books and records of any contractor or subcontractor with whom a defense contract had been placed, to prevent the accumulation of unreasonable profits.

Under this authority the War Department, the Navy Department and the Maritime Commission, on April 25, 1942, directed the estab-

lishment of cost analysis sections and price adjustment boards. The cost analysis sections were to conduct surveys of costs and profits incident to war contracts, and to act as fact finding agencies for the price adjustment boards. The boards were to assist the Departments and the Commission in securing voluntary adjustments or refunds whenever costs or profits were deemed excessive.

On March 28, 1942, however, the day after the Second War Powers Act became law, and nearly 2 weeks before Executive Order 9127 was issued, the House of Representatives adopted the Case Amendment to H. R. 6868 (Sixth Supplemental National Defense Appropriation Act, 1942), the purpose of which was to limit the profits on any war contract to 6 percent, thereby precipitating the whole question of additional controls over war profits.

2. **Section 403 was adopted as an alternative to fixed profit legislation.** —The War and Navy Departments are opposed to uniform flat percentage profit legislation on the theory that this virtually places contracts on a cost-plus basis and because it is felt that the rate of profit should be related to the contribution and performance of the contractor and not to a fixed statutory percentage. A flat profit control limitation, in the opinion of these Departments, does not achieve its primary objective of uniformity of treatment. Although it allows a fixed uniform percent of profit on gross sales, this is most unfair as applied to the different types of business engaged in war work. It does not recognize the fact that in different lines of business the same volume of sales may require widely different amounts of capital, skill, and work, depending on the rate of turn-over or production, the nature of the article or services, and similar factors. Moreover, some contractors will be using Government facilities, some will be Government financed either through advance payments, direct loans, or cost-plus-fixed-fee contracts, while others will be using their own facilities and capital.

Many vital war items have required for their production the application over a period of years of highly developed inventive genius, original designing and mechanical skill. Also, many products require such precision in manufacture that few contractors can qualify for their production. Furthermore, it not infrequently happens that the contractor who develops such an article is producing it in his own plant with his own capital and with his own painstakingly developed machinery. Another contractor may be engaged as a new and separate source of supply, and may receive new plant, machinery and equipment, without cost, from the Government; the "know how" and patent licenses may have been obtained without cost from the original contractor. As a result of these contributions and modern equipment, the second contractor frequently produces the article at a lower

cost than the original contractor. It is obvious that the second contractor is not entitled to the same rate of profit as the original one.

On the other hand, in some cases the costs of a new producer have been twice that of the original contractor because of a lack of skill and "know how." Under fixed statutory limitations the new contractor might receive twice the profit of the original producer. This is obviously most unfair. Consideration must also be given to the situation where a "run of the mill product," requiring little skill, is being manufactured and where material costs are relatively large; and also to cases where subassembling is performed by a subcontractor.

It is apparent, from these examples, that a uniform maximum rate of profit for everyone would necessarily be unfair to many. Furthermore, industry studies have revealed diversities in production so varied that, with rare exceptions, even application of a uniform rate to broad classifications by industries would not be practical or equitable. Renegotiation appears to be the only method so far suggested which is sufficiently flexible to cope with the diversity between industries or the variations within them.

The War and Navy Departments, therefore, suggested the elimination of the Case amendment and, at the request of the Chairman of the Senate Subcommittee on Appropriations, representatives of the War and Navy Departments and Mr. Donald M. Nelson, Chairman of the War Production Board, agreed to suggest a substitute method of preventing excessive or unanticipated profits on war contracts. The substitute method recommended by the War and Navy Departments and Mr. Nelson was not adopted by Congress, but the Case Amendment was eliminated and section 403 was enacted in its place. Section 403 was based upon the theory that the contract prices of each contractor might be adjusted after consideration of experience in the performance thereof and after negotiation with the contractor. Section 403 was amended by section 801 of the Revenue Act of 1942, approved October 21, 1942, to meet certain administrative problems encountered in its application, but its basic principles were not changed. It is true that the very flexibility of renegotiation makes complete uniformity and certainty almost impossible and the necessity of dealing with cases individually creates a serious administrative burden. Nevertheless, it is felt that the benefits and advantages of renegotiation outweigh these disadvantages and make it preferable to other methods proposed.

3. **Section 403 is not a tax act designed to raise revenue, but is a price adjustment act designed to lower costs.**—Section 403 has been occasionally but inaccurately interpreted as a tax act. The problem of excessive war costs and profits is primarily a problem of pricing and not of

taxation. Heavy taxation does not meet the problem but tends to aggravate it by creating an incentive for increasing costs.

Three important respects in which taxation is ineffective in meeting the problems solved by renegotiation are:

First—War matériel contracts, which have been generally profitable, sometimes are excessively so because many war industries have had to be created under forced draft. In many cases profits have been unpredictable because the production of repetitive items has increased by geometric proportions. Therefore, the accumulation of excessive profits by some war contractors has been and always will be unavoidable. These excessive profits are extremely irregular. They accrue to some contractors, not to others. Taxation, which must apply equally to all war and civilian businesses, cannot keep pace with this erratic development of excessive war profits.

Second—War industries lack the normal competitive incentive for low-cost, efficient operation. The Government, in many instances must buy from every available source of supply, regardless of cost. Neither taxation nor any proposed profit limitation formula restores this incentive. In fact, taxation and most limitation formulas put a premium on high costs.

Third—The munitions industry is extremely varied. A large part of it operates with Government capital or Government guarantees, substantially reducing private risks. Some contractors can continue their peacetime processes with little change. Others must attempt unfamiliar and unexplored operations. Some operations permit a very rapid turn-over of the contractor's investment, others a very slow turn-over. No formula for limiting profits can deal equitably with all these circumstances.

Renegotiation of contracts can do what taxation and flat formulas cannot. It can fit the profit to the facts. It can reduce excessive profits, leaving reasonable profits untouched. It can reward low-cost efficiency. It can distinguish between degrees of risk and venture. It is the only device flexible enough to fit the variety of war industries.

As section 403 is designed to meet this pricing problem, the exactitude and uniformity of application found under a tax act cannot be expected. An equal degree of uniformity might be expected in the renegotiation of groups of contracts after "the facts are in" as would have been reached at the time of initial negotiations had all the facts then been known. The degree of uniformity under the original negotiations would be varied, however, by the extent to which various factors might be given different weighting by different persons or groups. Consequently, the results of renegotiation will not and can not reach the mathematical uniformity resulting from a tax statute that is con-

cerned only with the determination of the amount of net income based upon a stated formula.

4. **Specified purposes of and remedies under section 403.**—Subsection (b) of section 403 requires the insertion in contracts for an amount in excess of $100,000 made after April 28, 1942, of a provision requiring renegotiation of the contract price at a period or periods when, in the judgment of the Secretary of War, the Secretary of the Navy, the Secretary of the Treasury, or the Chairman of the Maritime Commission, the profits can be determined with reasonable certainty, as well as a provision requiring the contractor to insert a similar provision in each subcontract for an amount in excess of $100,000 made by him under such contract.

Subsection (c) of section 403 authorizes and directs the Secretary of War, the Secretary of the Navy, the Secretary of the Treasury, and the Chairman of the Maritime Commission, whenever in his opinion excessive profits *have been realized, or are likely to be realized,* from any contract with his Department or the Commission, as the case may be, or from any subcontract thereunder, whether or not made by the contractor, to require the contractor or subcontractor to renegotiate the contract price of any existing contract or subcontract, even though made prior to April 28, 1942 (provided final payment had not been made prior to that date), and of any contract or subcontract made thereafter, *whether or not it contains a renegotiation or recapture clause,* unless such contract or subcontract provides otherwise or is exempted pursuant to other provisions of the statute.

The statute defines renegotiation as including a refixing of the contract price by the Secretary or the Chairman. This refixing is generally accomplished by mutual agreement arrived at by negotiation between the contractor and the price adjustment board of one of the Departments or the Commission. Under these agreements, excessive profits are eliminated in various ways, among which are the following: (1) A direct cash refund by the prime contractor to the Government, in which event his contract prices would not be adjusted for the period covered; (2) a reduction in the contract prices on future deliveries under prime contracts, which automatically would accrue to the benefit of the Government; (3) a direct cash refund by the subcontractor to the Government; and (4) a reduction in the contract price on future deliveries under subcontracts, with a provision that any prime contractor receiving the benefit thereof must pass on an equivalent benefit to the Government in the form of a corresponding reduction in the contract prices of its prime contracts or a direct cash refund to the Government. These methods may also be used in combination and are not exclusive of other appropriate and effective methods applicable to particular situations.

In the event it becomes impossible to reach a mutual agreement, the case is then referred to the official of the Department or the Commission to whom authority has been delegated under the statute, who gives consideration to the use of such special measures as he may deem necessary or advisable.

II. GENERAL PRINCIPLES FOLLOWED AND FACTORS CONSIDERED IN DETERMINING THE EXISTENCE OF EXCESSIVE PROFITS

In the present emergency the existence of excessive profits does not necessarily indicate that a contractor has taken undue advantage of the Government or that the contracting officers have failed to exercise good judgment under all the circumstances. Companies have been asked to produce war equipment with which neither they nor others have had any previous experience, and in quantities far beyond anything previously contemplated. Under such circumstances the estimates of costs have necessarily been unreliable and when subjected to the test of actual production have often proved to be substantially higher than the actual costs. Consequently, many contractors have been left with profits which they neither anticipated nor wish to retain. The true purpose of renegotiation is to determine, preferably by agreement, the amount of these profits which exceed a fair margin under all the circumstances, and these circumstances are bound to vary in individual cases.

1. **General principles followed in determining excessive profits.**—In considering whether costs or profits on war contracts are excessive, the price adjustment boards are guided by the following broad principles:

(*a*) That the stimulation of quantity production is of primary importance.

(*b*) That reasonable profits in every case should be determined with reference to the particular performance factors present without limitation or restriction by any fixed formula with respect to rate of profit, or otherwise.

(*c*) That the profits of the contractor ordinarily will be determined on his war business as a whole for a fiscal period, rather than on specific contracts separately, with the possible exception of certain construction contracts. Fixed price contracts are negotiated separately from fees on cost-plus-fixed-fee contracts.

(*d*) That as volume increases the margin of profit should decrease. This is particularly true in those cases where the amount of business done is abnormally large in relation to the amount of the contractor's own capital and company-owned plant, and where

such production is made possible only by capital and plant furnished by the Government.

(*e*) That in determining what margin of profit is fair, consideration should be given to the corresponding profits in pre-war base years of the particular contractor and for the industry, especially in cases where the war products are substantially like pre-war products. It should not be assumed, however, that under war conditions a contractor is entitled to as great a margin of profit as that obtained under competitive conditions in normal times.

(*f*) That the reasonableness of profits should be determined before provision for Federal income and excess profits taxes.

(*g*) That a contractor's right to a reasonable profit and his need for working capital should be distinguished. A contractor should not be allowed to earn excessive profits on war contracts merely because he lacks adequate working capital in relation to a greatly increased volume of business.

2. **Particular factors considered when applicable in determining excessive profits.**—In determining the margin of profit to which a contractor is entitled, consideration is given to the manner in which the contractor's operations compare with those of other contractors with respect to the applicable factors; among such factors taken into consideration, when applicable, are the following:

(*a*) Price reductions and comparative prices.

(*b*) Efficiency in reducing costs.

(*c*) Economy in the use of raw materials.

(*d*) Efficiency in the use of facilities and in the conservation of manpower.

(*e*) Character and extent of subcontracting.

(*f*) Quality of production.

(*g*) Complexity of manufacturing technique.

(*h*) Rate of delivery and turnover.

(*i*) Inventive and developmental contribution with respect to important war products.

(*j*) Cooperation with the Government and with other contractors in developing and supplying technical assistance to alternative or competitive sources of supply and the effect thereof on the contractor's future peacetime business.

Consideration is also given to possible increases in cost of materials, imminent wage increases, and the risks assumed by a contractor such as inexperience in new types of production, delays from inability to obtain materials, rejections, spoilage, "cut-backs" in quantities, and guarantees of quality and performance of the product. It is also recognized that a contractor whose pricing policy results in com-

paratively reasonable profits is entitled to more favorable treatment than a contractor whose pricing policy results in a large amount of unreasonable profits unless this is attributable to reduced costs rather than over-pricing. The contractor who maintains only a reasonable margin of profit is subjected to the risks incident to the performance of a fixed price contract, while the contractor who practices over-pricing usually has taken few, if any, of such risks. In the latter case the profit of the contractor should be adjusted in the direction of the fee that might have been allowed under a cost-plus-fixed-fee contract for the production of similar articles.

The contractor in every instance is given ample opportunity to develop and present facts with respect to all of the above factors and to any other factors which in his particular case may be relevant to the contractor's over-all quality of performance, upon which his profit reward is based.

III. INTERPRETATIONS OF THE STATUTE

The following interpretations of the statute represent the present opinion of the Departments and the Commission and are subject to such revision from time to time as may appear desirable as a result of the operation of the boards under these interpretations. They are issued for information only and are subject to change without notice. To facilitate the issuance of changes, these interpretations are designated J–PAB–1 to J–PAB–12, inclusive.

J–PAB–1

1. **Contracts and subcontracts subject to renegotiation.**—Under subsection (c) of section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942 (Public, No. 528, 77th Cong.), approved April 28, 1942, as amended by section 801 of the Revenue Act of 1942 (Public, No. 753, 77th Cong.), approved October 21, 1942, whenever in the opinion of the Secretary of War, the Secretary of the Navy, the Secretary of the Treasury, or the Chairman of the Maritime Commission (each being hereinafter referred to as the "Secretary"), the profits realized or likely to be realized on any contract or contracts with such Department or Commission (each being hereinafter referred to as the "Department"), or from any subcontract or subcontracts thereunder whether or not made by the contractor, may be excessive, the Secretary is authorized and directed to require the contractor or subcontractor to renegotiate the prices of such contracts and subcontracts to eliminate any excessive profits thereunder.

The provisions of section 403 relate to all contracts entered into by the War and Navy Departments and the Maritime Commission. Con-

tracts of the Treasury Department subject to renegotiation include

(1) Contracts placed under section 201 of title II of the First War Powers Act, 1941, 55 Stat. 839 (principally lend-lease contracts, which may be identified by the symbols "DA–TPS" preceding the contract number);

(2) Contracts for strategic and critical materials placed under the authority of the Act of June 7, 1939, 53 Stat. 811 (such contracts made after March 1, 1943 may be identified by the symbols "SCM–TPS" preceding the contract number);

(3) Contracts for supplies for refugee relief under the Red Cross program, placed under the authority contained under title III of the Third Supplemental National Defense Appropriation Act, 1942, 55 Stat. 817 (such contracts may be identified by the symbols "RR–TPS" preceding the contract number).

Other types of contracts regularly entered into by the Procurement Division of the Treasury Department in the ordinary course of business prior to the war period, as such, are not subject to renegotiation unless negotiated under authority contained in title II of the First War Powers Act, 1941. However, purchase orders, issued by the War and Navy Departments and the Maritime Commission under General Schedule of Supplies Contracts, which are entered into by the Procurement Division of the Treasury Department on behalf of all departments and establishments of the Government, are considered as being subject to the provisions of section 403. Purchase orders issued by the Treasury Department itself under such contracts are also considered as being subject to the provisions of section 403 if such purchases are for lend-lease or for the Red Cross program.

All so-called lend-lease contracts entered into by the War Department, the Navy Department, the Treasury Department and the Maritime Commission are subject to the provisions of section 403. However, lend-lease contracts entered into by any other department or agency of the Government are not subject to renegotiation under existing law.

Subsection (c) of section 403 is applicable to all such contracts and subcontracts, whether or not such contracts or subcontracts contain a renegotiation clause, unless (i) final payment pursuant to such contract or subcontract was made prior to April 28, 1942, or (ii) the contract or subcontract provides otherwise pursuant to subsection (b) or (i), or is exempted under subsection (i), of section 403, or (iii) the aggregate sales by the contractor or subcontractor, and by all persons under the control of or controlling or under common control with the contractor or subcontractor, under contracts with the Departments and subcontracts thereunder do not exceed, or in the opinion of the Secretary concerned will not exceed, $100,000 for the fiscal

year of such contractor or subcontractor; provided, however, no renegotiation of the contract price pursuant to any provision therefor, or otherwise, shall be commenced more than one year after the close of the fiscal year of the contractor or subcontractor within which completion or termination of the contract or subcontract occurs.

The term "subcontract" as used in subsection (c) is defined to mean any purchase order or agreement to perform all or any part of the work, or to make or furnish any article, required for the performance of another contract or subcontract. The term "article" is defined to include any material, part, assembly, machinery, equipment, or other personal property. This definition of "subcontract" is much broader than under the Vinson-Trammell Act, in that profits on the production and sale of articles required for the performance of another contract or subcontract are subject to renegotiation, as well as profits on the production or sale of all materials incorporated into the end product, down to and including raw materials, except in the case of certain specified raw materials exempted under subsection (i) (1) (ii) of the statute. This definition is interpreted to include contracts with contractors and subcontractors (a) for the sale of an end product or an article incorporated therein, (b) for the sale of machinery or equipment used in the processing of an end product or of an article incorporated in an end product, (c) for the sale of component parts of or subassemblies for such machinery or equipment, and (d) for the performance of personal services required for the performance of the contracts and subcontracts included in (a), (b) and (c).

An allocation is made of sales of such machinery and equipment based on the nature of the use thereof (i. e., war or commercial production) and to the extent to which the production of the purchasers to whom such sales are made is subject to renegotiation, such sales are considered renegotiable. Thus if 60 percent of the sales of the purchasers to whom such machinery and equipment are sold is renegotiable, such sales of machinery and equipment are considered renegotiable to the same extent. In those cases where it is unduly burdensome or impractical to trace the end use of individual items of machinery or equipment, the Departments frequently make this determination on the basis of industry-wide estimates or by some other method mutually agreed upon.

The term "article" has also been interpreted to include commercial products as well as equipment fabricated for particular uses or purposes. The fact that commercial products are sold for industrial uses, either directly or through jobbers or other commercial channels, does not exclude such articles from this definition. The same tests are applied to both ordinary commercial products and equipment fabricated for special uses and purposes.

The fact that all or part of such articles are sold under price ceilings fixed by the Office of Price Administration does not exclude such articles from this definition, or exempt profits made on the sale thereof from renegotiation.

J–PAB–2 (*a*)

2. **Exemptions.**—2 (*a*) *Payment before April 28, 1942.*—Contracts and subcontracts are not subject to renegotiation under the statute if final payment pursuant to such contract or subcontract was made prior to April 28, 1942. If final payment on a contract or subcontract was not made prior to April 28, 1942, profits made thereunder at any time, even in years prior to 1942, are subject to renegotiation. The Departments have adopted the policy that this provision with respect to payment before April 28, 1942 will be interpreted so that payment will be deemed to have been made although certain relatively small unliquidated items may not have been finally determined and paid for.

This exemption raises the legal question of when a series of transactions constitute one contract or several contracts. If the transactions constitute one contract and final payment had not been made before April 28, 1942, then all the transactions thereunder are subject to renegotiation. If, however, the transactions constitute several contracts, then only those contracts on which final payment had been made before April 28, 1942, are exempt. This question arises frequently in cases involving reorders and orders under option agreements, periodic deliveries under purchase orders, and other similar circumstances. In determining whether an order for further quantities or work constitutes a new and separate contract, the test is whether a new or additional promise is given by the contractor with respect to the additional order, or whether this additional quantity or work is covered by an option, or otherwise, under the initial contract.

J–PAB–2 (*b*) (i)

2. (*b*) (i) *Fixed exemptions: Contracts with other governmental agencies; Defense Plant Corporation.*—Subsection (i) (1) (i) of the statute provides that the statute shall not apply to any contract by a Department with any other department, bureau, agency or governmental corporation of the United States or with any Territory, possession, or State or any agency thereof or with any foreign government or any agency thereof. Contracts between such agencies or governmental corporations and private contractors, and subcontracts thereunder, are likewise not subject to renegotiation, except in those instances where the agency or governmental corporation is acting as a

direct agent for a Department. In these instances, the contract is deemed to be with the principal for whom the agency or governmental corporation is acting as direct agent, and not with the agency or governmental corporation, and accordingly, if otherwise subject to renegotiation, will not be exempted. Thus, contracts with Defense Supplies Corporation, Metals Reserve Company, Rubber Reserve Company, and similar governmental corporations are not subject to renegotiation unless it appears that the governmental corporation was acting as the direct agent for one of the Departments.

As to contracts with the Defense Plant Corporation, the following statement of policy has been approved by the Under Secretary of War and the Under Secretary of the Navy:

> With respect to contracts placed by Defense Plant Corporation for machine tools and other equipment and personal property to be included in leased facilities to prime contractors with or subcontractors of the War and the Navy Departments, the War and the Navy Departments will obtain appropriate information as to sales, costs, and profits on such contracts and will include such contracts in the renegotiation wherever possible. If the contractors object to such renegotiation and the information indicates the possibility of excessive profits, the information will be transmitted to Defense Plant Corporation which will examine the information with a view to renegotiation in consultation with the War or Navy Departments. Contracts placed by Defense Plant Corporation for the construction of plants, as distinguished from the furnishing of equipment and supplies, will not be renegotiated nor will contractors be required to furnish information as to their profits on those contracts.

It frequently happens that manufacturers of machine tools and other equipment and personal property for Defense Plant Corporation prefer to obtain a clearance from any possible statutory liability for excessive profits on those contracts instead of relying solely on the view of the Department that such contracts are not subject to renegotiation, and this procedure enables them to do so. The Departments and Defense Plant Corporation also prefer to have such contracts included in the renegotiation whenever possible because in many instances the Department agrees to indemnify the Defense Plant Corporation against loss threon.

J–PAB–2 (*b*) (ii)

2 (*b*) (ii) *Fixed exemptions: Contracts for certain raw materials.*— Subsection (i) (1) (ii) provides that the statute shall not apply to any contract or subcontract for the product of a mine, oil or gas well, or other mineral or natural deposit, or timber, which has not been

processed, refined, or treated beyond the first form or state suitable for industrial use; and the Secretaries are authorized by joint regulation to define, interpret, and apply this exemption. Such joint regulation, promulgated as of February 1, 1943, is as follows:

"1. The term 'exempted product,' as used in this regulation, shall mean any of the following products:

Aggregates consisting of washed or screened sand, gravel or crushed stone.

Aluminum ingots and pigs; alumina; calcined or dried bauxite; crude bauxite.

Antimony ore, crude; antimony ore, concentrated; antimony metal; antimony oxide.

Arsenic powder; arsenious oxide (white arsenic).

Asbestos fibre.

Bismuth.

Cement.

Chromium ore and ferrochrome not processed beyond the form or state suitable for use as an alloy or refractory in the manufacture of steel; bichromates; chromic acid.

China clay; kaolin clay; fire clay; brick and tile made from clays other than kaolin, china or fire clay.

Coal, prepared; run-of-mine coal.

Copper ore, crude; copper ore, concentrated; copper billets, cathodes, cakes, ingots, ingot bars, powder, slabs, and wirebars.

Fluorspar ore; fluorspar fluxing gravel; lump ceramic ground fluorspar; acid grades of fluorspar.

Crude iron ore; pig iron.

Gas, natural, not processed or treated further than the processing or treating customarily occurring at or near the well.

Gypsum, crude; calcined gypsum.

Lead ore; refined lead bars, ingots and pigs; antimonial lead bars, ingots and pigs.

Lime.

Magnesite; dead burned magnesite.

Metallic magnesium, pigs and ingots.

Manganese ore; ferromanganese; silicomanganese.

Oil, crude, not processed or treated further than the processing or treating customarily occurring at or near the well.

Phosphate rock; superphosphate.

Ferromolybdenum; calcium molybdate; molybdenum oxide.

Rock salt; common salt of all grades.

Refined silver bars, shot, powder and grains.

Stone, rough dimension.

Sulphur, crude.

Standing timber, logs, logs sawed into lengths, and logs with or without bark.

Refined pig tin.

Tungsten ore and concentrates; ferrotungsten; tungsten powder.

Vanadium ore and concentrates; ferrovanadium; vanadium pentoxide.

Zinc anodes, balls, oxides, powder and slabs.

"2. Subsection (i) (1) (ii) of section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, as amended, is interpreted to mean that each of the exempted products is 'the product of a mine, oil or gas well, or other mineral or natural deposit, or timber, which has not been processed, refined or treated beyond the first form or state suitable for industrial use'. The provisions of said section 403, as amended, shall not apply to contracts or subcontracts for the exempted products.

"3. In cases where a contractor or subcontractor (*a*) processes, refines, or treats a product to bring it up to the form or state of an exempted product and, (*b*) further refines, processes or treats such exempted product beyond the first form or state suitable for industrial use in order to perform his contract or subcontract, then in such cases the exempted product in its first form or state suitable for industrial use shall be considered, for the purposes of renegotiation under section 403, as amended, as an item of cost at its established sale or market price.

"4. This regulation may be amended from time to time, revising the list of exempted products contained in paragraph 1 of this regulation."

J–PAB–2 (*c*)

2 (*c*) *Discretionary exemptions.*—Under subsection (*b*) of the statute, the Secretary, if in his opinion the provisions of the contract or subcontract are otherwise adequate to prevent excessive profits, may provide that renegotiation shall apply only to a portion of a contract or subcontract, or shall not apply to performance during a specified period or periods, and may also provide that the contract price in effect during any such period or periods shall not be subject to renegotiation. Under subsection (i) (2) of the Statute, the Secretary is authorized, in his discretion, to exempt from some or all of the provisions of the statute, both individually and by general classes or types: (i) any contract or subcontract to be performed outside of the territorial limits of the continental United States or in Alaska; (ii) any contracts or subcontracts under which, in the opinion of the Secretary, the profits can be determined with reasonable certainty when the contract price is established, such as certain classes of agreements for personal services, for the purchase of real property, perishable goods, or commodities the minimum price for the sale of which has been fixed by a public regulatory body, of leases and

license agreements, and of agreements where the period of performance under such contract or subcontract will not be in excess of 30 days; and (iii) a portion of any contract or subcontract or performance thereunder during a specified period or periods, if in the opinion of the Secretary, the provisions of the contract are otherwise adequate to prevent excessive profits. Such contracts and subcontracts remain subject to renegotiation until specifically exempted as provided in the statute.

(i) The Secretary of War has delegated to the Chiefs of the Supply Services including the Matériel Command, Army Air Forces, respectively, and the Secretary of the Navy has delegated to the Under Secretary of the Navy, authority, in their discretion, to exempt, pursuant to subsection (i) (1) (ii), any contract or subcontract to be performed outside of the territorial limits of the United States or in Alaska from some or all of the provisions of the statute. This authority may be exercised with respect to existing contracts and with respect to contracts executed in the future.

Like authority has been delegated to the Director of Procurement by the Secretary of the Treasury.

No contract or subcontract to be performed outside of the territorial limits of the United States or in Alaska will be exempt except upon specific exemption individually or as a class by one of the Chiefs of the Supply Services, or the Commanding General, Matériel Command, Army Air Forces, of the War Department, the Under Secretary of the Navy or the Director of Procurement in the Treasury Department.

(ii) The Departments deem it impractical to issue jointly any regulations establishing exemptions of classes of contracts or subcontracts referred to in subsection (i) (2) of the statute because of variations, as between the Departments, in the circumstances under which those contracts and subcontracts are entered into. Pursuant to that subsection, exemptions may, however, from time to time hereafter be established by the respective Departments, applicable only to contracts with such Department and subcontracts thereunder. Such an exemption will not extend to contracts with any other Department or subcontracts thereunder, of the same class, unless specifically concurred in by the Secretary of such other Department.

J–PAB–2 (*d*)

2 (*d*) *Subcontracts under exempt contracts.*—The Departments interpret subsections (i) (1) (i) and (i) (1) (ii) of the statute to mean that subcontracts under a contract or subcontract exempted by those subsections, are likewise exempt. This, however, does not apply to subcontracts under a contract or subcontract exempted by discre-

tionary action of one of the Secretaries pursuant to subsection (i) (2) of the statute.

J–PAB–2 (*e*)

2 (*e*) *Annual sales under $100,000.*—While the statute provides that the renegotiation clause need be included only in contracts and subcontracts for amounts in excess of $100,000, nevertheless contracts and subcontracts for amounts of $100,000 or less are subject to renegotiation unless otherwise exempted. The statute, however, is not applicable unless the aggregate sales by the contractor or subcontractor, and by all persons under the control of or controlling or under common control with the contractor or subcontactor, under contracts with the Departments and subcontracts thereunder do not exceed, or in the opinion of the Secretary concerned will not exceed, $100,000 for the fiscal year of such contractor or subcontractor.

J–PAB–3

3. **Subcontracts for real property excluded.**—The term "article" is defined to include any "material * * * or other personal property." This definition, by inference at least, excludes real property. It follows, therefore, that a sale of real property or the construction of improvements thereon or of equipment to become a part thereof which is required to perform another contract is not included in the definition of the term "subcontract." This situation must be carefully distinguished from the case where the sale of the real property or the construction of improvements thereon or equipment therefor is the subject matter of a prime contract with one of the Departments. Thus, a contract to sell, construct or equip a building for a contractor requiring it in order to peform a contract or a subcontract would be excluded; while a contract to sell, construct or equip a building directly for a Department (or for one acting as an agent for a Department) would constitute a prime contract which would be subject to renegotiation.

J–PAB–4

4. **Statutes of limitation.**—The statute provides two statutes of limitation, one on the renegotiation of individual contracts and the other on renegotiation for an expired fiscal year or years.

(*a*) *Renegotiation of individual contracts.*—No renegotiation of the contract price pursuant to any provision therefor, or otherwise, shall be commenced by the Secretary more than one year after the close of the fiscal year of the contractor or subcontractor within which completion or termination of the contract or subcontract, as determined by the Secretary, occurs. (See subsection (c) (6).) The Depart-

ments interpret this provision to mean that renegotiation commences on the specific date set by the Department conducting renegotiation for the initial renegotiation conference unless otherwise agreed by the contractor.

The question has arisen as to whether the term "completion * * * of the contract," as used in this provision, means final delivery, acceptance or payment. The Departments have adopted the view that completion of the contract means final delivery or acceptance under the contract, rather than final payment, and the fact that a contractor may still have certain obligations under guarantees of performance or the fact that there may be unliquidated items outstanding does not extend the time of completion beyond the date of final delivery or acceptance.

(*b*) *Renegotiation for prior years.*—Any contractor or subcontractor may file with the Secretaries of the Departments concerned financial statements for any prior fiscal year or years, in such form and detail as the Secretaries shall prescribe by joint regulation. The Secretary of each such Department has one year thereafter within which he may give written notice of renegotiation, in form and manner to be prescribed in such joint regulation, fixing a date and place for an initial conference to be held within 60 days, and unless such notice is given by one of the Secretaries and renegotiation commenced by such Secretary within 60 days, the liability of the contractor or subcontractor for excessive profits realized during such year or years will be discharged. (See subsection (c) (5).)

A joint regulation prescribing the form of the financial statements which the contractor or subcontractor may file was promulgated as of February 1, 1943.

J–PAB–5

5. **Recognition of exclusions and deductions allowed for Federal tax purposes.**—Under subsection (c) (3) of the statute, as amended, the Secretary in determining the excessiveness of profits must "recognize the properly applicable exclusions and deductions of the character" which the contractor or subcontractor is allowed under chapter 1 and chapter 2 E of the Internal Revenue Code. Since those items must be properly applicable to the profits from the contracts and subcontracts being renegotiated, they must be allocated between the renegotiable and nonrenegotiable business, even though the full amount is allowed for tax purposes. The words "of the character" disclaim the implication that the renegotiating authorities are required to compute and allow the actual dollar amount of exclusions and deductions which the Bureau of Internal Revenue would allow.

The Departments have issued the following interpretations with

respect to the recognition of exclusions and deductions allowed for Federal tax purposes:

J–PAB–5 (*a*)

5 (*a*) *Amortization, depreciation and conversion.*—Under section 124 of the Internal Revenue Code, if a contractor has acquired or constructed with his own funds facilities especially adapted for use in war production, he may amortize the cost over a 5-year period at the rate of 20 percent per year upon obtaining a Certificate of Necessity from the Secretary of War or the Secretary of the Navy. Even though the contactor has obtained a Certificate of Necessity, he need not amortize the cost at this special rate but may, if he desires, amortize his cost at ordinary rates.

In computing net profits before Federal income and excess profits taxes of any contractor or subcontractor, for purposes of renegotiation, the amount of amortization allowed under section 124 of the Internal Revenue Code (except to the extent of depreciation) will not be allowed as an item of cost. However, the amount of such amortization in excess of depreciation will be deducted from such profits and not considered as representing excessive profits for purposes of renegotiation. In determining whether and the extent to which profits remaining after deducting the amount of such amortization are excessive, consideration will be given to the extent that it appears that the contractor or subcontractor will have residual value in the amortized facilities so far as it may be reasonably ascertained.

If the emergency is terminated during the 5-year period, the amortization period may be shortened accordingly, and the contractor or subcontractor will be entitled to adjust his taxes for prior years, on the conditions stated in the Internal Revenue Code, to give effect to the corresponding increase in the deduction taken in each such year, but there is no authority for reopening renegotiation agreements to give consideration to this *accelerated* amortization corresponding to the adjustment of taxes for prior years to which the contractor or subcontractor may thus become entitled.

War facilities not covered by Certificates of Necessity, representing permanent capital additions for the manufacture of war products or materials, are depreciated by the Bureau of Internal Revenue, and will be depreciated in renegotiation, at the ordinary rates of depreciation for corresponding property. The demands of war production, however, frequently require the use of facilities for extraordinary consecutive periods of day and night shifts, and under those circumstances the Bureau and the renegotiation authorities may allow depreciation on the machinery, but not on the buildings, at higher rates.

The full amount of costs of converting facilities to war production which do not represent permanent additions, such as rearrangement of machinery, is allowed by the Bureau, and will be allowed in renegotiation, for the year in which it is incurred. This does not include losses on commercial inventory which has become unsaleable as a result of wartime regulations or loss of market.

J–PAB–5 (*b*)

5 (*b*) *Losses from prior years.*—Section 122 of the Internal Revenue Code authorizes the deduction for any taxable year of the "net operating loss" for the first and second preceding taxable years, subject to certain exceptions and limitations. The part of such loss which was attributable to contracts or subcontracts subject to renegotiation is a "properly applicable" deduction which is allowed in renegotiation, but the part which was attributable to commercial business or to contracts and subcontracts not subject to renegotiation is not allowed. The term "net operating loss" and the amount thereof which is deductible for tax purposes is defined in the code. In determining the amount of "net operating loss" to be allowed for renegotiation purposes, losses on contracts and subcontracts pursuant to which final payment was made prior to April 28, 1942, or which for other reasons would not be subject to renegotiation even had such losses been incurred during the fiscal year or other period under consideration, are not allowed.

Even though a contractor has no "net operating loss" to carry over for tax purposes, the renegotiating authorities, nevertheless, give consideration, under proper circumstances, to losses incurred in prior years on contracts and subcontracts subject to renegotiation. This does not necessarily mean that the full amount of such losses are to be allowed against profits for the fiscal year or other period under consideration, but only that they may be recognized as one of the factors in determining whether such profits are excessive.

The Internal Revenue Code also provides for the "carry back" of "net operating losses" in subsequent years through adjustment of taxes for prior years, but there is no authority for reopening renegotiation agreements to give consideration to net losses incurred in periods subsequent to the periods covered by such agreements.

J–PAB–5 (*c*)

5 (*c*) *War losses.*—Section 127 of the Internal Revenue Code provides that the amount of the loss on account of property destroyed or seized on or after December 7, 1941, in the course of military or naval operations by the United States or any other country engaged in the present war may be allowed as a deduction from income in the

year in which such destruction or seizure occurs. The fact that the property has been destroyed or seized in the course of the war does not of itself establish the loss as a "properly applicable" deduction to be recognized in renegotiation. In order that such a loss be recognized in renegotiation, the contractor or subcontractor must furnish evidence satisfactory to the renegotiating authorities of the connection between the property destroyed or seized and the performance of the contracts or subcontracts being renegotiated.

J–PAB–5 (*d*)

5 (*d*) *Interest.*—Interest on borrowed capital is deductible under the Internal Revenue Code and is, therefore, allowed where properly applicable for purposes of contract renegotiation.

The general principle used in the allocation of interest is that all interest on borrowed funds is allocated between sales subject to renegotiation and sales not subject to renegotiation on the basis of the proportion which each category of sales bears to the total business, with the exception that in no case is the interest charged to sales subject to renegotiation less than the interest on those borrowings which can be definitely ascertained as applicable to such sales (e. g., "V" loans, advance payments, etc.), and similarly, in no case is interest charged to sales not subject to renegotiation less than the interest on those borrowings which can be definitely ascertained as applicable to such sales. An appropriate portion of such interest will be allocated to income, if any, derived from sources other than sales.

So long as the borrowed capital is used for war purposes, it does not matter when the obligation was incurred. Interest on long-term bonds and obligations issued long before the war is allowable if the capital represented by such obligations is used for war production.

J–PAB–5 (*e*)

5 (*e*) *Advertising.*—Allowances for advertising expenses are based upon deductions allowed by the Bureau of Internal Revenue for tax purposes. These allowable deductions have been described by Commissioner Guy T. Helvering of the Bureau of Internal Revenue in a statement issued on September 29, 1942, as follows:

> To be deductible, advertising expenditures must be ordinary and necessary and bear a reasonable relation to the business activities in which the enterprise is engaged. The Bureau recognizes that advertising is a necessary and legitimate business expense so long as it is not carried to an unreasonable extent or does not become an attempt to avoid proper tax payments.
>
> The Bureau realizes that it may be necessary for taxpayers now engaged in war production to maintain through advertising, their

trade names and the knowledge of the quality of their products and good will built up over past years, so that when they return to peacetime production their names and the quality of their products will be known to the public.

In determining whether such expenditures are allowable, cognizance will be taken of (1) the size of the business, (2) the amount of prior advertising budgets, (3) the public patronage reasonably to be expected in the future, (4) the increased cost of the elements entering into the total of advertising expenditures, (5) the introduction of new products and added lines, and (6) buying habits necessitated by war restrictions, by priorities, and by the unavailability of many of the raw materials formerly fabricated into the advertised products.

Reasonable expenses incurred by companies in advertising and advertising technique to speed the war effort among their own employees, and to cut down accidents and unnecessary absences and inefficiency, will be allowed as deductions. Also reasonable expenditures for advertisements including the promotion of Government objectives in wartime, such as conservation, salvage or the sale of War Bonds, which are signed by the advertiser, will be deductible provided they are reasonable and are not made in an attempt to avoid proper taxation.

Ordinarily, product advertising specifically offering individual products for current sale (as distinguished from institutional advertising designed to keep the advertiser's name or the names of its peacetime products before the public) is charged in full to commercial business, but product advertising by subcontractors may be allowed in a reasonable amount as a charge against renegotiable business with respect to products sold primarily for use in war production.

The test of whether expenditures for advertising are reasonable is whether they are ordinary and necessary and bear a reasonable relation to the business activities in which the enterprise is engaged. In making this test of reasonableness, consideration is given to the amount spent for institutional advertising, and for product advertising of the nature of institutional advertising. If such expenditures are extravagant and out of proportion to the size of the company or to the amount of its advertising budget in the past, such payments will be disallowed as elements of cost.

J–PAB–5 (*f*)

5 (*f*) *Salaries, wages, and other compensation.*—Subsection (*d*) of section 403 provides that "in renegotiating a contract price or determining excessive profits * * * the Secretaries of the respective Departments shall not make any allowance for any salaries, bonuses

or other compensation paid by a contractor to its officers or employees in excess of a reasonable amount." Pursuant to such provision consideration is given to the nature of the work, extent of responsibility and experience and effectiveness of the officer or employee, and increases in compensation since January 1, 1939; and comparison is made where possible with the compensation of officers or employees in similar positions in other companies within the particular industry. Reasonableness of compensation is determined only within broad limits, and weight is given to the determination by the company of the value to it of the services of an officer or employee.

Any statutory provision, and any Executive orders or regulations and salaries issued under the Act of Congress approved October 2, 1942, regulating or limiting the payment of wages and salaries will be observed in renegotiation so far as applicable.

J–PAB–6

6. **Costs of post-war conversion.**—Contractors frequently create reserves for the purpose of reconverting their plant facilities to normal peacetime operations at the termination of the war. It is the policy of the Departments to disallow any such charges for the reasons that (i) the necessity for the reconversion may never arise; (ii) the nature, extent and cost of reconversion is too conjectural to warrant a present determination with respect thereto; and (iii) the unknown duration of the war precludes an estimate with any degree of accuracy of the amount of money which may be required for reconversion. This is in accordance with the policy stated by Mr. Donald M. Nelson, Chairman of the War Production Board, in a letter dated March 6, 1942, addressed to the Under Secretaries of the War and Navy Departments.

J–PAB–7

7. **Patent royalties.**—Public Law 768, 77th Congress, approved October 31, 1942, provides that whenever an invention, patented or unpatented, is manufactured for the United States, with license from the owner, and such license provides for the payment of royalties at rates or amounts "believed to be unreasonable or excessive by the head of the department or agency of the Government which has ordered such manufacture", the head of the Department concerned shall notify the licensor and the licensee and within a reasonable time thereafter shall "fix and specify such rates or amounts of royalties, if any, as he shall determine are fair and just, taking into account the conditions of wartime production" and shall authorize the payment thereof by the licensee to the licensor. It further pro-

vides that the licensee shall not thereafter pay to the licensor nor charge to the United States a royalty in excess of that specified in the order and that the licensor's sole and exclusive remedy for royalties in excess thereof shall be by suit in the Court of Claims or in the district courts having concurrent jurisdiction. The statute further provides that:

> Nothing herein contained shall be deemed to preclude the applicability of Public Law 528, 77th Congress [i.e., section 403], as the same may be heretofore or hereafter amended so far as the same may be applicable.

As part of the renegotiation with any contractor or subcontractor who has included in costs substantial amounts for royalties paid or payable under patent licenses, inquiry will be made as to any action taken, pending or contemplated under the statute, and no allowance will be made for royalties in excess of any rate or amount fixed and specified by the head of the department or agency of the Government which has ordered manufacture thereunder.

In the absence of an order under the royalty statute, the renegotiation authorities will consider whether or not the amount of the royalties is fair and reasonable under the circumstances (taking into consideration the affiliation, if any, of the licensor and licensee).

J–PAB–8

8. **Contracts with manufacturers' representatives.**—Contracts between manufacturers and their representatives are subject to renegotiation as subcontracts when the representative is performing, or agrees to make available on request, engineering, mechanical, or other services related to the performance of one or more prime contracts with one of the Departments or subcontracts thereunder, including assistance in the obtaining of priority certificates and in other matters required in connection with performance of the contract. For example, manufacturers' agents in the machine tool industry customarily hold themselves ready to furnish engineering advice, mechanical service, and advice on training in the use of tools irrespective of whether they are availed of by the manufacturer, and by contract or custom the commissions of the agent are usually paid in either case and charged by the manufacturer into the cost of the tool. These activities comprise "part of the work required for the performance of another contract" within the definition of subcontact in the renegotiation statute. When a manufacturer's representative also acts as dealer he is in substantially the same position as a jobber and his sales of articles to one of the Departments or a contractor with a Department or a subcontractor thereunder are subject to renegotiation

whether the articles are delivered from his own inventory or shipped direct by the manufacturer. The fact that the prices on articles handled by manufacturers' representatives and jobbers are regulated under Office of Price Administration price ceilings does not affect the result. The reasonableness of such charges determines the extent to which they will be allowed as costs of the contractor for the purpose of renegotiation.

J–PAB–9

9. **Over-all renegotiation; Cost-plus-fixed-fee contracts.**—Renegotiation on the basis of the over-all profit on the war contracts of a contractor or subcontractor for a specified period was not expressly authorized by the original statute and was adopted by the Departments as a matter of policy. This method is now authorized by the statute, as amended, which expressly provides for renegotiation of contracts and subcontracts as a group without separately renegotiating the contract price of each contract or subcontract. The statute also contains, however, the original provision for renegotiation by individual contracts, and in some instances the Secretaries have found that method more convenient in actual practice. Under renegotiation on an over-all basis, excessive profits are determined by a study of a contractor's financial position and the profits, past and prospective, from his contracts and subcontracts taken as a whole for a particular fiscal year or other period rather than by analyzing each individual contract or subcontract on a unit cost basis.

Only contracts with the Departments named in the statute and subcontracts thereunder are subject to renegotiation and accordingly sales and costs are segregated between them and other contracts and business. War contracts not subject to renegotiation ordinarily will be renegotiated if the contractor or subcontractor so requests, provided their inclusion does not reduce the profits on the renegotiable business, but under no circumstances will commercial or civilian business be included in the renegotiation.

In renegotiation on an over-all profit basis, fees under cost-plus-fixed-fee contracts will be renegotiated separately from the fixed-price contracts of the contractor.

J–PAB–10

10. **Credit for Federal taxes; State and local taxes.**—Before the amendment to the statute, concern had been frequently expressed that a contractor might be required to pay taxes on his profits and then be required at a later date to refund these profits as a result of renegotiation. The statute originally made no express provision for crediting against excessive profits eliminated through renegotiation Federal

income and excess profits taxes assessed with respect thereto. In the absence of such credit the contractor would be forced to pay twice, once in the form of taxes and the second time by a refund of excessive profits. While it seemed plain that the original statute did not intend such double liability, section 403 was amended to provide that in determining the amount of excessive profits the Secretary shall allow the contractor or subcontractor credit for the amount of the Federal income and excess profits taxes paid or payable with respect to such excessive profits, as provided in section 3806 of the Internal Revenue Code.

Under section 3806 of the code, in case of renegotiation with respect to years for which Federal income and excess profits returns have not been filed, the amount of excessive profits eliminated may be excluded from gross income in such returns, provided at the time of filing the return the renegotiation has progressed to such a stage that the amount of excessive profits eliminated has become certain. This procedure has been specifically authorized by I. T. 3577 (International Revenue Bulletin 1942 No. 37), and is subject to the condition that a tax may be assessed on any portion of the excessive profits which is not eliminated by renegotiation.

State and local taxes are recognized as a proper item of expense, subject, of course, to allocation between renegotiable and nonrenegotiable business.

J–PAB–11

11. **Final agreements and clearance.**—When a contractor or subcontractor has renegotiated in good faith for a specified period and agreed to eliminate excessive profits for such period, he is entitled to assurance that the matter will not be reopened at a later date. The original statute did not expressly provide for any final clearance from liability for excessive profits, but under the statute as amended, the Secretaries are expressly authorized to make agreements and "any such agreement shall be final and conclusive according to its terms; and, except upon a showing of fraud or malfeasance or a wilful misrepresentation of a material fact, such agreement shall not be reopened as to the matter agreed upon, and shall not be modified by any officer, employee, or agent of the United States." The Secretary of each Department has delegated to the Secretary of each other Department the power to sign final and other agreements on his behalf, with respect to renegotiations assigned to such other Department. Thus, if a case for renegotiation is assigned to the Secretary of one Department for renegotiation, the Secretary of that Department has the power to sign a final agreement on behalf of the Secretaries of the other Departments.

J–PAB–12

12. **Responsibility of contractors to withhold payments of excessive profits to subcontractors.**—Under the terms of the statute, as originally adopted, concern was expressed by many contractors in regard to their liability to withhold excessive profits made by their subcontractors. Under the statute as amended, the contractor is under no obligation to withhold payments to a subcontractor unless there has been a determination by the Government of the existence of excessive profits. In other words, the contractor should make payment to the subcontractor in accordance with the terms of the subcontract until such time as a determination of excessive profits under the subcontract has been made and the contractor has been directed to withhold payments to the subcontractor. If at such time there are further payments due, the contractor should retain the amount specified in such direction. If all payments have been made to the subcontractor prior to the time when the contractor receives notice of a direction for withholding such excessive profits, the contractor has no responsibility or obligation in the matter of withholding payments under such subcontract. Conversely, a subcontractor is liable to the Government only for the repayment of amounts representative of excessive profits actually paid to him by a contractor and not for those eliminated through reductions in contract prices or otherwise.