1073-5

THE INTERNAL REVENUE CODE OF 1954

[H.R. 8300, PART 1. (Apr. 07-08, 1954). Hearings on An Act to revise the IRS laws. Senate Finance Committee, 1073-5, includes 501 (c)(3) "Johnson Amendment" and capricious self-defined tax-exemptions for British offshore bank holdings, 649 pgs., 83rd Congress, 2nd Session. GPO.]

Click here to go directly to obfuscated and search-blocked offshore bank account exemptions, PDF p. 311

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-THIRD CONGRESS

SECOND SESSION

ON

H. R. 8300

AN ACT TO REVISE THE INTERNAL REVENUE LAWS OF THE UNITED STATES

PART 1

APRIL 7 AND 8, 1954

Printed for the use of the Committee on Finance

PDF p. 319 transcription of scrambled offshore British accounts exemptions:

For our purposes, “readily convertible” can only mean such convertibility as can be effected easily, i.e. without an particular effort or sacrifice on the part of the taxpayer and as is not contrary to his wishes and does not run counter to his private or business intentions and interests. Though probably the term must not be interpreted in so broad a sense as to denote a convertibility which is available to the owner of blocked currency only by virtue of a general permission, it would seem reasonable to carry the interpretation nearly to that point. Another approach to define “deferable income” would be simply to say that income not readily convertible may be equal to income not taxable under statutes and case law, to hold, in other worlds that “deferable income” is income the restrictions of which make it nontaxable.” The difficulty, however, lies in the fact tht no clear-cut rule exists as to what kind of restrictions are required from the point of view of Federal income taxation to render an income nontaxable,” and none is offered in the mimeograph. Finally, it should be noted that the preamble to the mimeography contains the statement that the monetary or exchange restrictions often make it difficult for taxpayers to ascertain the value, in terms of United States dollars of the blocked income * * *.” One might therefore be allowed to look upon this angle, which would lead to an interpretation of these terms to the effect that not readily convertible, and therefore deferable, income is income the value of which in terms of United States dollars cannot be readily ascertained. It seems, however, that such reasoning provides too narrow a basis for the application of the mimeograph.

Consequently, the first interpretation, given here, is probably the only safe basis for the application of the mimeograph. In fact, following our outline about the present status of the Case law it is obvious that “deferable income” is not a synonym for “nonstaxable income”; there is definitely income which is to be included in gross income if no election is made under the mimeograph, but which is deferable if election is made.”

2. Ending of deferment

In other words of the mimeograph, income ceases to be deferable income when, to the extent thereof-

(a) Money or property in such foreign country is readily convertible into United States dollars or into other money or property which is readily convertible into United States dollars;

(b) Notwithstanding the existence of any laws or regulations forbidding the exchange of money or property into United States dollars, conversion is actually made into United States dollars or other money or property which is readily convertible into United States dollars; or

(c) such income is used for nondeductible personal expenses, is disposed of by way of gift, bequest, device or inheritance, or by dividend or other distribution, or, in the case of a resident alien, a taxpayer terminates his residence in the United States.

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CONTENTS

THE INTERNAL REVENUE CODE OF 1954

WEDNESDAY, APRIL 7, 1954

United States Senate,
Committee on Finance,
Washington, D. C.

The committee met, pursuant to call, in room 312, Senate Office Building, at 10:30 a. m., Senator Eugene D. Millikin (chairman) presiding.

Present: Senators Millikin, Butler, Martin, Williams, Flanders, Carlson, Bennett, Johnson, Hoey, Frear, and Long.

The Chairman. The meeting will come to order.

We shall begin hearings today on the Internal Revenue Code of 1954 (H. R. 8300). In lieu of reprinting the entire House report of this Act I submit for the record a brief summary of the principal provisions prepared for the use of the Committee on Finance by the technical staff of the Joint Committee on Internal Revenue Taxation.

(The summary referred to follows:)

Summary of H. R. 8300, the Proposed Internal Revenue Code of 1954 as Passed by the House of Representatives

(Prepared by the staff of the Joint Committee on Internal Revenue Taxation)

I. Rearrangement of the Code

H. R. 8300 substantially rearranges the present code in order to place its provisions in a more logical sequence. The internal revenue title is divided into seven subtitles:

A. Income taxes
B. Estate and gift taxes
C. Employment taxes
D. Excise taxes
E. Alcohol, tobacco, and certain other excise taxes
F. Procures and administration
G. The Joint Committee on Internal Revenue Taxation

The major rearrangements were made in subtitles A, B, and F, although some changes or rearrangements were also made in most of the other subtitles as well.

Each of the subtitles is broken down into chapters which in the case of the income taxes subtitle are as follows:

1. Normal taxes and surtaxes
2. Tax on self-employment income
3. Withholding of tax on nonresident aliens and foreign corporations and tax-free covenant bonds
4. Rules applicable to recovery of excessive profits on Government contracts
5. Tax on transfers to avoid income tax
6. Consolidated returns

Chapter 1, which contains most of what are commonly thought of as the income-tax provisions, regroups those provisions, many of which are unduly separated in the present code, into the following subchapters:

A. Determination of tax liability
B. Computation of taxable income
C. Corporate distributions and adjustments
D. Deferred compensation, etc.
E. Accounting periods and methods of accounting
F. Exempt organizations
G. Corporations used to avoid income tax on shareholders
H. Banking institutions
I. Natural resources
J. Estates, trusts, beneficiaries, and decedents
K. Partners and partnerships
L. Insurance companies
M. Regulated investment companies
N. Tax based on income from sources within or without the United States
O. Gain or loss on disposition of property
P. Capital gains and losses
Q. Readjustment of tax between years and special limitations

The provisions in each subchapter are classified into parts, the parts sometimes are divided into subparts, which are then divided into sections.

In addition to a rearrangement of provisions the proposed new code makes a number of changes in basic concepts relating to income.

In the definition of gross income the involved, repetitious language of the present code section has been replaced by the brief statement that "gross income means all income from whatever source derived." Thus, the statute adopts the broad language of the Constitution. No attempt is made to define the general term "income." The meaning and scope of that term must in any case be finally determined by the Supreme Court. The fact that some items are excluded from gross income under other sections of the new code is indicated by the introductory qualifying clause "except as otherwise provided in this subtitle."

Immediately following the general definition there has been added, for purposes of illustration, a list of 15 items which are to be included in gross income. They represent the more common types of income, and many of them are specified in the present code. In the new section they are separately stated and numbered so that they may be more easily identified. Any item which falls within the general definition will constitute gross income whether or not it is specifically mentioned in the illustrative list.

The definition of "adjusted gross income" has been clarified, and has been modified in two respects. Adjusted gross income, both under the code and under the proposed revision, is used for four specific purposes, all of which relate only to individuals.

(1) The imposition of the optional tax where adjusted gross income is less than $5,000;

(2) The determination of the standard deduction;

(3) The determination of the deduction for medical expenses; and

(4) The determination of the deduction for charitable contributions.

The definition itself is for the most part the same as that now contained in the present code. It consists of gross income minus certain deductions. The deductions are largely the same in the present code and the proposed code.

A new section, for the first time, provides a single term to describe the portion of the taxpayer's income upon which the tax is imposed. The term is "taxable income."

Under the present code the tax, in the case of an individual, is imposed upon the "net income" in excess of certain credits. The difference between the credits allowed for purposes of the normal tax and the surtax, respectively, produces a "normal-tax net income" and a "surtax net income." In the case of a corporation, the present code provides for "adjusted net income," "normal-tax net income," and "corporation surtax net income".

The adoption of the single term "taxable income," applicable to all taxpayers, makes it possible to discard all of these terms. This is accomplished by treating as deductions from gross income the items which now constitute credits against net income. Except in the case of an individual using the standard deduction, "taxable income" is defined as the gross income minus all the allowable deductions other than the standard deduction. The personal exemptions of individuals are included among the allowable deductions. If an individual elects to use the standard deduction, his taxable income consists of his adjusted gross income minus the sum of the standard deduction and the deductions for personal exemptions.

There is one item which is treated differently as between individuals and corporations. In the case of the former, partially tax-exempt interest, if included in gross income, constitutes the basis for a credit against tax. In the present code this interest is a credit against income. The credit equals 3 percent (the normal tax rate) of the amount so included. In the case of a corporation, the amount of partially tax-exempt interest included in gross income is allowable as a deduction from gross income. However, for purposes of the surtax with respect to corporations the taxable income is computed without the allowance of this deduction. This device avoids the definition of a special base for the corporate surtax.

The abandonment of the term "net income," together with the numerous variations necessitated by the complicated system of credits against net income, and the substitution of the term "taxable income" defined in a single section, should simplify the process by which the taxpayer determines the portion of his income which is subject to tax.

II. Tax on Individuals and Corporations

A. *Combination of normal tax and surtax (sec. 1)*

Under present law the individual income tax rate structure consists of a 3 percent normal tax and a graduated surtax.

Under the bill, the normal tax and surtax rates have been combined into a single rate schedule. To take care of partially tax-exempt interest a 3-percent credit against the tax is allowed.

B. Head of family (sec. 2)

Present law allows half of the benefit of income splitting to single taxpayers who maintain in their home a child, grandchild, or any other person whom they claim as a dependent.

The bill extends the full benefit of income splitting to a "head of family." The dependent giving the taxpayer head-of-family status no longer must live in the taxpayer's household, but the taxpayer must actually support such dependent. Such dependents under the bill are limited to a son, daughter, father, mother, brother, or sister. These classes of dependents are somewhat narrower than present law, deleting in particular the following classes: grandparents, grandchildren, aunts and uncles, nieces and nephews, stepsisters and stepbrothers, and in-laws (other than mother-in-law or father-in-law where the taxpayer's spouse is deceased).

TABLE 1.—*Comparison of the individual income tax liability for a head of household with 1 dependent under present law and under H. R. 8300*

Net income (after deductions but before exemptions)	Tax liability		Reduction in tax	
	Present law	H. R. 8300	Amount	Percent
$2,000	$100	$100		
$3,000	300	300		
$4,000	508	500	$8	1.6
$5,000	778	760	18	2.3
$6,000	1,508	1,416	92	6.1
$10,000	2,060	1,888	172	8.3
$15,000	3,708	3,260	448	12.1
$25,000	8,082	6,724	1,358	16.8
$50,000	22,788	19,592	3,196	14.0
$100,000	59,520	52,776	6,744	11.3
$500,000	416,388	403,548	12,840	3.1
$1,000,000	[1] 870,000	858,548	11,452	1.3

[1] Maximum effective rate limitation of 87 percent.

It is estimated that the changes made in this provision will decrease revenues by $50 million in the fiscal year 1955.

C. Corporate income-tax rate (sec. 11)

Under present law the corporate normal tax rate is reduced from 30 percent to 25 percent as of April 1, 1954, while the surtax rate of 22 percent is unchanged. The bill extends the 30-percent normal tax rate for 1 year, thus continuing the 52-percent maximum corporate rate until April 1, 1954.

The continuation of the present corporate rate is expected to save approximately $1.2 billion in revenue for the Government in the fiscal year 1955.

III. CREDITS AGAINST TAX

A. Dividends received by individuals (secs. 34 and 116)

Under existing law dividends are taxed twice: once in the hands of the corporation and once in the hands of the shareholder. Under the bill an individual may exclude from his gross income up to $50 of dividend income received from a domestic corporation during a taxable year ending after July 31, 1954, and before August 1, 1955. In subsequent taxable years he may exclude up to $100 of the dividend income he receives. These exclusions are granted for each individual filing a tax return, which means that a husband and wife filing a joint return will have two exclusions where each is a dividend recipient.

In addition, the taxpayer is allowed a credit (sec. 34) against tax equal to 5 percent of dividend income above the exclusion received after July 31, 1954, and before August 1, 1955, and 10 percent of dividend income above the exclusion received after July 31, 1955.

This can be illustrated by an individual who received $250 of dividends in, say, September 1954. He would exclude $50 of these dividends from his income and would receive a credit equal to 5 percent of the $200 of remaining dividend income, or $10, which he could deduct from his tax as otherwise computed. If he received the dividend in September of 1955 the exclusion would be $100 and the tax credit 10 percent of $150, or $15.

The amount of the credit is limited to 2 percent of taxable income in 1954, 7 percent in 1955, and 10 percent in subsequent years. This limitation restricts the credit to the amount of dividend income which actually enters into the tax base. The use of 2 percent and 7 percent for 1954 and 1955 removes the necessity of prorating income in the 2 years.

The dividend-received credit is not allowed with respect to dividends paid by foreign corporations, tax-exempt domestic corporations, or insurance companies. The credit does not apply to dividends of exempt farm cooperatives or to distributions which have been allowed as a deduction (in effect treated as interest) to a mutual savings bank cooperative bank, or building and loan association.

The percentage reduction of tax under the combined dividend exclusion and credit is greatest in the lowest bracket and declines progressively as the income level rises. This is indicated in the following table:

TABLE 2.—*Comparison of tax liability under present law and H. R. 8300 of a person receiving all his income from dividends in the year 1956*

MARRIED COUPLE, 2 DEPENDENTS

Amount of income [1]	Present law tax	H. R. 8300 tax [2]	Percentage reduction in tax	Amount of income [1]	Present law tax	H. R. 8300 tax [2]	Percentage reduction in tax
$3,000	$60	$20	66.7	$25,000	5,318	3,280	38.3
$4,000	240	110	54.2	$50,000	15,970	11,673	27.0
$5,000	420	200	52.4	$100,000	44,724	35,915	19.7
$8,000	976	484	50.4	$300,000	194,804	167,968	13.8
$10,000	1,372	700	49.0	$500,000	356,950	312,115	12.6
$15,000	2,486	1,360	45.3	$1,000,000	706,450	623,615	11.7
$20,000	3,800	2,220	41.6				

[1] Income before deductions and personal exemptions. Tax computations assume itemized deductions equal to 10 percent of income in arriving at net income for tax purposes.

[2] All dividends are assumed to be received by the husband. (If a wife receives dividends they would get a $200 exclusion from income.)

NOTE.—The plan becomes fully effective in 1956 and provides for exclusion of first $100 of dividends and a 10-percent tax credit on dividends in excess of the exclusion. The amount of dividends on which the credit is computed is not to exceed the taxable income (net income after deductions and personal exemptions).

TABLE 3.—*Comparison of the combined corporate and individual income taxes on $1 of corporate profits before tax under present law and under H. R. 8300* [1] *when fully effective.*

Stockholder's taxable income	Corporate profits before tax	Corporate tax	Stockholders dividend	Present law		H. R. 8300		Percentage reduction in tax on stockholder's dividend
				Stockholder's tax on dividend	Amount of income after tax	Stockholder's tax on dividend	Amount of income after tax	
								Percent
$2,000	$1	$0.52	$0.48	$0.10	$0.38	$0.05	$0.43	50.0
$6,000	1	.52	.48	.12	.36	.07	.41	41.7
$8,000	1	.52	.48	.14	.34	.09	.39	35.7
$10,000	1	.52	.48	.16	.32	.11	.37	31.3
$15,000	1	.52	.48	.23	.25	.18	.30	21.7
$20,000	1	.52	.48	.25	.23	.20	.28	20.0
$25,000	1	.52	.48	.28	.20	.23	.25	17.9
$50,000	1	.52	.48	.35	.13	.30	.18	14.3
$100,000	1	.52	.48	.42	.06	.37	.11	11.9

[1] It is assumed the stockholder's equity from $1 of corporate earnings is subject only to the tax credit provision, for simplicity purposes the $100 exclusion has been ignored.

On the basis of current dividend payments of about $9 billion annually it is estimated that the dividend-exclusion and dividend-received credit provided by the bill will reduce revenues by $240 million in the fiscal year 1955.

B. Retirement income credit (*sec. 38*)

Presently, unlike pension incomes generally, benefits under social security, railroad retirement, and certain other Federal programs are tax exempt. The bill adjusts this differential treatment by allowing a limited tax credit for the forms of retirement income which are presently taxable.

An individual over 65, who had previously worked, is granted a credit against tax determined by multiplying the first bracket rate (now 20 percent) by the amount of his retirement income up to $1,200. Retirement income is defined as pensions, annuities, dividends, rent and interest.

The retirement income base is reduced in two ways—

(1) by the amount of social security, railroad retirement, certain veterans' pensions or other retirement pension excluded from gross income; and

(2) by the amount of earned income during the year in excess of $900. Military disability pensions and workmen's compensation payments do not serve to reduce retirement income. The earned income test is similar to the social security work test, $900 equaling $75 per month. This provision would completely eliminate the credit if the individual earned over $2,100 in the year.

To qualify, an individual must have previously earned at least $600 a year in any 10 preceding years. A widow whose spouse would qualify is herself qualified. If both husband and wife have previously worked, each can qualify for the retirement income credit.

TABLE 4.—*Maximum amount of certain types of income*[1] *a single person can receive (over 65 years of age) and pay no tax under H. R. 8300*

	Present law	H. R. 8300
Total income	$2,767	$2,767
Dividend exclusion		100
Adjusted gross income	2,767	2,667
Standard deduction	277	267
Personal exemption	1,200	1,200
Taxable income	1,290	1,200
Tax liability	258	240
Tax credit (retirement)		240
Net tax liability	258	0

[1] Assumptions as to income received:
(a) Individual receives $100 of dividends.
(b) The remaining segment of income is received as annuity income the cost of which has been fully excluded in prior years.

TABLE 5.—*Maximum amount a married couple, both over 65 years of age, and both having the same amount of dividend income, can receive in dividends and pay no tax under H. R. 8300*

	Present law	H. R. 8300
Total income (dividends)	$8,052	$8,052
Dividend exclusion		200
Adjusted gross income	8,052	7,852
Standard deduction	805	785
Personal exemptions	2,400	2,400
Taxable income	4,847	4,667
Tax liability (before credits)	980	947
Tax credit (retirement)		480
Tax credit (dividends 10 percent taxable income)		467
Total net tax liability	980	0

TABLE 6.—*Maximum amount of certain types of income*[1] *a married couple can receive (both spouses over 65 years of age) and pay no tax under H. R. 8300*

	Present law	H. R. 8300
Total income	$5,533	$5,533
Dividend exclusion		200
Adjusted gross income	5,533	5,333
Standard deduction	553	533
Personal exemptions	2,400	2,400
Taxable income	2,580	2,400
Tax liability	516	480
Tax credit (retirement)		480
Net tax liability	516	0

[1] Assumptions as to income received:
(a) Husband and wife each receive $100 of dividend income.
(b) The remaining segment of income annuity income the cost of which has been fully excluded in prior years.

It is estimated that this provision will reduce revenues by $125 million in the fiscal year 1955.

IV. Deductions in Arriving at Adjusted Gross Income

A. Transportation expenses (sec. 62 (2) (C))

Under present law business transportation expenses can be deducted by an employee in arriving at adjusted gross income only if they are reimbursed by the employer or if they are incurred while the employee was away from home overnight. Other business transportation expenses can be deducted from gross income if the taxpayer itemizes all of his deductions.

The bill will permit employees to deduct expenses for actual travel whether or not away from home overnight. Thus, if the employee uses his own car a deduction will be allowed for the cost of gasoline, oil, auto repairs, and depreciation. Commuting expenses between home and place of employment are not allowable deductions.

B. Business expenses of outside salesmen (sec. 62 (2) (D))

As in the case of the transportation expenses described above, business expenses of an "outside salesman" who is an employee presently may be deducted in arriving at adjusted gross income only if they are reimbursed or incurred while he is away from home overnight.

This bill treats outside salesmen in effect like self-employed persons with respect to these expenses, permitting the deduction of their expenses in arriving at adjusted gross income even though the salesmen use the standard deduction. These deductions include expenditures for entertainment of customers, split commissions paid on subcontracts, etc. An "outside salesman" is defined as an employee engaged principally in the solicitation of business for his employer at places other than the employer's place of business.

V. Special Inclusions in Gross Income

A. Alimony and separate maintenance payments (sec. 71)

Present law taxes to a recipient, and allows the payor a deduction, for periodic alimony or separate maintenance payments if the payments are a legal obligation imposed by a court decree or by a written agreement incident to a decree.

The bill extends the tax treatment described above to periodic payments made by a husband to his wife under a written separation agreement even though they are not separated under a court decree if they are living apart and have not filed a joint return for the taxable year.

B. Annuities (sec. 72)

The so-called 3-percent rule under present law taxes an annuitant on the annuity payments he receives to the extent of 3 percent of the amount he paid for the annuity. Any payments he receives above this amount are considered to be the return of his capital and are excluded from tax until the cumulative amount excluded equals the amount he paid for the annuity. Thereafter, the annuity payments received are taxable in full.

The bill spreads the tax-free portion of the annuity income evenly over the annuitant's lifetime. In the usual case the exclusion will equal the amount the annuitant paid for the annuity, divided by his life expectancy at the time the payments begin. This exclusion is to remain the same even though he outlives this life expectancy. Under this rule the company providing the annuity will be able to supply the annuitant with a statement indicating that for the rest of his life a stated amount of his annuity income will be excluded annually from his income subject to tax.

However, an individual receiving a pension financed in part by contributions from his employer will not be taxed under the life expectancy method if the amounts payable under the annuity in the first 3 years equal, or exceed, his cost for the annuity. Such individuals are to exclude all annuity payments until they have recovered their capital tax free; thereafter, all annuity payments will be taxable in full except, of course, for the retirement income credit which may exempt as much as $1,200 of this income each year.

Any refund paid to a beneficiary at the death of an annuitant is to be exempt from tax. However, the annuitant's cost (to be spread tax free over his expected life) is to be reduced by the refund anticipated computed in accordance with his life expectancy.

In the case of joint and survivor annuities, the cost of the annuity, in determining the annual exclusion, is to be spread over the combined life expectancy of the annuitants. This replaces the present rule providing a new calculation for the survivor on the basis of the estate value, but the change is made only in cases where the original annuitant dies after January 1, 1954. A special supplemental deduction is allowed the survivor in this case for the estate tax attributable to the survivor annuity.

The life expectancies of those already receiving annuity payments will be determined as of January 1, 1954, and the cost, or consideration, to be recovered tax free will be reduced by any amounts already recovered tax free under the 3-percent rule.

The rule described above applies to payments for a fixed number of years as well as to payments for life. Amounts received under a paid-up endowment contract also will be taxed in this manner where the policyholder elects, within 60 days after he has the right to receive a lump sum, to receive the payments in installments instead.

TABLE 7.—*Comparison of the tax treatment provided under present law and under the annuity and retirement provisions of H. R. 8300 for a single person 65 years of age receiving $6,000 from a purchased annuity which cost $70,000—life expectancy assumed to be 15 years and cost of purchased annuity is not recovered tax-free in first 3 years**

Year of retirement	Present law: Annual annuity income	Present law: Taxable income	Present law: Amount of annuity excluded	Present law: Tax attributable to annuity income [1]
1st through 17th year	$6,000	[3] $2,100	$3,900	$422
18th year	6,000	[4] 2,300	3,700	466
19th and subsequent years	6,000	6,000	0	1,360

Year of retirement	H. R. 8300: Annual annuity income	H. R. 8300: Taxable income	H. R. 8300: Amount of annuity excluded	H. R. 8300: Tax attributable to annuity income [1]	H. R. 8300: Tax credit for retirement income [2]	H. R. 8300: Net annual tax during taxpayer's life on annuity income
1st through 17th year; 18th year; 19th and subsequent years	$6,000	[5] $1,333	$4,667	$267	$240	$27

[1] Assuming individual has other income equaling the personal exemption and deductions.
[2] Maximum amount of tax credit allowable, 20 percent of $1,200.
[3] 3 percent of the cost of the annuity.
[4] Annuity income of $6,000 less remaining cost of annuity not recovered tax-free in first 17 years.
[5] Cost of purchased annuity divided by 15 years life expectancy subtracted from annual annuity.
*Because if the cost is recovered in 3 years, then under the "Annuity Provision" of the bill such amounts in excess of the cost are fully taxable to the extent they exceed the amount excluded under the "retirement income" provision of the bill.

TABLE 8.—*Comparison of the tax treatment provided under present law and under the annuity and retirement provisions of H. R. 8300 for a retired single individual 65 years of age receiving an annual annuity of $3,000 with the individual's contributions amounting to $7,000, the cost of which will be recovered tax free in less than 3 years*

Year of retirement	Present law			
	Annual annuity income	Taxable income	Amount of annuity excluded	Tax attributable to annuity income [1]
1st	$3,000	[3] $210	$2,790	$42
2d	3,000	[3] 210	2,790	42
3d	3,000	[5] 1,580	1,420	316
4th and subsequent years	3,000	3,000	0	620

Year of retirement	H. R. 8300							
	Annual annuity income	Taxable income	Amount of annuity excluded	Tax attributable to annuity income [1]	Tax credit for retirement income [2]	Net tax on annuity income	Reduction in tax over present law	
							Amount	Percent
1st	$3,000	[4] 0	$3,000	0	0	0	$42	100.0
2d	3,000	[4] 0	3,000	0	0	0	42	100.0
3d	3,000	[5] 2,000	1,000	$400	$240	$160	156	49.4
4th and subsequent years	3,000	3,000	0	620	240	380	240	38.7

[1] Assuming individual has $900 of "work income" and balance from investments equaling the personal exemptions and deductions.
[2] Maximum amount of tax credit allowable, 20 percent of $1,200.
[3] 3 percent of consideration paid.
[4] Total amount of annuity excluded until cost of annuity is recovered tax free.
[5] Annuity income of $3,000, less remaining cost of annuity not excluded in first 2 years.

It is estimated that the annuity rules will decrease revenues by $10 million in the fiscal year 1955.

C. Amounts which are not annuity payments, but received under annuity or endowment contracts (sec. 72 (e) and (h))

Individuals frequently receive under annuity contracts amounts which are not strictly speaking annuity payments, such as dividends and amounts received from the surrender, redemption, or maturity of the annuity contract. Under present law, such amounts are taxed to the extent that they exceed the portion of the consideration paid for the contract which has not previously been recovered free of tax.

The bill makes two changes in the present treatment. First, proceeds other than annuity payments which do not constitute a complete discharge of the carrier's obligation under the annuity contract (for example, dividends as contrasted with amounts received from the surrender of the contract) are to be taxed in full without any exclusions, if received on or after the date the annuity payments begin. Where the proceeds from the annuity contract are received either before the date annuity payments begin or in full discharge of the contractual obligation these proceeds will be taxed, as under existing law, only to the extent that they exceed the consideration.

A second change made by the bill deals with cases where such proceeds are received in a lump sum in one year. In such cases, the tax on the lump-sum proceeds cannot exceed the tax which would be payable if the proceeds had been received in 3 equal installments: 1 in the year of receipt, and the other 2 in the 2 preceding years.

D. Prizes and awards (sec. 74)

The tax treatment of prizes and awards under present law is uncertain although they have usually been held to be taxable.

The bill includes in income subject to tax all prizes and awards except those made in recognition of past achievements of a religious, charitable, scientific, educational, artistic, literary, or civic nature, where the recipient was selected without any action on his part and is not required to render substantial future services. This exception is intended to exempt such awards as the Nobel and Pulitzer prizes. "Giveaway" program prizes and essay contest prizes will be taxable in all cases despite some exceptions in case law (Pot O'Gold and Ross Essay Contest).

Scholarships and fellowships are not covered by the rules described above. The bill contains a specific provision dealing with them. (See sec. 117 in pt. VI–G.)

E. Discharge of indebtedness (secs. 76, 108, 1017)

Under present law, whether cancellation of indebtedness results in income to the debtor, and to what extent, is now a matter to be determined according to various rules developed by the courts.

The bill provides that all discharges shall be included in income of the debtor unless they fall within specified categories where income is deemed not to accrue. The specified exemptions are as follows:

(1) Transactions having the character of a gift to the taxpayer;

(2) Transactions having the character of a contribution to the capital of the taxpayer;

(3) Transactions effected as an adjustment of the purchase price of property acquired in connection with the assumption of the indebtedness discharged; or

(4) Any other transaction in which the discharge is attributable to the existence between the parties of a relationship other than that of debtor-creditor.

These specifications give recognition to the situations as they actually exist in day-to-day transactions. For example, a father interested in the financial welfare of his son may, without consideration, discharge the unpaid note his son had given to him. Such a discharge would ordinarily constitute a gift to the son. Even in cases where there is not such a close personal relationship, a creditor may settle a debt for less than full value to assure continued business relations with the debtor. In actual practice, the determination of whether discharge of indebtedness results in income or not will be dependent on the circumstances of individual cases.

These enumerated exceptions are to be inoperative where the indebtedness discharged is an accrued item which the debtor has deducted on his income-tax return and from which he has received a tax benefit, and the creditor has not accrued his claim as income. In such cases, the debtor will be required to include as income for the year of cancellation the amounts deducted for tax purposes but never paid out or counted as income by his creditor.

Under present law, where cancellation of indebtedness of a corporation, evidenced by a security, results in income which would otherwise be taxable in the year of cancellation, such taxation may be avoided if the debtor corporation reduces the basis of its assets (in accordance with Treasury regulations) by the amount of the cancellation.

Under the bill this privilege is extended to an individual, if the indebtedness was incurred in connection with property used in his trade or business, and it is available (to such individuals and to corporations) whether or not the canceled indebtedness was evidenced by a security.

Present law permits railroads to exclude income arising from the cancellation of indebtedness, without any corresponding reduction in the basis of their properties, if the cancellation is pursuant to an order of the court in bankruptcy or receivership proceedings. This provision now inapplicable to taxable years beginning after December 31, 1954, has been extended to apply to cancellations in taxable years beginning before January 1, 1956.

VI. Exclusions From Gross Income

A. *Employee death benefits* (*sec. 101*)

Present law provides that beneficiaries of a deceased employee are to receive a special exclusion of up to $5,000 for payments by an employer. Under existing law, this exclusion is available only where the employer is under a contractual obligation to pay the death benefits and is not available where an employee has a nonforfeitable right to the benefit before death.

The bill extends this exclusion to death benefits whether or not paid under a contract. It also extends the exclusion to distributions under a qualified profit-sharing plan even though the employee had a nonforfeitable right to the amount while living.

The $5,000 limit on the exclusion under present law applies to payments with respect to any one employer. The bill limits this exclusion to $5,000 with respect to the death of any employee.

B. *Interest element in life-insurance proceeds* (*sec. 101* (*d*))

Existing law exempts proceeds of life insurance paid by reason of death, even though the proceeds may be paid in installments so that a portion of the payments represent interest earned after the death of the insured.

The bill provides that the interest element in life insurance proceeds accruing after the death of the insured (after the date of enactment of the act) is to be included in the income of any beneficiaries, except that an exclusion of up to $500 a year is provided for the widow of a decedent and an exclusion of up to $250 a year is to be provided for each other beneficiary who is a child or lineal descendent or ancestor of the decedent. The change does not, however, affect the present taxation of interest received on proceeds left with an insurance company under an agreement to pay interest.

C. *Payments for injury and sickness* (*secs. 104, 105, and 106*)

Under present law, amounts received as accident or health benefits are exempt only if the benefits are paid under a contract of insurance. This results in a tax differential against plans which are self-insured by the employer. It also involves difficult questions as to whether or not an insurance contract is involved, for example, in a State with a compulsory employer injury and sickness program which permits the employer to self-insure if he posts a bond with the State.

The bill applies the same exclusion rule to both insured and noninsured plans if the plans meet certain qualification tests. Sickness and accident benefits are (1) entirely excluded if received as compensation for injury or sickness (for example, for hospital bills), and (2) excluded up to $100 a week if received as compensation for loss of wages.

For a plan to qualify it must be for the exclusive benefit of employees and it must meet certain nondiscrimination tests similar to those applied to pension plans. Employees must have enforceable rights to benefits. Further, to qualify, the plan must provide a waiting period before payments to compensate for loss of wages begin. This will disqualify sick leave where no waiting period is provided.

If an employee under a qualified plan receives supplementary payments as compensation for loss of wages under a nonqualified plan (e. g., a direct payment from the employer's pocket) the nonqualified amount will be taxable and will also serve to reduce the limitation of $100 on the weekly exclusion.

The bill makes clear that employers' contributions to sickness and accident plans are not to be taxed to the employee at the time they are made.

D. Rental value of parsonages (sec. 107)

Under present law, the rental value of a home furnished a minister of the gospel as a part of his salary is not included in his gross income.

The bill provides that the present exlusion also is to apply to rental allowances paid to ministers to the extent used by them to rent or provide a home.

E. Income taxes paid by lessee corporation (sec. 110)

Under some long-term leases, a lessee contracts to compensate the lessor for income taxes assessed on the rental payment.

Under present law the lessor is deemed to derive additional taxable income from the income tax paid on its behalf by the lessee. The lessee, in turn, is required to pay a tax on such income of the lessor, and so on. The lessee, however, is entitled to deduct such tax payments in computing its own income tax liability.

Under the bill, the income tax liability payable by the lessee on such rental income is to be excluded from the lessor's gross income and denied as a deduction to the lessee. This applies only to leases entered into before January 1, 1954, where both lessee and lessor are corporations. This provision has been in effect with respect to excess profits tax liabilities.

F. Combat pay of members of the Armed Forces (secs. 112, 692)

Present law provides an exclusion from gross income for members of the Armed Forces serving in combat zones or hospitalized as the result of wounds, disease, or injury incurred while serving in a combat zone. In the case of enlisted personnel, an exclusion from gross income is granted for all pay received for service in a combat zone or while hospitalized as a result of such service; for commissioned officers the exclusion is limited to the first $200 of pay received in a month. Under present law this exclusion is available only for service in a combat zone between June 24, 1950, and January 1, 1955.

The bill provides that this exclusion is to be available with respect to service in a combat zone after June 24, 1950, during an "induction period," that is, during a period when persons are generally subject to induction into the armed services under an act like the Universal Military Training and Service Act.

Present law also has a special tax-forgiveness provision applicable to an individual who dies after January 24, 1950, and before January 1, 1955, while in the Armed Forces if his death resulted from service in a combat zone. Any income tax he owes the Government at the time of his death is forgiven. As in the case of the exclusion, the bill extends this provision to apply to service in a combat zone after June 24, 1950, during an "induction period."

G. Scholarships and fellowship grants (sec. 117)

The present statute and regulations do not cover the tax treatment of scholarships and fellowship grants. The bill provides that the usual scholarship or fellowship paid to a candidate for a degree is to be nontaxable. A special rule is provided where the terms of the scholarship or fellowship require the rendering of teaching or research services. In this case a part of the grant will be taxable determined by applying the compensation rates for work of a similar nature to the particular work required. In this situation present law does not permit such an allocation but taxes the whole grant unless the services required are purely nominal.

In the case of a scholarship or fellowship for teaching or research where the individual is not a candidate for a degree, the grant will be taxable income if the grant (excluding expenses) plus any compensation from the previous employer, comes to more than 75 percent of the recipient's salary in the year preceding the grant. Thus a tax benefit is only extended to such fellowships if the individual has suffered a real income decline in order to accept the grant.

In all cases, amounts received to cover expenses (other than living expenses) connected with the scholarship or fellowship will not be included in taxable income if they are so expended.

H. Contributions to the capital of a corporation (secs. 118, 355)

The bill provides that in the case of a corporation, gross income is not to include any contribution to the capital of the taxpayer. This in effect places in the code the court decisions on this subject. This provision deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift, yet the anticipated future benefits may be so intangible as not to warrant treating the contribution as a payment for future services.

In the corporate reorganization provisions of the bill, a corporation takes the basis of assets in the hands of the transferor where the contribution to capital is made by a shareholder but takes a zero basis for property contributed by a nonshareholder unless the property is received as a gift.

I. Meals and lodging (*sec. 119*)

Under present law meals and lodging have been held to be taxable to the employee unless they were furnished for the convenience of the employer. Even in such cases, however, they are not excluded from the gross income of the employee if there is any indication that they are intended to be compensatory.

Under the bill these meals and lodging are to be excluded from the employee's income if they are furnished at the place of employment and the employee is required to accept them at the place of employment as a condition of his employment.

J. Subsistence payments to State police officers (*sec. 120*)

The bill provides an exclusion from gross income, not to exceed $5 a day, for subsistence allowances paid to members of a police department of a State, Territory, the District of Columbia, or a possession. There is no comparable exclusion under existing law.

VII. Personal Exemptions

A. Earnings test for dependent (*sec. 151*)

Present law provides a $600 exemption for a dependent if the dependent has gross income of less than $600. The bill continues this earnings test for all dependents as defined under present law except that a son, stepson, daughter or stepdaughter of the taxpayer may have income in excess of $600 provided they are under 19 years of age or are full-time students at an educational institution.

The estimated revenue loss from this provision is $75 million in the fiscal year 1955.

B. Definition of dependent (*sec. 152*)

Under existing law a dependent is defined as an individual over half of whose support is received from the taxpayer and one who bears 1 of 8 specified relationships to the taxpayer.

The bill modifies the support test in two respects. It provides that in the case of children of the taxpayer who are students, any scholarships they receive for study at an educational institution are to be ignored in applying the support test.

The second change in the support test relates to cases where two or more persons supply the support of another individual but no one can claim the dependency exemption because of the failure of anyone to supply more than one-half of the support. Under the bill a group of contributors may annually designate one of their number to claim the dependency exemption where no one in the group contributed more than half of the dependent's support if all of the tests with respect to the dependency exemption (except the support test) are met by each member of the group; the person designated to receive the dependency exemption has contributed more than 10 percent of the dependent's support; and all other members of the group who have contributed more than 10 percent of the support have agreed in a written statement that they will not claim the exemption for that year.

The bill also modifies the "relationship" test of existing law. The bill provides that a taxpayer may claim as a dependent an individual over half of whose support he supplies, irrespective of the relationship of such individual to the taxpayer, if the individual has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household. The bill also provides a dependency exemption for cousins of the taxpayer, whom he supports, who are receiving institutional care (required by reason of a physical or mental disability) but prior to being placed in the institution were members of the same household as the taxpayer.

At present individuals may not be claimed as dependents if they are not citizens or residents of the continental United States (including Alaska and Hawaii) unless they are residents of a contiguous foreign country. The bill expands this exception for contiguous countries to permit taxpayers to claim as dependents individuals who are residents of the Canal Zone, Panama, and in certain cases the Philippines. For a resident of the Philippines to qualify he must be a child born to or adopted by the taxpayer in the Philippines before July 5, 1946, and the taxpayer must have been a member of the United States Armed Forces at the time the child was born or adopted.

It is estimated that this provision will decrease revenues by $10 million in the fiscal year 1955.

VIII. Itemized Deductions for Individuals and Corporations

A. Business expenses not to include charitable gifts above limitation (sec. 162)

At the present time corporations are allowed a deduction for charitable contributions up to a limit of 5 percent of their income otherwise subject to tax. In addition, they are allowed to take as business-expense deductions contributions to charitable and other organizations where the institution is to render a service commensurate to the contribution. However, where no service is rendered, a business-expense deduction may not be taken for amounts not allowable as charitable contributions only because they are in excess of the 5-percent limitation.

The bill makes it clear that the rule presently applicable to corporations is also to be applicable in the case of individuals.

B. Interest (sec. 163)

Although interest payments are deductible under present law, administration practice has denied any deduction for carrying charges on installment purchases unless the interest element is stated separately.

Where carrying charges, but not interest, are stated separately, the bill permits the deduction as interest of an amount equal to 6 percent of the average unpaid balance (computed as of the 1st of each month) under the installment contract during the taxable year.

It is estimated that this amendment will decrease revenues by $10 million in the fiscal year 1955.

C. Apportionment of taxes on real property between buyer and seller (sec. 164)

Under present law, a taxpayer who buys real estate may be denied a deduction for the local property taxes which he assumes and pays if under local law the seller of the property has become liable for the tax prior to the date of sale. This occurs because the Supreme Court has held that the deduction for taxes depends upon the time when the tax becomes a lien upon the property. If, for example, the tax lien attached to the property before the date of sale, only the seller would be allowed to deduct the tax for income-tax purposes, regardless of the manner in which the sales contract allocated the tax between buyer and seller. The purchaser would be allowed no deduction but would include the portion of the tax he paid in the basis of the property.

The bill provides that the purchaser and seller of real property are to each claim a deduction for that part of the real property tax which is proportionate to the number of months in the property tax year during which he held the property. This provision applies whether or not the parties to the sale actually apportion the tax. A special rule extends the benefit of this provision to cash basis taxpayers.

D. Theft losses (sec. 165 (e))

The regulations under present law indicate that generally ordinary losses can be taken only in the year in which they are sustained.

The House adopted a provision which provides that theft losses can be deducted in the year in which the taxpayer discovers the loss, and only in that year.

E. Losses on securities in affiliated corporation (sec. 165 (g))

Present law provides that if the stock or securities of a subsidiary corporation become worthless the parent corporation may deduct an ordinary loss (rather than a capital loss) if it owned 95 percent of the stock of the subsidiary, and if 90 percent of the gross income for all years was derived from sources other than investment-type encome.

"Gross income" means gross receipts from sales or services less the cost of goods sold. Thus, even though the subsidiary may have been primarily engaged in commercial or industrial operations, a decline in the gross profit margin (or a loss) from such operations may have reduced the non-investment-type income to less than 90 percent of the whole.

For this reason the provision has been changed to permit an ordinary loss deduction if 90 percent of the subsidiary's "gross receipts" had been derived from non-investment-type income.

The bill also reduces the 95 percent ownership requirement to 80 percent. This conforms this provision with the change made in the general affiliation requirement for consolidated returns.

F. Bad debts (sec. 166)

Under existing law, business bad debts may be deducted in full. Nonbusiness bad debts of an individual, however, are treated as short-term capital losses.

If a debt at the time it becomes worthless is not directly related to the taxpayer's trade or business, under present law it is treated as a nonbusiness bad debt. This rule is applied whether or not the debt was related to the taxpayer's trade or business at the time it was created.

The House bill permits the taxpayer to deduct as a business bad debt an obligation which becomes worthless, whether or not it is directly related to the trade or business at that time, if it was a bona fide business asset at the time it was created or acquired.

G. Depreciation (sec. 167)

Present law allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. The annual deduction is computed by spreading the cost of the property over its estimated useful life. Most taxpayers use the straight-line method which spreads the cost evenly over the years, although other methods are available, including the declining-balance method subject to a limitation of the rate to 150 percent of the corresponding straight-line rate. Moreover, the declining balance method presently must be applied to old as well as new assets and thus much of the advantage of this method is lost.

The bill provides for a liberalization of depreciation with respect to both the estimate of useful life of property and the method of allocating the depreciable cost over the years of service.

The provision specifies that depreciation allowances computed under any one of the following methods are to be considered reasonable for new property acquired or constructed after December 31, 1953:

(1) The straight-line method allowable under present law.

(2) The declining-balance method, using a rate not in excess of twice the straight-line rate. Under this method a uniform percentage is applied to the unrecovered basis of the property. Since the basis of a particular property is constantly reduced by prior depreciation, the percentage is applied to a constantly declining balance. The depreciation allowances under this method, therefore, are considerably larger in the early years of the life of a property than those resulting from the straight-line method. The declining-balance method at twice the appropriate straight-line rate will write off approximately 40 percent of the cost of an asset in the first quarter of its service life and two-thirds of the cost in the first half of its life.

(3) Any other method consistently applied so long as the accumulated depreciation allowances for a property at the end of each year do not exceed the allowances which would have resulted from the use of the declining-balance method described above. Alternative methods which would be considered reasonable would include those based on units of production or a combination of straight-line rates.

The depreciation methods provided in the bill apply to all types of tangible depreciable assets. They are limited, however, to property new in use and therefore never before subject to depreciation allowances. In the case of property constructed by the taxpayer, the methods apply to construction completed after December 31, 1953, but only to that portion of cost incurred subsequent to that date. In the case of property acquired by the taxpayer after December 31, the proposed depreciation methods apply only to new property.

The bill also provides that where the taxpayer and the Internal Revenue Service have agreed in writing to a rate of depreciation to be applied to a particular property or to a group account, that rate will continue to be appropriate for tax purposes until such time as evidence is produced which was not taken into consideration when the agreement was made. The burden of proving the evidence rests with the party initiating the change to a different rate. When the necessity for a change has been established it will be made only prospectively.

The bill further provides that the Internal Revenue Service may not disturb a depreciation rate used by a taxpayer so long as the useful life determined by the Internal Revenue Service to be correct does not differ by more than 10 percent from the useful life used by the taxpayer.

The differing effects of straight-line and declining balance depreciation (at twice the straight-line rate) for single new assets are shown in the following table.

TABLE 18.—*Annual charges for and accumulated depreciation of an asset costing $100,000 with estimated life as shown, under both straight-line and the 200-percent declining-balance method provided by H. R. 8300*

Year	10-year life				20-year life				40-year life			
	Straight-line 10 percent		200 percent declining balance 20 percent		Straight-line 5 percent		200 percent declining balance 10 percent		Straight-line 2½ percent		200 percent declining balance 5 percent	
	Annual charge	Cumulative	Annual charge	Cumulative	Annual charge	Cumulative	Annual charge	Cumulative	Annual charge	Cumulative	Annual charge	Cumulative
1	$10,000	$10,000	$20,000	$20,000	$5,000	$5,000	$10,000	$10,000	$2,500	$2,500	$5,000	$5,000
2	10,000	20,000	16,000	36,000	5,000	10,000	9,000	19,000	2,500	5,000	4,750	9,750
3	10,000	30,000	12,800	48,800	5,000	15,000	8,100	27,100	2,500	7,500	4,513	14,263
4	10,000	40,000	10,240	59,040	5,000	20,000	7,290	34,390	2,500	10,000	4,287	18,550
5	10,000	50,000	8,192	67,232	5,000	25,000	6,561	40,951	2,500	12,500	4,073	22,623
6	10,000	60,000	6,554	73,786	5,000	30,000	5,905	46,856	2,500	15,000	3,869	26,492
7	10,000	70,000	5,243	79,029	5,000	35,000	5,314	52,170	2,500	17,500	3,675	30,167
8	10,000	80,000	4,194	83,223	5,000	40,000	4,783	56,953	2,500	20,000	3,492	33,659
9	10,000	90,000	3,355	86,578	5,000	45,000	4,305	61,258	2,500	22,500	3,317	36,976
10	10,000	100,000	2,684	89,262	5,000	50,000	3,874	65,132	2,500	25,000	3,151	40,127
11					5,000	55,000	3,487	68,619	2,500	27,500	2,994	43,121
12					5,000	60,000	3,138	71,757	2,500	30,000	2,844	45,965
13					5,000	65,000	2,824	74,581	2,500	32,500	2,702	48,667
14					5,000	70,000	2,542	77,123	2,500	35,000	2,567	51,234
15					5,000	75,000	2,288	79,411	2,500	37,500	2,438	53,672
16					5,000	80,000	2,059	81,470	2,500	40,000	2,316	55,988
17					5,000	85,000	1,853	83,323	2,500	42,500	2,201	58,189
18					5,000	90,000	1,668	84,991	2,500	45,000	2,091	60,280
19					5,000	95,000	1,501	86,492	2,500	47,500	1,986	62,266
20					5,000	100,000	1,351	87,843	2,500	50,000	1,887	64,153
25									2,500	62,500	1,460	72,263
30									2,500	75,000	1,130	78,539
35									2,500	87,500	874	83,398
40									2,500	100,000	676	87,149

Ignoring any stimulus to investment and assuming all eligible taxpayers adopt the declining balance, the loss in the fiscal year 1955 would be about $375 million. In the second and immediately subsequent years there would be greater losses, again ignoring any effect on investment.

H. Charitable and similar contributions (sec. 170)

The House bill raises the charitable contribution limit for individuals from 20 percent to 30 percent of adjusted gross income, but this extra 10 percent is to be allowable only with respect to contributions to religious orders, educational institutions, hospitals, churches, and conventions of churches. This extra 10 percent deduction for charitable contributions is to be available with respect to any contributions to the specified types of organizations, even though contributions to to other organizations account for the full amount allowable under the regular 20 percent limitation.

The House also made three other changes in the charitable contribution deduction.

At present a taxpayer (either corporate or individual) who has made the maximum allowable charitable contribution, if he subsequently carries back a net operating loss to that year, finds his allowable charitable contributions have been reduced by this downward adjustment in his income. The House bill ignores the net operating loss carryback in applying the percentage limitations.

At present the 20-percent limitation on charitable contributions does not apply where the combination of the taxpayer's charitable contributions and income tax in the current year and in each of the past 10 years equal 90 percent or more of his taxable income. The bill provides that this 90 percent test needs to be met in only 9 out of the last 10 years.

At present it is possible for a taxpayer to receive both a charitable deduction and an exclusion from income where funds are placed in a trust for a limited period of years with the income therefrom for a period of years being devoted to charitable, educational, or similar purposes. The House bill provides that no charitable deduction is to be allowed in the case of transfers to trusts after March 9, 1954, where the income or principal of the trust may revert to the grantor if the chance of his receiving back the property is more than 1 in 20.

It is estimated that the changes made in the charitable contribution deduction will decrease revenues by $25 million in the fiscal year 1955.

I. Amortization of premium on callable bonds (sec. 171)

Under existing law, a bond premium may be amortized, at the election of the taxpayer, over the remaining life of the bond or to the earliest call date, whether or not the bond is actually called. This has given rise to the following type of case, which is illustrated by using recent figures of an actual bond issue. The bond sold at a price of 120. It was a 30-year bond with interest of 3.75 percent and callable on 30 days' notice at 102. The circumstances made an actual call very unlikely. A buyer of the bond could, therefore, purchase the bond at 120, hold it for 6 months, and sell it again at approximately 120. During this period he would have a premium of 18 points, the difference between the market price and the call price, which under existing law he could write off in 30 days as an ordinary deduction. The amortization reduces the basis of the bond to 102. The buyer, therefore, pays a capital-gains tax on a "gain" of 18 and gets a deduction of 18 against ordinary income. At a price of 120 the interest return on this bond is approximately 2¼ percent, which is far below a Government 30-year bond.

The bill provides that a bond premium may not be amortized to the earlier call date if that date is within 3 years of the original date of issue. This will have no effect on bonds having a call date, for example, on 30 days' notice beginning any time after 3 years from the original date of issue. It will, however, discourage the issue of bonds at a substantial premium by means of a very early call date. This limitation will avoid disturbing issues bearing an original long call date as they approach the call date. In the 14th year of a 20-year bond, it may be generally understood that the bond will be called on the call date in the 15th year. A premium on the purchase of the bond then would likely be a loss to the purchaser in the 15th year. A limitation on amortizing this premium would discourage the market for these bonds in the period just preceding the call date.

This provision applies to bonds issued after January 22, 1951, and acquired after January 22, 1954. This latter date was the date of public announcement of this action by the Committee on Ways and Means.

J. Net operating loss deduction (sec. 172)

Under present law a net operating loss may be offset against net income of other years by means of a 1-year carryback and a 5-year carryforward. The House has extended the period for the carryback to 2 years. This, in combination with the 5-year carryforward, provides a total span of 8 years for absorbing a loss.

The bill also modifies the method of computing the amount of the net operating loss. Under present law, certain adjustments are made in arriving at the amount determined to be the net operating loss. Thus, adjustments are made for any tax-exempt interest received by the taxpayer, the excess of percentage or discovery depletion over cost depletion, the excess of nontrade or nonbusiness deductions of taxpayers other than corporations over gross income from such sources, the excess of capital losses of taxpayers other than corporations over capital gains, and the deduction with respect to long-term capital gains for taxpayers other than corporations. In effect, all these adjustments reduce the amount of the loss which may be carried to another year. Under the revised provisions, all the present adjustments have been retained with the exception of the one for tax-exempt interest. The receipt of tax-exempt interest thus will no longer serve to reduce a net operating loss.

Under present law, essentially the same adjustments that are made in computing a net operating loss for a year, with the exception of the one relating to nontrade or nonbusiness expenses, are likewise made in the year to which the loss is carried before such loss may be applied against taxable income. Thus, if a 1953 loss were carried back to 1952 to be applied against 1952 income, any excess of percentage depletion over cost depletion with respect to 1952 in effect would first be used to reduce the 1953 loss carryback before it could be applied as a deduction against 1952 income. In addition, present law provides, in the case of a corporation, for a similar adjustment in the year to which the loss is carried for the dividends received credit in that year. The loss carryback in effect thus is likewise reduced by the portion of the intercorporate dividends received tax free before such loss is applied against taxable income. Under the revised provisions, however, no adjustments are made in the year to which the loss is carried prior to computing the amount of the net operating loss deduction. The net operating loss deduction thus will be simply the sum of all the net operating loss carryovers and all the net operating loss carrybacks to the taxable year. Certain adjustments (not including any adjustment for tax-exempt interest) will have to be made, however, in determining the income for any year which must be subtracted from a net operating loss to determine the portion of such loss which will still be available to carry to a subsequent year.

Presently the net operating losses which may be deducted by a taxpayer other than a corporation are limited to expenses or losses incurred in operating a business. But the loss on a sale of all or part of a business or its principal assets by an individual has been held to be not includible in his net operating loss on the grounds that such a sale was not attributable to the "operation" of a business. The bill permits taxpayers other than corporations who sell a business or certain business assets to include as part of the net operating loss for the year any loss sustained on the sale of business assets.

It is estimated that the revenue loss under the amendments to the net operating loss deduction provision will be $100 million in the fiscal year 1955. This is a nonrecurring loss, which would in any event occur in the next 5 years under present law.

K. Research and experimental expenditures (sec. 174)

No specific treatment is authorized by present law for research and experimental expenditures. To the extent that they are ordinary and necessary they are deductible; but court decisions have held that to the extent that they are capital in nature they are to be capitalized and amortized over useful life.

The House bill provides that these expenditures, incurred subsequent to December 31, 1953, may, at the option of the taxpayer, be treated as deductible expenses. It also provides that a taxpayer may elect to capitalize such expenditures and if no other means of amortization is provided (such as depreciation in the case of patents), may write them off over a period of not less than 60 months, beginning with the month in which benefits are first realized.

The tax treatment for these expenditures, once adopted, must be adhered to consistently unless approval for a change (with respect to all or a part of such expenditures) has been obtained from the Secretary or his delegate.

These options do not apply to expenditures for land or for depreciable property used in experimentation work. Also excluded are exploration expenditures incurred for minerals, oil, or gas which are presently provided for under other provisions.

L. Soil and water conservation expenditures (sec. 175)

Under present law expenditures made by farmers to improve their land are generally required to be capitalized rather than deducted as current expenses. The capitalized expenditures increase the farmers' tax basis for the land and are recoverable for tax purposes upon sale of the land. However, the Tax Court has held that substantial expenditures for the terracing of farms may be regarded as maintenance costs and, hence, be deducted as current expense.

This section permits farmers to elect to expense, rather than capitalize, expenditures for soil and water conservation, including expenditures for the prevention of land erosion. Expenditures for soil and water conservation mean expenditures for treatment or moving of earth. These expenditures include, but are not limited to, leveling, grading, and terracing; contour furrowing; construction of diversion channels and drainage ditches; control and protection of watercourses, outlets and ponds; eradication of brush; and planting of windbreaks. These expenditures do not include the purchase or construction of facilities, appliances, and structures made of concrete, metal, etc., and thus subject to allowance for depreciation.

The deductions for soil and water expenditures for any 1 year are limited, however, to 25 percent of the gross income derived from farming. In any year in which actual expenditures of this type are more than the maximum deduction permitted, the excess of these expenditures may be carried over to the following year and will be considered the first expenditures made in that year.

The deduction for soil and water conservation expenditures is also limited to land which, prior to or at the same time as the expenditures for soil and water conservation are made, was or is used in farming.

Taxpayers must decide whether they are going to expense soil and water conservation expenditures in the first year after 1953 in which they have such expenditures, and must continue this policy with respect to subsequent similar expenditures unless they receive permission from the Secretary or his delegate to make a change.

The reduction in revenues resulting from this provision in the fiscal year 1955 is estimated to be $10 million.

IX. Special Itemized Deductions for Individuals or Corporations

A. Expenses for production of income (sec. 212)

Existing law allows an individual to deduct expenses connected with earning income or managing and maintaining income-producing property. Under regulations costs incurred in connection with contests over certain tax liabilities, such as income and estate taxes, have been allowed, but these costs have been disallowed where the contest involved gift-tax liability. A new provision added by the House bill allows a deduction for expenses connected with determination, collection, or refund of any tax liability.

B. Medical, dental, and similar expenses (sec. 213)

Present law allows the deduction of medical, dental, etc., expenses which are in excess of 5 percent of adjusted gross income, and any outlays for drugs and medicine may be included in "medical expenses." The maximum medical expense deduction allowable under present law is $1,250 for each exemption but with an overall limit of $2,500 per return or $5,000 in the case of a joint return.

The House bill makes three major changes in this provision. It allows medical expenses in excess of 3 percent of adjusted gross income to be deducted, instead of only those in excess of 5 percent; outlays for drugs and medicines may be included in "medical expenses" only to the extent they exceed 1 percent of adjusted gross income; and the maximum limitations are raised from $1,250 to $2,500 per exemption, and the overall limit per return is raised from $2,500 to $5,000, or in the case of a joint return from $5,000 to $10,000. For a head of family the overall limitation is raised from $2,500 to $10,000.

A new provision has been added to allow the expenses of a last illness to be deducted on the final return of a decedent even if paid after death. A new definition of "medical expenses" is provided which incorporates regulations under present law and also provides for the deduction of transportation expenses for travel prescribed for health, but not the ordinary living expenses incurred during such a trip.

TABLE 10.—*Comparison of the amounts of medical expenses allowable as deductions under present law and H. R. 8300 by selected adjusted gross income classes*

Adjusted gross income classes	Medical expenses			Amount allowed as deductions under—			
				Present law	H. R. 8300		
	Hospital and doctors	Drugs and medicines	Total	Excess over 5 percent of adjusted gross income	Expense for drugs and medicines taken into account (excess over 1 percent of adjusted gross income)	Total medical expenses for determination of amount over 3 percent of adjusted gross income	Amount allowable as deduction (excess over 3 percent of adjusted gross income)
$3,000	$125	$25	$150	0	0	$125	$35
$5,000	250	75	325	$75	$25	275	125
$8,000	400	100	500	100	20	420	180
$15,000	800	200	1,000	250	50	850	400
$25,000	2,000	400	2,400	1,150	150	3,150	2,400
$50,000	8,000	2,000	10,000	[1] 1,250	1,500	9,250	[2] 2,500

[1] Limitation allowable under present law for a single person with no dependents. For a single person with 1 or more dependents maximum allowable deduction under present law is $2,500 and for a married couple with 2 or more dependents, maximum allowable deduction is $5,000.
[2] Limitation allowable under H. R. 8300 for a single person with no dependents. For a single person with 2 or more dependents maximum allowable deduction is $5,000; for a married couple with 2 or more dependents, $10,000; for a head of family with 3 or more dependents, $10,000.

The reduction of the lower limitation from 5 to 3 percent and the doubling of the maximum deductions would involve a revenue loss of $125 million in the fiscal year 1955, but with the limitation on drugs and medicine this loss is reduced to $80 million.

C. Child-care expenses (sec. 214)

The bill provides a new deduction for child-care expenses paid by a working widow, widower, or divorced person, or a working mother whose husband is incapacitated. The child must be below the age of 10 (or 16 if the child is physically or mentally unable to attend a regular school). The deduction is limited to actual expenses, but it may not exceed $600. The expenses must be for the purpose of permitting the taxpayer to follow a gainful employment. Expenses paid to a person who is a dependent of the taxpayer may not be deducted. An individual deducting these expenses may not use the standard deduction.

TABLE 11.—*Comparison of the individual income tax liability for a widow with 1 child under present law and under H. R. 8300 assuming $600 child care expenses and such person is head of a household*

Net income (after deductions but before exemptions)	Tax liability		Reduction in tax under H. R. 8300 resulting from—		Total reduction	
	Present law	H. R. 8300[1]	Child care provision	Head of household provision	Amount	Percent
$1,500	$60		$60		$60	100.0
$2,000	160	$40	120		120	75.0
$3,000	360	240	120		120	33.3
$4,000	568	440	126	$2	128	22.5
$5,000	778	640	126	12	138	17.7
$8,000	1,508	1,284	156	68	224	14.9
$10,000	2,060	1,732	180	148	328	15.9

[1] Assuming taxpayer itemizes deductions.

The estimated fiscal year 1955 revenue loss resulting from this provision is $40 million.

D. Taxes and interest paid to cooperative housing corporations (*sec. 216*)

Tenant-stockholders in a cooperative apartment corporation are presently allowed the same deduction for property taxes and interest available to a homeowner. The bill extends this treatment to stockholder-tenants in a cooperative development of homes.

E. Deduction for dividends received by corporations (*secs. 243–246*)

Under existing law a corporation is entitled to a credit against net income of 85 percent of the dividends it receives from other domestic corporations which are subject to tax. The bill provides that the recipient corporation will be entitled to a deduction instead of a credit. Certain corporate distributions, such as dividends paid by mutual savings banks which are allowed as an interest deduction, are not treated as a dividend. Similarly dividends received from regulated investment companies are subject to the limitations provided in the regulated investment company provisions.

To correlate with the rules applicable in the case of the dividend received credit under section 34 for dividends received by individuals, the corporate dividends received deduction does no apply in the case of dividends from the following corporations:

(1) Insurance companies.

(2) China Trade Act corporations.

(3) Corporations exempt from tax under section 501 (relating to certain charitable and similar organizations) or section 521 (relating to farmers' cooperative associations).

(4) Corporations treated under the provisions of section 931 (relating to exemption of income from United States possessions).

In the case of corporations falling within the latter two categories, the denial of the dividends received deduction applies if the corporation was exempt either for the taxable year in which the distribution is made or for the preceding taxable year.

F. Corporate organization expenditures (*sec. 248*)

Under present law the expenses incurred on behalf of a corporation incident to its creation are capital expenditures and thus not deductible. They may be amortized for tax purposes only when their useful life may be determined definitely by reference to a limited term of existence specified in the corporate charter. Where the corporate life is not so limited, organizational expenses are recovered for tax purposes only in the year of liquidation.

The House bill provides that a corporation may elect to amortize organizational expenses over a period of not less than 60 months, beginning with the month in which the corporation is first active in business.

This provision is not applicable to the professional fees and other expenses incurred in connection with stock issues or transfers of corporate assets in reorganization. As is now the generally accepted practice, these expenses are to be charged directly to the capital paid in to the corporation as a result of the transaction.

X. Items Not Deductible

A. Certain amounts paid in connection with insurance contracts (sec. 264)

Present law disallows a deduction for interest on a loan incurred or continued to purchase a single premium life insurance or endowment contract. Since interest on the savings element of a life-insurance policy is generally tax free, this disallows a deduction for the cost of obtaining tax-free income. The bill extends this treatment to single premium annuity contracts purchased after March 1, 1954.

The bill also deals with a variation of this device where the purchaser borrows funds which he deposits with the insurance company for payment of future premiums, thus obtaining an interest deduction but not reporting the interest accumulations on the funds deposited. The bill provides that if an amount is deposited with the insurer for a substantial number of future premiums the contract will be treated as a single-premium contract.

B. Disallowance of losses, expenses, and interest between related taxpayers (sec. 267)

In transactions between related taxpayers, present law denies losses on sales or exchanges of property and deductions for unpaid expenses or interest.

The House bill expands the concept of related taxpayers to include (1) a fiduciary dealing with a beneficiary of any other trust created by the same grantor; (2) a fiduciary dealing with a corporation controlled by the grantor or the trust; and (3) an exempt organization controlled by a person or his family.

Where losses on the disposition of property are disallowed, present law provides for no adjustment of gain when such property is subsequently sold to outsiders.

The bill recognizes gain to the original transferee only to the extent that it exceeds the amount of loss not previously allowable to the transferor. This new rule does not affect the basis of the property for determining gain; consequently, depreciation and other items which depend on that basis are unaffected.

C. Acquisitions made to evade or avoid income tax (sec. 269)

Existing law authorizes the Commissioner of Internal Revenue to disallow a deduction, credit, or allowance in cases where control of a corporation is acquired principally to obtain deductions, credits, or allowances not otherwise available, for the purpose of tax evasion or avoidance.

A provision added by the House bill has the effect of throwing on the corporation the burden of proving that there was no such purpose of evasion or avoidance in cases where the consideration paid in acquiring control of another corporation, or corporation property, is substantially disproportionate to the sum of the adjusted basis of the property and the tax benefits not otherwise available. This provision will apply to cases where the tax basis of the property acquired for depreciation and other purposes, together with the tax value of other tax benefits, such as operating loss carryovers, is substantially greater than the amount paid for the property. Disparities of this type generally arise where the old basis is continued in the hands of the new owner. The corporation in such cases is to be required to establish by a clear preponderance of the evidence that the principal purpose of the acquisition was not tax avoidance.

D. Hobby losses (sec. 270)

Under present law, if losses from a trade or business exceed $50,000 a year for 5 consecutive years, only $50,000 of the annual loss may be offset against income from other sources and the portion of annual loss above $50,000 is disallowed.

The bill removes from the application of this provision losses and expenses incurred because of drought, casualty and abandonment losses, and expenditures which may, at the taxpayer's option, either be capitalized or deducted when incurred. Deductions for these items are to be omitted in computing the amount of the taxpayer's loss for purposes of determining whether he has a loss in excess of $50,000. Moreover, these deductions are to be allowed even if the taxpayer's losses exceed $50,000 a year for 5 consecutive years. This provides the same treatment for these losses and expenses as is presently provided for interest and taxes.

E. Rental payments to governmental units for use of manufacturing facilities (sec. 274)

Present law exempts from Federal income-tax interest on securities issued by States and their political subdivisions as well as Territories and possessions of the United States.

The House bill disallows deductions to private businesses for rental payments made to State or local governmental units for the use of property acquired by the governmental unit by the issuance of industrial development revenue bonds authorized after February 8, 1954. Industrial development revenue bonds are those issued to finance the acquisition or improvement of real estate which is to be used to any substantial extent by private business for manufacturing purposes and which do not pledge the full faith and credit of the issuing authority for the payment of principal and interest.

This provision does not affect the tax-free status of State and local government obligations.

XI. Corporate Distributions and Adjustments

A. Corporate distributions (secs. 301-312)

(1) *Current distributions and effect on earnings and profits (secs. 301, 308, and 310)*.—The House bill retains the general rules of present law, with respect to distributions by a corporation to its shareholders. Thus, the amount of gain realized by a stockholder upon a distribution is the amount of money distributed, or the fair market value of any securities of the distributing corporation or of any property distributed. Where one corporation receives a dividend in property other than money from another corporation, present law limits the intercorporate dividends received credit to the basis which such property had in the hands of the distributing corporation, but the property in the hands of the distributee receives an increased basis, equal to its fair market value. The bill makes no change in this rule for intercorporate dividends but provides for a carryover of basis in such a case, with the

result that the basis of such property in hands of the distributee corporation will be the amount on which the tax is to be measured.

As under present law, the bill provides that a shareholder, other than a corporation, is taxed on the fair market value of property distributed to the extent of the earnings and profits of the distributing corporation. Similarly, to the extent the distribution is not out of earnings and profits, it reduces the basis of the stock on which the distribution is made (any excess over this basis is taxable at capital gain rates). Present law is also retained for distributions out of pre-March 1, 1913, earnings or appreciation in value.

The bill writes into the statute a rule that a corporation does not realize gain by reason of a distribution of its property even though the value of the property distributed exceeds its cost to the corporation. Two exceptions are made to this general rule, however, in order to prevent tax avoidance. Where the corporation is using the last-in-first-out (LIFO) method of valuing its inventories, if this inventory is distributed in kind, the corporation is to be taxed on the amount of the difference between what the value of this inventory would be if the corporation had not been on LIFO and the value of this inventory under LIFO.

The second exception is where distributed property is subject to a liability in excess of its basis. If a corporation has property which cost $200, subject to a debt of $500, but which has a fair market value of $1,000, the corporation would be taxed on $300. The corporation is treated, in effect, as if it had sold the property and realized $500 after retirement of the liability.

Under the bill, the adjustment to the earnings and profits of the distributing corporation will be the amount of such earnings expended in acquiring the property distributed. Thus, if property worth $100 is distributed but if there are only $75 of earnings and profits from which the distribution can be made, the taxable amount will be only $75. If the property cost the corporation only $50, however, its earnings and profits will be reduced only by $50, and $25 will remain in its earnings and profits account.

If there is a distribution of inventory assets, the earnings and profits account will be increased by the excess of the fair market value of the inventory over cost. The net effect to the corporation is the same as if the earnings and profits account were reduced only by the cost of the inventory. Unlike a distribution of LIFO inventory, there is no corporate tax on the distribution of other types of inventory.

A rule provided in the bill determines the manner in which earnings and profits are to be allocated where there is a partial liquidation, a corporate separation, or a redemption. In general, the earnings and profits of the transferor, or distributing, corporation in such a case will be decreased by an amount which bears the same ratio to the earnings and profits prior to the transaction as the adjusted basis of the assets distributed bears to the adjusted basis of the total assets.

(2) *Redemptions of stock (secs. 302 and 311)*.—Under present law it is not clear when a stock redemption results in capital gain or ordinary income. Some courts have held that a distribution disproportionate to the shareholder's ownership of common stock in the corporation results in capital-gains treatment. Other courts have required, in addition, a contraction of the business for such treatment.

The bill sets forth the conditions under which stock may be redeemed at capital-gain rates. In general, these include redemptions to pay death taxes, complete liquidations, partial liquidations (defined to insure a definite corporate contraction), and redemptions by a shareholder holding less than 1 percent of the common stock. The bill defines when a substantially disproportionate redemption of a shareholder's stock will qualify so as not to be taxable as a dividend; namely, when a particular shareholder's holdings of common stock after the distribution is less than 80 percent of his holdings before the distribution.

A distribution in complete redemption of a shareholder's stock will also result in capital gain. A shareholder is considered as owning stock held by members of his immediate family, or by partnerships, corporations, and trusts which he controls.

The rules of family ownership will not apply if the shareholder completely terminates his interest in the corporation and does not reacquire, other than by bequest or inheritance, an interest (other than an interest as a creditor), for a period of 10 years thereafter. However, such a shareholder may not have made or received a gift of stock of the corporation, to or from his wife, for example, within 10 years prior to the distribution. If any interest is reacquired by a shareholder within the prohibited period, an additional tax may be recovered as if the original distribution had been a dividend.

(3) *Redemption to pay death taxes* (*sec. 303*).—The bill retains existing provisions of law allowing stock to be redeemed to pay death taxes without dividend consequences. The application of this provision is broadened to allow stock to be redeemed where it not only constitutes 35 percent of the value of the gross estate but also 50 percent of the value of the net estate.

The provision has also been broadened by (1) including funeral and administration expenses as one of the purposes for which stock may be redeemed, (2) extending the time for redemption to 60 days after a decision of the Tax Court concerning the estate tax liability has become final, and (3) allowing stock of two or more corporations to be redeemed if certain tests are met.

(4) *Redemption through use of related corporations* (*sec. 304*).—While the bill retains the provision of existing law which prevents tax avoidance where a subsidiary corporation purchases stock in its parent from the shareholders of the parent, an area of possible tax avoidance exists by the use of substantially the same device, that is, sales of stock between corporations owned by the same interests. Where an individual owning all of the stock of two corporations sells stock of one to the other, the bill provides that where the effect of the sale is in reality the distribution of a dividend, the sale will be taxed as such.

(5) *Distribution of stock and stock rights* (*sec. 305*).—The bill eliminates uncertainties of existing law (basing taxability on variations in shareholder's proportionate interests) in the case of distributions of stock and stock rights to shareholders. Such distributions will be allowed tax-free, with limited exceptions where the distributions are, in reality, in lieu of cash or property. This treatment will apply not only to recapitalizations, but also to a distribution pursuant to a corporate acquisition, a statutory merger or consolidation, or a corporate separation.

(6) *Distributions in connection with readjustments* (*sec. 306*).—Where a recapitalization, a corporate acquisition of stock or property, a merger or consolidation, or a corporate separation takes place, a shareholder may receive money or property, known as "boot," in addition to the stock or securities which may be received without the recognition of gain. As under existing law, the transaction as a whole is not disqualified as a tax-free exchange but the boot is subject to tax.

The bill follows the principles of the existing boot provision but has correlated the boot rules with the rules relating to corporate distributions generally. For example, the distinction between the tax treatment of a dividend received as an ordinary distribution (taxable in full) and a dividend received in connection with a recapitalization (taxable to the extent of the shareholder's gain) has not been preserved.

Where securities are exchanged for securities, the bill adopts the rule of *Commissioner* v. *Neustadts' Trust* (131 F. 2d 528), that no gain or loss is recognized where the securities received are in the same principal amount as the securities surrendered. Where the principal amounts received and surrendered vary, the *Neustadt* rule is applied to so much of the principal amount of the bonds received as equals the amount surrendered. In the case of a shareholder surrendering stock and securities and receiving stock and securities in return, the bill follows the rule of *Bazley* v. *Commissioner* (331 U. S. 737). Thus the fair market value of an excess of principal amount of securities received over securities surrendered will be taxed as boot.

(7) *Basis to shareholders and security holders* (*sec. 307*).—The bill follows the principles of existing law relating to the basis of stock, securities, or property received by shareholders or security holders in connection with corporate reorganizations but has combined the applicable provisions of existing law into one section. In general, the stock and securities received take over the basis of stock and securities surrendered, or if none are surrendered, as in a corporate separation, (such as a spin-off) for example, the stock and securities take an allocable part of the basis of the old stock and securities. These rules apply generally to transfers to a controlled corporation, a recapitalization, a statutory merger or consolidation, a corporate acquisition of stock or property, or a corporate separation.

The bill provides a rule to eliminate the necessity under present law of making negligible basis allocations between stock and stock rights issued on such stock. Under this rule the basis of the rights will be zero unless the taxpayer elects to allocate or unless the value of the right is 15 percent of the value of the stock at the time of distribution, in which event the allocation must be made.

(8) *Tax on transfers in redemption of nonparticipating stock* (*sec. 309*).—In recent years, a mechanism known as the "preferred stock bailout" for attempting to withdraw earnings from a corporation at rates applicable to capital gains, rather than dividends, has developed. The shareholders, usually of a closely held corporation, cause a dividend in preferred stock on their holdings of common to be declared. This dividend stock is then sold. Although it may be subject to immediate redemption from the purchaser, such a transaction has been held to give rise to only a capital gains tax on the shareholders at the time of sale (*Chamberlin* v. *Commissioner* (207 Fed. 2d 462) *cert. den.* March 8, 1954).

In order to eliminate the use of the preferred stock bailout, the bill imposes a tax at the corporate level at the time any such dividend stock is redeemed within 10 years from its date of issuance. This tax would amount to 85 percent of the amount paid out in redemption of the preferred stock.

(9) *Definitions relating to stock and securities* (*sec. 312*).—The bill provides definitions of participating and nonparticipating stock and of securities, which correspond to instruments ordinarily considered common stock, preferred stock, and bonds, respectively. These definitions will remove questions in connection with so-called "thin incorporations" where the capital is supplied primarily in the form of loans by stockholders. If the corporate obligation constitutes true debt within the definition of a security, questions concerning the deductibility of interest payments or amounts attributable to worthless obligations will be removed.

B. Liquidations (*secs. 331–336*)

Under existing law, the tax consequences of a corporate liquidation may vary with the statutory provision under which it is effected. The bill combines these provisions into one set of rules of general application.

(1) *General rules* (*secs. 331, 332, and 334*).—The liquidation rules under the bill do not impose a tax until there has been an economic realization of gain. Accordingly, unrealized appreciation in the value of property received at the time of the liquidation of a corporation will not be taxed to the shareholder or to the corporation. At the same time, if the value of any property received in the liquidation is less than the shareholder's cost of his stock in the corporation, a shareholder will be allowed a capital loss. Moreover, under the bill, a shareholder will in general be permitted to receive the purchase price for his stock as his basis for the assets distributed to him in liquidation where the assets' cost to the corporation is less than the purchase price of the stock but their value is greater. In this respect, the principle of *Kimbell-Diamond Milling Co.* (187 F. 2d 718) is effectuated.

As under existing law, any liquidation gain is a capital gain to an individual shareholder. The bill also preserves existing law in allowing the tax-free liquidation of a subsidiary corporation into its parent.

(2) *Collapsible corporations* (*secs. 332, 334, and 336*).—A new approach has been adopted for the tax treatment of corporations which manufacture property and are immediately liquidated in order that the imposition of a tax at the corporate level may be avoided. Existing law imposes a tax at the time of sale of the stock, or liquidation, of such a corporation at ordinary income rates. Since the tax avoided is ordinarily a tax at the rates applicable to ordinary income, the bill will preserve this tax at either the corporate or shareholder level. In order to accomplish this result, inventory assets (defined to include certain depreciable business property and rights to future income) which have appreciated in value will retain the basis in the hands of the distributee which such assets had in the hands of the liquidating corporation. This will insure recovery on subsequent disposition by the recipient of a tax measured by the difference between the cost of the property constructed and its value.

(3) *Court Holding Company (sec. 335).*—The bill eliminates questions arising as a result of the necessity of determining whether a corporation in process of liquidating made a sale of assets or whether the shareholder receiving the assets made the sale. Compare *Commissioner* v. *Court Holding Company* (324 U. S. 331), with *U. S.* v. *Cumberland Public Service Company* (338 U. S. 451). This last decision holds that if the distributee actually makes the sale after receipt of the property, there will be no tax on the sale at the corporate level. The bill provides that if a corporation in process of liquidation sells assets there will be no tax at the corporate level, but any gain realized will be taxed to the distributee-shareholder, as ordinary income or capital gain depending on the character of the asset sold.

C. Corporate organization, acquisition, separation, and insolvency reorganizations (secs. 351–373)

The bill revises those provisions of existing law relating to corporate organizations and reorganizations with respect to both terminology and definition of transactions which may qualify for nonrecognition of gain or loss. Thus, except in the case of insolvency, the general term "reorganization" is no longer used. The names substituted more accurately describe the transactions which take place, such as a corporate acquisition of stock or property, or a corporate separation.

(1) *Corporate organizations (sec. 351).*—The bill retains the rules relating to the tax consequences of the creation of a corporation. Where one or more persons transfer property to a corporation in exchange for its stock or securities no gain or loss is recognized to either the corporation or to its shareholders if they are thereafter in control. Under existing law, however, the interest of the shareholders in the corporation after the transfer must be in substantially the same proportion as were the respective interests of the shareholders in the property prior to the transaction, or else the entire transaction becomes a taxable one in which gain or loss is recognized. Under the bill any disproportion in stock interest will merely render the transaction taxable to that extent.

(2) *Corporate acquisitions (secs. 352 and 359).*—Under existing law a corporation may transfer either its stock or property to another corporation without recognition of gain or loss if such other corporation exchanges all or part of its stock. Since existing law makes no distinction between publicly held and closely held corporations, it is possible for a small corporation to transfer its assets to a large publicly held corporation in exchange for a small fraction of the stock of the large corporation. This is very little different from a sale of the smaller corporation for cash. The bill will require a substantial interest in the continuing enterprise, specifically that the shareholders of the corporation transferring its stock or property shall receive at least 20 percent of the common stock of the acquiring corporation.

In the case of a corporate acquisition of property, 80 percent of the transferor's property must be acquired, the percentage being determined by value of properties, less liabilities. These standards are substituted for the general requirement of present law that "substantially all" the properties must be acquired in such a case. The bill requires in addition that the transferor corporation liquidate after a transaction of this type has occurred.

The bill also provides that in the tax-free acquisition of property by a corporation which is a subsidiary, the shareholders of the transferor corporation may, without recognition of gain, receive stock of the parent of the acquiring subsidiary corporation. This eliminates a formality of existing law. *Groman* v. *Commissioner* (302 U. S. 82), and *Helvering* v. *Bashford* (302 U. S. 454).

(3) *Corporate separations (sec. 353).*—Under existing law, a corporation may transfer part of its assets to a newly created corporation; if immediately after the transfer, the transferee corporation is controlled by the transferor or its shareholders. This requirement, which implies that only stock of a transferee corporation may be distributed, has been eliminated. Thus, a corporation may distribute the stock of an existing subsidiary tax free to its shareholders, and it will not be necessary, as at present, to create an intermediate holding company.

In addition, the bill provides that the transferee corporation may be controlled by persons who were shareholders of the transferor. For example, if individuals A and B transfer their separate sole proprietorships to a corporation in which each receives 50 percent of the stock, these businesses may again be separated but into corporate entities, one of which may be wholly owned by A and one by B.

Present law contemplates that a tax-free separation shall involve only the separation of assets attributable to the carrying on of an active business. Under the bill it will be immaterial whether or not the assets are those used in an active business. Investment assets may, therefore, be separated from the risks of the other corporate business and transferred to a newly created corporation. The stock may then be distributed, whether or not prorata, to the shareholders without gain being recognized.

In the event that a shareholder receives, as a result of a corporate separation, stock in a corporation which, generally speaking, for each of the 5 preceding years has received more than 10 percent of its income from investments, the corporation will be characterized as an "inactive corporation." Any amount received with respect to the stock of such an inactive corporation (for a period of 10 years from the time of the stock distribution) whether as a distribution in liquidation or otherwise, or as proceeds of sale, will be taxable as a dividend. An inactive corporation may be removed from its classification, however, where for a period of 5 consecutive years, 90 percent or more of its income is from sources other than investments.

(4) *Gain or loss to corporations (secs. 354 and 359).*—The principles of existing law are retained which afford nonrecognition of gain at the corporate level where one corporation acquires the stock or assets of another corporation pursuant to certain specified transactions. However, the bill makes a distinction between publicly held corporations and corporations not so held. For this purpose any corporation will be considered to be publicly held unless 10 or fewer shareholders own more than 50 percent of the stock, such ownership being determined either by voting power or value and determined with the application of the attribution of stock ownership rules. The bill will allow mergers and consolidations carried out under State law to be effected without recognition of gain or loss where the parties to the transaction are publicly held corporations without regard to the rules described below with respect to corporate acquisitions.

Publicly held corporations are not denied the opportunity of carrying out other tax-free transactions, described as corporate acquisitions, where one of the parties is a closely held corporation, and a closely held corporation may be a party to a statutory merger or consolidation. However, if a closely held corporation is involved, there must also be compliance with the various rules relating to corporate acquisitions.

(5) *Basis to corporation (sec. 355).*—The rules of existing law with respect to basis of assets received have been retained for transfers to a controlled corporation, a corporate acquisition of property, a merger or consolidation, and a corporate separation. A carryover of basis from the transferor is provided in such cases.

The present law requirement of a carryover of basis is changed, however, where there is a corporate acquisition of stock. The bill provides that the stock basis to the acquiring corporation shall be the aggregate basis of the assets of the corporation the stock of which is acquired. Thus, if the corporation is liquidated, the basis of its assets will be correlated with the basis such assets would have had if they had initially been acquired in a corporate acquisition of property, rather than stock.

(6) *Assumption of liability (sec. 356).*—In the case of the organization of a corporation by a transfer to a controlled corporation, a statutory merger or consolidation, a corporate acquisition of property, or a corporate separation, it is often the assets of a going business, including its debts, that are being transferred. The bill retains the provisions of present law which allow the assumption of liabilities in such cases by the transferee without the recognition of gain, together with existing safeguards directed against the case where liabilities are assumed for purposes of tax avoidance.

An additional rule has been provided to impose a tax where the assets are subject to liabilities in excess of basis. In such a case the bill provides that gain will be recognized in the amount of this excess.

(7) *Liquidation followed by reincorporation (sec. 357).*—The bill adopts a provision directed against attempts to receive corporate earnings at capital gain rather than dividend rates by liquidating and then reincorporating the assets, other than cash and investment assets. Under this provision, if individuals control (defined as ownership of 50 percent of the stock) a corporation which is liquidated, and if more than 50 percent of the operating assets are reincorporated within 5 years, then the entire transaction will be considered to have been a corporate acquisition of property. Assets not reincorporated will, therefore, be considered as having been distributed as boot, and an appropriate amount of earnings and profits will be ascribed to the corporation receiving the balance of the assets.

(8) *Foreign corporations (sec. 358).*—The bill continues the effect of existing law which makes the nonrecognition provisions previously described inapplicable in the case of a foreign corporation unless prior to the transaction it is established to the satisfaction of the Secretary that the proposed transaction does not have as one of its principal purposes the avoidance of Federal income taxes.

(9) *Insolvency reorganizations (secs. 371 to 373).*—The bill continues the provisions of existing law which relate to nonrecognition of gain or loss (and corresponding basis provisions) where there is a corporate reorganization pursuant to bankruptcy, receivership, or a similar proceeding.

D. Carryovers to successor corporations (sec. 381)

Present law makes no provision for the transfer from one corporation to another, in a tax-free merger or consolidation, of the major tax benefits, privileges, elective rights and obligations which were available to the predecessor. These include such items as loss carryovers, unamortized bond discount, installment sales reporting, Lifo inventory method, etc. The courts have held, in general, that such tax attributes of a corporation may be preserved only by continuing the corporation's identity. For example, the surviving corporation in a merger is generally entitled only to the tax attributes from its own premerger experience and not from the experience of the other corporations merged. More recently, however, this separate entity rule appears not to have been followed.

The bill provides for the carryover of about 16 specific tax attributes or items from one corporation to another in certain tax-free reorganizations. The principal items are loss carryovers, earnings, and profits, and certain elections such as the inventory and depreciation method of accounting.

E. Special limitation on net operating loss carryover (sec. 382)

Under present law where a controlling interest in a corporation is acquired for the purpose of avoiding or evading tax liabilities the Internal Revenue Service may disallow the benefits of a deduction, credit, or allowance which would otherwise be enjoyed by the acquiring person or corporation. This provision has proved ineffectual, however, because of the necessity of proving that tax avoidance was the primary purpose of the transaction.

The bill adds a provision designed to limit undue tax benefits of this character by restricting the amount of a net operating loss carryover which may be utilized in cases where 50 percent or more of the common stock of a corporation is acquired by new owners. In such cases the net operating loss carryover to the current and subsequent taxable years is to be reduced by the percentage of new ownership acquired either by purchase or by decrease in such stock outstanding. This provision does not apply to publicly held corporations or to transactions in which stock is acquired in a tax free exchange, or by inheritance, bequest, or gift.

XII. Pension, Profit-Sharing, and Stock-Bonus Plans

The bill retains the general advantages of qualified pension and profit-sharing plans; that is, deferral of tax to the employee, current deduction for the employer, and tax exemption for the trust. The vague tests as to whether or not a plan qualifies as nondiscriminatory have been replaced by specific requirements which in general provide greater flexibility, permitting adaptation of plans to particular circumstances. Also, safeguards are provided, and in some areas the new rules are more strict than present law.

A. Treatment of employees receiving benefits (secs. 401, 402).

One change made by the bill would allow employees under nonqualified plans to defer tax until benefits are received. Present law allows this deferral only where the benefits are forfeitable. This change will allow more favorable treatment of employees under deferred compensation contracts, although the employer will not get a deduction until the benefits are paid unless the payment is part of a qualified plan. Further, the bill provides long-term capital gains treatment for lump-sum distributions from either trusteed or insured plans, if they are qualified, which are made either because of separation from service or because of death after retirement. Present law taxes at ordinary income rates any distributions from insured plans and distributions from trusteed plans due to death after termination of employment.

B. Tax treatment of payments by an employer (*sec. 403*)

Under present law employers may take a current deduction for payments to qualified plans at the time the contribution is made if such amounts do not overstate the normal cost. Amounts to cover unfunded past service costs may be spread over the remaining service of the employees affected or over a 10-year period. An alternative is provided in present law which allows the past service costs to be spread in any manner the employer chooses if the total annual contribution is less than 5 percent of wages and salaries of covered employees. The bill raises the percentage in this last alternative to 10 percent.

Under present law, in profit-sharing plans a deduction is allowed for purchase of a retirement annuity only if it is purchased through a trust. The bill removes this trust requirement for qualified plans.

Present law forbids deductions to a profit-sharing plan by profitable corporations in an affiliated group for a loss company in the group. The bill removes this restriction.

In the case of nonqualified plans the employer presently obtains a deduction for contributions if the employees' rights to the amounts are nonforfeitable (in which case the employee takes up the contribution in income immediately). The employer gets no deduction for payments into a nonqualified plan if the employee's rights are forfeitable. Under the bill, in all cases of nonqualified plans, the employer will only get a deduction when the amounts are paid to the employee (and reporting is similarly deferred for the employee).

C. Requirements for qualified plans (*sec. 501* (*e*)) .

As under present law, to qualify a plan must be solely for the benefit of employees and their beneficiaries. Further, the plan must meet tests of nondiscrimination with respect to coverage and benefits. these are modified in the bill.

(1) *Coverage requirements.*—The coverage requirements under present law for nondiscrimination are either that—

(i) the plan covers 56 percent of the employees (i. e., 70 percent of employees are eligible and 80 percent of the eligibles participate); or that

(ii) the plan is held by ruling of the Commissioner not to be discriminatory in favor of shareholders, officers, or principal employees.

The coverage requirements in the bill are more liberal and also replace the dependence on rulings with specific tests. A number of examples of nondiscriminatory categories are given in the bill, but these, as well as any other category, must meet the specific tests.

A plan will not in any case be considered discriminatory if 25 percent or more of all eligible employees are participants (or 50 percent if there are less than 25 employees in the firm). In determining these percentages part-time employees and employees with less than 5 years' service need not be counted as eligible employees. On the other hand, employees cannot be considered as covered if at their current salary they would not be entitled to benefits.

Other plans with narrower converage than this will be held discriminatory only if—

(a) more than 30 percent of the contributions are used to provide benefits for shareholders (employees owning themselves or in their families 10 percent or more of the voting stock); or

(b) more than 10 percent of the employees covered by the plan are "key employees." Key employees are the highest paid 10 percent of all employees but not more than 100 employees.

(2) *Benefit requirements.*—Under the bill certain requirements must also be met as to nondiscriminatory conditions within the covered group. For pension or annuity plans the ratio of contributions and benefits to wages or salaries must not be higher for a high-paid employee than a low-paid employee, except that the first $4,000 of wages paid (approximating social-security coverage) can be ignored in establishing the benefits.

For profit-sharing or stock-bonus plans 75 percent of the employer's contributions must be allocated to employees on the basis of their total compensation, including the first $4,000 of earnings. The remaining 25 percent of the contributions may be allocated as the employer sees fit. However, the contributions made on behalf of any employee cannot be more than twice as high a portion of wages as contributions for any other employee.

Certain restrictions presently imposed by regulations are also removed. To qualify a plan need not use a definite, predetermined formula; benefits for beneficiaries may be restricted to the employee's close relatives; and in the case of a profit-sharing plan amounts contributed by the employer may be in excess of current earnings if accumulated earnings are sufficient to cover the contributions.

Despite the new qualifications described above, a pension trust will be considered as qualified if it already has qualified under existing law.

D. Tax treatment of an employee's exempt trust (*secs. 501* (*a*), *503–505, 511–515*)

Under the bill, qualified pension trusts are treated in the same manner as tax-exempt educational foundations under present law. While the income of these trusts generally will be exempt, a tax is to be imposed on "unrelated business income" derived from the active conduct of a business or from rental income from certain lease arrangements. Also, the exempt status of such trusts may be removed if they engage in certain "prohibited transactions," such as making loans to the employer creating the trust without adequate security and a reasonable rate of interest.

In addition, certain restrictions are placed on the investments of the trusts. The trust's investments in securities of any one company may not exceed 5 percent of the value of the assets of the trust or more than 10 percent of the voting power of the stock of the company. The first of these restrictions also applies to parcels of real estate.

These investment restrictions do not apply to existing investments, to investments in the employer corporation (or its parent or subsidiaries), to annuity or retirement-income contracts, to Government securities, to cash items, or to investments in regulated investment companies.

The income of a trust not qualified or not meeting the investment restrictions or which engages in certain prohibited transactions is fully subject to tax.

XIII. Employee Stock Options (Sec. 421)

The revenue bill of 1950 established a new set of rules for the tax treatment of certain employee stock options. As a result of this act, when an option qualifies as a "restricted stock option" no tax is imposed at the time the option is granted or exercised. Instead the tax is deferred until the stock is sold and at that time, if certain conditions are met, any gain realized is a capital gain.

Before the Revenue Act of 1950, the Internal Revenue Service held that the employee was taxable at the time he exercised the option and at that time had ordinary income to the extent the difference between the market value of the stock at the time of exercise and the purchase price of the stock under the option. This rule still applies for compensatory options which do not meet the qualifications of a "restricted stock option."

The bill retains the present "restricted stock option" provision but makes certain changes.

Under present law an option is denied treatment as a "restricted stock option" if not exercised before the death of the employee. The bill provides that the exercise of "restricted stock options" by the estate or beneficiary of a deceased employee is to have the same tax effect as if the employee had exercised the option. In addition, the estate tax attributable to the inclusion of the option in the decedent's estate is to be allowed as a deduction for income-tax purposes in the year in which the estate or beneficiary has an increased income as a result of disposing of the stock acquired under the option.

The bill further provides that variable price options may qualify as "restricted stock options." A variable price option is an option in which the price to be paid by the employee for the stock is determined by reference to the market value of the stock, for example, an option permitting an employee to purchase stock at 85 percent of the value of the stock. The variable price option was not easily adaptable to the statutory language of present law because the existing provision appears applicable only to an option which stipulated its option price in dollars and cents. The bill provides that these options are to qualify as restricted stock options if the option price is within 85 percent of the value of the stock at the time the option was granted, and the other qualifications of restricted stock options are met.

Under present law if the employer corporation is reorganized in a tax-free reorganization and the employee has not exercised his option, it is not clear as to whether the employee still has a "restricted stock option." On the other hand, the rights of employees who have exercised their "restricted stock options" are protected. The bill preserves the rights of the employee holding an unexercised restricted stock option.

The bill also provides that changes in the terms of a restricted stock option, exercisable over a period of 10 years or less, which are attributable to the reorganization of the employer corporation are not to be considered a modification requiring a new option price. Also, any changes in the terms of an option exercisable over a period of 10 years or less, which do not benefit the employee, are not to be considered a modification requiring a new option price. Under present law any substantial change in the terms of the option requires a new option price, irrespective of whether or not the employee received an additional benefit.

The House bill also provides that any options granted after the enactment of this bill in order to qualify as restricted stock options may only be exercisable over a period of 10 years or less.

Under present law a person who owns more than 10 percent of his employer coproration cannot receive a "restricted stock option." The bill provides that if the option price at the time the option is granted is at least 110 percent of the value of the stock at that time and the option is exercisable over a period not exceeding 5 years an employee, even though owning more than 10 percent of the stock of his employer, can receive a "restricted stock option."

The regulations under present law relating to the acquisition or transfer of stock acquired under a "restricted stock option" in joint tenancy have been incorporated in the new law. This permits stock acquired in common-law States may be owned jointly without incurring a tax liability.

Under present law when stock acquired under a "restricted stock option" is disposed of prior to 2 years from the date the option was granted or 6 months from the date the stock was acquired, the past returns of the employee and the employer for the year the option was exercised must be reopened to tax the employee and allow the employer a deduction for any difference between the option price and the price of the stock at the time the option was exercised. The bill provides that any necessary adjustments are to be made in the year the stock is sold.

XIV. Accounting Provisions

A. 52- or 53-week year accounting periods (sec. 441)

Under present law the accounting period used by a taxpayer in computing taxable income must end on the last day of a calendar month. Corporations in certain industries (e. g., retail sales, meatpacking, radio and television) for business purposes (but not for tax purposes) close their annual accounting period on a particular day of the week rather than on the last day of the month. The books of these corporations are closed on whatever date a particular day of the week occurs for the last time in a calendar month (or falls nearest to the end of a calendar month). As a result their annual accounting periods consist of 52 weeks (364 days) in 5 out of 6 years, and 53 weeks in the sixth year.

The bill enlarges the term "fiscal year" to include this 52–53-week period.

Special rules are provided for effective dates and for the transitional problems which may arise in the year of change.

B. Prepaid income (sec. 452)

Under present law payments received in advance for the use of property in future years or for services to be rendered in future years are includible in the income of the recipient in the year they are received. This is true regardless of the taxpayer's method of accounting.

The bill permits accrual-basis taxpayers to defer the reporting of advance payments as income until the year, or years, in which, under the taxpayer's regular method of accounting, the income is earned. However, it provides that the period over which the prepayments may be deferred cannot exceed 5 years after the year of receipt. This limitation will not affect the great majority of prepayments which are earned within 5 years, but will reduce substantially the administrative work.

Where amounts are received in advance and it is not expected that the amounts will be earned within the 5-year period, taxpayers who have so elected are to take the prepayments into account ratably over the period of the taxable year of receipt and the 5 succeeding taxable years. With the consent of the Secretary or his delegate, however, the taxpayer may allocate the income in another manner.

Where a taxpayer dies or where, for any other reason, the liability with respect to the deferred income ceases, the prepayments not previously reported as income become taxable in the year in which such an event occurs.

The election provided in this provision is available only with respect to advance payments received by a taxpayer in a taxable year beginning after December 31, 1953.

C. Initial payment before use of installment method (sec. 453 (b))

Under present law, in order to use the installment method of reporting income in the case of sales of real property or casual sales of personal property, some payment must be made in the year in which the sale occurs.

The bill provides that in the case of a sale of real property or a casual sale of personal property made in a taxable year beginning after 1953 there need be no payment made in the taxable year in which the sale occurs, if initial payments in a subsequent year do not exceed the prescribed 30 percent of the selling price.

D. Change of method from accrual to installment (sec. 453 (c))

Under present law a taxpayer who changes his accounting method from the accrual basis to the installment basis pays a double tax on certain income. Under the accrual method the entire profit from a sale is taken into account in the year of sale, regardless of when the collection is made. Under the installment method, the profit from a sale is recognized piecemeal as the cash is collected. In the early years following a change from the accrual to the installment method, present law taxes portions of the profit realized from all installment collections, including profits in collections on sales made before the change which previously had been reported as taxable income under the accrual method.

The bill provides that a taxpayer shifting from the accrual to the installment method of accounting is not to be taxed twice on the same income. The tax attributable to an amount included in income for the second time is eliminated or is at least decreased to the extent of the tax for a prior year attributable to its inclusion under the earlier method of accounting.

E. Accrual of real property taxes (*sec. 461*)

Under present law a deduction for the payment of local property taxes accrues upon the date when the amount and liability for the tax becomes fixed. In many jurisdictions the amount and liability for a property tax for the calendar year 1955, for example, would be fixed on a date late in 1954 and, under court decisions, is deductible for accrual-basis taxpayers only at that time.

The bill provides that an accrual basis taxpayer may in the future accrue a real property tax ratably over the period for which the property tax is imposed.

Special rules are provided to cover the transitional problems which may arise as a result of the change.

F. Reserves for estimated expenses (*sec. 462*)

Under present law deductions for expenses and losses incurred by a taxpayer may be taken only when all events have occurred which fix the fact and the amount of the taxpayer's liability. While present law permits a reserve for prospective bad debts, reserves for other expenses and losses are not allowed.

The bill permits an accrual-basis taxpayer to deduct reasonable additions to reserves for estimated expenses. The expenses must be related to income taxed during the year (except for adjustments or corrections of previously established reserves) and must be allowable deductions which the Secretary or his delegate is satisfied can be estimated with reasonable accuracy. A reserve is to be considered reasonably estimated when it is based on reliable data or statistical experience of the taxpayer or of others in similar circumstances. Reserves for general contingencies, indefinite future losses, or for amounts in litigation do not fall in this category.

At the end of each year these reserves are to be adjusted to reflect the best estimate currently available; any amount by which a reserve is found to be excessive is to be taken into account in the year of determination.

The election to establish reserves for estimated expenses is not available with respect to any deduction attributable to income reported in a taxable year beginning before 1954, or to prepaid income which the taxpayer has elected to defer.

G. Other changes in methods of accounting (*sec. 481*)

At present taxpayers who request permission to change their method of accounting (other than to the installment method), or to change the manner in which they compute significant items such as inventories, are required to make certain adjustments in the year of the change. These transitional adjustments prevent income and expenses from being reported for tax purposes more than once and prevent the omission of certain income entirely. Under certain circumstances, however, where a change in accounting method is made involuntarily, the courts have denied the Internal Revenue Service the right to require these adjustments. In other cases, where the adjustments are made, the tax results in a "bunching" of income in the year of change.

The bill provides that the necessary transitional adjustments will be made in all cases where there is a change in method of accounting, whether the change is voluntary or involuntary. It also provides an averaging device where the taxpayer has had at least 2 years' experience under the old method of accounting and where the transitional adjustments result in an increase in his taxable income of more than $3,000 in the year of change. The averaging device to be used provides that the tax of the person making the change is not to be increased by more than it would be if the net transitional adjustment were spread evenly over the year of the change and the 2 preceding years.

H. Revenue effect

It is estimated that the changes made by the House bill relating to accounting periods and principles will decrease revenues by $45 million in the fiscal year 1955.

XV. Tax-Exempt Organization (Sec. 514)

The bill extends the unrelated business income tax to exempt pension, profit-sharing and stock bonus trusts. The provisions of present law relating to "prohibited transactions" and also the provision imposing certain limitations on accumulations on certain exempt organizations are also made applicable to these trusts. This is discussed further under the section of this report relating to pension, stock bonus and profit-sharing plans. (See No. XII (D).) Apart from this change, only one minor modification was made in the tax treatment of exempt organizations.

Under the "unrelated business income" tax, educational, charitable and certain other organizations presently are subject to tax on their rental income derived from leases, for more than 5 years, to the extent of their outstanding indebtedness which was incurred to acquire or construct the leased property.

The bill subjects rental income to the unrelated business income tax in the case of these exempt organizations where the lease is for 5 years or less, if the same business tenant occupies the property for more than 5 years. However, in such cases, the tax is to become applicable only in the sixth year in which such a tenant occupied the leased property. As in the case of leases for more than 5 years, the tax is to apply only to the extent outstanding borrowed funds were used to acquire or construct the leased property.

XVI. Corporations Used To Avoid Income Tax on Shareholders

A. Accumulated earnings tax (secs. 531–536)

Section 102 of existing law imposes a special tax on any corporation formed or availed of for the purpose of avoiding the surtax on shareholders by permitting earnings or profits to accumulate in the corporation. The statute further provides that if earnings and profits are permitted to accumulate beyond the reasonable needs of the business, this fact will be considered determinative of the purpose to avoid tax unless the corporation proves otherwise by the clear preponderance of the evidence.

(1) *Burden of proof.*—At the present time if the Commissioner of Internal Revenue proposes a deficiency on the ground that the taxpayer has accumulated earnings and profits in excess of the reason-

able needs of the business, the taxpayer has the burden of proof as to the reasonableness of the accumulation.

Under the bill, the taxpayer may, upon receipt of notice of a proposed deficiency with respect to the accumulated earnings tax, file a statement of the grounds on which the taxpayer relies to establish the reasonableness of the accumulation. If the taxpayer submits such a statement within the proper time, the burden of proof will be upon the Government as to whether the accumulation is in excess of the reasonable needs of the business. If the taxpayer does not file such a statement, it must bear the burden of proof as under existing law. It must also bear the burden of proof if the statement does not present facts sufficient to indicate the basis of the grounds on which it relies as to the reasonableness of the accumulation. If the Secretary or his delegate fails to give the taxpayer notification prior to the issuance of a notice of deficiency, then the Government must bear the burden of proof even though the taxpayer has filed no statement.

(2) *Reasonable needs of the business.*—One principle which has been applied under present law in determining "the reasonable needs of the business" is the so-called immediacy test, under which there must be an immediate need for the funds in order to justify the retention of earnings. In some cases section 102 has been applied even though the corporation had definite plans for expansion and the bona fides of the expansion program were not in question.

The bill expressly provides in the statute that the reasonable needs of the business shall include the "reasonably anticipated" needs of the business. It is contemplated that this amendment will cover the case where the taxpayer has specific and definite plans for acquisition of buildings or equipment for use in the business. It would not apply where the future plans are vague and indefinite, or where execution of the plans is postponed indefinitely.

(3) *Accumulated earnings credit.*—Under the bill an accumulated earnings credit is allowed for the first $30,000 of earnings and profits accumulated by the corporation. Earnings and profits in excess of $30,000 may, of course, be retained if held for the reasonable needs of the business. There is no comparable credit under existing law.

(4) *Publicly held companies.*—Under present law the section 102 tax is theoretically applicable to publicly held as well as closely held companies. As a practical matter, the provision has been applied only in cases where 50 percent or more of the stock of a corporation is held by a limited group.

The bill provides a specific statutory exception for any corporation which has more than 1,500 shareholders and no more than 10 percent of the stock of which is held by any individual (including the members of his family). The corporation must demonstrate its right to the exception by showing that it meets the stock ownership requirement.

(5) *Computation of accumulated earnings tax.*—The bill revises the provisions relating to computation of the accumulated earnings tax. It provides that the foreign tax credit is to be allowed in determining the amount subject to the accumulated earnings tax. The corporation will also be given credit, in computing the accumulated earnings tax, for dividends paid not later than the 15th day of the 3d month following the close of the taxable year.

B. Personal holding companies (secs. 541–547)

H. R. 8300 retains the provisions of present law which impose a special tax on the undistributed income of personal holding companies. Several amendments have been made, however.

Under the bill, the personal holding tax has been integrated with the income tax so that a single return will serve the purposes of both taxes. It is anticipated that the Internal Revenue Service will provide a separate schedule to be filed by companies subject to this tax. Under present law when a corporation subject to the tax fails, because of negligence or poor advice, to file a personal holding tax return, the period of limitation on assessment of this tax remains open indefinitely, and the corporation may be barred from making a deficiency dividend distribution unless it can demonstrate that the failure to file a return was due to reasonable cause. Under the bill, the filing of an income tax return will begin the running of the statute of limitations for both taxes. However, the period of limitation for assessment is extended to 6 years with respect to the personal holding company tax if the corporation fails to furnish information as to its stock ownership and items of personal holding company income.

The deficiency dividend provision, which enables a corporation to eliminate a prior personal holding company tax by making a special distribution of dividends, is made generally applicable by the bill except in the case of fraud for willful failure to file an income tax return. The benefits of the provision may be obtained by an informal agreement signed by the taxpayer and the Commissioner's representative in lieu of the closing agreement procedure required at the present time.

Under existing law a corporation first becomes subject to the personal holding company provisions only if it meets two tests: 80 percent or more of its gross income is personal holding company income as defined in the statute, and 50 percent or more of its stock is owned by five or fewer individuals (including members of their families). If in any 1 year the corporation meets the 80 percent income test, then the percentage test is 70 percent for each of the next 3 years. The bill adopts a single 80 percent income test.

The stock ownership requirements have been retained in their present form with the exception that the bill provides that an exempt organization or charitable trust is to be counted as an individual in determining whether 50 percent or more of the stock is owned by five or less individuals.

The bill also changes the application of the personal holding company provisions to corporations filing a consolidated return. The bill treats the group as a single corporation to determine whether the personal holding company income test is met. Thus, the provisions which have previously been applicable only to affiliated groups of railroad corporations are extended to any other affiliated group. This treatment is applicable only if the common parent derived 80 percent or more of its income from the affiliated group for the three preceding taxable years, no member of the group would be a personal holding company if its income derived from the group is disregarded, and no member of the group is a corporation exempt from the personal holding company provisions.

The definition of personal holding company income has been amended in two respects. Under present law when a corporation rents property to its principal stockholders the rental income is treated as personal holding company income and the corporation may be subject to the penalty tax. The bill provides that such rental income is not to be treated as personal holding company income unless the corporation has other personal holding company income amounting to 10 percent or more of its total gross income. Another amendment to the definition of personal holding company income provides that gains from the sale of securities or commodities are not to be considered as gross income to the extent of the losses on such sales. Thus gross income and personal holding company income will reflect only the net gains from such transactions.

In the computation of undistributed income subject to the personal holding company tax, the bill provides that taxes are to be deducted when accrued. Under existing law it is not clear as to whether taxes may be deducted in the year paid or in the year accrued. The bill permits taxpayers who have been deducting taxes when paid to continue to do so but such taxpayers may, if they so desire, make an irrevocable election at any time to change to the accrual method.

The deduction allowed for taxes in computing amounts subject to the personal holding company tax has been extended to include foreign taxes claimed as a credit for income tax purposes. However, the deduction for taxes may not include the alternative capital gains tax.

The consent dividend provisions of existing law were enacted in connection with the undistributed profits tax in the 1930's to enable corporations to comply with dividend distribution requirements without the necessity of an actual payment of dividends. The bill eliminates these provisions from the law.

Other amendments to the personal holding company provisions include technical revision of the 1 year net operating loss carryforward allowed to personal holding companies, and limitation of the provision of present law which excludes amounts subject to a lien from the personal holding company tax. The lien provision has been amended to provide that any income excluded under this provision is to be included in the income of the corporation for the year in which the lien is released. Dividends attributable to such an inclusion will be taxable to the shareholders either in the year of dividend payment or, at the election of the taxpayer, ratably over the period of the lien.

XVII. Worthless Stock in Affiliated Banks (Sec. 582)

Under present law, if stock or securities of a subsidiary owned by the parent corporation become worthless the loss may be deducted by the parent as an ordinary loss (instead of a capital loss), if 90 percent of the aggregate gross income of the affiliated company for all taxable years was derived from sources other than investment income. In the past banks have not qualified for this tax treatment because most of their income is derived from investment sources. The bill removes this restriction in the case of banks by treating stock held in an affiliated bank as a noncapital asset.

XVIII. Natural Resources

A. Rates of percentage depletion (sec. 613 (b))

Under present law taxpayers owning economic interests in specified types of mineral deposits are allowed percentage depletion deductions whenever these exceed depletion based on capital costs. Such depletion is computed as the lesser of (1) a statutory percentage of gross income from mineral property or (2) 50 percent of the net income from the property before depletion. On mines of minerals not accorded percentage depletion, discovery depletion may be deducted as an alternative to cost depletion if discovery value materially exceeds investment costs.

Under the bill there are a few increases, but no reductions, in the rates of percentage depletion allowed by present law and regulations. The bill has continued the present rates of percentage depletion of 27½ percent for oil and gas and 23 percent for sulfur. Under the new provision depletion allowances, other than those for oil, gas, and sulfur, are divided into two groups: Specific items depletable at 15, 10, and 5 percent and another general class for all other minerals.

The specific 15-percent group contains: Metal mines, rock asphalt, vermiculite, slate, chemical and metallurgical limestone, and ball, china, and sagger clay. All of these items under present law are entitled to the 15-percent rate except slate which has been in the 5-percent category.

The specific 10-percent group contains: Asbestos, brucite, coal, lignite, perlite, and wollastonite. Under present law all of these items receive the 10-percent rate, although lignite has been covered only by an interpretation that it is a grade of coal.

The specific 5-percent category includes all the items presently listed at 5 percent except slate which has been raised to the 15-percent class, and in addition the 5-percent class is to include peat and mollusk shells (including clamshells and oyster shells).

Minerals in the above categories will receive the stated depletion allowance regardless of the way they are used. All other minerals not specifically listed are placed in a general class to receive percentage depletion at the rate of 15 percent, subject to the limitation that if they are used for the same purposes for which stone is commonly used, they are to be regarded as stone and entitled to a percentage depletion rate of 5 percent. This end use test is imposed to prevent discrimination in percentage depletion rates between materials which are used competitively for the same purposes. The general 15-percent category is intended to include, for example, quartz sands or pebbles when sold for their silica content and novaculite and the following minerals which now receive 15 percent: aplite, bauxite, fluorspar, flake graphite, beryl, garnet, feldspar, mica, talc (including pyrophyllite), lepidolite, spodumene, barite, phosphate rock, trona, bentonite, gilsonite, thenardite, borax, fuller's earth, tripoli, refractory and fire clay, quartzite, diatomaceous earth, and potash. This group also covers minerals for which percentage depletion is not presently available such as gypsum, natural mineral pigments, olivine, and kyanite, but it does not include dirt, sod, or mosses, or minerals taken from the sea or air or from sources generally considered inexhaustible.

The classification of nonmetallic minerals into these broad all-inclusive groups makes it possible to eliminate the discovery value depletion provisions of present law.

B. Definition of income from property (*sec. 613* (*c*))

Under present law and the bill, the gross income rates referred to above are applied to "gross income from the property." This is defined as gross income from mining, and "mining" in turn is defined as the extraction of the minerals, the "ordinary treatment processes" normally applied to obtain commercially marketable mineral products and certain transportation.

The bill continues these definitions except in three respects. In the case of magnesite, burning is to be regarded as an ordinary "treatment process" and in the case of talc, fine pulverizing is to be regarded as such a process. The present definition of "sulfur processing" is specifically related to the Frasch process, so that the general rule for ordinary treatment processes is to be available for sulfur produced in other ways.

C. Mine tailings (*sec. 613*)

Depletion allowances under present law are allowed with respect to mines and natural deposits. The bill would extend percentage depletion at the appropriate rates to mine owners for minerals recovered from the residue that had accumulated from their mine.

D. Definition of mineral property (*sec. 614*)

Although depletion allowances are computed with respect to mineral properties, present law does not define a "property." In general administrative regulations state that each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land constitutes a property. From the standpoint of both taxpayers and administrators, however, this division of properties creates difficulties because, in some instances, it requires the preparation of multiple depletion schedules and computations where a single computation would serve the same purpose.

The bill clarifies the situation with respect to depletable properties by adding a statutory definition of "the property." This provision adopts as the general rule the same definition relating to separate interests now established by regulations. In addition, however, the new provision permits a taxpayer to elect to treat as one property an aggregation of his separate operating mineral interests which constitute all or part of an operating unit.

E. Gain or loss in the case of timber or coal (*secs. 272, 631*)

Under section 117 (k) (1) of present law a taxpayer may treat as a capital gain the difference between his basis and the fair market value of timber at the time it is cut. Under section 117 (k) (2) a taxpayer may treat as capital gain payments made to him by a lessee under a lease of coal or timber property. The lessor is required to retain an economic interest in the coal or timber disposed of under the lease.

Present law makes no specific provision for the expenses of the taxpayer attributable to the holding of the timber or to the making and administering of the contract under which the coal or timber is disposed of.

With regard to the cutting of timber which is recognized as a sale it is specifically provided that administrative and other expenses, incurred in the taxable year timber is cut, in connection with the holding and quantity measurement of the timber, shall be an adjustment to the basis of the timber cut. These expenses will not be deductible in any other way.

With regard to the disposal of coal or timber by the owner under a lease by virtue of which the owner retains an economic interest in the coal or timber, it is provided that the expenses of making and administering the contract and preserving the economic interest retained under the contract will be an adjustment to the basis of the coal or timber disposed of. These expenses are not deductible in any other manner.

If the adjustment to basis required under this section results in a loss, the part of the loss attributable to taxes would be allowed as an ordinary deduction. Any loss attributable to other expenditures would constitute a loss from the sale of real property used in the trade or business.

In the case of coal, the section is made applicable to sublessors.

F. Revenue effect

It is estimated that the amendments made in the depletion provisions will result in a reduction in revenues of $27 million in the fiscal year 1955.

XIX. Estates, Trusts, and Their Beneficiaries

A. General rules (secs. 641–643)

As under present law, the committee's bill provides that trusts and estates are to be taxable on their earnings after allowance for certain credits, deductions and distributions to beneficiaries.

The credits and deductions provided are substantially the same as under present law with two exceptions:

(1) The deduction for a personal exemption was increased from $100 to $300 in the case of trusts that are required to distribute all of their income currently (the present $600 for estates remains unchanged, as does the $100 for other trusts), to eliminate the taxation of small amounts of capital gains.

(2) An exclusion is allowed for the first $50 or $100 of dividend income and a tax credit equal to 5 percent or 10 percent of any remaining dividend income retained by the fiduciary, to align the tax treatment of trusts and estates with the general dividends received provision.

The bill adopts the general principle that to the extent of the trust's current income all distributions are deductible by the estate or trust and taxable to the beneficiaries. This approach represents a basic departure from the general rule of the existing law that taxable distributions must be traced to the income of the estate or trust for the current year.

This approach, however, requires the use of a measure to impose an outside limit on the total distributions deductible by the estate or trust and taxable to the beneficiary. In general, the measure adopted by the bill for this purpose is taxable income, computed without regard to capital gains and losses unless these gains and losses are utilized in determining the income available for distribution.

The bill adheres to the theory of existing law that an estate or trust is treated as a conduit through which income passes to the beneficiary. In order to implement this theory in a satisfactory manner, it is necessary to include in the measure items of income and deductions which are not reflected in taxable income. Thus, the distributable net income of an estate or trust is defined as its taxable income for the current year, excluding capital gains and losses not distributed by the estate or trust, the portion of extraordinary cash dividends and taxable stock dividends allocated to principal (in the case of simple trusts described below), but including tax-exempt interest, the dividends received exclusion, and foreign income of foreign trusts.

The approach adopted by the bill eliminates the necessity, in determining the taxability of distributions, of tracing such distributions to the income of the estate or trust for the current taxable year. Furthermore, amounts not included in the gross income of the estate or trust will generally not be taxable to the beneficiaries.

B. "Simple" trusts (secs. 561 and 562)

A trust (but not an estate) may qualify under the "simple trust" provisions if all of its income is required to be distributed currently and it makes no charitable distributions. If it makes occasional distributions out of principal it is disqualified only for the years in which the principal is distributed. Essentially the treatment provided for simple trusts is the same as that provided by present law.

Qualifying trusts are allowed to deduct distributions made to the extent of their distributable net income and beneficiaries are required to include the distributions in their incomes for tax purposes only to the same extent.

The bill specifically provides that the character of the income to the beneficiaries is to be the same as it was to the trust (e. g., capital gains to the trusts are capital gains to the beneficiaries) and a specific rule is provided to divide up the various types of income among the beneficiaries in the absence of specific provisions in the trust instrument.

C. "Complex" trusts and estates (secs. 661–663)

For all estates and trusts not qualifying under the simple trust provision (including discretionary trusts, trusts with charitable beneficiaries, and trusts making current distributions but also making distributions of principal) deductions are—

(1) first allowed for distributions required to be made currently, and

(2) then, if any distributable net income remains, allowed for any other amounts distributed (other than specific gifts or bequests not paid in installments) but only to the extent of the remaining distributable net income.

In the case of those trusts or estates which may have paid out or set aside amounts for charitable purposes, their taxable income, and therefore their distributable net income, is already reduced by such amounts.

The beneficiaries of these trusts (or estates) are required to include in their income for tax purposes, distributions made to them out of income required to be distributed currently and then other distributions made to them to the extent of their proportionate share of the amount allowed as a deduction to the trust.

Upon termination of the trust (or estate) any of its net operating loss or capital loss carryovers which have not been used are to be made available to the distributees. Under existing law these loss carryovers are wasted.

D. Five-year throwback rule (*secs. 665–668*)

In spite of the elaborate 65-day and 12-month rules, it is still possible under the existing law to shift the tax burden from a beneficiary to a trust. These rules, in effect, throw back to the year the income is realized by the estate or trust any distribution of such income made within 65 days after the close of the taxable year. To meet this and similar situations, the bill provides that distributions by a trust in excess of its distributable net income for the current taxable year will be "thrown back" to each of the five preceding years in inverse order and will be taxed to the beneficiaries to the extent that the distributable net income of those years was not, in fact, distributed.

To prevent double taxation, the beneficiaries receive an offsetting credit for any taxes previously paid by the trust which are attributable to the excess so thrown back. In effect, the beneficiaries, except for the fact that they report the income in the year the accumulation is distributed or made available to them, are placed in the same position as if the trust had made the distribution at the time it received the income.

This throwback provision applies only to accumulations of income in taxable years beginning after December 31, 1953. It does not apply to estates or to simple trusts. Moreover, distributions exceeding distributable net income by less than $2,000, distributions representing accumulations during the minority (or before the birth) of the beneficiary, and distributions for the maintenance, support, or education of a beneficiary are specifially excluded from the application of this provision.

E. "Clifford" type trusts (*secs. 671–678*)

The bill also provides rules to determine when a trust's income is to be taxed to the grantor because of the grantor's substantial dominion and control over the trust property or income.

Existing law contains a statutory provision dealing with trusts in which the grantor retains a power of revocation and also a provision dealing with trusts whose income is accumulated or used for the benefit of the grantor. In addition, regulations (commonly known as the Clifford Regulations) provide a series of rules to determine when trust income is to be taxed to the grantor because of: a reversionary interest within a specified period; powers to control the beneficial enjoyment; or certain broad administrative powers. The bill includes specific provisions to this effect in the estate and trust subchapter. These provisions generally adopt the approach of the regulations (and the two provisions of existing law) but with modifications.

Under the regulations, trust income is taxed to the grantor where he can take back the principal or income within 15 years, if he (or his wife) as trustee has certain administrative powers over the trust property. If he does not possess these powers, the trust income will be taxed to him if he can recapture the principal or income within 10 years. Under the bill the grantor is not to be taxed by reason of a reversionary interest in an irrevocable trust unless the reversion may occur within 10 years. If the beneficiary is a designated school, hospital, or church, the grantor is to be taxable because of a reversionary interest only if the reversion will occur within less than 2 years, but, as pointed out in the discussion under section 170, the grantor is not allowed a charitable deduction.

Under the regulations, the grantor will be taxed on the trust income if certain related or subordinate trustees hold a power to apportion income or principal among different beneficiaries. Under the bill, the grantor will not be taxed if he can establish that the related or subordinate trustee is not acting in accordance with the grantor's wishes.

A person other than the grantor may be treated as the substantial owner of a trust if he has powers of the type which would make the grantor taxable, unless the grantor himself is deemed taxable because of such a power. Similar rules are contained in the regulations under existing law (commonly known as the Mallinkrodt Regulations). The bill, however, makes a specific exception to the effect that a power to apply the income for support of dependents is not to result in the trust income being taxable to such other person unless the income is actually applied for the support of dependents.

F. Revenue effect

Only the increase in exemptions from \$100 to \$300 is expected to affect revenues to an appreciable extent. It is estimated that this will decrease revenues in the fiscal year 1955 by \$3 million.

XX. Income in Respect of Decedents (Secs. 691, 692)

Under existing law income in respect of a decedent which is received after his death by his estate or other beneficiaries is taxed to the recipients rather than being treated as accruing to the decedent in a lump sum immediately prior to his death. The recipients are allowed an offsetting deduction for any estate tax attributable to the inclusion of this right to income in the decedent's gross estate, but do not acquire a new basis for this property at the date of the decedent's death.

The above treatment, under existing law, is limited to the first decedent. The bill provides that a right to income received from a decedent, or a prior decedent, is to be includible in the income of the recipient with an offsetting deduction for any estate tax attributable to such property.

Under existing law, it is not clear whether income in respect of a decedent which is received by an estate or trust will be treated as such in the hands of the beneficiary if distributed by the estate or trust. The bill provides that if the estate or trust makes a distribution of income in respect of the decedent, the deduction for the estate tax is to be given to the recipient beneficiary, instead of the estate or trust.

Under existing law, gain on uncollected installment obligations is treated as realized on the death of the decedent. An exception is provided to this rule, however, if a bond is filed which is conditioned on the subsequent reporting of the gain on the obligation by the person who acquired the obligation from the decedent. The bill eliminates the necessity of this bond requirement by providing that in all cases the uncollected installment obligations are to be treated as income in respect of the decedent.

The bill also extends the treatment provided for income in respect of a decedent to certain income not now eligible. This treatment is extended to (1) that part of the value of a survivor's annuity included in the estate-tax base of the decedent annuitant which represents the interest accumulation for the survivor annuity since the annuity's purchase, (2) the value of unexercised restricted stock options included in the gross estate of the decedent employee, and (3) payments to a deceased partner by a partnership which are includible in the income of the estate or beneficiary of the deceased partner.

XXI. Partners and Partnerships

The House bill provides comprehensive statutory tax provisions for partners and partnerships. In general, the proposed statutory treatment retains the existing scheme of regarding the partnership as merely an income-reporting, and not a taxable, entity. In addition, a statutory pattern has been established for contributions to a partnership, distribution by a partnership, transfers of partnership interests by sale or on the death of a partner, termination of partnership taxable years, transactions between a partner and the partnership, and the treatment of payments to a retiring partner or a deceased partner's estate or heir.

A. *General rules (secs. 701–707)*

(1) *Income of partners.*—Under the bill, as under present law, partners will be liable individually for income tax on their distributive shares of partnership income. The bill provides that the partnership will act as a mere conduit as to income and loss items, transferring such items directly to the individual partners.

The items required to be segregated will retain their original character in the hands of the partner as though they were realized directly by him from the same source from which realized by the partnership and in the same manner. After excluding the items required to be separately treated, the remaining income or loss, which corresponds to the ordinary income or loss of the partnership under present law, is attributed to the partners.

The computation of partnership income is generally on the same basis as existing law. The partnership is allowed the usual business deductions, but is denied the deductions peculiar to individuals.

The bill provides that all elections with respect to income derived from a partnership (other than the election to claim a credit for foreign taxes) are to be made at the partnership level and not by the individual partners. This rule recognizes the partnership as an entity for purposes of income reporting.

(2) *Distributive shares.*—The taxation of partnership income or other items directly to the partners requires a determination of each partner's share of such items. In general, such shares under the bill will be determined in accordance with the partnership agreement, as under existing practice.

In the case of property contributed to a partnership, there has been considerable doubt, under present law, as to the partners' distributive shares of gain and loss upon the sale of such property and as to the allocation among the partners of depreciation on such property. This problem arises when the tax basis of the contributed property is greater or less than the value of such property at the time of contribution. Under the approach adopted by the bill, the allocation of gain or loss and of depreciation is to be in accordance with the distributive shares of the partners generally. Thus, if 1 or 2 equal partners contributes to a partnership property which is worth $100 but has a tax basis of $40, and the other partner contributes cash of $100 which is used to purchase property with a value of $100, the partners will share equally in the depreciation allowance, notwithstanding the low basis of the property contributed by the first partner. The sharing of gain or loss upon a sale or exchange of either property will also be identical as between the partners. However, upon the liquidation of the partnership the partners who have received too large depreciation deductions (or too small a gain) will have relatively larger capital gains than will be true in the case of the other partners.

(3) *Taxable years of partners and partnerships.*—Under existing law a partner treats his distributive share of partnership income as income to him at the close of the partnership taxable year. Such income is not reportable by the partner until he files his return for the taxable year in which such partnership year ends. Because of these rules it has been possible, generally by the selection of a fiscal year as the partnership year, to postpone the realization of partnership income by as much as 11 months. The bill provides, in general, that a partnership may not, without the consent of the Secretary or his delegate, either adopt a fiscal year or change from a calendar year to a fiscal year. The same requirement is made applicable to partners shifting from a calendar year to a fiscal year basis. It is contemplated that the use of a fiscal year will be approved where valid business reasons for such an accounting period are shown.

Under present law the death of a partner may result in the closing of the partnership year and the bunching of more than a year's income in the decedent's last year. Where the partnership and the partners are on different taxable years, this rule may have the effect of concentrating as much as 23 months' income in the final return of the deceased partner, that is, the income for the partnership year ending within his taxable year and the income for the taxable year closed by the partner's death. The bill provides that the partnership year is not to close on the death of the partner. The partnership year will then run to its normal conclusion, and the decedent's share of the income for such year will be taxable to the estate. To the extent that the right to receive such income constitutes income in respect of a decedent, the estate is entitled to a deduction for the estate tax attributable to the inclusion of such right in the decedent's estate.

The bill further provides that the taxable year of a partnership is not to close as a result of the admission of a new partner, the liquidation of a partner's interest by means of a distribution, or a sale or exchange of a partner's interest in the partnership. Thus, it would not be possible by the admission of a new partner to terminate the partnership taxable year and commence a new partnership year. However, the partnership year does close if there is a termination of the partnership. A termination is defined for this purpose as a discontinuance of the business activities carried on by the partnership, or the sale of an interest of more than 50 percent in partnership capital or profits to persons not members of the partnership. The partners may choose to ignore the termination if they wish to continue to the close of the normal partnership year.

While the partnership year does not close for the continuing partners when a partner severs his interest in the partnership, the partnership year does close with respect to such partner. When a partner merely reduces his interest in a partnership, the partnership taxable year is not closed, but the amount of his distributive share must be determined with regard to the varying interests which he held during the year.

(4) *Transaction between partner and partnership.*—When a partner sells property to, or performs services for the partnership, a determination must be made as to whether the transaction is to be treated in the same manner as though the partner were an outsider dealing with the partnership (the "entity" approach). An alternative ("aggregate" approach) is to view the partner as dealing with himself to the extent of his own interest and as dealing with the partnership with respect to the balance of the transaction. The present code does not cover the problem and judicial decisions on the subject go in either direction. The "entity" rule has been adopted by the bill.

However, under the prescribed rule, a sale between the partnership and a partner will not be recognized if it involves a "controlling" partner, that is, a partner who owns 50 percent or more of a capital or income interest in the partnership. Where a sale involves a controlling partner, any money or property passing between the partner and the partnership is treated in a manner which, in general, prevents the recognition of gain or loss. The basis of the property transferred remains unchanged.

Under present law, fixed payments to a partner are not recognized as a salary but considered as a distributive share of partnership earnings. The existing approach has been to treat the fixed salary in years in which earnings are insufficient to meet the salary as a withdrawal of capital, taxable to the extent that the withdrawal is made from the capital of other partners. The bill provides that payment of a fixed or guaranteed amount for services shall be treated as salary income to the recipient and allowed as a business deduction to the partnership.

B. Contributions to a partnership (secs. 721–723)

Contributions to a partnership have the same effect under the proposed provisions as under present practice. No gain or loss is recognized either to the contributing partner or to the partnership. The property contributed to a partnership has the same basis to the partnership for purposes of gain, loss, depreciation, etc., as in the hands of the contributor.

The basis of the contributing partner for his interest in the partnership is increased under the bill by the basis of the property transferred to the partnership. If the contributed property is subject to a debt, the basis of the contributing partner's interest is reduced by the portion of the indebtedness assumed by the other partners.

C. Distributions by a partnership (secs. 731–735, 737)

The bill provides a new method for determining the basis of property distributed by a partnership and the adjustments to the basis of the interest in the partnership. These rules are applicable whether the distribution is out of income or partnership capital, and whether the distribution is pro rata to all the partners or has the effect of changing the respective partnership interests.

Under the bill, any property distributed by the partnership to a partner, in general, has the same basis to the distributee partner as in the hands of the partnership, i. e., a "carryover" basis. The money and property distributed is applied in reduction of the basis of the interest of the distributee partner. After the basis of his interest has been used up, any further distribution of money or property is taxed as capital gain to the distributee.

The distribution of money or property does not result in gain or loss to the partnership. Gain or loss is recognized to the recipient partner only in two cases. Gain is recognized, as indicated above, where the basis of any money or property received by a partner exceeds the basis of the partner for his interest in the partnership. The recognition of gain may occur either in a current distribution not affecting the partner's interest in the partnership, or in a distribution which reduces or terminates the partner's interest in the partnership. The recognition of loss is limited to a distribution terminating the interest of the partner. In such a liquidating distribution, capital loss is recognized to the extent that the basis of the partner for his interest in the partnership exceeds the basis to the distributee of the property distributed.

An exception is made to the use of the "carryover" basis where the basis of the property distributed exceeds its value at the time of the distribution. In this situation the basis of the property to the distributee is reduced to such fair market value. The partnership, however, is permitted to retain this "unused basis" and apply it to similar property held by the partnership.

Consistent with the use of the "carryover" basis, the holding period to the partner of distributed property includes the holding period of the property to the partnership.

A special rule has been provided for the purpose of distinguishing distributions which are subject to the rules discussed above from transactions involving a loan by the partnership to the partner. When a partner is obligated to make repayment to the partnership with respect to money or property received from the partnership, he is treated under the bill as receiving a loan to the extent of his obligation, and no reduction is made in the basis of his interest. If, however, such an obligation is canceled by the partnership without repayment, the partner will then be considered to have received a distribution equal to the amount of debt canceled. The transfer of property subject to an obligation to make repayment is treated as a sale by the partnership, so that gain or loss will be recognized to the partnership.

The provisions relating to distributions are subject to the special rules, discussed below, relating to unrealized receivables or fees, inventory or stock in trade which has substantially appreciated or depreciated in value, and payments to a retiring partner or the estate or heir of a deceased partner.

Present law requires that a portion of the basis of the distributee for his interest in the partnership be assigned to the property distributed. The use of the "carryover" basis eliminates the need for rules of allocation of basis as between capital assets and noncapital assets, and renders unnecessary any adjustment to the basis of the remaining assets in the partnership other than in the case where the distributed property has a value less than its basis.

The proposed rules for contributions to, and distributions by, a partnership, in effect, permit the tax-free transfer of property into or out of a partnership. Generally speaking, the basis of the property remains unchanged through the formation and dissolution of a partnership. This is made possible by reducing the basis of the distributee's interest in the partnership by the basis of the distributed partnership propety and by the recognition of gain or loss in the case of certain distributions.

D. Transfer of an interest in a partnership (secs. 741-743, 751)

(1) *General rules.*—Under present decisions the sale of a partnership interest is generally considered to be a sale of a capital asset, and any gain or loss realized is treated as capital gain or loss. It is not clear whether the sale of an interest whose value is attributable to rights to uncollected income gives rise to capital gain or ordinary income. There is also doubt under present law whether the basis of the assets of the partnership may be adjusted, or is required to be adjusted, to reflect the purchase price paid by a new partner for his interest.

The general rule that the sale of an interest in a partnership is to be treated as the sale of a capital asset is retained by the bill. In general, the transfer of an interest will not affect the basis of partnership assets. Provision is made, however, whereby the partnership may elect to adjust the basis of partnership assets to reflect the increase or decrease in the basis of the partnership interest transferred by sale or upon the death of a partner. Such an election, once filed, is irrevocable until the termination of the partnership and will require similar basis adjustments with respect to all future transfers of partnership interest. By making adjustments to the basis of partnership assets, the same effect is achieved as though the partnership had dissolved and been reformed, with the transferee of the interest as a member of the partnership. The increase or decrease in the basis of partnership assets may be allocated to such assets in accordance with their respective bases or in any other equitable manner approved by the Secretary or his delegate.

It is to be noted that, if the election to increase or decrease the basis of partnership property is made, the change in the basis of the partnership assets will affect all members of the partnership according to their distributive shares and not merely the transferee partner.

(2) *Unrealized receivables or fees and inventory or stock in trade.*—The bill provides that, if in connection with the transfer of a partnership interest, the partner receives any amount attributable to his share of (1) the unrealized receivables and fees of the partnership or (2) substantially appreciated or depreciated inventory or stock in trade, such amounts are to be treated as ordinary gain or loss. In effect, the partner is treated as though he disposed of such items independently of the rest of his partnership interest.

Since an ordinary income tax is paid by the seller on these items, the purchaser of an interest is permitted to deduct from his gross income an amount equal to the income recognized by the seller with respect to such items. This amount may be spread ratably over the period of time in which it is estimated that the unrealized receivables and fees will be collected or the inventory will be disposed of, or may be allocated in any other equitable manner which is approved by the Secretary.

A decedent partner's share of unrealized receivables and fees will be treated as income in respect of a decedent. Such rights to income will be taxed to the estate or heirs when collected, with an appropriate adjustment for estate taxes. However, a decedent's share of appreciated or depreciated inventory or stock in trade is not treated as income in respect of a decedent. The decedent's interest in such inventory or stock in trade will be increased or decreased in basis in the same manner as other property held by the decedent. The change in basis at the time of death will not be reflected in the basis of partnership assets but will be used by the estate or heir as an adjustment to the income received on the disposition of such property. The estate or heir is thus treated in the same manner as a purchaser with respect to the decedent's interest in appreciated or depreciated inventory or stock in trade.

The term "unrealized receivables or fees" is used to apply to any rights to income which have not been included in gross income under the method of accounting employed by the partnership. The provision is applicable mainly to cash basis partnerships which have acquired a contractual or other legal right to income for goods or services. "Substantially appreciated or depreciated inventory or stock in trade" includes any noncapital assets, the value of which exceeds by more than 20 percent the basis of such inventory and exceeds by more than 10 percent the basis of all partnership property other than money.

The treatment provided upon the sale of an interest in income items is also extended to any distribution by the partnership to a partner.

The provisions relating to unrealized receivables or fees and appreciated or depreciated inventory prevent the use of the partnership as a device for obtaining capital-gain treatment on fees or other rights to income. Amounts attributable to such rights would be treated as ordinary income if realized in normal course by the partnership. The statutory treatment proposed, in general, regards the income rights as severable from the partnership interest and as subject to the same tax consequences which would be accorded an individual entrepreneur.

E. Payments to a retiring partner or a successor in interest of a deceased partner (sec. 736)

When a partner retires or payments are made to the estate or heir of a deceased partner, the amounts paid may represent several items. They may, in part, represent the withdrawing partner's capital interest in the partnership. They may include his pro rata interest in unrealized receivables and fees of the partnership and its potential gain or loss on inventory. Part of such payments may also be attributable to an arrangement in the nature of mutual insurance among the partners. The present code contains no provisions relating to the tax treatment of such payments and existing case law presents no consistent approach.

When a retiring partner or the successor of a deceased partner receives a share of partnership income in return for the complete relinquishment of the interest in the partnership, under the bill the distributions will be allocated between (*a*) payments for the value of the capital interest and (*b*) other payments. Such allocation will be made in accordance with regulations prescribed by the Secretary or his delegate.

The amounts paid for the capital interest of the withdrawing partner under the bill are treated in the same manner as a distribution. The remaining partners are allowed no deductions for such payments. For this purpose payments for a "capital interest" do not include amounts attributable to a partner's interest in unrealized receivables and fees, amounts paid for substantially appreciated or depreciated inventory, and amounts paid for good will in excess of its fair market value.

A different treatment is provided under the bill for the portion of the payments to a withdrawing partner which is not made in exchange for the capital interest of such partner. Such payments are treated as a distributive share of partnership income to the withdrawing partner. Thus, they are taxable to the withdrawing partner in the same manner as if he continued to be a partner and are excluded in determining the income of the remaining partners. However, if such payments are continued for a period of more than 5 years after the retirement or death of the partner, they are treated as a gift from the remaining partners to the withdrawing partner. Accordingly, these payments are taxable to the remaining partners (with no increase in the basis of such partners for their interest in the partnership) and are exempt from income tax in the hands of the recipient.

XXII. Temporary Formula for Taxing Life-Insurance Companies (Sec. 802)

For the past 3 years life-insurance companies have been taxed under temporary provisions which apply a flat rate tax of 3¾ percent on the first $200,000 and 6½ percent on amounts in excess of $200,000 of net investment income with certain adjustments. First adopted in 1951 as a temporary expedient, these provisions were successively extended to 1952 and 1953. The bill provides for the extension of these provisions for 1 more year.

The proposed extension is for 1 year only to provide time in which to work out a sound long-range formula for the taxation of life-insurance companies. A subcommittee of the House Committee on Ways and Means has been set up for this purpose.

XXIII. Regulated Investment Companies

Regulated investment companies which meet various requirements with respect to asset diversification, capital structure and operations and which distribute at least 90 percent of their ordinary income are treated as conduits of income and taxed only on their undistributed income. Dividends paid by such companies are taxed in the usual manner to shareholders except that dividends arising from capital gains realized by the company are identified and receive capital-gains treatment in the hands of the recipient. The bill continues these basic provisions with only two significant changes.

A. *Foreign tax credit* (*sec. 853*)

Existing law grants citizens and domestic corporations a credit against income tax due for any income, war profits, and excess profits taxes paid or accrued to a foreign country. A regulated investment company ordinarily receives little or no tax benefit from the credit for foreign taxes withheld because it does not pay sufficient income tax to utilize the tax credit. The bill permits the shareholders of regulated investment companies to take the foreign tax credit for foreign income and similar taxes paid on the investment income of the company in the same manner as if they had held the foreign investments themselves. However, the passing on of the foreign tax credit is to be limited to situations in which more than 50 percent of the value of the assets of the regulated investment company is invested in foreign securities.

B. Dividends-received credits (*secs. 854, 855*)

Under existing law corporate investors in regulated investment companies receive the usual 85 percent dividends-received credit on dividends paid by the investment companies, including those identified as capital-gain distributions. Part of the dividends may, however, arise from interest on bond investments of the regulated investment company. Since neither the corporation paying the interest nor the regulated investment company will have paid tax on that amount, there is no justification for a dividend received credit. A similar problem arises in connection with the application to individual shareholders in regulated investment companies of the dividend exclusion and dividends-received credit for individuals, contained elsewhere in this bill.

Under the bill, if more than 25 percent of the income of the regulated investment company is from interest, both the dividends-received deduction for corporations and the dividend exclusion and credit for individuals provided by this bill are to be available only on the portion of the regulated investment company's distributions which actually represents dividend income. If less than 25 percent of the company's income is from interest, the dividend credits and allowances will apply to the entire distribution by the regulated investment company.

XXIV. Foreign Income

A. Nonresident aliens and foreign corporations (*secs. 864, 871, 881*)

Under existing law, nonresident aliens who are employed by a foreign subsidiary of a domestic corporation are not taxed on compensation received for services performed while in United States provided their stay in United States does not exceed 90 days in the taxable year and the compensation does not exceed $3,000. The bill extends the same treatment to nonresident alien employees of a foreign branch of a domestic employer.

The bill provides that the tax base for nonresident aliens is extended to include capital gains. Similarly, the tax base for foreign corporations not engaged in business in United States is enlarged to include capital gains.

B. Foreign tax credit (*secs. 901–905*)

Existing law provides that foreign income, war profits, or excess profits taxes may be taken either as a credit against the United States tax or as a deduction at the election of the taxpayer. The credit for foreign taxes is subject to a per country limitation and an overall limitation. The per country limitation restricts the foreign tax which may be claimed as a credit to an amount bearing the same proportion to the taxpayer's total tax liability as his income from the foreign country bears to his total income. The overall limitation applies a similar formula with respect to the aggregate of foreign taxes otherwise allowable as a credit.

Existing law also provides that a foreign tax credit may be taken for foreign taxes that are imposed "in lieu of" income, war profits, or excess profits taxes. Where a domestic corporate taxpayer owns at least 10 percent of the voting stock of a foreign corporation, it is allowed credit for a proportionate part of any foreign income, war profits, or excess profits taxes paid by the foreign corporation, based on the ratio of the dividends it receives from the foreign corporation to the accumulated profits from which the dividends were paid. Similarly, if such a foreign corporation, in turn, owns 50 percent or more of the voting stock of another foreign corporation, the foreign parent is deemed to have paid a proportionate part of the foreign taxes paid by its subsidiary.

The bill makes a number of important changes in the foreign tax credit.

(1) The overall limitation is eliminated, thus preventing losses in one foreign country from reducing the allowable foreign tax credit for taxes paid to another country.

(2) The "in lieu of" concept is supplanted by the "principal tax" concept. Under the "principal tax" concept, the taxpayer may claim a credit either for the traditional income, war profits, and excess profits taxes or for a principal tax levied by a national government. The principal tax is defined as the tax imposed on the taxpayer's trade or business which constitutes the principal source of tax revenue from that business to the foreign country. However, sales, turnover, property, or excise taxes are excluded if they are generally imposed.

(3) In limited circumstances, the receipt of property in the form of a royalty from a wholly owned foreign subsidiary is treated as a dividend distribution for purposes of the foreign tax credit.

C. Definition of noncorporate foreign income (secs. 911, 912)

Income earned abroad by United States citizens who are bona fide residents of a foreign country is excluded from United States income tax. (The exemption also applies to the extent of $20,000 per year for presence in a foreign country for 17 out of 18 months.) If the taxpayer is engaged in a trade or business in which both personal services and capital are material income producing factors, existing law permits a maximum of 20 percent of the income from the business to be treated as earned income. The bill increases this percentage to 30 percent.

D. Western Hemisphere trade corporations (secs. 921, 922)

The treatment of Western Hemisphere trade corporations remains substantially unchanged from existing law except for a new provision that incidental purchases outside the Western Hemisphere will not disqualify a corporation which is otherwise entitled to the 14-point differential.

E. Business income from foreign sources (secs. 37, 923)

The bill provides a new credit against tax to the extent of 14 percent of the following classes of business income derived from foreign sources:

(1) Income from branches engaged in specified activities.

(2) Income received as compensation for the rendition of technical, engineering, scientific, or like services.

(3) Dividends received from a foreign corporation under specified conditions.

(4) Interest received from a foreign corporation under specified conditions.

In the case of qualifying foreign branches, the credit is available when the income is brought home and is includible in the corporation's gross income under the provisions (discussed below) relating to the deferral of branch income.

The foreign income credit applies to dividends received from a foreign corporation if the foreign corporation derives at least 95 percent of its earnings outside the United States and at least 90 percent from the active conduct of a trade or business. These requirements are comparable to those provided in qualifying for Western Hemisphere trade corporation treatment. The trade or business, however, must be conducted through a factory, mine, oil or gas well, public utility facility or other like place of business situated within the foreign country. In addition, not more than 25 percent of the income may be derived from the sale of products manufactured in the foreign country but intended for use, consumption, or sale in the United States. There is excluded from the definition of a trade or business (1) any establishment which is pricipally engaged in the purchase or sale of merchandise (other than a retail sales establishment), and (2) the employment of an agent for import purposes. To qualify for the credit on such dividends, the domestic corporation, either alone or in conjunction with not more than 3 other domestic corporations, must own more than 50 percent of the voting stock of the foreign corporation. As an alternative, the credit is available if the domestic corporation owns at least 10 percent of the voting stock of the foreign corporation and furnishes know-how services to it. These requirements must be fulfilled both in the year the profits were earned as well as in the year the dividends are paid by the foreign corporation.

In the case of interest received by a domestic corporation from a foreign corporation, the same qualifications as to ownership, type of income, and active conduct of a trade or business apply as in the case of dividends, except that the requirements have to be met only in the year in which the interest is paid.

The credit may not offset more than 14 percent of the taxable income where there is income from country X but where the corporation's only other activities result in a loss from domestic operations. The credit is not available to the following types of domestic corporations: (1) A corporation allowed a Western Hemishpere Trade Corporation deduction or a China Trade Act deduction; (2) a regulated investment company; (3) an insurance company; (4) a personal holding company; (5) a shipowner's mutual protection and indemnity association.

F. China Trade Act corporations (secs. 941–943)

The special deduction allowed China Trade Act corporations under existing law (formerly a credit against net income) is retained, except that the definition of China has been deleted and the deduction is made applicable to persons resident in Formosa instead of China and only to United States citizens. Similarly, dividends from China Trade Act corporations may be excluded by residents of Formosa but not by residents of China as under existing law.

G. Deferral of tax on branch income (secs. 951–958)

The House bill contains a new treatment for foreign branches of domestic corporations which substantially equates the treatment of a foreign branch with that of a foreign subsidiary. Under the bill, a domestic corporation may elect to defer taxation of income allocable to its foreign branch until such time as the income is withdrawn from the branch and included in gross income of the domestic corporation under the rules set forth in the bill.

To qualify for the deferral provisions the branch must derive at least 90 percent of its income from the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business, and 95 percent of its income must be from sources outside the United States. These requirements are the same as those imposed for purposes of determining whether dividends from a foreign corporation qualify for the foreign income credit. Similarly, the deferral of tax on branch income is denied if more than 25 percent of its income is derived from the manufacture of goods intended for use or sale in the United States.

The election to defer is available for each separate foreign branch of the taxpayer even though more than one branch may be operated in a foreign country. Where the election is exercised, the foreign branch is treated as a separate entity and a completely separate set of accounts must be maintained to reflect the operations of the branch. Transactions between the branch and home office are to be treated as though the branch were a separate corporation dealing at arm's length with the home office. Thus, the gross income, expenses, losses, deductions, and other items properly allocable to the branch are not to be taken into account in determining the taxpayer's income until the branch income is withdrawn from the branch. The domestic corporation is not entitled to percentage depletion with respect to branch operations. Also, any gain or loss on transactions between the domestic corporation and the branch is to be determined in the same manner as if the branch were an independent entity. Thus, any loss incurred by the branch may not be offset against other income of the corporation. In determining when branch income is withdrawn and thus includible in the income of the domestic corporation, the amount considered withdrawn is the excess of the taxpayer's investment in the branch at the beginning of the year plus the branch income for the year (or minus the branch loss for the year) over the investment in the branch at the close of the year; however, the amount deemed withdrawn may not exceed the accumulated branch income. This prevents a decrease in investment which is a return of capital from being taxed as income.

The taxpayer may not deduct foreign taxes allocable to a branch as to which the election applies, even though it actually pays the taxes. The deduction instead is permitted to the branch in computing its branch income. When the branch income is withdrawn and includible in the domestic corporation's income, the latter is entitled to a proportionate foreign tax credit based on the includible branch income which bore the burden of the taxes attributable to the branch. This treatment is analogous to that afforded with respect to foreign taxes paid by a foreign subsidiary of a domestic corporation.

The election of branch treatment may be terminated either voluntarily by the taxpayer or involuntarily when the branch fails to meet the requirements imposed for such treatment. Once the election is terminated, the taxpayer may reelect branch treatment only with the consent of the Secretary or his delegate.

The corporations which are ineligible for the foreign income credit are also denied the election to defer tax on branch income. In addition the domestic corporation may not elect the branch income treatment if (1) more than 50 percent of its stock in value is owned, directly or indirectly, by alien individuals or (2) if it is exempt from tax as an exempt organization.

H. Revenue effect

It is estimated that the provisions dealing with foreign income would involve a revenue loss of $147 million in the fiscal year 1955.

XXV. Gain or Loss on the Sale of Property

A. Change in basis of property acquired from a decedent (sec. 1014)

Under existing law most property transferred as a result of the death of an individual receives a new basis at the date of death equal to its then market value (or value 1 year later if the estate-tax optional valuation date is used). This change in basis is not available, however, with respect to property included in the decedent's gross estate for estate-tax purposes if the property was transferred in contemplation of death, was acquired by the surviving tenant of a joint tenancy or tenancy by the entirety, or was included in the gross estate as a reserved income transfer.

The bill provides a new basis at date of death (or 1 year later if the optional valuation date is used) for nearly all property includible in the decedent's gross estate for estate-tax purposes. The only exceptions to this general rule are income in respect of a decedent, unexercised restricted stock options and the survivor's interest in a joint and survivor annuity. Under that provision when the income is reported for income-tax purposes by the estate or beneficiary, a deduction is allowed for any estate tax attributable to the values included in the decedent's gross estate. This is a substitute for the new basis at death.

B. Depreciation sustained while property is used by a tax-exempt organization (sec. 1016)

Where a tax-exempt organization which has held a property for a number of years becomes taxable (as in the case of the application of the unrelated business income tax since the Revenue Act of 1950) questions have been raised as to what basis the property should have for purposes of computing depreciation for income-tax purposes.

The present code does not deal specifically with this problem. The bill endorses the position taken by the Internal Revenue Service by specifically providing that the basis of the property is reduced for depreciation, to the extent sustained during any period since 1913 when the property was held by an organization not subject to income taxation.

C. Sale of an annuity contract (sec. 1021)

A rule is provided to prevent the operation of the new rule for taxing annuities from resulting in a basis of less than zero in the case of a sale of an annuity contract. Otherwise, the general rules for computing gain or loss on the sale of property apply.

D. Sale or exchange of a residence (sec. 1034)

The Revenue Act of 1951 eliminated in most cases the immediate recognition of a capital gain on the sale of a taxpayer's principal residence, provided that the proceeds are used to acquire a new residence. In the case of qualifying sales the basis of the old residence is carried over to the new residence.

Present law provides that gain is recognized only to the extent that the selling price of the old residence exceeds the cost of the new. However, the selling price may not be reduced by the expenses of sale or by expenses of fixing the residence for purposes of the sale. Under the bill, the selling price is reduced, for purposes of recognizing gain by selling expenses and repairing expenses incurred within the period the sale was effected.

Another change in present law provides that the involuntary conversion of property used both as a personal residence and as business property will be subject to the replacement requirement for business property (18 months plus permissive extensions) rather than the 1-year replacement requirement on residences.

The special provision allowing members of the Armed Forces a period of 4 years to purchase a new residence was due to expire on January 1, 1954. This expiration date has been eliminated.

E. Mortgage foreclosures (sec. 1035)

The regulations treat a foreclosure as a sale and provide that the creditor recognizes gain or loss based on the difference between the fair market value of the property and the portion of the loan which is satisfied by the proceeds of the foreclosure sale. The amount of any remaining unsatisfied indebtedness is allowed as a bad debt deduction. Under the bill recognition of gain or loss is postponed until the creditor disposes of the property. The foreclosed property assumes the same basis as the debt plus foreclosure expenses and less later payments by the mortgagor. Taxable gain or loss is to be realized on ultimate disposition of the property, and on payments by the mortgagor after disposition. The gain or loss will be capital gain if the mortgage is a capital asset in the hands of the mortgagee and the gain or loss will be ordinary if the mortgage is not a capital asset..

F. Exchanges of insurance policies (sec. 1036)

Under present law, where one insurance policy is exchanged for another, the excess of the value of the policy received over the premiums paid for the exchanged policy is taxable. The bill provides that no gain or loss is to be recognized on the exchange of—

(1) a life-insurance contract for another life-insurance contract or for an endowment or annuity contract;

(2) an endowment contract for another endowment contract or for an annuity contract; and

(3) an annuity contract for another annuity contract.

In the three types of nontaxable exchanges listed above, the contract received by the taxpayer will take the basis of the contract exchanged for it, with adjustments for other payments accompanying the transfer. When an endowment contract is exchanged for a life insurance contract, gain will continue to be recognized at the time of the exchange.

XXVI. Capital Gains and Losses

The treatment of capital gains and losses is not basically changed in this bill. The application of capital gains taxation in the case of certain special types of assets, or transactions, however, has been revised.

A. Definition of capital asset to exclude certain accounts and notes receivable (sec. 1221)

Under present law a taxpayer is required to take into income the value of an account or note receivable acquired in the sale of inventory or stock in trade, or in connection with the rendering of services. Unless the taxpayer is a dealer in accounts and notes, however, he receives only a capital loss if he sells the account or note for less than he previously took into income.

The House bill provides ordinary loss or income treatment where an account or note, acquired in the manner described above, is sold or exchanged. This is the treatment presently applicable if the account or note is held until maturity.

B. Holding period (sec. 1223)

Present law, in determining long- or short-term capital gains and losses, permits the holding period of an asset given up in a tax-free exchange to be added to the holding period of an acquired asset. The bill permits the adding of the two holding periods only where both assets are capital assets.

Under both present law and the bill, a taxpayer who holds a commodity futures contract for more than 6 months, and then sells it, has a long-term capital gain or loss. However, under present law if at any time he accepts delivery of the commodity, his holding period starts again as of that time. The bill provides that delivery in such a case does not start a new holding period.

C. Short sales and options (secs. 1233, 1234)

Under present law a short sale always results in a capital gain or loss. Under the bill the gain or loss will be the same type as if the property used to close the sale had been sold for immediate delivery rather than through a short sale. Hedging transactions in commodity futures will continue to result in ordinary gain or loss.

Under present law in the case of the failure to exercise an option the holder of the option always realizes a short-term capital loss and the grantor a short-term capital gain; in the case of the sale of an option the holder (unless a dealer in options) realizes a long- or short-term capital gain or loss depending on how long he held the option. The bill provides consistent treatment for sale and failure to exercise an option and in the case of the holder of the option makes the treatment as capital gain or ordinary income depend on whether the character of the property to which the option applied. The grantor of the option always will receive ordinary income on the failure to exercise any option.

Present law does not count as part of a holding period any period in which a taxpayer is both long and short with respect to substantially the same investment. A short sale is defined to include a put for this purpose. Since puts can be used for tax avoidance only if the property had appreciated prior to the purchase of the put, it is provided that puts purchased the same day as stock that can be used in the exercise of the put (and, if the put is exercised, the stock purchased on that date is so used) are not classified as short sales.

D. Bonds and other debt (sec. 1232)

Under existing law gain realized from a corporate or Government bond in registered form or with coupons attached is capital gain if the bond is sold, exchanged, or held to retirement. In the case of noncoupon, nonregistered bonds any gain or retirement is ordinary income.

In the case of bonds and other evidences of indebtedness issued after December 31, 1954, the bill makes two changes. Capital gain treatment on retirement is extended to noncoupon, nonregistered bonds. In the case of both kinds of bonds a provision is inserted to tax the recovery of the original issue discount as ordinary income. If the bond is held over 6 months and sold prior to maturity, the gain realized up to a pro rata portion of this discount is taxed as ordinary income, the excess is taxed as capital gain. The rule may be illustrated as follows: An individual purchases a 10-year bond with coupon interest at 3 percent from an investment bank at a price of 90 on February 1, 1955. The redemption price is 100. It is sold February 20, 1960, at 97. The bond has been held for 60 months of its life of 120. The fraction 60 over 120 multiplied by the discount of 10 yields 5. The gain up to 5 would be taxed as ordinary income and the balance of 2 is capital gain.

E. Sale of patents by an inventor (sec. 1235)

Under present law an amateur inventor may receive capital gains treatment on the outright sale of his patent but a professional may not. However, if a sale arrangement results in royalty income, rather than installment payments, even an amateur inventor receives ordinary income tax treatment.

The bill removes the distinctions between amateurs and professionals and between royalty income and installment sales. If the inventor disposes of all his interest in the patent under the contract, and all payments under the contract are required to be completed within 5 years, the payments will be treated as capital gains. The price may depend upon the productivity use or disposition of the patent in the hands of the buyer during this 5 year period. If the payments will extend over more than a 5-year period, they will be treated as ordinary income.

F. Investment account of real estate dealers (sec. 1237)

Present law results in uncertainty in distinguishing between real estate held by real estate dealers for sale to customers (which results in ordinary gain when sold) and real estate held for investment (which results in capital gain when sold).

The bill provides that all gain, except an amount attributable to the effort of the dealer in selling the property (5 percent of sale proceeds less expenses), will be treated as capital gain if:

1. The property is specially identified as being held for investment within 30 days of acquisition or 90 days after the date of enactment.
2. The dealer makes no substantial improvement in the property.
3. The property is held for 5 years.

Gain from property, whether or not identified as being held for investment, which does not meet test 2 or 3 will be classed as ordinary or capital gain under the general tests provided for sales of property. This section is limited to individuals.

G. Sale of subdivided real estate (sec. 1238)

At present, an individual who subdivides real property held for investment purposes is likely to be held a dealer and subjected to ordinary income tax rates on the entire long-term gain.

The bill provides that a taxpayer, not otherwise a dealer in real estate, subdividing real estate may report income from the sales of lots as capital gains. The taxpayer must, in general, have held the property for 5 years and must have made no substantial improvement. In such cases the first five sales may be made subject only to capital gain or loss treatment. In the year in which the sixth sale is made, and in any subsequent sales of the property, the subdivider is treated in substantially the same manner as provided in the case of investment accounts of real estate dealers.

H. Private annuities (sec. 1241)

Private annuities involve the exchange of property for a promise on the part of the buyer to pay a life income. Presently, the tax treatment of these transactions is in an uncertain status due to conflicting court decisions.

Under the bill the capital gains tax is to be imposed on the seller of the property in the year of the exchange on any excess of the value of the annuity, plus other consideration received, over his basis for the property. The annuity is not to be discounted for the financial condition of the person agreeing to pay the annuity. Moreover, a taxable gift element may be recognized in the exchange. In addition to the capital gains tax, the seller of the property is to pay tax under the new annuity rule, using the value of the annuity to determine his exclusion.

The purchaser of the property (the payor of the annuity) may have an interest deduction for part of the annuity payment. His basis for the property acquired initially is to be determined by reference to the purchase price for the property including the value of the annuity. Later mortality gain or loss is to result in a basis adjustment to the property (or capital gain or loss if the property has been disposed of).

XXVII. Readjustment of Tax Between Years

A. Averaging (secs. 1301–1304)

Present law provides a spreading back of income for tax purposes in many situations where income earned over a period of years is received in 1 year. The bill retains this treatment but incorporates three substantive changes in existing law. It provides (1) that a partner cannot spread back his distributive share of partnership income earned in prior years to years prior to his becoming a member of the partnership, (2) that the maximum period over which income from an invention can be spread back is increased from the present 36 months to 60 months, and (3) that a taxpayer, in computing the tax attributable to income spread back to earlier years, is not to have the benefits of income splitting for years prior to 1948 (even though he filed a joint return for the year of receipt).

B. Adjustments to closed taxable years (secs. 1311–1315)

Under existing law an adjustment of the tax may be made for years otherwise barred by the statute of limitations where either the taxpayer or the Commissioner of Internal Revenue maintains a position in an open taxable year inconsistent with the position adopted with respect to the same item in the closed year. An adjustment is also permitted in closed taxable years under certain conditions where the taxpayer claimed a deduction in the wrong taxable year or the Commissioner included an item of income in the wrong year.

In addition to technical amendment describing the circumstances under which the adjustment to closed taxable years may be made, the bill makes two significant changes.

At the present time the adjustment to closed taxable years may be made only on the basis of a final determination of the tax liability with respect to the open year. The final determination must be either a decision of a court, a closing agreement, or a formal allowance or disallowance of a refund claim. The bill provides that adjustment in the closed year may be made on the basis of an informal determination signed by the taxpayer and on behalf of the Commissioner. The informal determination will not be binding on the parties, but if the determination should later be altered or revoked, the adjustment in the closed year will also be revised.

Under present law the adjustment is limited to a recomputation of tax for the year of the error. Such an adjustment may be wholly inadequate where there was, for example, a net operating loss in the year of the error which affects the tax for other years. The adjustment provisions have accordingly been amended to take into account not only the corrected tax liability for the year of the error but changes in taxes for other years resulting from changed net operating loss or capital loss carryovers.

C. Involuntary liquidation of LIFO inventory (sec. 1321)

Under existing law taxpayers on the LIFO inventory basis are given special treatment in the case of involuntary liquidations of inventories occurring after January 1, 1950, and before January 1, 1954, which are related to war conditions or to the disruption of normal trade channels which caused a scarcity of the inventory goods, provided that replacement is made prior to January 1, 1956. If these conditions are met, an appropriate adjustment is allowed for the year of liquidation to cover the cost of replacing that inventory in the later year.

The bill provides that this treatment may be applied to involuntary liquidations occurring in any taxable year ending before January 1, 1955. This section has not otherwise been changed from present law.

D. Claim of right (sec. 1341)

Under present law a taxpayer may take a deduction in the year of restitution where he is obliged to repay amounts which he received and included in income in a prior year because it appeared that he had an unrestricted right to such amounts. The deduction allowable in the later year may not compensate the taxpayer adequately for the tax paid in the earlier year.

The bill provides that if the amount wrongfully received exceeds $3,000, the taxpayer may recompute the tax for the prior year, excluding from income the amount repaid. This is an alternative to taking the deduction in the year of restitution.

XXVIII. Consolidated Returns

The bill makes several changes in the provisions of existing law allowing the filing of consolidated returns by an affiliated group of corporations. It retains, however, the 2 percent additional tax on the income of an affiliated group exercising the privilege of filing such a return, just as the 85 percent intercorporate dividends credit has also been retained although changed to a deduction.

A. Inserting the consolidated return regulations into the code (*secs. 1501–1718*)

Since the Revenue Act of 1928, the law has provided that the Secretary is to prescribe regulations, legislative in character, giving detailed rules for the filing of a consolidated return by an affiliated group of corporations. These regulations are inserted into the law, changed only to the extent necessary to reflect changes made elsewhere in the code.

The filing of a consent to the regulations on joining in the filing of a consolidated return is no longer necessary.

B. Change in affiliation test (*sec. 1502*)

Present law provides that for corporations to join in the filing of a consolidated return, one must own 95 percent of the outstanding stock of the other. The bill lowers this stock ownership affiliation test to 80 percent.

C. Election to file consolidated returns (*sec. 1505*)

Under both present law and the bill, once the members of an affiliated group of corporations have joined in filing a consolidated return they are required to continue to do so for subsequent years unless one of certain specified conditions occur.

One of the conditions under present law which gives the members of an affiliated group a new election arises when there has been an amendment to the tax laws which makes the filing of consolidated returns less advantageous to affiliated groups generally. The bill retains this and the other conditions under which a new election is available. It also makes clear that the expiration of a provision is to have the same effect as an amendment to the tax law in determining whether such a new election is available.

D. Earnings and profits (*sec. 1732*)

Neither the present code nor regulations indicate how the tax imposed on an affiliated group of corporations filing a consolidated return is to be allocated among the various members in determining their accumulated earnings and profits.

The bill provides four alternative elective methods for determining the reduction in the accumulated earnings of each member of an affiliated group joining in the filing of a consolidated return. The four methods are:

(1) Under the first alternative, the tax is apportioned among the members in accordance with the taxable income each has produced, disregarding any member which has a loss. This rule is to be followed where the affiliated group fails to make any election on its first return.

(2) Under the second alternative, the tax liability of the group is allocated to the several members on the basis of the percentage which the tax each member would have paid had it filed a separate return is of the aggregate of these separate taxes.

(3) The third alternative is the same as the first but with the additional requirement that the tax attributable to any subsidiary member of the affiliated group is not to be higher that it would have been had such member filed a separate return and any excess of such tax is to be attributed to the members of the affiliated group, the tax of which is lower by reason of joining in the filing of the consolidated return or to the parent corporation.

(4) The fourth alternative would permit the tax liability of the group to be allocated in accordance with any other method selected with the approval of the Secretary.

XXIX. Disallowance of Minimum Exemption and Credit (Sec. 1731)

Under present law, if a corporation transfers property (other than money) to another corporation which it controls and which was created or utilized for the purpose of receiving the transferred property in order to obtain either an additional $25,000 minimum surtax exemption or an additional $25,000 minimum excess profits tax credit, the benefit of the additional credit or exemption is disallowed to the transferee corporation. Under existing law, this provision is not applicable with respect to taxable years beginning after December 31, 1953.

The bill extends this provision indefinitely insofar as it relates to the $25,000 minimum surtax exemption and includes within it the $30,000 accumulated earnings credit provided in connection with the tax on accumulated earnings.

XXX—Estate Tax

Substantive changes have been made in the estate tax by the House bill but the basic structure of this tax has been retained and the rates in effect under present law have been continued.

A. Combining the basic and additional tax (secs. 2001 and 2011)

Under present law estate-tax liability is computed by first determining a "tentative tax" (basic and additional taxes). Then, if the estate is over $100,000 a "basic estate tax" is computed and 80 percent of this represents the maximum credit allowed for State death taxes.

The bill does away with the necessity of separately computing the basic tax. This is made possible by expressing the maximum credit allowable for State death taxes as a percent of the taxable estate of the decedent.

This method of computing the tax does not change the tax liability of any citizen or resident of the United States or the credit allowed for State death taxes. It does, however, raise slightly the tax of those few nonresident aliens who are entitled to a credit for State death taxes.

A method of determining the basic and additional estate taxes separately is retained under the bill since some State death taxes and the exemption of estates of certain members of the Armed Forces require the separate computation of these taxes.

B. Credit for tax on prior transfers (sec. 2013)

Present law allows a deduction for property received from a prior decedent (or by a gift subject to tax) within 5 years of the current decedent's death. The deduction is allowed for the value of the property still in the possession of the current decedent at the time of his death (or which can be traced as having been acquired in exchange for such property) and is independent of the amount of the tax paid on the prior transfer. The deduction is reduced if the property is subject to a debt or claim and no deduction is allowable if the property was received from the current decedent's spouse.

The bill substitutes a credit for the existing deduction which removes the necessity of tracing the property. A credit is allowed for the tax paid on the property in the estate of the prior decedent but it cannot be larger than if the current decedent had not received the property since the credit is based upon the value of the property at the time of the death of the prior decedent the requirement of identifying the property among the assets of the decedent is eliminated. Moreover, property transferred between spouses, to the extent no marital deduction was available, is eligible for this credit.

The credit is to be allowed in full for 2 years following the death of the prior decedent and then decreases by 20 percent every 2 years thereafter until no credit is allowed after the 10th year.

The credit for gift tax paid on a prior transfer has been omitted.

C. Alternate valuation (sec. 2032)

Present law allows an estate to be valued at either the date of a decedent's death or 1 year thereafter. The value of the property on the valuation date selected is also used to determine the income tax basis for the property in the hands of the transferee.

The bill provides that the option to value property as of a year after death is to be available only if the property declines by one-third in value during the year after death. In all other cases valuation at the date of death is to be compulsory.

Since all property includible in the gross estate will receive a date-of-death basis for income tax purposes, relatively minor shifts in value will have little net tax result. The higher estate tax due on account of the use of the date-of-death value will be offset by the income tax savings to the legatees by virtue of the higher basis.

D. Transfers taking effect at death (sec. 2037)

Under present law property previously transferred by a decedent is includible in his gross estate if possession or enjoyment of the property can be obtained only by surviving him. This rule applies whether or not the decedent has retained an interest in the property.

This rule has been discarded by the House bill. In the future the bill provides that property previously transferred by a decedent will be includible in his estate only if he still had (either expressly or by operation of law) immediately before his death a reversionary interest in the property exceeding 5 percent of its value, that is, if he, prior to his death, had 1 chance in 20 that the property would be returned to him.

E. Annuities (sec. 2039)

Under present law the value at the decedent's death of a joint and survivor annuity purchased by him is includible in his gross estate.

It is not clear under existing law whether an annuity of that type purchased by the decedent's employer, or an annuity to which both the decedent and his employer made contributions is includible in the decedent's gross estate.

The bill requires the inclusion of a joint and survivor annuity in the gross estate to the extent that the decedent contributed to its cost and, for the purpose of determining the extent of the decedent's contribution, the payments made by the employer under an unqualified plan, are to be taken into account. However, under an approved trust, pension, or retirement plan the employer's contributions are not to be considered as having been made by the decedent.

For values which are included in the gross estate the bill provides an additional exclusion (income in respect of a decedent) when the survivor reports the income, equal to the estate tax attributable to the interest element of the survivorship feature which has accrued since the annuity was purchased.

F. Proceeds of life insurance (sec. 2042)

The proceeds of life insurance on a decedent are subjected to tax in his estate under present law if the policy is payable to the executor, if the decedent paid the premiums on the policy (in this case includible in proportion to the amount paid), or if the decedent possessed any elements of ownership in the policy at date of death.

The bill retains the present rule including life-insurance proceeds in the decedent's estate if the policy is owned by him or payable to his executor, but the premium test has been removed. However, the 5-percent reversionary interest rule, applicable to other property, is also made applicable to life insurance.

It is estimated that the change made in this provision will reduce revenues by about $25 million in the fiscal year 1955.

G. Expenses, indebtedness, and taxes (sec. 2053)

Funeral expenses, administration expenses, claims against the estate and unpaid mortgages are deductible in computing the taxable estate under present law. However, this deduction is limited to those expenses allowable by the laws of the jurisdiction under which the estate is being administered and cannot exceed the value of the property included in the gross estate subject to claims, that is, the probate estate. Thus, if the decedent has placed most of his assets in a trust (not includible in his probate estate) funeral and other expenses actually paid by beneficiaries or expenses of administering trust property paid out of the trust assets are not allowed as a deduction to the extent they exceed the value of the property in the probate estate.

The bill provides that expenses incurred in connection with property included in the gross estate, although not in the probate estate, are to be allowed as deductions, if the expenses are of the type which would be allowed as deductions if the property were in the probate estate. These expenses must be paid within the period provided for the assessment of the estate tax.

In addition, expenses in connection with property not subject to claims are allowed under the bill without regard to the total value of the probate estate if they are actually paid within 1 year of the decedent's death.

H. Marital deduction (sec. 2056)

(1) *Life estate with power of appointment.*—Present law allows the marital deduction to apply to property placed in "trust" if the surviving spouse has a general power of appointment plus a right to all the income from the property. The bill specifically allows property to qualify for the marital deduction if the surviving spouse has—

(*a*) a right to the income from the property during her life, and

(*b*) a power of appointment.

If the surviving spouse is not the sole beneficiary of a trust, the transfer to the spouse will still qualify to the extent she has both the income interest and power of appointment.

Conforming changes have been made for life insurance or annuity payments where the surviving spouse has a power of appointment.

(2) *Widows' allowances.*—Under present law amounts paid to a surviving spouse, pursuant to a court order, for her support while the estate is in administration are eligible for the marital deduction only if the payments do not constitute a "terminable interest." The deduction may be disallowed, whether or not the payments are made prior to the filing of the estate-tax return.

The bill modifies this rule by making the terminable interest rule inapplicable to all amounts paid the widow pursuant to State laws for her support during the settlement of the estate, to the extent of payments made within one year after the decedent's death. Subsequent payments, however, will continue to be subject to the terminable interest rule as under present law.

I. Stocks situated in the United States (sec. 2104)

Under present law stock held by nonresident aliens is treated as property situated in the United States if it is stock of a domestic corporation regardless of where the certificates are located, and if it is stock of a foreign corporation, if the certificates are located in the United States.

Under the bill only the first of these rules is retained: Stock is to be deemed to be situated in the United States only where it is stock in a domestic corporation.

J. Members of the Armed Forces dying as a result of service in a combat zone (sec. 2201)

Present law exempts from the additional estate tax members of the Armed Forces dying before January 1, 1955, in a combat zone, or from wounds or disease incurred while in a combat zone.

The bill extends this exemption from the additional estate tax to cover any period in which persons generally are subject to induction under the Universal Military Training and Service Act. This change is similar to those previously described in the case of the income tax.

XXXI. Gift Tax

A number of substantive changes have been made in the gift-tax provisions by the House bill but the rate of tax is left unchanged.

A. Nonresident aliens (sec. 2051)

Present law applies the gift tax to all gifts made by citizens or residents of the United States. In the case of nonresident aliens the tax is imposed on all gifts of property within the United States.

The bill imposes a gift tax with respect to all gifts made by citizens or residents of the United States wherever the property is situated. In the case of nonresident aliens who are engaged in business in the United States tax is imposed with respect to gifts of property situated in the United States. With respect to all other nonresident aliens the tax is imposed only with respect to tangible property situated in the United States.

B. Gifts to minors (sec. 2503)

Under present law doubt arises as to whether a gift in trust for a minor can be a present interest since the child does not presently have complete control over the property. Where a child's guardian who has control over gifts to a child is personally responsible for the support of a child, it would appear that a valid gift could only be for a child's future benefit and the gift would be a future interest not qualifying for the $3,000 exclusion.

The bill provides that gifts to minors will not be considered gifts of future interests if the income and property can be spent by or for the child prior to his attaining age 21 and if not so spent passes to the child when he reaches age 21 (and to his estate if he dies prior to age 21).

C. Revaluation of gifts for prior years (sec. 2504)

Due to the cumulative nature of the gift tax and the progression in gift-tax rates, the tax liability for gifts in a particular year is dependent on the correct valuation of gifts in prior years. Therefore, a taxpayer's gift tax liability for 1953, for example, might be dependent on whether the valuation of a gift made in 1935 is larger, smaller, or the same as previously reported, although the statute of limitations has run on the tax paid on the 1935 transfer.

The bill provides that the value of a gift as reported on a taxable gift tax return for a prior year is to be conclusive as to the value of the gift (after the statute of limitations has run) in determining the tax rate to be applied to subsequent gifts.

D. Tenancies by the entirety (sec. 2515)

Under present law the creation of a tenancy by the entirety may result in a gift from one spouse to the other at the time the tenancy is created. The termination of the tenancy may also constitute a gift unless the proceeds are divided between the husband and wife.

The bill provides that unless the spouse who furnishes the major part of the consideration for the property elects otherwise, a transfer of real property to a tenancy by the entirety will not be regarded as a gift at that time. However, when such a tenancy is terminated a gift is considered as occurring at that time to the extent the proceeds are returned to the husband and wife other than in proportion to the consideration furnished by each spouse. Since this section is limited to tenancies by the entirety, joint tenancies will be taxed in the same manner as at present.

E. Property settlements incident to divorce (sec. 2516)

Under present law property settlements between spouses are not regarded as taxable gifts if the property settlement is incorporated in the decree of divorce. However, the gift-tax status under present law of settlements not incorporated in the decree of divorce is uncertain.

The bill provides that transfers pursuant to property settlements are not to constitute taxable gifts if followed by a divorce within a reasonable length of time.

F. Marital deduction (sec. 2523)

The bill makes it clear that transfers to a spouse of a legal life estate in property coupled with a general power of appointment are eligible for the marital deduction under the gift tax. This corresponds to the changes made in the marital deduction under the estate tax.

XXXII. Excise Taxes on Alcoholic Beverages and Tobacco (Chs. 50, 51)

The bill substantially revises the administrative provisions of present law relating to alcoholic beverages and tobacco although no changes in tax rates are made.

A. Use of returns for payment of tax

In the case of the excises on both alcoholic beverages and tobacco products the bill provides that the taxes are to be paid by returns rather than by the purchase of stamps. The bill provides that the Secretary may institute the return system at any time after January 1, 1955. Representatives of the Treasury Department advised the House Ways and Means Committee that while no definite date has been set for instituting the return system, plans have been made to require a weekly return when the plan is first put into effect. Subsequent extensions of time for filing returns will be dependent on the fiscal situation and on the experience with the weekly return.

Under present law taxes on these products are paid for by the purchase of stamps which must be affixed to packages or containers prior to or at the time of removal of the products from the factory or other bonded premises. Because of this procedure, producers must finance tax payments between the time the stamps are purchased and the time they receive payment for the taxed products from their vendees. The bill provides a method whereby a changeover can be made to a delayed-return system.

B. Penalties

Under present law the provisions imposing penalties for violation of the law with respect to the taxes on alcoholic beverages and tobacco products often provide for minimum as well as maximum fines and jail sentences. The mandatory minimum requirements have been deleted in the bill.

C. Distilled spirits

Due to a lack of time the revision of the distilled spirits provisions was more limited than in the case of the provisions relating to the other alcoholic beverage and tobacco taxes. In view of this, at the direction of the House Ways and Means Committee an Alcohol Tax Survey Committee of the Treasury Department is now working with a committee of the distilled spirits industry to consider further changes for submission to the next Congress. Nevertheless, a number of substantive changes have been made in this bill. The more important changes, other than those already mentioned, are listed below.

(1) Authorization for voluntary destruction of distilled spirits prior to withdrawal from bond is provided by the bill. Present law provides for the collection of tax on distilled spirits voluntarily destroyed unless such spirits are unfit for beverage purposes.

(2) Distilleries are authorized to conduct other businesses, except specifically prohibited businesses, on distillery premises, when it is found by the Secretary or his delegate that such operations will not jeopardize the revenue. Currently, only operations connected with the production of distilled spirits may be conducted on distillery premises.

(3) The bill removes the requirement of present law that all stills, for whatever purpose intended (except stills for refining petroleum), be registered. Registration is to be required only of stills intended to be used for the distillation, redistillation, or recovery of distilled spirits.

D. Fermented malt beverages

The provisions of this bill relating to fermented malt beverages represent a substantial revision of present law. The provisions listed below represent the more important changes made.

(1) Brewers are authorized to use their premises for producing and bottling soft drinks and for such other businesses as the Secretary may find will not jeopardize the revenue. Breweries which on June 26, 1936 were bottling soft drinks are now allowed to carry on such business. Under the bill this privilege is to be available to all brewers.

(2) The bill provides for the refund or credit of tax paid on beer belonging to a brewer if it is returned to the brewery for reconditioning, for use as materials, or destroyed under required supervision. Provision also is made for credit or refund of tax paid if beer belonging to a brewer is lost by casualty (other than by theft). No claim for casualty loss will be allowed, however, if the brewer was indemnified by insurance or otherwise. Under present law, there is no provision for such credits or refunds.

(3) Brewers owning two or more breweries are authorized to transfer beer without payment of tax from one brewery to another. Existing law does not permit such transfers, but comparable tax-free transfers under bond are permitted for wines and distilled spirits.

E. Wines

The major changes made in the wine laws are listed below.

(1) Wineries are to be granted permission to carry on certain operations besides the making of wine, if these operations are conducted in a manner which will not jeopardize the revenue.

(2) A thorough revision of the definitions of wines, the methods of preparation permitted, and the required standards of quality is made in this bill. One of the most important changes is the provision permitting use of methods acceptable in "good commercial practice" to correct and stabilize wine. Present law prescribes that only "usual cellar treatment" may be used.

(3) The bill provides a new category of premise, the taxpaid wine bottling house, which will operate under Government supervision. Under present law the Government cannot supervise the bottling of taxpaid wine.

(4) Provision is made for the allowance of all losses of wine while in bond except losses by theft occurring because of negligence or collusion. No allowance will be permitted where the claimant is indemnified by insurance or otherwise. Allowance also is made for voluntary destruction of wine in bond. Under present law, all losses in bond are allowed purely at the discretion of the Commissioner.

(5) The bill authorizes the refund or credit of tax paid on unmerchantable sparkling or artificially carbonated wine which has been returned to a bonded premise. No such provision now exists.

(6) The bill provides that the tax base for sparkling and artificially carbonated wines is to be a wine gallon instead of the present base of each one-half pint or fraction thereof in each container. The rates for these wines have been restated to make them practically the equivalent of the existing rates.

(7) The bill imposes the wine tax on sake and other rice wines. Presently these wines, because they are made from grain, can only be made at breweries and are subject to tax as beer.

These wines usually contain from 16 to 18 percent of alcohol. The rate of tax on wines of this strength is 67 cents per gallon. The tax on beer is about 29 cents a gallon.

(8) The bill clarifies the exemption from tax for hard ciders (usually sold during season by farmers at roadside stands) to provide that it applies when the cider is not preserved by any process or by the addition of any material and is not offered for sale as wine or a substitute for wine.

F. Tobacco products

The new chapter relating to cigars, cigarettes, chewing and smoking tobacco, snuff, and cigarette papers and tubes represents a complete revision of present law. The important changes are listed below.

(1) Detailed statutory provisions specifying the permitted sizes of packages and the exact wording of notices and labels to be put on packages have been removed. The revised law gives authority to effect changes by regulation.

(2) The bill authorizes credits or refunds to be made to the manufacturer for tax paid on articles lost by casualty (except by theft) while in his possession. Present law already allows the refund of tax on articles withdrawn from the market by the manufacturer. Several court decisions have interpreted "withdrawal from the market" to include loss by casualty (other than theft), while taxpaid articles are still in the possession of the manufacturer. This change brings the law specifically in line with these court decisions.

(3) The bill provides that every person before commencing business as a manufacturer of tobacco products must obtain a permit to engage in such business. The permit may be refused if it is deemed that the applicant is unlikely to comply with the tobacco tax provisions. Once issued, permits may be suspended or revoked after hearing before proper authority.

At the present time, manufacturers and dealers must register before commencing business, but such registration has only informational value as there is no restrictive control connected with such registration.

XXXIII. Provisions Relating to Procedure and Administration

The House bill makes a comprehensive revision of the portion of the Internal Revenue Code relating to procedure and administration. Administrative provisions presently scattered throughout the code have been brought together into a new subtitle. The new provisions relate generally to all internal revenue taxes imposed and, with the exception of those applying to the alcoholic beverage and tobacco taxes, only a few administrative provisions of special application have been left in the taxing subtitles.

The 3 changes of most general application and interest—the changes in the time for filing returns, the changes made in the declaration system for individuals, and the establishment of a declaration system for corporations—are discussed in the first 3 sections below. Other changes of significance are described briefly in the remaining sections under their chapter headings in the new code.

A. *Filing date for tax returns (secs. 6072, 6073)*

The bill postpones from March 15 to April 15 the date for individuals using a calendar year to file their income-tax returns. A similar 1-month postponement is provided for individual income taxpayers using a fiscal year.

This change in filing dates is effective for the 1954 tax liabilities of calendar year taxpayers which are reported for tax purposes in 1955. It is also effective for fiscal year taxpayers with respect to tax liabilities of years beginning after December 31, 1953.

The change in the return date also involves the postponing from March 15 to April 15 of the filing date for the declaration of estimated tax (and the first payment of estimated tax). However, no changes were made in the case of the present June 15, September 15, and January 15 dates for amending declarations of estimated tax (and for the last three quarterly payments of estimated tax).

Under present law farmers are required to file their declarations of estimated tax by January 15 or, if they do not wish to file their declarations by that time, file their final return by January 31. The bill moves up this alternative filing date for final returns of farmers from January 31 to February 15. It also extends the definition of farming to include oyster farming.

No change was made in the March 15 filing date for corporations except in the case of tax-exempt cooperatives. The filing date for the returns of these cooperatives was postponed until September 15 (following the year of tax liability) to coincide with their last date for declaring patronage dividends with respect to the prior year's business.

B. *Declarations of estimated tax by individuals (secs. 6015, 6654)*

Under present law individuals whose tax liabilities are not substantially discharged by withholding are required to file declarations of estimated tax and to pay on a quarterly basis the amount by which their estimated tax exceeds that which will be withheld during the course of the taxable year. A declaration of estimated tax must be filed by an individual whose income is primarily from wages or salaries if this income is expected to be more than $4,500 plus $600 for each exemption. Individuals with over $100 of income from sources not subject to withholding are required to file declarations of estimated tax if they expect their gross income to exceed $600.

Under the bill an individual with no more than $100 of gross income from sources other than wages or salary is required to file a declaration only if gross income is expected to be $5,000 or more. However, no declaration will be required by a married person if his gross income, combined with that of his spouse, is expected to be less than $10,000. The $10,000 requirement also applies to heads of families.

For individuals who expect to receive more than $100 of income not subject to withholding, a declaration will be required only if gross income from other sources is expected to be more than $600 per exemption plus $400.

Additional charges are imposed under present law for failure to file a declaration or make a payment of the estimated tax or for substantial underestimates of tax liability. For failure to file a declaration or to pay an installment of the estimated tax, the total charge may be as high as 9 percent of the unpaid installment. For a substantial underestimate of tax, that is, an estimated tax which is less than 80 percent of the actual tax liability for the year (66⅔ percent in the case of farmers), a charge of 6 percent of the amount by which the final tax liability exceeds the estimated tax may be imposed. This charge and the charge for failure to file a declaration or pay an installment of estimated tax may run concurrently and result in a combined charge of 15 percent of the estimated tax due.

In place of the present system of additional charges, H. R. 8300 provides a uniform charge of 6 percent per annum for underestimates and unpaid installments of estimated tax. In general, this charge will be imposed where the installment payment made by the taxpayer is less than 70 percent (66⅔ for farmers) of the quarterly installment due on the basis of the tax shown on the final return (less the amount of tax withheld). The 6 percent per annum charge will be based on the amount of this difference.

However, no charge will be imposed, even if the installment payment is less than 70 percent of the quarterly installment due, if the amount paid as estimated tax is (1) the same as the previous year's tax or (2) the tax for the previous year as it would have been if the rates and personal exemptions applicable to the current year had been used.

In addition, the taxpayer will be able to avoid an additional charge if his total payments on or before any installment date are at least 70 percent of an estimated tax computed by projecting to the end of the year the income received from the beginning of the year up to the month in which an installment is due.

C. Declarations of estimated tax and tax payment schedule for corporations (sec. 6016)

The Revenue Act of 1950 accelerated corporation tax payments from 4 quarterly installments spread over the 12 months following the taxable year to two 50-percent installments, payable in the third and sixth month after the close of the taxable year. The transition to a 2-installment system was accomplished over a 5-year period beginning with 1950 and ending with 1954 tax liabilities. Calendar year corporations, for example, will pay 45 percent of their 1953 tax liabilities in March of 1954, 45 percent in June and 5 percent each in September and December. Their 1954 tax liabilities will be paid half in March and half in June of 1955.

The bill provides a system of declarations of estimated tax for the larger corporations which restores the four quarterly installment system and reduces the time the corporation is given for the payment of its tax. It requires corporations to file a declaration of estimated tax and to make a partial payment on account of current tax liability by the middle of the ninth month of the year of the tax liability and another by the middle of the last month of the same year. When this plan is fully effective, calendar-year corporations will pay one-fourth of their estimated tax on September 15 of the year of the tax liability and another quarter on December 15 of the same year. A quarter will be paid on March 15 of the year following the taxable year and the final payment on June 15 of that year.

The bill makes provision for a gradual shift to the new system over a 5-year period, starting in 1955. In the case of a calendar-year corporation 5 percent of the estimated 1955 liability will become due on September 15, 1955; another 5 percent will be due in December, and about 45 percent of the actual tax will be payable in the following March and another 45 percent in June. For the 1956 liability, the September and December payments will be about 10 percent and the following March and June payments about 40 percent each. The September and December payments will continue to increase each year until they both reach 25 percent of the estimated tax for 1959 liabilities, when both the March and June payments will have been reduced to about 25 percent of the actual tax. In 1960, and in subsequent years, corporation income taxes will be due in four quarterly installments, extending from the middle of the ninth month of the current year to the middle of the sixth month of the following year. The schedule of corporate tax payments during the past 5 years and the schedule under the bill for the next 5 years is as follows:

TABLE 16.—*Payment schedule for corporation income tax under prevailing law, 1949–54, and proposal, 1955–59*

(Calendar year corporations; showing percent of tax liability due in each installment)

Income year	Income year		Following year				Total
	September	December	March	June	September	December	
1949			25	25	25	25	100
1950			30	30	20	20	100
1951			35	35	15	15	100
1952			40	40	10	10	100
1953			45	45	5	5	100
1954			50	50	0	0	100
1955 [1]	5	5	45	45			100
1956 [1]	10	10	40	40			100
1957 [1]	15	15	35	35			100
1958 [1]	20	20	30	30			100
1959 [1]	25	25	25	25			100

[1] Applicable to tax liability, in excess of $50,000.

The bill exempts from the required declaration of estimated tax and the new taxpayment schedule corporations whose yearly tax liability cannot reasonably be expected to exceed $50,000. Moreover, it limits the current payment requirements to that portion of the tax liability in excess of $50,000. Because of these exemptions, the declaration system in this bill will not affect the 390,000 corporations whose annual tax liability is less than $50,000. It will, however, affect the 35,000 corporations with tax liabilities above $50,000.

In the case of some fiscal year corporations, however, the speedup will have the effect of shifting payments to an earlier fiscal year of the Government. Because of the changes in the payments of the fiscal-year corporations it is estimated that there will be an annual increase in tax collections in the fiscal years 1956 through 1960 of approximately $150 million, assuming present tax rates.

The bill prescribes for corporations the same additional charges prescribed in the case of declarations of estimated tax by individuals. These charges are equal to 6 percent (per annum) of the amount of underpayment. However, the charge will not be imposed if the estimated tax upon the basis of which the installments are paid falls into any of the following four categories:

(1) If it amounts to 70 percent of the tax (in excess of $50,000) shown on the final tax return;

(2) If it amounts to as much as the previous year's tax;

(3) If it is equal to what would have been last year's tax liability if current tax rates had been applicable, less $50,000, to previous year's income; or

(4) If it is at least equal to 70 percent of the tax (less $50,000) due on the basis of projecting to the end of the year the income received from the beginning of the year up to the date of the declaration or its amendment.

D. Information and returns (ch. 61)

(1) Present law requires the reporting of payments to another person (not a corporation) of more than $600 consisting of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other gains, profits, and income. In the case of interest payments present law requires this reporting regardless of the size of the payments. H. R. 8300 omits these provisions from the new code. This does not affect the information returns presently required from corporations in the case of dividends and interest, nor reports presently required as to the collections of foreign items.

(2) The bill raises the minimum income tax return filing requirement from $600 of gross income to $1,200 of gross income for individuals over age 65.

(3) Married taxpayers are to be allowed to file joint returns after having filed separate returns without first paying the tax shown on the separate returns.

(4) In the case of corporate returns, 1 officer will be required to sign the return instead of 2 as at present. Moreover, any officer duly authorized by the company will be able to sign, rather than only certain specified officers as at present.

(5) The Secretary or his delegate will be given the authority to grant an extension of time, up to 6 months, for the filing of any tax return. At present, this authority is limited to the income and certain other taxes. Corporations are also given a 3-month automatic extension for filing their income tax returns upon the filing of an appropriate form and the paying of the tax installment estimated to be due.

(6) The Secretary or his delegate is to be authorized to allow the filing of returns in whole dollar amounts rather than showing the exact cents.

E. Time and place for paying tax (ch. 62)

A uniform rule is provided permitting the Secretary or his delegate to extend the time for the payment of any tax for a period not in excess of 6 months (the 10-year period, however, is retained for the estate tax). This is present law for income taxes, estimated income taxes, unemployment taxes and gift tax, but in the case of many others there either is no provision for an extension of time or provision for only a 90-day extension.

F. Assessment (ch. 63)

Prior to the enactment of the reorganization plans, in the case of each of approximately 90 million returns, the law called for the making of assessment lists by the collectors, the transmission of these lists to Washington, and certification before assessment was accomplished. The effect of the reorganization plans on these requirements is not expressed in the 1939 code.

Under the bill the assessment is to be made by recording the taxpayer's name, address and tax liability.

G. Collection (ch. 64)

(1) Under the bill while assessment may be made immediately when returns are filed early, payment before the due date for the return may not be demanded.

(2) The Secretary or his delegate is authorized to receive any check or money order for payment of taxes or stamps. Present law closely limits the type of check or money orders which may be received for stamps.

(3) It is made clear that the lien for taxes arises at the time the assessment is made.

(4) Existing law is clarified and amplified as to the status of tax liens relative to other liens. They are to be subordinate to previous valid liens of a bona fide mortgagee, pledgee, or purchaser but superior to these liens if such a person had knowledge of the tax liability.

(5) In certain estate and gift tax situations priority of lien is provided for bona fide mortgagees and pledgees. The situation of bona fide purchasers for full value is also improved in some cases.

(6) The law is clarified with respect to the right of distraint and levy (seizure) for the collection of tax liability. Also, in all cases of jeopardy the right is granted the Service to seize property immediately after notice and demand. Under present law there must be a 10-day waiting period in the case of income, estate, and gift taxes.

(7) The right to levy on salaries due is extended to permit the levying on salaries due Government employees in the same manner as is presently possible in the case of other employees.

(8) The list of household goods, etc., exempt from levy is modernized. Present law exempts "1 cow, 2 hogs, 5 sheep" (if the sheep are not worth more than $50), etc. The new provision exempts "necessary" wearing apparel and schoolbooks; fuel, provisions, personal effects, and furniture to the extent of $500; and necessary books and tools for the taxpayer's trade or profession up to $250.

Present law requires appraisals of the property exempt from levy by three "householders of the vicinity." The new provision requires appraisal of the exempt property only if the taxpayer demands it, and then the appraisal is to be made by three disinterested individuals summoned by the officer making the seizures.

(9) The treatment provided for the sale of seized real and personal property is made uniform.

Present law requires that the place of the sale must be not more than 5 miles away from where the property was seized but this limit can be ignored on special order of the Commissioner. The new provision requires the sale to take place in the same county as the seizure except by order of the Secretary or his delegate.

More freedom is permitted in the methods of holding the sale of seized property to obtain the highest price possible to the benefit of both the taxpayer and Government: Sale by sealed bids as well as by auctions is permitted, the sale of items may be made singly or in groups, and downpayments by purchasers with the balance being paid in a month are permitted.

(10) New rules are provided for the sale of seized perishable goods to make such seizures feasible.

(11) New rules are provided to insure valid titles to purchasers of automobiles lawfully seized and sold by the Government.

(12) A new provision permits the releasing of seized property if the taxpayer makes satisfactory arrangements for the payment of his tax, such as the payment in installments from part of his salary.

H. Abatements, credits, and refunds (*ch. 65*)

The rules now expressly provided in the code with respect to certain excises, that refunds will be made only if it can be shown that the taxes were not passed on to others (or were repaid to them) have been extended to include the cabaret tax, taxes on admissions and dues, and the tax on pistols and revolvers. Also, the rules permitting refunds of manufacturers' and retailers' excise taxes, with respect to price adjustments, are extended to include such adjustments with respect to the excises on diesel fuel and pistols and revolvers.

I. Limitations (*ch. 66*)

(1) The 3-year period of limitations for assessment or refund now applying in the case of the income, estate and gift taxes is applied to excise taxes, which presently have a 4-year limitation period.

(2) The period of limitation for assessment is made 6 years instead of 5 in the case of the omission of 25 percent of gross income, and a similar rule is applied in the bill to the estate and gift taxes. However, under the bill this longer period is not to apply if disclosure of the nature and amount of omitted items is made on or with the tax return.

(3) A 6-year limitation for assessment is provided for failure to include personal holding company data on the special schedule provided for this purpose in the corporation income tax return (no longer to be a separate return).

(4) As under present law there is to be no limitation on the time for assessment where no return is filed. However, if a "corporation" erroneously in good faith files a trust or partnership return, under the bill such return is to start the running of the statute of limitations.

(5) The income-tax rules, presently providing that the period for assessment is extended during bankruptcy or receivership proceedings, are to be made applicable to all Federal taxes and to any Federal- or State-court proceeding.

(6) The 6-year period during which taxes may be collected after assessment is extended for the time the taxpayer's property is outside the United States.

(7) The income-tax rule, that for limitation and interest purposes an early return is deemed as filed on the last day for filing, is extended to returns for all taxes.

(8) The period for criminal prosecution is extended from 3 to 6 years for willful failure to pay any tax or to make a tax return, for making false statements, for intimidating United States officers, and for certain offenses by such officers. Also, the period (3 or 6 years as the case may be) is extended for the period the individual involved is outside the United States or is a "fugitive from justice" within the United States.

J. Interest (ch. 67)

(1) One rule is provided under the bill for interest charged or paid: It is to be 6 percent from the due date until the amount is paid or from the date of overpayment until not more than 30 days before a refund is paid. This is to apply to all taxes except where payment of estate tax is deferred under certain circumstances, when the present 4-percent rate is to apply. However, no interest is to be paid on refunds made within 45 days after the due date of the returns.

(2) In the case of a net operating loss carryback the bill provides that interest on a deficiency in the year to which the loss is carried runs until the end of the loss year; interest on a refund is to begin at the end of the loss year (rather than when the claim is filed as at present).

K. Additions to tax, additional amounts, and assessable penalties (ch. 68)

(1) The additions to the tax (5 percent for negligence and 50 percent for fraud) are to be applied to deficiencies or underpayments and not to the whole tax, as is presently true in the case of the excise taxes. These additions, and also the addition of from 5 to 25 percent for failure to file a return on time, are to be applied to the net tax, i. e., the tax after credits for tax withheld, estimated tax paid, or other prepayments.

(2) A 50-percent addition to tax is to be provided for failure to pay a stamp tax, in lieu of the present 100-percent penalty.

(3) Where withheld or collected taxes are required to be deposited in approved depositories an amount equal to 1 percent per month is to be charged for any amount which should have been but was not so deposited, until it is deposited or until the tax intended to be deposited becomes payable.

L. General provisions relating to stamps (ch. 69)

Provisions relating to issuance, use, cancellation, and redemption of stamps, now scattered throughout the code, are combined in one chapter.

M. Transferees and fiduciaries (ch. 71)

Assessment of a transferee for a tax liability of the transferor is presently allowed under the income, estate, and gift taxes. The bill extends this to all other taxes but only (as to such taxes) if the transferee liability results from the liquidation or reorganization of a corporation or liquidation of a partnership.

N. Crimes, other offenses, and forfeitures (ch. 75)

In this chapter all criminal offenses are brought together, as are all other offenses, and all provisions relating to forfeitures, except those relating to alcoholic beverages, tobacco, and short-barreled firearms.

In general, uniform penalties are provided instead of the varying penalties now provided for what in substance is the same offense, namely, the attempt to evade tax. For offenses of this type the penalties usually provided by the new provisions are fines of up to $10,000 or imprisonment up to 5 years or both. Minimum penalties, however, are omitted.

(1) A provision of the Criminal Code makes it an offense punishable by a $5,000 fine or 3 years' imprisonment or both to forcibly assault, resist, oppose, etc., any officer or employee acting under the internal-revenue laws. A similar, but amplified, provision of this bill covers all cases where the officer is intimidated or injured; that is, where corruptly, by force or threat of force, directly or by communication, an attempt is made to impede the administration of the internal-revenue laws. The penalty in the case of all such attempts to interfere with administration of the internal-revenue laws is to be a fine of not more than $10,000 or imprisonment for not more than 5 years or both.

(2) More rigid restrictions have been imposed upon State officers to prevent divulging, or permitting to be seen, information obtained from the inspection of Federal tax returns. The restrictions imposed and the penalties for violation, are similar to those already in effect for Federal officers.

(3) The bill provides more severe penalties for offenses by Government employees, making them correspond to the penalties imposed in the case of offenses by taxpayers generally.

O. Judicial proceedings (ch. 76)

(1) In the case of civil actions for refund, it is provided that when a taxpayer has sued for refund in a district court (or the Court of Claims) and the Government sends a notice of deficiency, the taxpayer is to be able to have all issues decided either in the district court (or Court of Claims) or in the Tax Court.

(2) Where a petitioner is a foreign corporation, trust, or estate, or a nonresident alien, it is provided that the Tax Court can order the foreign corporation, or its parent or subsidiary, or any other person under the control of the petitioner, to produce books and papers even if they are abroad. If the petitioner does not comply, the Tax Court is directed to strike out pleadings, dismiss the proceedings, or give judgment by default, as circumstances may indicate.

P. Miscellaneous provisions (ch. 77)

(1) Under the bill, if any claim, statement, or other document except a tax return is received after the day on which it is required to be filed it will nevertheless be considered as filed on time if the postmark shows a date on or before the due date. A registry receipt is to be prima facie evidence of delivery.

(2) The bill provides that the time for filing any document, or for performing any act, is to be extended to the day following Saturdays, Sundays, or legal holidays, as determined in the District of Columbia

if the act is to be performed in Washington, or as determined under local law, if the act is to be performed in a district office or elsewhere. This presently is the rule with respect to petitions to the Tax Court.

XXXIV. Review of Refund Cases

Under present law the Joint Committee on Internal Revenue Taxation reviews all internal revenue tax refund cases involving more than $200,000.

The bill provides that in the future the Joint Committee on Internal Revenue Taxation is to review all such refund cases involving more than $100,000.

XXXV. Summary of Revenue Effects of Bill

Table 17.—*Summary of the effects on individual and corporate tax collections in the fiscal year 1955 of the Internal Revenue Code of 1954, H. R. 8300*

	Amount (millions of dollars)
Individual:	
Head of family provisions	−50
Taxation of annuities	−10
Exclusion of retirement income	−125
New definition and treatment of dependents	−85
Interest charge deduction on installment contracts	−10
Depreciation	−75
Raise charitable individual contribution limitation from 20 to 30 percent	−25
Medical expense provisions	−80
Child-care expense deduction	−40
Personal exemption increase from $100 to $300 for distributable trusts	−3
Life insurance (premium payment test)	−25
Soil and water conservation expense deduction	−10
Dividend exclusion and tax credit	−240
Total individual	**−778**
Corporation:	
Depreciation	−300
Net operating loss deduction	[1 2] −100
Percentage depletion	[1] −27
Accounting provisions	[1] −45
Treatment of foreign income	[1] −147
Extension of 30-percent normal tax rate	+1,200
Total corporation	**+581**
Grand total	**−197**

[1] A small part of this estimate applies to individuals, which cannot be clearly segregated.
[2] A large portion of this decrease in collections in the fiscal year 1955 will be offset by increased collections in future years.

The Chairman. Our first witness will be the Honorable George M. Humphrey, Secretary of the Treasury.

Mr. Secretary, please take the stand.

STATEMENT OF HON. GEORGE M. HUMPHREY, SECRETARY OF THE TREASURY

Secretary HUMPHREY. Mr. Chairman, if it meets with your pleasure, and the gentlemen of the committee, I have a statement here that I will make, and then I would like to ask Mr. Folsom to run through, in a rather rapid way, the details of some of the provisions that will be of interest to you. Then we will be prepared to answer such questions as we can. If it is agreeable to you, I will start with the statement.

The CHAIRMAN. Very well.

Secretary HUMPHREY. The Treasury appreciates the opportunity to tell, in open session here today, why we think the tax revision bill now before your committee is so tremendously important to the future of our country. Copies of this statement will be available for you in a moment.

Before I go into details of the revision bill and the reasons why it should be enacted, I would like to look for just a minute with you at the hodgepodge which is our present tax system and how it got to be that way.

Our tax laws were last completely rewritten in 1876. It is obvious that some of the tax laws of 78 years ago, when the total Federal tax take was $294 million, might very well not be proper tax laws in 1954, when the tax take is upwards of $60 billion. And it is also true of many later provisions.

Many of the specific provisions of the present Internal Revenue Code have outlived their usefulness. They now work hardships on millions of individuals. They also reduce the incentive for those in business to try new things or to improve the way they are doing things at present. We realize that some of the present provisions of the code were adopted to raise money quickly during periods of heavy spending for war purposes. But we have wound up with an overall tax system which has many defects.

The fact that our tax system needs revision is not something, incidentally, that the Republican Party has just suddenly proposed.

For years, congressional committees, with Democratic chairmen and Democratic majority membership, have recommended revision. And Democratic minority members of the House Ways and Means Committee, in 1947–48, when the Republicans were the majority in Congress, also recommended revision and specifically listed double taxation of dividends and more flexible depreciation as items needing prompt consideration.

The general tax revision bill now before you, in other words, is not an arbitrary proposal of this administration. Most of its major provisions have been developed after long objective study and—in the absence of compelling political reasons to the contrary—have, over the years, been supported on both sides of the aisle in both the House and the Senate.

With most sincere conviction, I say that a modernization of our tax structure, as provided in part by the present tax revision bill, is something which this Nation must have for continued growth and prosperity.

The terrific importance of the tax structure upon our economy is obvious when we stop to think that 25 percent of the national income now goes for Federal taxes. With this larger proportion of our national income going into Federal Government, it is only sensible that the tax laws provide the fewest possible hardships for individual taxpayers.' It is also important that the tax laws include the fewest possible drags on the wheels of American ingenuity and business in going ahead with new and better things under the free-enterprise system which has made this country great.

For the future of our country, we must get out of our tax system as many of the inequities to individuals and barriers to economic growth as we possibly can. That is the purpose of the tax revision bill before you. There are many other changes in the code which we will continue to study and make further recommendations on in the years ahead. But this is a good start in cleaning up what at present is a very messy and stifling national tax structure.

In addition to straightening out the many inequalities of the tax code, we will keep working toward further cuts in total taxes required. And when we have cut spending so that we can cut taxes even further, we will then recommend that these tax cuts be made in rates, because it is in rates that the principal increases have been made in the past 15 years.

The CHAIRMAN. Mr. Secretary, in rates as distinguished from what?

Secretary HUMPHREY. From rates as distinguishing from exemptions. The general revision bill is only a part, but a very vital part, of our entire tax program. And this tax program, as the President said in his March 15 tax broadcast, is "the cornerstone" of the administration's entire effort. It is a whole tax program which, when we include some excise cuts to which we were opposed, will make effective tax cuts of $7.4 billion this year.

As the President pointed out at his news conference last week, this is the largest total tax cut made in any year of our history.

The spending program of this administration's 1955 budget is $12 billion less than called for by the 1954 budget we found when we arrived. And it is $8.5 billion less than was actually spent in fiscal 1953.

Without these savings, there could have been no tax relief for anyone. Because of these savings, tax cuts of more than $7 billion have been possible.

On January 1, taxes were cut by $5 billion by the reduction in individual income taxes, and the expiration of the excess-profits tax. The tax revision bill which we are discussing specifically today, while reforming the tax structure, will also result in reductions of $1.4 billion. We should note, also, that attached to this tax revision bill is the continuation of the corporation income tax at the 52 percent rate—an extension which will net $1.2 billion this year, or almost enough to pay for the entire cost of the revision bill. This hardly makes the bill a "giveaway to business" as some have called it.

The cost of the revision bill was provided for in the budget message—page M28—with a net loss from individual taxes—now, these are net figures—of $585 million, and a net increase in collections from corporate income taxation of $570 million, reflecting both the continuation of the 52 percent rate and revision measures. Additional items adopted in the House increase the revenue loss from individual income taxes by $193 million.

There are three main points about the general revision bill: First, it is designed as a reform of the tax structure and not a tax reduction bill. We must keep this in mind as we hear the arguments against it which are based on the misinformation that it is cutting taxes in what some people think is the wrong way. It is a reform program which has been proposed for years and years as needed reform.

Second, it helps millions upon millions of taxpayers who have been plagued by unjust and unfair hardships over many, many years.

Third, and most important of all, it will help our economy to grow; it will help new businesses to start, old businesses to expand, all businesses to modernize, and so help the creation of more and better jobs and better living for everyone.

A few specific provisions will show how millions of various types of Americans will be benefited by specific proposals.

Some 1,300,000 taxpayers will benefit by a change which allows a child to be continued as a dependent even if he earns more than $600 a year.

Some 1,500,000 people will benefit from fairer treatment for retired persons on pensions.

Some 8,500,000 people will benefit from larger deductions for medical expenses.

Some 1,600,000 people will benefit from allowing more liberal deduction of interest under installment-purchase contracts.

Some 500,000 farmers will benefit from more liberal allowance for soil-conservation expense.

Some 6½ million of the 47 million taxpayers will benefit from the partial relief from double taxation of dividends.

Some 9,600,000 individuals, as well as 600,000 corporations, will benefit from more flexible provisions for depreciation.

The main purpose, as I said, is to help the economy expand and provide more jobs and better living.

The tax structure in this country has reached the point where initiative is seriously stifled.

The features in this tax-revision bill which make it more attractive for the man who saves money to invest, or more attractive for the businessman to replace his present inefficient machinery, are the sort of things which can help this economy keep growing. Let's look at two of these controversial so-called business provisions for a moment.

The recommendation to reduce double taxation of dividend income will encourage the investment of savings so that business can expand and create more jobs. Largely because of tax restrictions, the trend in recent years has been sharply away from equity financing toward borrowing. This is the wrong way for America's economy to finance its expansion.

I might add, there, Mr. Chairman, that there is nothing more important, in my opinion, for the future of America than to encourage widespread investment in American business. America needs big business. It requires big business, big enterprises, to do the things in big ways that a big country has to have. To corporate ownership, the division of corporate ownership, the extension of it, the encouraging of millions of small investors to participate in the ownership of America and American productive power is, in my mind, one of the gratest things that can be done for the stability and the strength of America in the future.

The CHAIRMAN. That applies, also, to little business, doesn't it?

Secretary HUMPHREY. It does to all business, Mr. Chairman.

The broadest possible participation must be had in both big and little business. A great many Americans receive dividends.

The CHAIRMAN. How many are there? Have you figured it out?

Secretary HUMPHREY. About $6\frac{1}{2}$ million taxpayers receive dividends.

The CHAIRMAN. Is there any estimate of those who don't pay taxes who receive some dividends?

Secretary HUMPHREY. Yes; about a million more, I think.

Tax relief which will encourage investors to invest in the growth and development of old and new American businesses is in the interests of all the citizens.

A great many Americans receive dividends. Three-fourths of all individuals who get dividends earn less than $10,000 a year. A recent United States Steel Corp. survey showed that 56 percent of its 280,000 stockholders earn less than $5,000 a year. Relief to stockholders is not limited to just a few wealthy individuals.

Senator MARTIN. Do you have any information as to how many stockholders of United States Steel also work in their various plants?

Secretary HUMPHREY. Senator Martin, I cannot tell you, but I know this, that the Steel Corp. has, in round figures, about the same number of stockholders that they have employees.

Senator MARTIN. I knew they had.

Secretary HUMPHREY. And they have a large number of employees. It runs into a good many thousand. What the percent is of the total, I can't tell you.

Senator WILLIAMS. I noticed you said $66\frac{2}{3}$ percent of all of the United States Steel stockholders earn less than $5,000.

Secretary HUMPHREY. Fifty-six percent.

Senator WILLIAMS. Did United States Steel release any figures as to the percentage of their total dividends which went to this group?

Secretary HUMPHREY. In dollars?

Senator WILLIAMS. Yes.

Secretary HUMPHREY. I believe so. I will see that you get a copy of the report.

(The report in question was placed in the record by Mr. Keith Funston who appeared on April 12, 1954.)

Senator WILLIAMS. I have seen it.

Secretary HUMPHREY. They have a very interesting compilation.

Senator LONG. Have you seen that study, Secretary Humphrey, that points out that six-tenths of 1 percent of the people own 80 percent of all corporate stock?

Secretary HUMPHREY. I don't know just how that is. I suppose it is about $8\frac{1}{2}$ into 160 million, but that takes into account babies and children and everything else.

Senator LONG. What I saw said that six-tenths percent of all families, so you wouldn't need to worry about the baby calculation on that.

Secretary HUMPHREY. I wouldn't think that was right. I think a little better picture of the situation is given if you think of it in terms of the taxpayers. There are 47½ million taxpayers in the country and——

The CHAIRMAN. Mr. Secretary, I am advised by the staff that the Brookings Institute claims that there are about 9 million families owning some stocks.

Secretary HUMPHREY. I don't know how many families there are.

Senator LONG. Your figure is not meeting the point I am getting to. The point I am getting to is that you are counting little tidbits of stock here and there to say how many families own stock. If you look at where the stock is really held, and if that figure is correct, that one-half of 1 percent of the people own 80 percent of all of the corporate stock, then we can begin to see where this benefit will go, as far as the tax reduction is concerned.

Secretary HUMPHREY. Senator, I don't think that will quite explain it either. In the figures that you take into account with stockholders, it is a very rapidly growing thing and it must be a very rapidly growing thing. The pension trusts and these insurance funds and these big funds are becoming very large corporate stockholders. They are listed as big stockholders, which they are, but the money they get belongs to millions of other people.

Senator LONG. Is it not true that the bill we have here provides that only individuals would get the benefit of this double-taxation proposal?

Secretary HUMPHREY. It is the individual, but you are talking about where the money goes, and I am saying that a large part of corporate money goes to trust funds and to funds that are listed as being stockholders which, in reality, are charities and things that have a very wide distribution.

Senator LONG. Will these charities and pension funds get the benefit of this double-taxation picture?

Secretary HUMPHREY. No. The charity doesn't pay a tax at all. It doesn't need a benefit. The benefit goes to individuals. But when you are talking about the amount of money that goes to big stockholders, you must eliminate, as I am saying, these big stockholders which are big stockholders for the benefits of millions of other stockholders like the insurance and pensions and trust funds.

Senator LONG. If we are looking to see who gets the benefit of this proposal, you cannot count these pension funds in there because they are not paying a tax anyway. Then that narrows it down to the fact that you have about 6 million stockholders in this country and that out of those——

Secretary HUMPHREY. No, you have about nine.

Senator LONG. As you spread this tax exemption, however, you get down to the fact that the only study I have seen on this subject shows that six-tenths of 1 percent of the people own 80 percent of all corporate stock.

Secretary HUMPHREY. I am sure that is a mistake. I am sure that figure is not right.

Senator LONG. Do you have any computation to meet that figure? Have you made any study of it?

Secretary HUMPHREY. Oh, yes, we have got some figures, and I will be glad to get information for you about it, but I am sure that figure is in error.

(The material referred to is as follows:)

Data on Stock Ownership

Two studies have produced figures similar to those mentioned by Senator Long. The results are summarized in Effects of Taxation on Investments by Individuals by Butters, Thompson, and Bollinger and Stock Ownership Among American Families by Katona, Lansing, and deJanosi, Michigan Business Review, January 1953. These are the first scientific surveys in this area and are based on very small samples, in one case only a few hundred people. Even those who collected this data have important reservations about the accuracy of the concentration of ownership figures. For example, the Katona study states:

"These data are new, they are available from one survey only, and they cannot be checked satisfactorily against any existing statistics. The findings must be regarded, therefore, as tentative until they can be corroborated.

"* * * It is possible that the sample * * * contains too many or too few families who own stock worth $1 million or more, and it is of course possible that the information on the value of their holdings is erroneous."

These studies contain the figures used by Senator Long which are based on the value of family stockholdings. The same studies also contain estimates of stock ownership based on family income which show less concentration than the figures used by Senator Long and and are more significant in appraising the tax revision bill. Another recent sample shows that 53 percent of the shares of the United States Steel Corp. held by individuals is held by persons with incomes under $10,000.

Discussion of the concentration of ownership of publicly held stock is not strictly relevant to the proposal in the bill.

The bill covers both publicly held and privately held corporate stock; the studies cover only publicly held stock. This means that the large number of small, closely held corporations are completely excluded. It is estimated that there are 1 million or 2 million shareholders who own shares only in so-called closed corporations (excluded from the surveys).

The bill refers to dividends received; the surveys cover the value of the stocks. There are wide variations between the value of stocks and their dividend payments.

The bill gives greater relief to small shareholders than to large shareholders; the inferences drawn from studies on stock ownership take no account of this fact and thereby overstate the concentration of direct benefits from the provision.

There is an unmistakable trend toward larger shareholdings by smaller investors, who would receive the largest proportionate relief as a result of this provision. The proposed 10-percent credit would mean 50-percent relief of double taxation for an investor subject only to the first bracket—20 percent—tax rate. This same credit would mean only 20-percent relief for an investor in the 50-percent bracket. In the highest tax bracket the relief would be only 11 percent.

The Chairman. Mr. Secretary, if that is true, assuming that the percentage is along that line, would it not be well to do those things taxwise and otherwise to broaden the base of stock ownership?

Secretary Humphrey. That is right. I think the chairman is following the point that I tried to make a minute ago, that what we are seeking to do is to broaden the ownership of America in the greatest possible way and that is the best thing that can happen in America. I think it is going on very rapidly, if you will look at the trend of the figures. You will see that it is going on and it should be encouraged.

Senator Frear. Mr. Chairman, may I ask a question right along that line of the Secretary, whom I admire very much? If we are going to broaden the base, then we are going to have to have a greater number of stockholders coming from the lower- and middle-income groups. If we give larger personal exemptions, it would mean a little more money with which they could buy stocks, would it not?

Secretary Humphrey. I think it is far better to give it the other way, to give them the inducement to buy the stock and in that way save the money.

Senator FREAR. But if their income is not such that they can buy stock because they are paying it in taxes, then they can't own the stock. We have got to give them money with which to buy the stock.

Secretary HUMPHREY. But Senator, we have given $7½ billion out this year already. That is a tremendous amount of money to put out in 1 year.

Senator LONG. Isn't it all going to the same people, though?

Secretary HUMPHREY. No, Senator, this goes to every single taxpayer in America. They all get something. There is not one who doesn't get something.

Senator LONG. Might I point this out, Secretary Humphrey: When this excess-profits tax expired, the people who hold corporate stock were the people who got the exclusive benefit of that, and that goes entirely to the same people who hold this corporate stock to get the benefit of this double dividend proposal. In other words, there is the same group getting the second round of relief. That is by and far a group that benefited from the expiration of these last increases in income taxes.

Secretary HUMPHREY. What you are doing is putting the money where it can be used to make the jobs that people have to have. A tax cut does you little good if you haven't got a job. That is what we are losing sight of all through this discussion. We must provide jobs, and I think I can demonstrate to you that it is even more necessary now than it ever was before.

Senator BUTLER. Secretary Humphrey, is it true that the deduction credit is limited to the first $50?

Secretary HUMPHREY. $50 this year and $100 next year. Then the percentage over that is simply in the first bracket.

Senator BUTLER. That would not mean very much to a large stockholder.

Secretary HUMPHREY. It means 10 percent of whatever it is, that is all. It means much more to a little stockholder than to a big one. What a big stockholder gets, gentlemen—and I think we ought to understand it—if he gets a thousand dollars of dividends, is $100 free and 10 percent of $900, or $90. So his gross saving in tax that we are so concerned about is $90 plus whatever tax saving results from excluding the $100 from his total income. The rest of it goes on and he pays up to his highest rate on it. So the big stockholder is not getting any boon to be relieved of the high brackets in any large amount, any more than the little stockholder.

The little stockholder gets a bigger percentage, as I say, because that first $100 is a bigger percent than the 10 percent would be later.

Senator JOHNSON. Mr. Chairman, may I make an observation and a very brief one?

The CHAIRMAN. Senator Johnson.

Senator JOHNSON. I think the Secretary is making a powerful argument for equity capital and an argument that should be made and kept before committees of Congress constantly, but is not the problem today consumption and not production? We need consumers worse than we need producers, because we are producing more than we can consume. I don't know what we can do about it, but equity capital is not the only problem we have. We need some buyers.

Secretary HUMPHREY. Senator, I don't want to be appearing to duck that question, because that is the very one I want to answer, but I think I answer it in my statement, and I will be glad to either finish the statement or go to answers, but I don't think it is worthwhile to do both, because we will just be duplicating.

The CHAIRMAN. What is the wish of the committee?

Senator JOHNSON. I would rather he would proceed with his statement.

Secretary HUMPHREY. If it doesn't fully cover it we will come back to it, because I want to get that particular thing thoroughly cleared up. You say you don't know what we ought to do about it. From my point of view, I know exactly what we ought to do about it. We ought to pass this bill, because it provides the buyers we need both ways. I will try to cover that here and then come back to it, again.

The CHAIRMAN. Senator Johnson, will you agree to that?

Senator JOHNSON. I will be more than pleased to have him handle it that way.

Senator HUMPHREY. The method of relief proposed in this bill is a partial restoration of the treatment originally accorded dividends in 1913 and kept in the law until 1936. During that entire period, dividends were exempt from the normal individual tax which was typically the first bracket tax. The 10-percent credit against tax contained in the present bill will, in effect, exempt dividends from one-half of the present first bracket rate of 20 percent. This is the same general method of relief adopted in Canada in 1949, but goes only half as far, except in the case of the small stockholder who, by the terms of this bill, gets the first $100 of dividend income completely exempt.

It is one of the provisions which will help the expansion of business and the making of more jobs. We only need to remember that the average cost of providing plant and equipment for one job in America is between $8,000 and $10,000. It is certainly in the interest of all Americans that the incentive to provide the money to create more and more jobs is stimulated so that our increasing numbers of available workers can have the opportunity for employment and wages at the American high standards.

Another provision of this bill allows more flexible changes for depreciation. This proposal will benefit 9,600,000 individuals—farmers, small businessmen, et cetera—as well as 600,000 corporations. Here, again, the purpose is to stimulate employment, plant expansion, and modernization.

The total deduction over the life of the property will not be increased and only the same total sum will be given as a tax deduction, but less restrictive rules than at present for writing off the investment in machinery or plant will encourage modernization and rebuilding of more efficient plant equipment and the creation of more jobs for the production of better and cheaper things for living.

Other countries have used special depreciation allowances with great advantage to encourage investment in new equipment and modernization of old plant and equipment. The change in tax allowances for depreciation in this bill are quite limited compared to depreciation treatment in countries such as Canada, Great Britain, Sweden, and Germany.

Nothing can so add to our national strength and preparedness as modernization of the whole industrial plant in America. There is nothing that can make more sure more jobs at which millions of people can earn high wages by producing more and better goods at less cost.

Our tax program has two objectives: (1) revision to reduce hardships on individuals and barriers to incentive; and (2) reduction of excessively high taxation as rapidly as it is justified by cuts in Government spending.

About 70 percent of all we spend is for security. We have made some savings in this area, and we will make more, but no one wants to endanger our security by cutting expenses unwisely.

The only way the Government can save money is to reduce its spending. This means either reduction of people from the Government payroll or buying less material, which, in turn, means that the people who produced that material are temporarily out of work. The dollars that are saved in Government spending reduces work for the man who used to get those dollars. So that big reductions cannot be made quickly without seriously dislocating the economy.

As we cut Government spending, we must return to the people in tax cuts—as we are now doing—the billions of dollars of Government money saved, so that it can then be put to making new jobs for the people who previously received their income from Government spending.

People who have been making things for the Government for killing must, in this period of transition, now get jobs making things for living. Those who were making tanks and guns must now make washing machines and automobiles. A great transition must take place.

To have real prosperity in America, we cannot stimulate consumer buying alone. Large tax cuts to millions of individuals just to buy consumer goods is not enough. Millions of people in this country earn their living making heavy things—big lathes, generators, heavy steel, and machinery that consumers do not buy. Such things are purchased by investors. Our tax program not only returns billions of dollars to consumers but also seeks to stimulate the investment of savings to buy the products of heavy industry—in the production of which so many millions of Americans get their livelihood.

This administration is opposed at this time to any further tax cuts than those proposed in this bill. We are particularly opposed to any increase in personal exemptions, for two simple reasons:

First, we cannot stand any further loss of revenue. An increase in exemptions of $100 would cost about $2.4 billion. An increase to $1,000 would cost nearly $8 billion.

Secondly, it would entirely remove millions of taxpayers from the tax rolls. The President said, in his broadcast, that "the good American doesn't ask for favored position or treatment. * * * Every real American is proud to carry his share of the burden. * * * I simply don't believe for one second that anyone privileged to live in this country wants someone else to pay his own fair and just share of the cost of his Government." When a further reduction in taxes is justified, it should be made by reducing the rates.

The CHAIRMAN. Mr. Secretary, I would remind you that the 80th Congress took about 7 million taxpayers off the rolls. Having participated in that, I have no shame about that.

Senator HOEY. At that time, Mr. Chairman, it also increased exemptions of those over 65 from $600 to $1,200.

The CHAIRMAN. That is right.

Senator HOEY. Which accounted for some of the $7 million taken off taxes.

The CHAIRMAN. No one escapes taxes in this country. You pay all of the taxes that there are, State taxes, city taxes and hidden taxes. But they are no less clearly demonstrable because they are hidden. The average American is paying, perhaps, a fourth of his income in taxes of one kind or another.

Secretary HUMPHREY. There is no doubt, Mr. Chairman, that taxes must come out of the cost of things. There is no doubt of it. On the other hand, the whole problem with respect to taxation is two things: First, how much money do you spend? The only real way to reduce taxes is to reduce spending. When you decide how much money you are going to spend, then the only other question there is with respect to taxes is how do you fairly distribute that burden?

Senator MARTIN. Mr. Chairman, the big taxpayer in America is the consumer.

Secretary HUMPHREY. It has been suggested that the current economic situation requires some type of tax action different from that proposed in this tax revision bill.

Just what is the status of our economy at the moment? There is frequent discussion about unemployment and how things are turning down. We can be mislead about how bad business really is and how much pickup can be made. This doesn't mean that I do not realize that a man who is out of a job is in serious trouble. I do not discount his difficulties in any way. This administration is concerned to see that everyone who wants to work can have employment. But let me call your attention to these plain facts:

In January and February of this year, there were more people employed in America than in any January and February in the whole history of this country, except in January and February of last year. In January of 1953 there were 60.8 million people employed, and in February of 1953, 61 million. In January of this year, there were 59.8 million employed, and in February, 60.1 million. I repeat this. Except for one year—1953—January and February of this year had more people employed than any January and February in our history.

Some economic indicators show downward trends in comparison with this same time last year, which was he highest year in our history. The index of industrial production is down 8 percent; civilian employment is down a little, as we have said; and the gross national production is down about 1 percent.

Yet, construction is running ahead of 1953. Business plant and equipment plans for 1954 are at a very high level. Personal income is running a very little higher than a year ago. And the general price level has been exceptionally stable.

Some people, fearing further downward trends, ask when the Government is going to get "in" and do something about it.

The fact is that the Government is always "in." There are so many things that the Government does—or does not do—that have a very real bearing on the state of the economy.

There are many things that the Government has already done; things recommended which are now before the Congress; and things which the administration has proposed either for the future or for action by executive agencies, all of which have and will help strengthen our economy.

First, in things already done, we should look at an area of Government action very close to us at Treasury—the area of flexible debt management and monetary policy.

The Federal Reserve Board—with its responsibility for monetary policy—reduced reserve requirements of member banks substantially as early as last June to make sure that there would be no bar to the proper volume of bank credit necessary to a growing economy. The Federal Reserve has purchased short-term Government securities in the market, to increase bank reserves, for a considerable period. The rate at which bankers can borrow from the Federal Reserve was reduced early in February.

Treasury debt management also has been a positive factor, and Government interest rates have fallen to the lowest point in many years. Last July, the Treasury had to pay $2\frac{1}{2}$ percent for an 8-month loan. In February we paid the same rate for a loan running almost 8 years. And our last 1-year money borrowing was at $1\frac{5}{8}$ percent. Ninety-day bills cost close to $2\frac{1}{2}$ percent last June; now they are down to 1 percent.

In the current economic enviornment, the Treasury has purposely done its financing in a way that would not interfere with the availability of long-term investment funds to corporations, State and local governments, and for mortgages to homeowners. We want to be sure that plant and equipment, home building, and other construction, all have ample available funds. The fact that construction thus far this year is running so high demonstrates how effective these policies are.

We have the Small Business Administration to ease the proper handling of credit in this particular and vital part of our economy.

Perhaps the biggest way that the Government is continually in the economy is in this mater of taxes. We have noted that tax cuts effected this year will total $7.4 billion, the largest total dollar tax cut in history. This saving of such huge amounts of money for peacetime use should have a tremendously beneficial effect in stimulating the economy.

Some of the things recommended by the administration and now before the Congress which will have considerable bearing upon the economy are as follows:

The President has asked legislation to broaden the base and benefits of old-age insurance. This legislation is currently before the House Ways and Means Committee.

In the housing bill, which is currently before the Senate, are two administration proposals affecting the building of homes. We have asked that the Government be allowed to change the terms of governmentally insured loans and mortgages as circumstances require. We have asked that a secondary home mortgage market be established.

The administration has urged that the highway construction program be increased and a record sum has already been voted by the House.

The administration is recommending a positive program for flexible price supports for the American farmer. The President's program is being actively considered by both the House and the Senate.

The administration has taken specific actions within the executive departments and with other governmental bodies to do things that will help strengthen our economy.

We have recommended legislation to improve unemployment insurance and the administration has asked the governors of the various States to study the possibility of making payment scales more realistic.

A committee for State, local, and Federal planning has been appointed and is now at work.

The President has asked the Office of Defense Mobilization to redirect its stockpiling program, which will help distressed mining areas.

The administration is going ahead with improved planning of its public works programs which can be available for any emergency.

Last, but far from least, the tax revision bill which we are specifically considering today, will, upon enactment, have a tremendously helpful effect upon the economy. While it is basically a long overdue tax reform bill, it can help greatly the current economic transition.

There are many business projects around the country which are being held up pending final decision of this revision bill. It is imperative that the earliest possible action should be taken. When the bill is enacted, these new or expanding businesses can go ahead with their plans, which will result in the creation of thousands of jobs and the vital expansion of our economy.

The CHAIRMAN. Mr. Secretary, I would like to invite your attention to the fact that the administration has taken a favorable viewpoint of reclamation matters. In addition, they have approved a wool bill which will help the wool growers of the West. They have approved a measure on stockpiling, which will help the miners of the West.

Secretary HUMPHREY. Thank you very much. We will see that those things are added.

The Government is always in the economy. That is one of the facts of life today. But we must remember the fundamental principle that the best government is the least government.

It is the citizens of our free economy who, through their initiative and ingenuity, must make sure that we keep moving ahead with higher employment, higher pay, and better living for all. The steps the administration has thus far taken—tax cuts, monetary and debt management operations, as well as the other items outside the fiscal field—are steps in the direction of restoring more freedom to our economy. And in more freedom in our economy is the strength of our Nation—not only in the current transition period but in the long run as well.

Mr. Chairman, with your permission I would ask Mr. Folsom to just run through in detail, but not at any length, these various items, and then I will be pleased to resume, Senator, the discussion of the very important point you brought up and any other matters that we can.

The CHAIRMAN. Proceed, Mr. Folsom.

STATEMENT OF MARION B. FOLSOM, UNDER SECRETARY OF THE TREASURY

Mr. FOLSOM. I am M. B. Folsom, Under Secretary of the Treasury.

Mr. Chairman and members of the committee, you each have before you a document giving a brief summary of 27 of the principal provisions of this bill. This document was prepared for your help in studying the various provisions. I think if you will take the document up and go along with me, I can briefly outline it.

(The analysis referred to follows:)

SUMMARY OF 27 OF THE PRINCIPAL PROVISIONS OF H. R. 8300

1. HEAD OF FAMILY

PRESENT	PROPOSED
Single people supporting certain dependents in their homes are treated as heads of household, with tax rates halfway between those of single and married people. Effect is to increase tax rates on families with children when one parent dies.	Allow full split income treatment to widows and widowers with dependent children and single people with very close dependent relatives, regardless of where they live. Eliminates special tax rate schedule for heads of households.

Number of taxpayers benefited: 800,000.

2. DEDUCTION FOR DEPENDENT CHILDREN REGARDLESS OF EARNINGS

Parent cannot claim child as dependent if child earns over $600. Effect is to discourage children from earning over $600.	Permit parent to continue to claim child as dependent regardles of earnings if child is under 19 or is a student and meets requirements of support. Child will pay tax on own income in excess of $600. Remove present feature which hurts incentive and gives rise to sharp increase in family tax liability due to an extra dollar of child's earnings.

Number of taxpayers benefited: 1,300,000.

3. SUPPORT TEST

(a) Dependent allowance provided only on the basis of specified relationships or legal adoption. No allowance for foster children or children awaiting adoption whom the taxpayer supports in his home.	(a) Allow the taxpayer to claim as a dependent any individual over half of whose support he provides, regardless of the degree of relationship, if the dependent lives in the taxpayer's home as a member of his household.
(b) No dependency exemption if several people share cost of support and no one provides more than half of cost.	(b) Permit people jointly supporting a dependent to decide among themselves that some one of them may claim dependency exemption.

Number of taxpayers benefited: 100,000.

4. DIVIDENDS-RECEIVED EXCLUSION AND CREDIT FOR INDIVIDUALS

Income is subject to double taxation, once to corporation as earned, and again to individual stockholders when remaining corporate income is distributed as dividends.	Correct existing inequity and eliminate double taxation completely on first $100 ($50 in 1954) of dividends received in a year by exemption of that amount from individual income tax. Give partial relief on dividend income above $100 by a 10 percent credit (5 percent in 1954). Remove longstanding obstacle to equity financing.

See attached analysis for details.
Number of taxpayers benefited: 7,000,000.

ANALYSIS OF DIVIDEND EXCLUSION AND CREDIT FOR INDIVIDUALS PROPOSAL

H. R. 8300 provides for the elimination of double taxation completely on the first $50 of dividends for 1954 and the first $100 for subsequent years by providing that those amounts are to be excluded from the income of the individual receiving the dividends. It gives partial relief on dividend income above those amounts by providing that 5 percent of the dividends shall be a credit against tax for the year 1954 and 10 percent of the dividends as a credit against tax in 1955. The credits apply to dividends received after August 1 in each year.

History of the exemption of dividends from individual income tax

When the first income tax law was enacted in 1913, a normal tax was imposed on individuals at the rate of 1 percent. In addition, a tax was imposed on corporations at the rate of 1 percent. At that time, dividends were completely free of the normal tax in the hands of the individual because, as the committee reports on that act state, the corporation was merely the collecting agent for the shareholder and the income should be taxed only once. This principle continued in the income tax law until 1936 with dividends being exempt from the normal tax but subject to surtax.

In 1936, President Roosevelt recognized the inequity of the double taxation of corporate income: first, in the hands of the corporation and, second, in the hands of the individual; and recommended that this be adjusted by the use of the undistributed-profits tax which would exempt the corporation completely from tax if it distributed all of its income. In the confusion over the enactment of this proposal, the dividends received credit by the individual was abolished and has not been in the law since that time. The recommendation to now permit such a credit to an individual is, therefore, not a new suggestion but merely restores to the tax law the historical concept of a credit to the individual for dividends received. With a 20 percent first bracket rate, the 10 percent credit will exempt dividends from one-half of the first bracket rate. This will be one-half of the relief accorded prior to 1936 when dividends were fully exempted from the normal tax, which was usually the same as the first bracket rate.

Relief from the double taxation of dividends has been recommended by numerous congressional groups and outside organizations. The method adopted is consistent with the original treatment in this country.

Experience in foreign countries

The method of relief from double taxation is a modification of the dividends received credit adopted in Canada in 1949. However, the present Canadian credit is 20 percent instead of the 10 percent provided in this bill. Moreover, limiting the credit to the amount of taxable income, when it is less than the amount of dividends, is a restriction not imposed under the Canadian system. On the other hand, the dividend exclusion provided by the bill is more liberal than the Canadian method for persons receiving small amounts of dividend income. It should also be noted that by another method complete credit has been permitted in England for over a century. No change in this method has been recommended by the Labor governments in England.

Purpose of the recommendation

The purpose of the recommendation, in addition to removing the inequity involved in the double taxation of corporation income, is to provide a source of equity capital. Corporations in recent years have had difficulty in obtaining equity capital with which to expand and buy new equipment. This has been especially true in the case of small business.

The ownership of stock in American corporations

Statistics of income for 1950 shows that more than three-fourths of all individuals reporting dividends have incomes of less than $10,000, and over 44 percent of dividend recipients have incomes of less than $5,000. Shareholders are not a class apart, but include farmers, housewives, schoolteachers, businessmen, retired persons, craftsmen, skilled and unskilled laborers.

It is desirable to encourage any trend toward wider participation in stock ownership of American industry. The proposal will encourage such investment by many individuals who are now inclined to prefer comparatively riskless outlets for their savings because of the tax penalties on dividends paid on corporate shares. This should help attain a broader base of ownership in American enterprise and a wider participation in its earnings.

The proposal follows the principle of the graduated income tax

The proposed dividend exclusion and credit confers partial relief for double taxation in the most administratively feasible manner. The method of adjustment affords greater relief for the low-income investor than for those at higher income levels. The percentage reduction of tax under the combined dividend exclusion and credit is greatest in the lowest bracket and declines progressively as the income level rises. For example, in the case of a married couple filing a joint return, the 10 percent credit alone will reduce existing tax liabilities on dividend income in the $4,000 first bracket (subject to a 20 percent rate) by 50 percent; on dividend income in the $12,000 to $16,000 bracket (subject to a 30 percent rate) by 33 percent; and on dividend income in the $32,000 to $36,000 bracket (subject to a 50 percent rate) by 20 percent. At very high income levels, the percentage reduction in tax on dividend income will be about 11 percent.

5. RETIREMENT INCOME CREDIT

Social security and railroad retirement benefits are not taxable; other forms of retirement income, such as teachers' pensions, are taxable.

Provide more equal treatment and alleviate hardships by allowing retired individuals a 20 percent tax credit on retirement income up to $1,200. Retirement income would include pensions and annuities, interest, dividends, and rents. To avoid duplicating existing exemptions, retirement income would be reduced by the amount of social security or other exempt pension income.

To equalize status of retirement income with nontaxable social-security benefits:

(a) Allow credit only for people over 65.

(b) Provide reduced credit for each dollar of income earned over $900.

(c) Require earnings of $600 in 10 prior years as basis for qualification for credit.

Number of taxpayers benefited: 1,500,000.

6. TAXATION OF PURCHASED ANNUITIES ON LIFE-EXPECTANCY BASIS

Three percent of cost is taxable; balance nontaxable until cost is recovered; then full amount is taxable. Effects vary widely and erratically with type of annuity contract and circumstances of the taxpayer. In some cases, taxpayer cannot possibly recover his full cost tax-free. In others, the taxpayer becomes fully taxable on annuity payments after short period of retirement.

Determine taxable portion of each annuity payment in a uniform manner on the basis of life expectancy by permitting tax-free recovery of cost over average life. Simplify reporting of annuity income. Avoid abrupt change in taxability during lifetime of person receiving annuity.

Number of taxpayers benefited: 800,000.

7. EMPLOYEES' PENSION AND PROFIT-SHARING PLANS

(a) Requirements are complex and create uncertainty as to whether particular plans qualify. Discretion to develop plans to meet individual needs is restricted. Benefits are taxed inconsistently. Inadequate safeguards to prevent dissipation of pension trust funds.

(a) Provide clear, simplified rules to facilitate determination as to whether particular plans qualify. Plans are granted greater flexibility to adjust to special needs, but cannot discriminate in favor of key employees or stockholders. Benefits are given more uniform treatment. Trusts are prevented from dissipating funds in certain prohibited transactions.

(b) Present value of survivors' annuity is subject to estate tax on death of husband.

(b) No estate tax on death of husband. Tax the benefits to survivors in same way as benefits to original retired person were taxed.

8. EMPLOYEES' SICKNESS AND ACCIDENT PLANS

Present	*Proposed*
(a) Law is indefinite on tax status. Fear exists that employees will be taxed on insurance premiums paid by employers on their behalf.	(a) Remove fear and uncertainty by providing that employees are not taxable on employers' contributions.
(b) Payments received while sick are tax-exempt if paid from an insured plan. Payments from other plans are taxable.	(b) Remove discrimination between insured and self-insured plans. For qualified plans, limit tax-exempt payments to $100 a week of compensation for loss of wages. Exempt in full hospital, medical and surgical benefits from qualified plans.

Number of taxpayers benefited: Potentially, all employees.

9. MEDICAL EXPENSE DEDUCTION

(a) Deduction for expenses in excess of 5 percent of income.	(a) Reduce percentage requirement to 3 percent.
(b) Ceiling of $1,250 per person and $5,000 per family.	(b) Double ceiling to $2,500 per person and $10,000 per family.
(c) Fairly broad definition of medical expenses.	(c) Tighten definition to exclude ordinary household supplies. Permit deduction of cost of transportation necessary for health but not ordinary living expenses incurred during trip.
	Overall effect of proposed changes is to liberalize and extend relief in real hardship situations due to heavy medical expense but curb deduction of ordinary or luxury living expenses in guise of medical costs.

Number of taxpayers benefited: 8,500,000.

10. CHILD CARE DEDUCTION

No deduction allowed.	Allow deduction for expenses up to $600 for care of young children, paid by a working widow, widower, or mother whose husband is incapacitated.

Number of taxpayers benefited: 300,000.

11. DEDUCTION OF INTEREST CHARGES IN INSTALLMENT CONTRACTS

Interest element in carrying charges is not deductible unless stated separately in the installment purchase contract.	Permit the deduction of interest up to 6 percent of the average unpaid balance due under the contract during the taxable year.

Number of taxpayers benefited: 1,600,000.

12. GIFT TAX ON PURCHASE OF HOME

If a man buys a home for himself and his wife and takes title jointly, the value of the wife's share is treated as a gift for tax purposes. Taxpayers are frequently unaware that such a purchase constitutes a gift and fail to file a gift-tax return.	Eliminate this difficulty and relieve taxpayers of gift-tax filing requirement on purchase of home in these situations by recognizing no gift until the house is sold and then only if there is a net transfer of funds from one spouse to another.

13. SALE OF PATENTS BY INVENTORS

Present	*Proposed*
An amateur inventor may receive capital-gains treatment on the outright sale of his patent; a professional may not. Distinction between amateur and professional and between royalty income and installment payments arbitrary and confusing. Discourages scientific, inventive work.	Provide fair, clear-cut rules to eliminate present arbitrary and confusing distinctions. Allow capital-gains treatment on sales of patents by inventor if based on productivity of patent for period of not more than 5 years and sale proceeds receivable in 5 years. Encourage scientific work.

Number of taxpayers benefited: All inventors.

14. REAL-ESTATE DEALERS

Present	*Proposed*
Generally taxed at ordinary income rates on gain from sale of investment holding.	Allow real-estate dealers to segregate investment holdings, as is done by dealers in securities. Allow capital gains on long-term holdings. Reduce litigation.

15. SALES OF REAL ESTATE BY INDIVIDUAL INVESTORS

Present	*Proposed*
Individual investors owning real estate may be classified as subdividers and taxed at ordinary income rates unless property is sold in a single tract.	Permit owners of investment real estate to sell property in separate pieces and still receive capital-gains rates. Facilitate disposition and development of property now frozen by tax uncertainties.

16. DECLARATIONS OF ESTIMATED TAX BY INDIVIDUALS

Present	*Proposed*
Estimates of tax and payments are due March 15, June 15, September 15, and January 15, with final return on March 15. No effective penalty for underpayment if adjusted by January 15. Declaration required in large number of cases where there is little or no tax liability in excess of that withheld. Complex and severe charges for failure to comply.	Change March 15 date to April 15 for both final return and first estimate. Give additional optional bases for estimates of tax due. Eliminate returns for about 1 million taxpayers with small liability not withheld at source. Impose 6-percent interest charge on deficiency in quarterly payments, if they fall short of 70 percent of amounts actually due.

Number of taxpayers benefited: 1 million exempted from filing estimates. All individual taxpayers benefited by extension of final return date to April 15.

17. DEPRECIATION

Present	*Proposed*
Cost of buildings and equipment usually depreciated by straight-line method in equal amounts over expected life of property. Rigorous estimate of useful life, resulting in retarded rate of writeoff of costs. Discourages investment, especially risky, long-range commitments.	Restore some discretion to taxpayers on depreciation allowances. Permit larger depreciation charges on buildings, machinery, and equipment (including farm buildings and equipment) in early years of life of property through use of the declining-balance method at double the corresponding straight-line rate. This will reduce tax barriers to investment by: (*a*) Letting property be written off while risk and prospective income can be foreseen. (*b*) Permitting some short-term financing for capital equipment. Liberalization of particular importance to small growing businesses since it will improve working capital position.

See attached table for examples.
Number of taxpayers benefited: Individuals, 9,600,000; corporations, 600,000.

Annual charges for and accumulated depreciation of an asset costing $100,000 with estimated life as shown under both straight-line and 200 percent declining balance

Year	10-year life				20-year life			
	Straight-line 10 percent		200 percent declining balance 20 percent		Straight-line 5 percent		200 percent declining balance 10 percent	
	Annual charge	Cumulative	Annual charge	Cumulative	Annual charge	Cumulative	Annual charge	Cumulative
1	$10,000	$10,000	$20,000	$20,000	$5,000	$5,000	$10,000	$10,000
2	10,000	20,000	16,000	36,000	5,000	10,000	9,000	19,000
3	10,000	30,000	12,800	48,800	5,000	15,000	8,100	27,100
4	10,000	40,000	10,240	59,040	5,000	20,000	7,290	34,390
5	10,000	50,000	8,192	67,232	5,000	25,000	6,561	40,951
6	10,000	60,000	6,554	73,786	5,000	30,000	5,905	46,856
7	10,000	70,000	5,243	79,029	5,000	35,000	5,314	52,170
8	10,000	80,000	4,194	83,223	5,000	40,000	4,783	56,953
9	10,000	90,000	3,355	86,578	5,000	45,000	4,305	61,258
10	10,000	100,000	2,684	89,262	5,000	50,000	3,874	65,132
11					5,000	55,000	3,487	68,619
12					5,000	60,000	3,138	71,757
13					5,000	65,000	2,824	74,581
14					5,000	70,000	2,542	77,123
15					5,000	75,000	2,288	79,411
16					5,000	80,000	2,059	81,470
17					5,000	85,000	1,853	83,323
18					5,000	90,000	1,668	84,991
19					5,000	95,000	1,500	86,491
20					5,000	100,000	1,350	87,841

Provisions of Particular Importance to Small Business

18. ACCUMULATION OF SURPLUS

Present

Penalty tax on unreasonable accumulation of earnings to avoid individual income tax, with burden of proof on taxpayer to prove retention not unreasonable and requirement of immediate investment. Source of serious uncertainty and controversy. Especially burdensome on small business which cannot readily accumulate funds for needed expansion projects.

Proposed

Shift burden of proof to Government if business submits reasons for accumulation. Remove requirement that retained earnings must be invested immediately. Provide that first $30,000 of retained earnings is not subject to penalty tax. Remove existing fears and uncertainties. Permit accumulation of adequate liquid funds for future expansion and financial reserves. Aid growth of small business from internal capital source.

19. RESEARCH AND DEVELOPMENT EXPENSE

Present

No specific statutory treatment. Uncertainty whether particular expenditure is deductible or must be capitalized, particularly where there is no regular research budget. Unusual research expenses must be capitalized and written off in later years. Discourages research. Especially restrictive for small business.

Proposed

Provide definite rules, giving option to taxpayers to capitalize or write off research and experimental expenses currently. Encourage research and experimental activity. Help small, pioneering businesses.

20. NET OPERATING LOSS DEDUCTION

Present	*Proposed*
Loss carryback for 1 year; carryforward for 5.	Extend loss carryback to 2 years; continue 5-year carryforward. Help small businesses with fluctuating income by increasing the opportunity for prompt tax relief to tide over a period when the cash is most needed.

21. PARTNERSHIP PROVISIONS

Present	*Proposed*
Inadequate statutory provisions. Present treatment based on rulings and court decisions is uncertain and inconsistent.	Provide comprehensive clear-cut pattern of treatment. Simplify rules and eliminate confusion. Permit formation of and changes in partnerships without undue tax complications. Facilitate flexible, equitable arrangements in partnership transactions.

22. CORPORATE RECAPITALIZATIONS AND REORGANIZATIONS

Present	*Proposed*
Complex and uncertain tax treatment. Unduly restrictive in connection with changes in corporate form of small businesses.	Simplify and make certain. In general, permit tax-free changes in capitalizations, with tax imposed only when funds or property are withdrawn from corporations. Change some of tax rules which now force sale of small businesses to larger corporations and at same time prevent bail-out abuse.

23. ACCOUNTING PROVISIONS

Present	*Proposed*
Many differences between rules for computing income for tax purposes and rules for computing income for business purposes under generally accepted accounting principles. Differences cause unnecessary administrative work and elaborate reconciliations. Tax rules tend to speed up the reporting of income and to defer the deduction of expenses and losses: (1) Prepaid income is taxed before earned, and (2) No current allowance is made for reserves for known future expenses.	Bring tax rules into harmony with generally accepted accounting principles, thereby eliminating to a great extent necessity for taxpayers to maintain two sets of records. Provide realistic timing of income for tax purposes in conformity with sound business practices: (1) Tax prepaid income as earned; (2) Recognize deductions for reserves for known future expenses; and (3) Allow property taxes to be allocated ratably over the period for which the tax is imposed.

24. SOIL AND WATER CONSERVATION EXPENSE

Present	*Proposed*
Uncertain and very limited tax deduction for soil and water conservation expense. These expenditures are generally capitalized as part of the cost of the land which is not depreciable and therefore recoverable only upon sale of the land.	Allow current tax deduction for specified soil-conservation expenses not in excess of 25 percent of gross farm income. Clarifies tax treatment and encourages sound conservative practices.

Number of taxpayers benefited: 500,000.

25. NATURAL RESOURCES

Present	*Proposed*
	Only minor changes, in view of budget message recommendation for postponement of major consideration in this area.
(*a*) Complex and unclear classification of nonmetallic minerals for purposes of percentage depletion, which excludes a few nonmetallics.	(*a*) Supply a simpler, more comprehensive classification and grant percentage depletion to omitted nonmetallics.
(*b*) No clear statutory definition of a property for purposes of percentage depletion allowances. Meaning of "property" is narrowly defined.	(*b*) Allow the taxpayer greater flexibility in combining operating interests in identifying a mineral property. Provide clear, workable definition of property.
(*c*) Percentage depletion denied on minerals produced from "mine tailings"—accumulated waste materials from mining operations.	(*c*) Extend percentage depletion to encourage recovery of minerals from residue.

26. FOREIGN INCOME

Present	*Proposed*
(*a*) Dividends from foreign subsidiaries taxed at regular United States rate.	(*a*) Tax income from foriegn subsidiaries at rate 14 percent below United States rate. This will reduce tendency of foreign countries to raise their rates to ours.
(*b*) Income from foreign branches taxed as earned.	(*b*) Permit foreign branches to be taxed as subsidiaries, and at the reduced rate. Postpone tax until income is brought home as in the case of foreign subsidiaries.
(*c*) Credit allowed against United States tax for foreign income taxes paid, subject to overall and per country limitations.	(*c*) Broaden definition of foreign taxes which may be credited. Remove overall limitation on tax credit, to avoid present penalty on companies going into new country where they expect to operate temporarily at a loss.
(*d*) Investment trusts can make no use of foreign tax credit which they receive. Investors in such trusts pay tax on the distributed income without benefit of foreign tax credit.	(*d*) Permit regulated investment trusts with substantial foreign investment to pass tax credit on to their stockholders.

27. ADVANCE PAYMENTS BY CORPORATIONS

Present	*Proposed*
By 1955, corporations will pay their entire income tax in two equal installments on March 15 and June 15. Concentration of payments leads to large fluctuations in public debt and disturbances in money markets. Well managed corporations fund tax liabilities in advance by purchase of short-term Government securities, on which Government pays interest.	Require estimates and advance payments on September 15 and December 15, starting at 5 percent in 1955 and rising to 25 percent in 1959. Exempt first $50,000 of tax liability, which will exempt over 90 percent of all corporations, but less than 10 percent of total corporate tax liability. Provide options for estimates comparable to new options for individuals, including relief provision for corporations with income concentrated in last part of year. Smooth tax receipts, public debt and money market movements; save interest by requiring large corporations to pay current tax liabilities to the Government instead of borrowing tax money from them.

Number of corporations affected: 35,000 out of total of 425,000.

Provisions Closing Loopholes

Over 50 loopholes have been closed, as noted by Chairman Reed. These include:

(a) Amortization of premium on bonds with short-term call dates against ordinary income and subsequent sale at capital gains rate.

(b) Unlimited tax-exempt sick benefit payments under insured plans, by which high-salaried employees could increase their net income, after tax, several-fold while on sick leave. Tax-exempt benefits in the form of wage and salary continuation payments limited to $100 a week.

(c) Purchase of corporations to secure benefits of loss carryovers.

(d) "Bail-outs" of corporate profits at capital gains rates by issuance, sale, and redemption of preferred stock.

(e) Collapsible partnerships.

Income tax rates and exemptions—1913–54

Income year	Range of rates (Percent)	Exemptions		
		Single	Married	Dependent
Mar. 1, 1913-15	1 - 7	$3,000	$4,000	....
1916	2 -15	3,000	4,000	....
1917	2 -67	1,000	2,000	$200
1918	6 -77	1,000	2,000	200
1919-20	4 -73	1,000	2,000	200
1921	4 -73	1,000	2,500	400
1922	4 -58	1,000	2,500	400
1923	3 -43.5	1,000	2,500	400
1924	2 -46	1,000	2,500	400
1925-28	1.5-25	1,500	3,500	400
1929	1.5-24	1,500	3,500	400
1930-31	1.5-25	1,500	3,500	400
1932-33	4 -63	1,000	2,500	400
1934-39	4 -79	1,000	2,500	400
1940 [1]	4 -79	800	2,000	400
1941	10 -81	750	1,500	400
1942-43 [2]	19 -88	500	1,200	350
1944-45	23 -94	500 per capita		
1946-47	19 -86.45	500 per capita		
1948-49	16.6-82.1275	600 per capita		
1950	17.4-84.357	600 per capita		
1951	20.4-91	600 per capita		
1952-53	22.2-92	600 per capita		
1954	20 -91	600 per capita		

[1] Exclusive of the defense tax of 10 percent of the total tax due.

[2] Exclusive of the victory tax applicable to 1943 which was imposed at a rate of 5 percent on net income after a specific exemption of $1,248 for a married couple filing a joint return and $624 for other taxpayers.

Combined exemptions and credits for family with 3 children and first bracket tax rates, 1940–54

Year	Combined exemptions and credits for family with three children	First bracket rate	Year	Combined exemptions and credits for family with three children	First bracket rate
		Percent			*Percent*
1940	$3,200	4	1948	$3,000	16.6
1941	2,700	10	1949	3,000	16.6
1942	2,250	19	1950	3,000	17.4
1943	2,250	19	1951	3,000	20.4
1944	2,500	23	1952	3,000	22.2
1945	2,500	23	1953	3,000	22.2
1946	2,500	19	1954	3,000	20
1947	2,500	19			

Effects of Increases in Exemption

For 1954, it is estimated that 47.2 million taxable returns will be filed, representing 77.7 million taxpayers.[1] The total individual income tax liability is estimated at $29.2 billion.

[1] Each joint return counted as 2 taxpayers.

Effects of increases in exemption above present $600

Exemption	Reduction in taxable returns	Reduction in number of taxpayers [1]	Reduction in tax liability
	Millions	*Millions*	*Billions*
$700	4.1	7.0	$2.4
$800	7.6	13.2	4.5
$900	11.2	19.4	6.3
$1,000	14.6	25.4	7.8

[1] Each joint return counted as 2 taxpayers.

The increase in the level of income received wholly tax-free by a family with three children is shown below, assuming standard deductions:

Exemption:	*Nontaxable income*
$600	$3,333
$700	3,889
$800	4,444
$900	5,000
$1,000	5,556

Following table from page 3 of Report of the Committee on Ways and Means, House of Representatives, to accompany H. R. 8300, a bill to revise the internal revenue laws of the United States, March 9, 1954.

Effect on receipts, fiscal year 1955, of measures contained in your committee's bill

[Millions]

	Loss	Gain
Individuals:		
Items having permanent effect:		
Full split income for head of family	$50	
Dividends received exclusion and credit [1]	240	
Taxation of annuities on life expectancy	10	
Deduction for certain dependents regardless of earnings [1]	75	
Dependent deduction for member of taxpayer's household who meets support test	10	
Retirement income credit	125	
Deduction of interest charges in installment contracts	10	
Medical expense deduction	80	
Child care deduction	40	
Personal exemption for trusts	3	
Premium test on life insurance	25	
Increase in charitable contribution limitation from 20 percent to 30 percent	25	
Subtotal	693	
Items which merely shift deduction or income between taxable years:		
Soil and water conservation expenditures [1]	10	
Depreciation [1]	75	
Subtotal	85	
Combined effect for individuals	778	
Corporations:		
Items having direct revenue effect:		
Natural resources [2]	27	
Treatment of income from foreign sources [2]	147	
Subtotal [2]	174	
Items which merely shift deductions or income between taxable years:		
Depreciation [1]	300	
Net operating loss deduction [1 2]	100	
Accounting provisions [2]	45	
Subtotal [2]	445	
Total [2]	619	
Extension of 52 percent rate for 1 year		$1,200
Combined effect on corporations [2]		581
Grand total, individuals and corporations	197	

[1] Items with substantial incentive effects.
[2] A small part of this estimate applies to individuals, but this cannot be clearly segregated.

1954 Tax reduction program—Full-year effects

	Billions
Reduction in individual income tax, Jan. 1, 1954	$3.0
Elimination of excess profits tax, Jan. 1, 1954	2.0
Tax revision bill	1.4
	6.4
Reduction in excise taxes, Apr. 1, 1954	1.0
	7.4

NOTE.—$1.1 billion of this total will occur in fiscal 1954; almost all the rest will occur in fiscal 1955.

Distribution of tax savings between individuals and corporations

	Individuals	Corporations
	Billions	*Billions*
Individual income tax reduction	$3.0	
Excess profits tax elimination		$2.0
Tax revision bill	.8	.6
Excise reduction	.8	.2
Total	4.6	2.8

Summary of budget figures, fiscal years 1953–55

[In billions]

	1953 actual	1954		1955
		Truman estimate Jan. 9, 1953	Budget message Jan. 21, 1954	
Expenditures:				
National security	$50.3	$54.7	$48.7	$44.9
All other	23.7	23.2	22.2	20.7
Total expenditures	74.0	77.9	70.9	65.6
Net receipts	64.6	68.0	67.6	62.7
Deficit	9.4	9.9	3.3	2.9

Mr. FOLSOM. The first item on page 1 is the changing of the definition of head of family. It now is head of household and is treated differently from husband and wife. The bill would accord full split income treatment to widows and widowers with dependent children and others with close dependent relatives. That would benefit 800,000 taxpayers and would cost us about $50 million.

At the back of this list there is a consolidated list showing the cost of these various items, but I will indicate them as we go along.

The second item has to do with permitting families to claim children as dependent even if they earn over $600. That will affect 1,300,000 taxpayers and will cost about $75 million.

The third item broadens the definition of support, mainly to bring in foster children as dependents. That would affect about 100,000 taxpayers and will cost about $10 million.

The CHAIRMAN. Mr. Folsom, I invite your attention to the fact that that is not a rich man's provision. The fellow who most needs the deduction is not the rich man. He can take it all right. He can get along without any deduction. The fellow who needs the $600 exemption that we are talking about is the average fellow and the fellow in the lower income-tax brackets.

Mr. FOLSOM. That is true, Mr. Chairman, and, of course, the present rule is quite unfair.

On the next page you have a brief description of the dividend provision. As the Secretary has already pointed out, this eliminates the first $100—50 in 1954 and $100 next year—of the dividends received and then it gives a partial relief on dividends above that $100 by a 5 percent credit on the tax in 1954 and 10 percent in 1955.

We have considered several different methods of handling this and we feel that the plan that we are recommending is the fairest and the simplest and the easiest to administer.

I think if I indicate briefly some of the background of this you might like to hear it.

Senator JOHNSON. What is the cost?

Mr. FOLSOM. The cost of the first year is $240 million. The third year, when it gets into full operation, will be $814 million. It will benefit roughly 7 million taxpayers.

Prior to 1936, as the Secretary indicated, there was no normal tax on dividends. If you consider the first bracket as the normal tax, that would mean now we would have a 20 percent credit. We are suggesting a 10 percent credit, about half of what we had in 1936. That 1936 provision was dropped out—it had been in since 1913, at the time the undistributed profits tax was put into effect. The undistributed profits tax was simply a tax on corporations for profits which were not distributed in the form of dividends. So there was no taxation at that time on the dividends that the stockholders received. When that was discontinued, they didnt' go back to the provision which we had prior to 1936. Since that time we have had this complete double taxation of dividends.

The CHAIRMAN. Do you handle it as an item against the tax rather than an exemption or a deduction? Why is that?

Mr. FOLSOM. We don't like the proposal of taxing only the earnings that are not distributed because it penalizes growing companies. You give an advantage to companies which are well established and pay out a large percentage of their earnings in dividends. The company which has to depend on retained earnings to finance itself would be at a great handicap because the tax would apply only on earnings not distributed.

We don't think that is sound at all. When that law was in effect in 1937 and 1938, there was considerable criticism. It stayed on the books a very short time because of that reason——

Senator HOEY. Is there any limitation on the amount of dividends to which this 10 percent applies?

Mr. FOLSOM. I will explain that. We start out first with this exemption, a complete exemption of the $100. Then we recommend a 10 percent credit for all dividends above that. If you take the man who is in the $4,000 salary class, he now pays a tax of 20 percent. Let us say he has a thousand-dollar dividend, after the $100 exclusion. He will get a reduction of $100 in his tax. That means he is paying half the tax on the dividends he paid before. He was paying 20 percent and now he is paying 10 percent. Let us take the man who is in the 50 percent bracket. He gets the same $100 credit.

He had been paying 50 percent and he will now pay 40 percent, so he is getting the same dollar reduction but only a 20 percent reduction compared with the 50 percent reduction for the man in the 20 percent bracket.

Senator HOEY. Suppose he is getting a hundred thousand dollars of dividends.

Mr. FOLSOM. He will get a 10 percent credit on it.

Senator HOEY. There is no restriction on the amount of the dividends?

Mr. FOLSOM. No.

Senator FREAR. I would like to ask a question but it refers to the previous item, Mr. Chairman.

I don't want to delay this.

The CHAIRMAN. Go ahead.

Senator FREAR. In your support back on No. 3, did you give any consideration to a double exemption where the supporter of a blind person is not the husband or wife?

In other words, suppose it was a child. He now gets one exemption if he supports a blind mother. But if it was the husband supporting a blind wife, they would get a double exemption.

Mr. FOLSOM. I am not sure whether that is in or not. I will have to check that and let you know on that. I don't think it is.

Senator FREAR. Do you have any idea, if that were the case, that you permitted that, what the cost would be in taxes?

Mr. FOLSOM. I imagine it would be a comparatively small item.

Senator FREAR. Thank you, Mr. Chairman.

Mr. FOLSOM. The system that we recommend to eliminate partially the double taxation of dividends is the plan which Canada adopted in 1949 after a complete study of the whole situation. They now have a 20-percent credit and we are only proposing 10 percent. I might also say that in England for years, since the beginning of the income-tax system over there, they have never had any double taxation of dividends.

Senator FREAR. Would you propose a 20-percent reduction if you thought that the Treasury could stand it, if you thought you could reduce the income by that amount? What you favor doing it the same as Canada?

Mr. FOLSOM. We would like to try this system out and see how it works. We are now suggesting 2 steps, 5 percent and 10 percent, and then we will depend entirely on the revenue situation at that time as to what we suggest.

Senator JOHNSON. Under your plan, when do we reach the maximum of $814 million?

Mr. FOLSOM. In 1957.

Now, going to the next page, we have the retirement income credit.

Senator LONG. What is the purpose in putting these things into effect gradually? If they are going to go into effect, why not go ahead and put them in? If we are going to have tax reductions next year and the year after, why not consider the overall economy and consider all taxpayers at that time.

Mr. FOLSOM. This is mainly a question of the loss of revenue involved. We are trying to lose just as little revenue as we can and at the same time give the people the benefits.

Senator LONG. It seems to me right now you are thinking in terms of who should be getting tax reductions this year, next year, and the year after. You have got a few of those tied by the proposals in there that are going to help some widow and a few people like that. It amounts to about $250 million that I can see. Those things just occur in the first year. They don't increase, so far as I can determine. Are widows going to get any additional benefit the second and third years?

Mr. FOLSOM. No; they continue right on.

Senator LONG. At the same rate, but on the other hand these corporation benefits grow year by year.

Mr. FOLSOM. If we could stand the loss of revenue we would like to do it this year, but we can't do it. I also mentioned the fact that these individual taxpayers have already just gotten a $3 billion cut on January 1.

Senator LONG. How much of that benefit goes to the average laboring man? Half of them didn't make more than $3,500 a year and the social-security increase wiped out their savings.

Mr. FOLSOM. Social security is looked upon by most wage earners as saving for old age. It is not the same as income tax.

Senator LONG. As far as increasing their purchasing power is concerned, a workingman with $3,500 a year income has less money to spend now than he did before that 10-percent reduction in income taxes went into effect, doesn't he?

Mr. FOLSOM. I think that is about the break-even point, somewhere around there.

Senator LONG. And more than half the workingmen make that much or less.

Mr. FOLSOM. But the point I am making is that there was a $3 billion tax cut to individual taxpayers the first of the year.

Senator LONG. There is one point I have in mind about that, though. From where we stand right now, based on your tax program, the average laboring man has less money in his pocket to spend now than he had before the tax reductions went into effect. It seems to me that those in the lower income brackets are more likely to spend money buying these consumer items that we would like to have purchased than those in the upper income-tax brackets. It is true that a man making $50,000 a year is paying a very high tax, but he is in a position to buy all of the foods he wants. If he is eating red beans and rice, it is just because he has had enough beef steak for the time being. But a workingman would like to buy clothes, shoes, washing machines, and things that he hasn't been able to buy up to this point. But he doesn't have any more purchasing power.

Mr. FOLSOM. Many of these provisions in here will benefit the individual taxpayer. The important thing, as the Secretary pointed out, is that we want to create more jobs for these people.

Senator LONG. You point out to me the provision in this bill that will put more money in the pockets of the average workingman with a wife and two children.

Mr. FOLSOM. I will get to quite a few of them as we go along. I am going to point them out to you here. I have mentioned in each case the number of taxpayers that will benefit. You have a million three hundred thousand, as the chairman pointed out, of the small-income taxpayers who will benefit from this exemption on dependent children of $600.

We have got 8.5 million benefiting from the medical expense provision that I will get to later on. I will cover those as I get to them.

Senator LONG. That is providing they have some considerable misfortune. How much is that medical expense going to cost the Government?

Mr. FOLSOM. It will cost us $80 million. It benefits, we think, 8.5 million taxpayers.

Senator LONG. That is about 5 percent of your third-year cost of this provision; isn't it?

Mr. FOLSOM. You can't pick out any individual item but must look at the bill as a whole.

Senator LONG. That is about 7 million. Aside from that 7 million and about 1 million on it——

Mr. FOLSOM. The one I am getting to next is the retirement income credit which would benefit a million and a half taxpayers. That provision, Mr. Chairman, has to do with the fact that now we exempt from taxation the benefits from social security. Under this provision we would extend that exemption to people who are retired from other pension plans, teachers' plans, firemen's plans, widows, policemen, and so forth. They will all get the same credit we now extend to people receiving social-security benefits. So we estimate that will benefit a million five hundred thousand people over 65 and it will cost us $125 million.

The next item has to do with the treatment of annuities. It would simplify the tax treatment of annuities and put it on what we think is a fairer basis. I will not explain that in detail.

Senator LONG. Mr. Folsom, you just said the individual received about $3 billion at the beginning of this year in tax benefits by a reduction. Is that difference of 2 billion, between 3 and 5, in excess profits?

Mr. FOLSOM. Yes.

Senator LONG. Let me ask you this question: How many taxpayers do you have paying income taxes in this country?

Mr. FOLSOM. I think there are 47 million taxable returns.

Senator LONG. More than half of them are paying more income tax now than they were paying—when you add the social-security increase—at the first of the year.

Mr. FOLSOM. No; it would be anything like that high figure.

Senator LONG. My understanding is that half of your laboring men have had no tax reduction if you consider the social security.

Mr. FOLSOM. Many people are not covered under social security.

Senator LONG. Out of that 47 million taxpayers, how many millions of them are not going to receive any benefit at all from this bill? Have you made any calculation of that?

You have got several million who would benefit from the medical expense provision, although I believe it might spread over quite a few, that is about $80 million. If you are going to spread $80 million among 47 million taxpayers, you are not going to save them much money.

Mr. FOLSOM. That applies to the people with great needs, with heavy medical expenses. Which ones of the 47 million will get that relief no one can tell.

Senator LONG. You say you have perhaps as many as 9 million taxpayers who own some corporation stock. I would ask this question: When you get to this widow over here and this man who has the working child and this person who has a very high medical expense, do you believe that is going to have something for every one of these 47 million in here?

Mr. FOLSOM. There is 1 plan that we propose which will fully exempt sickness and accident benefits from nondiscriminatory plans and exempt up to $100 a week of compensation for loss of wages from nondiscriminatory plans. That will benefit almost all employees at some time or other.

Senator LONG. How much will that cost?

Mr. FOLSOM. We haven't any estimate on that. I might say that a person with an insurance plan has that exemption now. Now we are suggesting extending it to everyone, insured and self-insured.

Senator LONG. If that is something that you are going to benefit everyone with, why haven't you gone to the trouble of finding what the expense will be?

Mr. FOLSOM. It is very difficult to estimate it.

Senator LONG. How much do you think it will cost the Government?

Mr. FOLSOM. I don't know.

Senator LONG. Is it going to be a major loss of revenue?

Mr. FOLSOM. No, but it will be a benefit to the people who get it.

Senator LONG. Do you think it will cost as much as $15 million?

Mr. FOLSOM. Oh, probably.

Senator LONG. You think it would cost as much as $15 million?

Mr. FOLSOM. We haven't any figures at all on that.

Senator LONG. Isn't it your responsibility to advise us how much revenue these benefits would cost?

Mr. FOLSOM. We are giving you the estimates we can on the cost of it. That one which I will get to later on we cannot estimate.

Senator LONG. Do you think it would run more or less than $15 million?

The CHAIRMAN. $14,999,999.

Senator LONG. I would like to have some idea, Mr. Chairman. I am not being facetious about it.

The CHAIRMAN. He has given you a fair answer.

Mr. FOLSOM. I cannot give you any cost estimates on it. I will look into it and if we can, I will do it.

Now, Mr. Chairman, on page 6, as far as employees' pension plans, we suggest greatly simplifying the rules for qualification. They are very complicated at the present time. We don't think Congress intended them to be that way. We want to change the law so we can simplify the rules and so the small companies will know what kind of pension plans will qualify and which ones will not qualify. We would also make it very clear that we do not make it easy for any plans to get in that should not qualify.

The second part of that is survivorship annuities. In most pension plans, and I think it is true in the congressional plan, you permit a person to receive a smaller annuity and have it continued to his wife after he dies. The way the law is now you would have to pay an estate tax on the present worth of that survivorship annuity. Many people do not want to face that heavy tax because they don't know whether the widow is going to receive anything. She might die a short time after.

The CHAIRMAN. How many pension plans are there?

Mr. FOLSOM. I don't know.

The CHAIRMAN. Fourteen or fifteen thousand?

Mr. FOLSOM. Probably more. Most plans have that provision it it. What we are saying is that now the person who retires pays an income tax on his retirement annuity. Under the bill this will continue when he dies and his widow, continuing to receive a survivorship annuity, will have to pay the income tax just as he paid it. You continue it on at the same rate. In the long run we think we will get more money.

Senator WILLIAMS. This particular feature is for widows alone, is it not?

Mr. FOLSOM. It is for the estate and, of course, the widow will naturally participate in that. We think in the long run we will get revenue out of this and it is only fair treatment.

The next item is the employees' sick benefit plan. At present if the plan is insured, the benefits are not taxable. We propose to give tax exemptions up to $100 a week regardless of whether it is insured or self-insured.

On the medical-expense deduction now, you can deduct for expenses in excess of 5 percent. We suggest reducing that to 3 percent.

The ceiling is now $1,250 and we suggest raising it to $2,500. The family ceiling is now $5,000 and we recommend raising it to $10,000. We would also tighten up on the definition of medical expenses. We think 8.5 million taxpayers will benefit and it will cost us $80 million.

The next item is the child-care deduction. We recommend allowing a deduction for expenses up to $600 for the care of young children paid by working widows or widowers or mothers whose husbands are incapacitated. That will cost us $40 million and will benefit about 300,000 taxpayers.

Senator LONG. Is there any reason why that should not be more than $600? Is it that this proposal to recognize the expense of a working mother and employing a baby sitter just the same as a businessman who has to employ a night watchman while he is away from his business?

Mr. FOLSOM. The Ways and Means Committee thought $600 would be a fair figure.

Senator LONG. You completely exempt the businessman for the expense of hiring a night watchman, don't you? Is there any reason why you shouldn't completely exempt a widow who has no husband or no one in the family to look after the children while she is gone for the expense of hiring a baby sitter?

Mr. FOLSOM. There is no exemption now and we think $500 or $600 would be all right. This will cost us $40 million.

Senator LONG. As between individuals, wouldn't it seem that she is perhaps even more entitled to that deduction than some of those people who draw corporation dividends?

Mr. FOLSOM. It is very difficult to administer this, anyhow.

The CHAIRMAN. It is $600 more than they have ever had before, isn't it?

Mr. FOLSOM. Sure.

The CHAIRMAN. It has taken a long time to grant anything. Nothing has been done so far; is that correct?

Mr. FOLSOM. We think $600 is a good start.

Senator JOHNSON. Would you give me again the cost of No. 10?

Mr. FOLSOM. $40 million.

Senator JOHNSON. Would you give me the cost of the 8,500,000?

Mr. FOLSOM. $80 million. This is all summarized on the last page of this document.

Senator LONG. What would the reaction be of the Treasury Department to a proposal to permit working mothers to deduct that same expense of hiring a baby sitter, even though their husbands are able to work, even though they are married and their husbands are able to work?

Mr. FOLSOM. You mean all working mothers?

That would add considerably to the cost.

Senator LONG. Is that the only objection to it, that it would add to the cost?

Secretary HUMPHREY. No, Senator, we are definitely opposed to that.

The Ways and Means Committee held long hearings on that and many of the child-care organizations and many of the churches and a great many people came in and objected to it. The Ways and Means Committee selected this as the proper way to do it.

Senator LONG. What is the argument against it? It is not a question of who objects, but what is the argument against it?

Secretary HUMPHREY. The child-delinquency cases.

There are great arguments that the mother ought to be at home looking after her children where there is a wage earner in the family.

Senator LONG. Of course, there are some cases where the mother is working so the children can have an opportunity to go to college or to become better citizens.

Secretary HUMPHREY. That is right and it all depends on the age of the children and various conditions, but there was very definite objection to this in the hearings and testimony.

The CHAIRMAN. You favor the increase that has been proposed?

Secretary HUMPHREY. We are in favor of doing it this way and limiting it in this manner.

Senator LONG. Actually, though, isn't that every bit as much of a legitimate expense on the part of a mother who feels that she must work, even though she is married, as it is on behalf of a businessman who has to hire that night watchman I was speaking of.

Secretary HUMPHREY. That is right.

Mr. FOLSOM. Mr. Chairman, on item No. 11, we would permit the deduction of interest on installment contracts. That will benefit 1,600,000 taxpayers and cost us about $10 million.

The CHAIRMAN. What kind of people would that affect?

Mr. FOLSOM. The people in the low-income groups, of course.

The next item is something that is very unusual. If a man now buys a home for himself and his wife and they take title jointly, the value of the wife's share is treated as a gift for tax purposes. Very few people understand that. We suggest eliminating that difficulty. We are relieving the taxpayers of filing a gift tax unless the house is actually sold, and then only if there is a net transfer of funds from one spouse to another.

The CHAIRMAN. Would this benefit rich or middle-class people or people in the lower income-tax brackets?

Mr. FOLSOM. It applies to everyone.

Page 9 simply gives a more definite and fairer treatment as to capital gains for real-estate dealers and inventors. We are trying to give capital gains to those who have bona fide claim to it.

Page 10 has to do with changing the date for the filing return of the first estimate from March 15 to April 15. This would help many taxpayers, and particularly would help the accountants and the trust departments and banks who fill out income-tax returns for many people.

Now, we get to the items affecting business concerns. Our main proposal as to depreciation has to do with making it optional for a taxpayer to use a declining-balance method double the corresponding straight-line rate. I have a table on the next page which will explain that quite clearly, I think. We have taken here an asset that would cost a hundred thousands dollars. The first set of figures assumes that that asset is estimated to last 10 years.

Under the present methods, the straight-line method, you charge $10,000 off each year. You will end up with a total of $100,000 written off. On the declining-balance method, the first year you will charge off $20,000. This leaves you $80,000. The next year you charge off 20 percent of the $80,000, or $16,000. You take 20 percent of the balance and it brings it down to $12,800. You see your charges go down. In the other column you have the accumulated figure. The first 2 years under the first method you would have written off $20,000. Under the proposed method you would have written off $36,000. You get 36 percent back in 2 years and 20 percent the other way.

At the end of the third year you have written off almost half. You have half written off in one-third of the life. When you get beyond that point, you charge less on a declining method than on a straight-line method, so we begin to pick up revenue on the fifth year. You end up with something still left. You keep writing off 20 percent of your balance. In most cases what is left would amount to about 10 percent of the cost of the assets. If you sell it at a loss at that time, you can charge the loss against income.

The CHAIRMAN. I think it is obvious but tell us, please, what is the virtue of that?

Mr. FOLSOM. The big advantage of this proposal is that in the first place your asset is written off in the way in which depreciation actually occurs. A machine, like an automobile, depreciates much faster in the first few years than later on. We are simply recommending going in accord with actual practice. The big advantage of it is that it would stimulate people to scrap old machines and buy new machines because you can get your money back in tax reductions quicker than you can under the other method.

It would be particularly helpful to small business in financing the purchase of a machine. Let us take this machine here of a hundred thousand dollars. A small business firm would go to the bank and say, "We are making money and we can get a reduction here of $36,000 from our taxes in 2 years. If you will loan us $50,000, I can put up another $14,000 and with this tax reduction I can buy this machine."

Otherwise, he might not be able to do it. We think it will greatly stimulate the introduction of new machinery.

Senator LONG. That stimulation is based on the immediate loss of revenue, is it not?

Mr. FOLSOM. We will lose money on it but we think we will get it back through increasing our base of taxes. Eventually, of course, it can be deducted only once. As I pointed out before, after the fourth or fifth year on this machine we will be collecting more taxes than we would on the other method. We are losing the first and making it up later on. In the process we are stimulating the purchase of new machines which we think will increase our revenue.

Senator LONG. Will you give us your estimate of what your revenue loss is for the first several years?

Mr. FOLSOM. Only for 1 year. We are estimating in 1 year over 9 million individuals will benefit from this. It applies to real estate, apartment houses, and everything else, providing you have it as a business operation. It doesn't apply to individual residences because you cannot deduct for depreciation on that now. It applies to business properties.

The CHAIRMAN. The sooner the property is fully depreciated, up goes the income taxes.

Mr. FOLSOM. Sure. You can take it only once.

The CHAIRMAN. If you took it all in the first year, thereafter you would have a heavier income tax, wouldn't you?

Mr. FOLSOM. Sure.

Senator LONG. On the other hand, if a man continues to expand his business and buy more and more machinery, every time you would get ready to pick up that revenue if he bought more machines you would not pick it up, would you?

Mr. FOLSOM. That would mean business was expanding and his profits were going up and our revenue would increase.

Secretary HUMPHREY. We are after a lot of people working. Every time he buys a machine a lot of people go to work.

Senator LONG. Let's just watch the revenue for a minute, though. Suppose he is making a profit of $36,000 and he gets $36,000 additional depreciation. You don't collect any taxes on that. If next year he buys $36,000 more and continues to expand his business, you are not collecting that revenue, are you?

Mr. FOLSOM. If his business is expanding we are getting more revenue.

Senator LONG. How are you getting it if he is not expanding the tax?

Mr. FOLSOM. He ought to be making more profits.

Senator LONG. If he makes more profits and continues to expand his business, where are you going to collect the tax?

Secretary HUMPHREY. You get it out of the profits and out of the earnings of all the people working. Every time a man goes to work it helps the income tax. You are all partners of mine. You are all working for me to some extent.

Senator LONG. You say you are getting it directly from the salaries of the laboring men?

Secretary HUMPHREY. Out of the wages and out of the profits of the business and out of the people who make these new machines. There are going to be a lot of people making them and there will be some profits there. If we can just stimulate the buying of machines and putting in the machines, our income taxes will go up.

Senator LONG. Here is one question I would like to ask about that. I understand that the automobile industry can make about 8 million automobiles a year. They are only making 6 million now. Do you think anyone is going to go in the automobile business if they can't sell the automobiles they have the capacity to produce already?

Secretary HUMPHREY. You have heard Mr. Curtice state how much he is spending. You don't need to guess about that, Senator Long. Mr. Curtice has stated the hundreds of millions of dollars that the automobile business is spending. There is no question about that. You don't need to guess on that one. He has announced that he is spending a billion dollars.

Senator LONG. He is spending a billion dollars more. Does that mean we are going to have any more automobiles produced next year than are produced this year?

Secretary HUMPHREY. You are going to have cheaper automobiles, cheaper and more efficient production, more efficient factories, and more goods of other kinds produced.

Senator LONG. How do you propose to get this automobile production to the 8 million that you already have the capacity to produce? How about those plants that are not producing at full capacity? Do they need this incentive in order to go into full production?

Mr. FOLSOM. Much of this would go to improve old plants and modernize them. That will cut the costs and lower prices. A large part of the industry expense now goes to modernization and not always to increased capacity. It works both ways. If you modernize and get more up-to-date machinery you can cut your cost and therefore lower prices.

Senator LONG. I can see merit to this plan and a great number of tax reductions. It seems to me when you try to determine which one you are going to give you have to determine all of the items of merit, considering which one would serve the greatest purpose at this time. The question in my mind is, What is preventing the automobile industry from producing more automobiles? Is it the fact that there is not sufficient tax incentive or the fact that they don't have the customers to sell the automobiles to?

Secretary HUMPHREY. You are getting into a big field that is entirely independent of the tax field. The reason the automobile people right now aren't producing more cars is because they produced too many cars of the old model last fall and they haven't got them sold yet. They have an inventory adjustment and the inventory adjustment is being worked off and automobile production is currently increasing.

Senator LONG. It sounds to me, Secretary Humphrey, as though you said what I asked, as though you answered my question to the effect that they are not producing more automobiles because they don't have enough customers for the cars they have already produced.

Secretary HUMPHREY. They produced last year's models and people want to buy this year's models. You have to produce the kind of goods that people buy. If you have some goods that were last year's models and you are coming out with improved goods, you will have trouble selling last year's goods.

Senator LONG. Can you make the statement that the automobile factories are in full production of this year's model?

Secretary HUMPHREY. No, and they are not going to be for some little time.

Senator LONG. Then, as far as wanting this year's model is concerned, the public apparently is not demanding this year's model to a sufficient extent to use present automobile facilities to full capacity.

Secretary HUMPHREY. It is an adjustment of inventory.

Senator LONG. Is that model difference the reason why steel is operating at 69 percent of capacity rather than a hundred precent?

Secretary HUMPHREY. It is partly that. It is partly to the extent that steel is bought from the automobile business. I had better wait until I get back on the stand, though, to answer further questions.

Senator WILLIAMS. Mr. Folsom, is it not a fact that this depreciation formula here is a formula which will be made available to the small-business man, giving many to some extent the same benefits which have been available almost entirely to the large-business man in the amortization certificates?

Mr. FOLSOM. Yes.

Senator BENNETT. Mr. Folsom, this privilege has been in existence based on a rate of 150 percent.

Mr. FOLSOM. Yes, for many years.

Senator BENNETT. It is now available at 200 percent. This is not a new principle. In other words, going back to your formula on page 12, up until this time, taking your 10-year life basis, the businessman has been privileged to deduct 15,000 the first year. Now, you are permitting him to deduct an additional five.

Mr. FOLSOM. This is a plan that has been recommended by many organizations. It is nothing that we have just suddenly struck upon ourselves.

Senator LONG. This incentive has some merit to it, but I question whether or not as between two alternatives a businessman is going to build a plant if he doesn't have sufficient customers. In other words, if he can't sell the product I have my doubts whether he is going to build a plant. It might be better to approach the problem by trying to have sufficient customers so he can sell that product.

Mr. FOLSOM. Maybe by improving his plant he can sell at a lower price and get a better product so he can sell it.

Senator LONG. Even at the terrific taxes that business was paying in 1953, you had about $28 billion invested in plant and expansion when you had a 52 percent corporation tax and an excess-profits tax. Does that coincide with your figures?

Mr. FOLSOM. Somewhere around that figure.

Senator LONG. That is my understanding. By contrast you can go back to 1946 when you had no excess-profits tax and only a 38 percent corporation tax and yet there was only $14,800 million invested in plant expansion. I am not saying that high taxes are going to get you plant expansion. I am not contending that for a moment. I am saying that the figures indicate that if a businessman has a market for his product he is going to expand his plant and production, if he has someone to do business with and someone who will buy the product. Do you have any facts to indicate that that has not been the case?

Mr. FOLSOM. Much of this expansion you mentioned is due to war economy and inflation and things of that sort. We will have to depend on normal incentives from now on. We don't want to depend on war and inflation to bring them about.

Senator LONG. The point is, if he had a chance of making profits he was willing to expand his plant even though the Government got most of his profits. I question whether he is going to be willing to expand his plant if he has very little opportunity of showing a profit.

Senator FLANDERS. Will the Senator yield for a moment?

Senator LONG. Surely.

Senator FLANDERS. I would like to say that the most successful elements in American business sometimes invest to make a market instead of waiting until a market shows up and then investing to take advantage to a readymade market. It is part of the American business scheme to invest to make a market.

Secretary HUMPHREY. Mr. Chairman, I just cannot refrain from saying a word at this time. If the Senator's viewpoint was the viewpoint of business, we wouldn't have any America. The thing that has made America is the fact that you have people in America who, under proper circumstances and with proper feeling of confidence in the security of their Government and in the soundness of the economy, go ahead and complete new things, build plants to build new things and make new things that people want and then go and sell them to them. They don't wait for people to come to their door and ask them to make something for them. Think of the new products. Go back 25 years. Look at the things that are made today that nobody ever heard of 25 years ago. How could they ask for them?

People made them and then went out and sold them. That is what makes America. It is the stimulation of sound economy and a proper base on which to operate and confidence in the country that makes people create all sorts of new things and create markets and create demand and get people to buy the things. You can name a thousand things. Take a television set. Who ever heard of a television set 25 years ago? Did somebody come up and rap on somebody's door and ask them to please make a television? No, American business went out and built television plants. They pioneered it. They developed it, invented it, pioneered it, built plants, bought machines, put people to work, made television sets, and then went out and sold them. That is the way America has grown and that is the way America will grow and the way it has to grow to provide jobs for all the coming younger generation who will want jobs and more jobs every year. America has to make more jobs every single year to keep the people of America employed. Unless they are employed, all this business about taxes doesn't amount to anything because they won't have anything to pay them with. You have got to get that payroll first.

Senator LONG. I would just like to point out that in order for you to produce you need to have a market to produce it for. The facts do indicate that, even with high taxes, business is willing to invest in plant expansion because they have done it.

Senator FREAR. Mr. Chairman, I cannot refrain from saying something, either. The Secretary is a better booster of the last 20 years than I thought he was.

Secretary HUMPHREY. Even the Democrats couldn't hold business down; it is that good. Just think what we would have been.

Senator BENNETT. Mr. Secretary, I can't refrain. Do you think the Democrats are going to succeed in holding business down under the present circumstances by their talk of depression?

Senator FREAR. I hope not.

Mr. FOLSOM. Mr. Chairman, you will note that these are some provisions that are designed particularly to help small business. There has been considerable criticism in the past of the application of this section 102 which penalizes what is called an unreasonable accumulation of earnings in order to avoid the stockholders' paying individual income taxes. Under this proposal we would shift the burden of proof to the Government to show that they must prove that the amount being accumulated is unreasonable and not necessary for the business. We think that is going to relieve the minds of a lot of small business concerns and it will be helpful generally.

The next item has to do with the treatment of research and development expenses. In large companies there is little difficulty involved in writing off the cost of development and research expenses. In small companies there is some uncertainty about it. A concern might buy a patent or have a heavy investment for research in one year. The tendency has been in some cases to make them capitalize that and write it off over a period of years instead of charging it off over 1 year. Now, we suggest making it optional. A concern can write it off in 1 year or spread it over a period of years.

The next item, the net operating loss deduction, we are now recommending giving companies under this bill a provision to extend their loss carryback to 2 years instead of 1 year. We would maintain the same provision we have now of carrying forward losses for 5 years. This would give them a chance to carry them back for 2 years. We feel that will probably cost us about a hundred million dollars originally but in the long run it won't cost us much because it is mainly a question of shifting. If you didn't shift it back for 2 years you might be able to shift it forward for 5 years in the future. We can't figure exactly what the net cost will be. That will be helpful in a small business particularly.

On page 14 we have a number of suggestions concerning partnerships and corporations, recapitalizations and reorganizations. They are mainly with the idea of simplifying the present rules. They will be particularly helpful to small businesses which want to rearrange their capital structures and we think in many cases it will prevent the necessity of these small companies being sold to larger companies. That is quite a detailed provision and I will not go into it but that is the purpose of it. Of course, those provisions won't cost us anything to speak of.

On the next page there are a number of changes we are recommending in accounting provisions which will bring the tax rules in harmony with generally accepted accounting principles as to income and expenses. There it is a question also of shifting, primarily, but we think that will cost us probably $45 million.

The next page has to do with soil and water conservation expenses to farmers and we expect it would benefit about 500,000 taxpayers and cost us about $10 million. That is allowing farmers deductions for soil conservation expenses.

In the field of natural resources we suggest only minor changes because, as the President indicated, we postponed until later a complete study of this whole question of natural resources.

The next item is the treatment of foreign income. At present a corporation with foreign subsidiaries can deduct from its United States tax the income taxes which it pays to foreign countries up to the full 52 percent. There has been a tendency on the part of these foreign countries to increase their income taxes up closer and closer to the 52 percent because they say these corporations operating in their countries will have to pay the 52 percent to the United States anyhow and they should get it there instead of having it come to the United States. In order to encourage investment in countries abroad by American industries and to avoid this tendency for them to raise their taxes, we propose in this plan that the tax income from these foreign subsidiaries be 14 below the United States rate, 38 percent instead of 52 percent. The so-called Western Hemisphere trade corporations now have a tax rate of 38 instead of 52. We are following the line already in the law relating to Western Hemisphere companies.

Senator LONG. What is the revenue loss there?

Mr. FOLSOM. $147 million. But we would be losing a good part of that anyhow because these countries increase their tax rates, of course, and we don't get the revenues here. England, Canada, Australia, and Germany, mostly have their taxes up to ours already. This is primarily to stimulate investments in undeveloped countries of the world by American capital.

Senator LONG. How much would it cost if you just extended that to new investments rather than applying that to existing investment overseas?

Mr. FOLSOM. I don't know whether we have any estimates on that basis.

Secretary HUMPHREY. You can't do that.

Mr. FOLSOM. It would be very unfair.

Senator LONG. Your present loss estimated is on the present businesses?

Mr. FOLSOM. Yes.

Senator LONG. Have you explored the possibility of working out a device to prevent these foreign countries from raising their taxes by virtue of the effect on our tax laws? In other words, have you explored to see how you might get this revenue without encouraging these foreign countries to——

Mr. FOLSOM. The purpose of this is to stimulate these companies to invest in these undeveloped countries of the world.

Senator LONG. That was the second purpose you stated.

Mr. FOLSOM. Because mentioned them in that order does not mean that is a secondary purpose.

Senator LONG. You mentioned that these foreign countries were raising their tax rates because they found that by doing it the loss was not to the corporation doing business but to the American Treasury.

Senator BENNETT. That is what is known as the good neighbor policy.

Senator LONG. Have you explored to see whether there is some-way you could perfect our tax laws so that a foreign country would not have that incentive to raise its tax rate in order to deprive the American Treasury of the taxes that we would otherwise collect?

Mr. FOLSOM. We don't see how you can do it if you don't give them credit at all because we can't tell the foreigners they can't have income tax in those countries or what their rate shall be.

Senator FREAR. But you do find a discrepancy in the income tax of foreign countries based on American capital?

Mr. FOLSOM. Yes, it does vary. Sometimes they do tax companies and not their own companies.

Senator CARLSON. Mr. Folsom, this 38 percent is already in effect in the Western Hemisphere? This would make it applicable to all the other nations?

Mr. FOLSOM. Yes, sir. We suggest treating branches now the same as subsidiaries. It would not apply to ordinary wholesale trade.

Senator CARLSON. It is limited to factory production?

Mr. FOLSOM. Yes.

The CHAIRMAN. Should it not apply to wholesale operations also?

Mr. FOLSOM. Well, of course, that would stimulate exports and it wouldn't necessarily mean investments in these countries. It would mean another loss of revenue.

The CHAIRMAN. The case has been brought to my attention. If you are in the wholesale distribution of oil products you have to maintain distribution facilities and tankers and many plant facilities abroad.

Mr. FOLSOM. I know it has been proposed and we have discussed it at length but we thought initially it should be confined to this.

The CHAIRMAN. That is what you thought but I am trying to find out what is the logical distinction between a distributing operation and any other operation. It is all part of the economy. It is all a part of American investment trying to do something abroad.

Mr. FOLSOM. This is where the main investment comes, in this area, and not just shipping of goods to these foreign countries.

Senator BENNETT. Under this law, isn't that privilege given to retailers? It is difficult for me to see how you can jump over the wholesaler and benefit the manufacturer and benefit the retailer and assume that the wholesaler is in a different class and therefore should not be benefiting from this.

Mr. FOLSOM. One of the arguments is that we would be accused of giving them an unfair advantage through rebates.

Secretary HUMPHREY. Senator, it is the difficulty with your dealings with other countries if you are giving a rebate through a tax deduction on goods made here and exported: The other countries claim that is a rebate which you give. If you are dealing in goods in the other countries, retail or wholesale, if you are doing business in those countries, then you get the benefit of it.

Senator BENNETT. Should not your distinction be at the level at which the goods are distributed but the fact that they are manufactured there?

Secretary HUMPHREY. Where the goods originate is the distinction, not the fact that they are wholesalers or retailers at all. The wholesaler gets it the same as the retailer does, doing business in the same place and under the same circumstances.

Senator FLANDERS. Does the law, then, as you propose it, permit corporations to get X tax benefit on their wholesale business under any circumstances?

Secretary HUMPHREY. On all goods produced in the country where they are doing business. By a tax device you cannot make goods in America and ship them to Venezuela and get a tax advantage in

America as a rebate on your Venezuela sale because then you are in trouble with your trade treaties with other countries of the world.

Senator FLANDERS. Can you extract oil or asphalt from Venezuela and sell it in other countries abroad and get a tax advantage from your wholesaling operations in other countries from Venezuelan material?

Senator HUMPHREY. That is right.

Senator FLANDERS. You can?

Secretary HUMPHREY. That is right. It has to do with treaty relationships.

The CHAIRMAN. Personally, I don't feel the answers are as clear as they should be. Mr. Stam, will you give that some special attention for the committee's benefit?

Secretary HUMPHREY. It is treaty relationships.

The CHAIRMAN. I think a lot of this whole field will be covered by these treaty conventions, but they are not perfect yet, and the matter of what the treaty is depends a good deal upon the integrity in the practices of the countries abroad.

They can frustrate most anything we may do in the way of foreign trade by internal policies. When you get all through with your treaties and everything else, you have just got a piece of paper unless there is an honest desire of the countries abroad to run their businesses so that American capital can live in those countries. It is not only a tax question, but there are all kinds of questions involved, including tariff regulations, regulations of money and all sorts of innumerous hurdles that we know exist in trade that may upset anything you do in a tax way.

Mr. FOLSOM. We will be glad to go into that more fully with you, Mr. Chairman.

The CHAIRMAN. If you would give us a supplemental memo on it, I would appreciate it. We will have that question taken up in executive session because we have had several people point out that they think the wholesalers should come under it. We would appreciate a supplemental memo and also Mr. Stam will give it some attention.

Mr. FOLSOM. We shall be glad to reconsider this subject with a view to possible modification in the House bill and advise the committee accordingly.

The next item has to do with advance payment of corporation income taxes. Due to the operations of the Mills plan, we are now collecting 45 percent of last year's taxes on corporations in March, and 45 percent in June. Next year it will be 50 percent in March and 50 percent in June.

That concentrates in a very short period of time this $20 billion we are collecting from corporations. It upsets our whole debt management program in the Treasury and also the money market generally. What this bill would do is to spread that out evenly over the year and at the same time advance part of the payment into the current year. We would exempt from this all companies with taxes of less than $50,000. It means corporations earning less than about $100,000 will not be covered by this. That would exempt about 90 percent of the corporations. Only 35,000 corporations out of a total of 425,000 would be affected by this. That is where the bulk of the revenue comes from. Most of the larger corporations are already buying tax anticipation notes during the year so that they can turn them in in March and June of the following year against their tax liability.

In those cases, we are paying interest on the tax notes. What we propose to do here, starting in 1955, is to have the corporation in the year 1955 pay 50 percent in March and 50 percent in June, wiping out the 1954 tax liability; we are asking them on September 15 to pay 5 percent of their 1955 taxes and 5 percent again in December. Then, in March they will pay 45 percent and 45 percent. The next year they will pay 10 percent in September and 10 percent in December and 40 percent and 40 percent. Eventually, we will reach a point in 1959 when they will pay 25 percent in September, 25 percent in December, 25 percent in March and 25 percent in June. That gradual approach we don't think will cause any more difficulty than the introduction of the Mills plan. We think it will be good for people to get more up to date on their tax payments and not to depend too much on their tax liabilities to finance their current operations. That will considerably ease our debt management problems and it is the only way we can see of getting around this difficulty we have now with this heavy concentration in March and June.

The corporations will still be quite a little behind individuals. The individuals are starting in January. We are going to be liberal in allowing for estimating in September. We have a liberal provision so we won't hold them down to exact figures at that time.

Senator FREAR. That's very good.

Mr. FOLSOM. As the last item, there are 50 loopholes that the bill would close. Chairman Reed outlined those in presenting this bill to the House and the only one I will mention is typical of the group. It gets back to the question of sick benefits we were talking about before. Here is where we are going to save some money to offset the cost of it. When the present law was put into effect giving tax exempt status to sick benefit payments under insured plans, very few insurance companies would write policies providing more than $50 or $75 a week benefits. But, in recent years they have cut off the maximum and now some of these insured plans provide almost unlimited benefits when people are out sick, for executives as well as the rank and file.

Under the present law, that is all tax exempt. Under our proposal, we would put a ceiling of $100 a week on tax exemptions of any sick benefit plan. That is typical of some of the loopholes which the bill would plug.

I would like to turn to page 21. On page 20 you have a historical record of the changes in income-tax rates and exemptions. On 21, simplified, you can take the case of a family wtih three children. If you start at the bottom you will find 1954. The family now has an exemption of $3,000. Their bracket rate is 20 percent. If you go back to 1947, you will find their exemption was $2,500. That is when the 80th Congress increased the exemption from $500 to $600. The $2,500 was in effect until 1943. In 1941 it was $2,700. All the way back to that time, we have had exemptions lower than we have now. At that time the tax rate in the first bracket was 10 percent and now it is 20 percent. In 1940 the exemption was $3,200, only slightly above the $3,000 we have now, and at that time the first bracket rate was 4 percent. If you go back the way you came up, you would reduce tax rates considerably before you would get your exemption above the present $3,000.

On page 22, we have a table showing the number of people who would be affected by increasing the exemption. If you go up from $600 to $700, you will cut down 4 million in taxable returns and reduce the number of taxpayers by 7 million, assuming that each joint return is counted as two taxpayers. That would lose $2½ billion.

Senator CARLSON. On that table on page 22, if I read that correctly, it is estimated we will have 77.7 million taxpayers in 1954 and if we had a thousand dollar exemption increasing it from $600 to $1000, we would lose or eliminate for tax purposes about one-third of the taxpayers of this Nation.

Mr. FOLSOM. That is about right.

Senator CARLSON. At a time when I think everyone must feel the responsibility and need for Government and their personal interest in Government.

Senator FLANDERS. Mr. Folsom, I think I have expressed at previous times my dislike of the universal sales tax. Why isn't Senator George's proposal the best argument for the universal sales tax that has yet been raised? That is the only place you can get the money that Senator George's proposals would eliminate from the income of the country. It seems to me he is batting right down that alley and that he is campaigning for a universal sales tax. That is the way it appears to me.

Mr. FOLSOM. If we lose this $8 billion, we will certainly have to get it back somewhere else.

Senator FREAR. As a matter of fact, I think a combination of the two could work, sir. Senator Carlson has made a statement now that if we eliminate one-third of the taxpayers we are eliminating one-third from any responsibility of Government operations. I have never been in favor of that, and I think the one-third might be eliminated through this increase in personal exemption should be put on the tax rolls in some manner at a minimum fee of $5 or $10, or whatever that might be, and that probably would have accompanied the personal exemption bill.

Mr. FOLSOM. Of course, this $100 increase in exemptions doesn't mean you get a $100 tax reduction.

Senator LONG. What is your argument for exempting aged persons from paying an income tax up to $1,200? Why do you feel they should be exempt from paying any income tax when you take them off the tax rolls?

Mr. FOLSOM. That has been in effect for some time.

Senator LONG. Don't you have other provisions in this bill to give further relief to those drawing retirement income?

Mr. FOLSOM. We give that relief in order to equalize a situation that now exists with regard to social security benefits which are not tax exempt. We don't think it is fair for a teacher or a widow of a policeman to have the same benefits.

Senator LONG. Either take away some of the benefits they are getting or give more to others who are not getting the same type of benefit. When you give more that indicates you approve of that $1,200 exemption for the social-security income.

Mr. FOLSOM. We don't think it would be wise to start taxing those people who are receiving social-security benefits and who have been exempt from taxes from the very beginning.

Senator LONG. You are proposing as a matter of administration policy that an aged person drawing $1,200 a year should not pay income tax. By contrast you are proposing that a man drawing $51 per month income should pay an income tax. Doesn't that person who is working for that $50 need to eat just as much as an aged person who is drawing $100 a month?

Mr. FOLSOM. Of course, he is making $51.

Senator LONG. That is over $600 a year.

Mr. FOLSOM. He is entitled to a standard 10-percent deduction. He wouldn't pay any tax.

Senator LONG. Let's say he is making $60 a month. Doesn't he need to eat just as much as an aged person getting a hundred?

Mr. FOLSOM. Sure.

Senator LONG. As a matter of fact, if he is working for that $60 he probably needs some extra nourishment, doesn't he?

Mr. FOLSOM. That is taken into account in setting the exemption. That is why you have the exemption in the first place.

Senator LONG. Is it not true that when the cost of living advanced that a man who had a $600 exemption found about 10 percent of that exemption wiped out. With increased pensions to try to overcome some of that, we increased old-age pensions something over $5 a month. In terms of purchasing power his exemption did not give him as much tax exemption as he had before. Isn't that correct?

Mr. FOLSOM. At that time when we had those lower exemptions, the total tax flow to the Government was considerably less than now. Also, the initial tax rate was much lower.

Senator LONG. You wouldn't argue that a person making $58 or $60 a month doesn't pay any taxes? You are not contending he is tax free?

Mr. FOLSOM. Oh, no. He pays a lot of other taxes besides Federal income tax.

Senator LONG. As a matter of fact, it was President Eisenhower who made the point that that man is paying 100 hidden taxes when he buys an egg and 150 when he buys a loaf of bread and over 200 if he had the good fortune to be able to buy an automobile.

Senator WILLIAMS. Mr. Folsom, don't you think that the least worry of any man earning that much is the rate of taxation?

Mr. FOLSOM. Yes, his tax is a very small item.

Senator LONG. Do you agree with the principle that the income tax should be in accord with a person's ability to pay the tax?

Mr. FOLSOM. The present system is based on that.

Senator CARLSON. Mr. Chairman, on that point of exemptions I think it is interesting to note that the exemptions for dependents was greatly increased from 1944 on. At that time, we made an exemption of less than $500 and in 1948 we stepped it up to $600. The exemptions for dependents previous to that time had been $200. I think that makes quite a little difference.

Mr. FOLSOM. The last table on that page shows at what point you begin to pay tax on the different exemption rates. Assuming, again, a family with three children, with a $600 exemption there is no tax paid until he reaches $3,333, assuming standard deductions. When you get to a thousand-dollar deduction, this family of three would not pay tax until they got up to an income of $5,556. Everybody below that would pay no Federal income taxes with a thousand-dollar exemption.

On page 23, you have a summary of the effects on revenue of these various provisions, showing at the bottom that we will lose 778 million from individuals. By extending the 52 percent rate to corporations, we gain 1,200 million. There is a loss of 619 to corporations, so we are getting a net gain from corporations of 581 million to offset the loss from individuals of 778. So, we get a net loss of 187 million from this bill. The way the budget was presented, there is a loss of about 15 million and this is a loss of 197 million. So, we are getting a difference of about 180 million. The deficit would be increased $180 million by this bill beyond what we estimated in the budget which was presented for 1955.

On the final page you have a brief summary of the budget situation showing the 1955 budget and the 1954 budget.

The CHAIRMAN. Are there any questions to Mr. Folsom?

I might say that this table at the last does not give account to the billion-dollar loss in revenue from the excise-tax bill.

That was the budget as submitted.

Senator FREAR. Should the personal exemption be increased, the tax savings that went to the individual—what would happen with that tax saving? Do you think it should be put in the savings account or the stream of the economy?

Mr. FOLSOM. It will vary widely with individuals, just like the $3 billion cut that took place effective the 1st of January. Much of that, probably, went into spending and some of it went into savings. Savings are still at a very high level.

Senator FREAR. It would be pretty hard, I suppose, to estimate what went into consumer buying versus what went into savings, or the percentage of it. It would probably be the same difficult task to make a guess. However, it is reasonable to assume that part of it would go into the purchasing power of the American public, is it not?

Mr. FOLSOM. Oh, yes.

Senator FREAR. Would you assess to that the same type of turnover that you would in borrowing from a bank? Say if a man deposits a hundred dollars it turns over six times or inflates six times or something like that. Could you assess the same value to the purchasing power of that amount of money that went into the extreme by the turnover within a 12-month period?

Mr. FOLSOM. I don't know how you could do that.

Senator FLANDERS. Mr. Chairman, I think the New Deal term for that was "leverage." I don't remember that the lever ever worked.

Senator FREAR. If you had a fulcrum which had enough and a lever long enough, you could move the world.

Senator CARLSON. Mr. Chairman.

The CHAIRMAN. Senator Carlson.

Senator CARLSON. The Treasury has prepared some tables that I have which show the tax saving from January 1, 1954, rate reductions based on salaries of $3,000, $4,000 $5,000 and $6,000. They have some other tables that they have prepared showing the effects of the tax benefits to individuals under the proposed rate exemptions of $100 additional, $700, $800, $900, and $1,000. I would ask unanimous consent that they be made a part of the record at this time.

The CHAIRMAN. They will be made a part of the record.

(The information is as follows:)

Tax savings from Jan. 1, 1954, rate reduction

Income after deductions, before exemptions	1953 tax	Present tax	Tax savings
	Single person		
$3,000	$542	$488	$54
$4,000	788	708	80
$5,000	1,052	944	108
$6,000	1,342	1,204	138
	Married couple, no dependents		
$3,000	$400	$360	$40
$4,000	622	560	62
$5,000	843	760	83
$6,000	1,085	976	109
	Married couple, 2 dependents		
$3,000	$133	$120	$13
$4,000	355	320	35
$5,000	577	520	57
$6,000	799	720	79
	Married couple, 3 dependents		
$3,000			
$4,000	$220	$200	$20
$5,000	440	400	40
$6,000	660	600	60

Tax savings from increase in per capita exemption to $700

Income before exemptions, after deductions	Present tax	Tax with $700 per capita exemption	Tax savings
	Single person		
$3,000	$488	$466	$22
$4,000	708	686	22
$5,000	944	918	26
$6,000	1,204	1,178	26
	Married couple, no dependents		
$3,000	$360	$320	$40
$4,000	560	520	40
$5,000	760	720	40
$6,000	976	932	44
	Married couple, 2 dependents		
$3,000	$120	$40	$80
$4,000	320	240	80
$5,000	520	440	80
$6,000	720	640	80
	Married couple, 3 dependents		
$3,000			
$4,000	$200	$100	$100
$5,000	400	300	100
$6,000	600	500	100

Tax savings from proposal to allow deduction for dependency exemption for child earning more than $600

Income after deductions before exemptions	Present tax	Tax under bill	Tax savings
	Single person, no dependency exemption under present law [1]		
$3,000	$484	$360	$124
$4,000	694	560	134
$5,000	916	760	156
$6,000	1,156	976	180
	Married couple, no dependency exemption under present law		
$3,000	$360	$240	$120
$4,000	560	440	120
$5,000	760	640	120
$6,000	976	844	132
	Married couple, 2 dependency exemptions under present law		
$3,000	$120		$120
$4,000	320	$200	120
$5,000	520	400	120
$6,000	720	600	120
	Married couple, 3 dependency exemptions under present law		
$3,000			
$4,000	$200	$80	$120
$5,000	400	280	120
$6,000	600	480	120

[1] Assumes full income splitting for head of family under proposal. Of the tax savings on incomes of $4,000, $5,000, and $6,000, the full income-splitting provision in the bill accounts for $8, $18, and $36, respectively.

Effect of proposed retirement income tax credit for persons over 65 years of age with $1,200 of retirement income

Net income	Only husband has retirement income: Present tax	Only husband has retirement income: Tax under bill	Only husband has retirement income: Tax savings	Husband and wife each have $1,200 of retirement income: Tax under bill	Husband and wife each have $1,200 of retirement income: Tax savings
	Single person, no dependents				
$3,000	$360	$120	$240	....	....
$4,000	576	336	240	....	....
$5,000	796	556	240	....	....
$6,000	1,048	808	240	....	....
	Married couple, no dependents				
$3,000	$120	....	$120	....	$120
$4,000	320	$120	240	....	320
$5,000	520	280	240	$40	480
$6,000	720	480	240	240	480
	Married couple, 2 dependents				
$3,000	....	....	....	....	....
$4,000	$80	....	$80	....	$80
$5,000	280	$40	240	....	280
$6,000	480	240	240	....	480
	Married couple, 3 dependents				
$3,000	....	....	....	....	....
$4,000	....	....	....	....	....
$5,000	$160	....	$160	....	$160
$6,000	360	$120	240	....	360

Income after deductions and before exemptions.

Tax savings from proposed reduction in medical expense limitation from 5 percent to 3 percent of adjusted gross income

[Assumption: Taxpayers have $500 of medical expenses]

Income after deductions before exemptions	Present tax	Tax under bill[1]	Tax savings
	Single person, no dependents		
$3,000	$415	$400	$15
$4,000	647	627	20
$5,000	880	857	23
$6,000	1,161	1,126	35
	Married couple, no dependents		
$3,000	$293	$280	$13
$4,000	504	487	17
$5,000	716	693	23
$6,000	939	910	29
	Married couple, 2 dependents		
$3,000	$53	$40	$13
$4,000	264	247	17
$5,000	476	453	23
$6,000	687	660	27
	Married couple, 3 dependents		
$3,000			
$4,000	$144	$127	$17
$5,000	356	333	23
$6,000	567	540	27

[1] Taxes computed on assumption that deductions, other than medical expenses, amount to 10 percent of income.

Tax savings from proposed dividends-received exclusion and credit on $250 of dividends, 1954 and 1955

Income after deduction, before exemptions	Present tax	1954		1955	
		Tax under bill	Tax savings	Tax under bill	Tax savings
	Single person, no dependents				
$3,000	$488	$467	$21	$451	$37
$4,000	708	687	21	671	37
$5,000	944	921	23	903	41
$6,000	1,204	1,181	23	1,163	41
	Married couple, no dependents [1]				
$3,000	$360	$340	$20	$325	$35
$4,000	560	540	20	525	35
$5,000	760	740	20	725	35
$6,000	976	955	21	939	37
	Married couple, 2 dependents [1]				
$3,000	$120	$100	$20	$85	$35
$4,000	320	300	20	285	35
$5,000	520	500	20	485	35
$6,000	720	700	20	685	35
	Married couple, 3 dependents [1]				
$3,000	...	...	...	...	...
$4,000	$200	$180	$20	$165	$35
$5,000	400	380	20	365	35
$6,000	600	580	20	565	35

[1] All dividends received by husband.

Effect of proposed installment credit provision assuming an average unpaid balance of $1,000 and interest at 6 percent

Net income [1]	Present tax	Tax under bill	Tax savings
	Single person, no dependents		
$3,000	$488	$476.00	$12.00
$4,000	708	694.80	13.20
$5,000	944	928.40	15.60
$6,000	1,204	1,188.40	15.60
	Married couple, no dependents		
$3,000	$360	$348.00	$12.00
$4,000	560	548.00	12.00
$5,000	760	748.00	12.00
$6,000	976	962.80	13.20
	Married couple, 2 dependents		
$3,000	$120	$108.00	$12.00
$4,000	320	308.00	12.00
$5,000	520	508.00	12.00
$6,000	720	708.00	12.00
	Married couple, 3 dependents		
$3,000			
$4,000	$200	$188	$12.00
$5,000	400	388	12.00
$6,000	600	588	12.00

[1] Income after deductions and before exemptions.

Tax savings from proposed deduction for child-care expenses, assuming $600 of such expenses

Income after deductions, before exemptions	Present tax	Tax under bill [1]	Tax savings
	Head of household, 1 dependent		
$3,000	$360	$240	$120
$4,000	568	440	128
$5,000	778	640	138
$6,000	1,012	844	168
	Married, 2 dependents		
$3,000	$120		$120
$4,000	320	$200	120
$5,000	520	400	120
$6,000	720	600	120
	Married, 3 dependents		
$3,000			
$4,000	$200	$80	$120
$5,000	400	280	120
$6,000	600	480	120

[1] Assuming full income-splitting for heads of families.

Tax savings from proposed head-of-family provision—single person, 1 dependent

Income after deductions, before exemptions	Present tax	Tax under bill	Tax savings
$3,000	$360	$360	....
$4,000	568	560	$8
$5,000	778	760	18
$6,000	1,012	976	36

Mr. Folsom. We neglected to mention some information on that point that we have in here.

Senator Long. I would like to ask for your best estimate of the revenue reductions that would take effect under this bill, based on the third year in operation. Do you have that, or have you projected it to the third year?

Mr. Folsom. Many of these items will be approximately the same. Some of them we can't estimate that far ahead, such as the depreciation item, as we are depending on the stimulation and increased revenue. We can only estimate for 1 year.

Senator Long. I have heard it suggested that this depreciation item will cost 2,200 million in the third year of operation. Have you made a study to see whether or not that is positive?

Mr. Folsom. We don't see how you can make any reliable estimates. You have got to allow for the increase in stimulation in new investment which we think will offset a part of the loss from the depreciation provision. Also, you must realize, as I said before, this is simply a shifting from one year to the other.

Senator Long. I have had some occasion to observe how some businesses operate, where they can take a major reduction by making a major investment. I am sure you have looked at some of those situations, too. Where that situation exists, the tendency is for the businessman to continue to pyramid his investment. I am not saying that that is not a good idea.

I like the idea of expanding these plants. But I would like to know what the positive cost is and I wonder to what extent you have explored that.

Mr. Folsom. We just haven't been able to make any estimates.

Senator Long. If this thing works as well as you hope it would work, it might be that you would never get to the point that the Government brings in any more revenue. It is just positive that the man might keep buying machinery to the point that he never paid any tax. You would just continue to pyramid his operation.

Senator Bennett. Mr. Chairman, I think this is a very vital point. I would like to get into the record the assumption that depreciation can only be taken once and every man has the right to fully depreciate the asset which he buys. When this man sells this particular machinery before he has exhausted its actual life in order to buy something else, he pays a profit on the difference between the price at which he sold it and the amount to which he depreciated it. If he depreciates it all the way, he pays tax on the sale price. I have been in business 30 years and the one thing that has been borne in on me is that you can't shenanigan the Government eventually on this question of depreciation. You are allowed to deduct the full value once in depreciation, but you can't pyramid it or you can't beat it. While

I recognize that this is a shifting, if you shift it out of the years immediately ahead, then you catch the fellow on in the years beyond. You can't shift it.

Personally, I feel that we should go to the British system, which allowed the taxpayer to set his own rate of depreciation and then make him stick to it. I have come to have the feeling that it costs more to collect the taxes that are involved in these questions of depreciation rates. The Bureau of Internal Revenue spends far more money arguing and trying to calculate depreciation rates than any other thing on which it deals with business. If that were eliminated as part of the cost of the collection of the tax, we would probably be better off in the end. I realize that the Treasury would say, "Well, that is fine, but at this particular time we cannot take a chance on the shifts that might affect the years immediately ahead." It is also interesting to observe that the fellows who got the accelerated depreciation privilege in World War II have paid more taxes than the people who proceeded on the normal rate, because the tax rates have risen and the fellow who has been able to charge his depreciation off against the 52 percent rate has been better off than the man who had the privilege in the early forties and charged his whole plant off. I personally think that there is altogether too much concern about the question of the rate of depreciation.

In the end you charge it off once.

Senator LONG. Of course, when you are thinking about the expense of financing the Government, it is always well to know how much money you are going to get. That is one of our responsibilities, here, and that is the Treasury's responsibility, to advise us, if they can, how much money this thing brings in, or how much less it brings in.

Mr. FOLSOM. Mr. Chairman. I might say that the main purpose of this is to put in a provision which should have been in here all along. Our present system is entirely too rigid when it comes to handling depreciation. Prior to 1934, the taxpawer had wider leeway as to how he was going to write off his plant. As long as it was based on sound accounting principles and consistent policy, they didn't question it because he could write it off only once. In 1934 they tried to raise 25 percent more from corporation taxes by cutting down on depreciation allowances.

There has been considerable criticism of depreciation ever since that time. Probably the greatest gripe that business people have now has to do with depreciation.

Now, we are putting into effect what should have been in there all along. We think it is a very good time to put it into effect. This system has been in effect in practically all other countries. We know machines do depreciate faster in their earlier years. We think it is very timely that it come in right now, because it will apply to all purchases after January 1, 1954, and it will serve as stimulation.

Senator LONG. One thing you must keep in mind is that if a busiman has his choice about it he is going to throw every expense he can into a high profit year. That is good business administration.

Mr. FOLSOM. He can't shift his depreciation policy around. It has to be consistent.

Senator LONG. That's right. I saw a statement that indicated that when a steel strike occurred in an excess-profits tax year, it meant that the Government picked up 75 percent of the cost of the steel strike. We don't want to have the situation occurring where the Government is picking up first one contingency and then another, in terms of the different business allowances we give.

Mr. FOLSOM. This is just one of the gross inequities we are trying to remove.

Senator FLANDERS. Mr. Chairman?

The CHAIRMAN. Senator Flanders.

Senator FLANDERS. I would like to go back to some information I would like to see in the record on the previous question of raising the personal exemptions. I wonder if you could put into the record in some form against the various proposals from $100 up to $400 increase in exemptions the effect on the personal income taxes of trying to replace those exemptions inside the personal income taxes. For instance, if you took the highest, raising the exemptions from $600 to a thousand dollars per person, how far down would you have to go? For instance, assuming $10,000 as an income allowed the upper income brackets, how far would that $10,000 as a maximum income take care of the loss from the high exemptions?

Maybe you would allow $12,000 as a maximum income. Would that take care of the higher exemptions? Maybe it is $15,000. But, if it is possible to calculate it, I would like to see some maximum income allowed that would take care of the exemptions as they are variously affected.

Mr. FOLSOM. We could give you a calculation like that. Of course, we are losing $7.8 billion and we have got to have an overall increase of about 27 percent. It would be a question of where you would concentrate that increase.

Senator FLANDERS. Suppose you worked on the principle of setting a maximum income. I think that would illustrate more clearly than anything else the limitations of the upper brackets of the income tax in filling in the loss from the increased exemptions. I think it would be clear that you have got to make up your loss somewhere besides in the personal income tax.

I would like to see figures which, if that is true, would demonstrate that. Besides that, it would be a grand argument for a universal sales tax. I hope that it can be put into an understandable form.

Mr. FOLSOM. We will be glad to furnish that.

(The information requested follows:)

The revenue loss for specified increases in per capita exemptions, the percentage increase in tax rates necessary to recoup such revenue loss, and the income levels above which the rate would have to be 100 percent to recoup the revenue loss

Increase in per capita exemptions	Revenue loss (in billions)	Percentage increase[1] in all rates necessary to recoup revenue loss	Income level (after exemptions and deductions) above which all income would have to be confiscated to provide the lost revenue
$100	$2.4	9	$19,000 ($38,000 on joint returns).
$200	4.8	19	$11,000 ($22,000 on joint returns).
$400	7.8	40	$6,500 ($13,000 on joint returns).

[1]Proportional increase in all rates (not percentage points); top rate limited to 100 percent.

Source: Office of the Secretary of the Treasury, analysis staff, Tax Division.

Amount of income at which (a) the tax under present law and (b) the tax with a $700 per capita exemption and a 9 percent[1] increase in rates would be equal

	Adjusted gross income	Net income
Single person (1 exemption)	$2,012	$1,811
Married person with 3 children (5 exemptions)	10,466	9,419

[1] Necessary increase to recoup $2.4 billion loss from increase in exemption to $700.

Revenue gain from a 100-percent tax on surtax of net income above $10,000, $15,000, and $20,000

Surtax net income over:	*Revenue gain from a 100-percent tax (in billions)*
$10,000 ($20,000 on joint returns)	$5.2
$15,000 ($30,000 on joint returns)	3.2
$20,000 ($40,000 on joint returns)	2.2

Senator WILLIAMS. Mr. Chairman, I would suggest that we have incorporated in the record a letter which Mr. Folsom, I think, prepared for me at my request a couple of weeks ago. I raised that same question. Assuming that we raised these exemptions and decided to put the revenue over in the upper brackets, how far would we have to roll back? I was supplied with the answer that if we took 100-percent tax on all incomes in excess of $10,000, put a ceiling on them and confiscated every individual income over $10,000, I think the figure was $5.2 billion extra revenue, or not even enough to make up the loss of revenue which would come from raising the personal exemption from $600 to $1,000.

I think that letter also brought it down to the $15,000 and $20,000 brackets, which would even lower the additional revenue. I think it would be well to incorporate it in the record at this point.

The CHAIRMAN. Do you have the letter?

Senator WILLIAMS. I have it, and will be glad to put it in the record.

(The information referred to appears at p. 149.)

Senator FLANDERS. Mr. Chairman, as I see it, there are two ways of getting at this. I am not quite sure just what way the Senator from Delaware was getting at it. You can start at the top and you can turn the taxpayers' pockets inside out—I have a few cents here in my pockets, and I am holding on to them.

The CHAIRMAN. He still has some left.

Senator FLANDERS. And you can see how far down the brackets you would go in turning the upper taxpayers' pockets inside out, or you can be less hardhearted and see how much you can allow the upper tax brackets to obtain. On a $10,000 basis a year as a maximum, you would see how far down that would carry you.

Secretary HUMPHREY. That is what he said.

Senator WILLIAMS. That is what I mean.

The CHAIRMAN. I would like to suggest to the Secretary of the Treasury while he is here and has seen this demonstration, that I think he has failed in his duty because the Senator still has something left.

Secretary HUMPHREY. As long as he still has a few cents we will be after him.

Senator BENNETT. Mr. Chairman, while we are on this matter, I would like to see, if it is possible, a chart which shows the increases in rate in each bracket that would be required. If we have a 27½ percent increase we obviously can't increase the top bracket 27½ percent because that would carry us well above a hundred, and a hundred is, after all, the limit that you can take away from a man.

Senator FLANDERS. Are you sure?

Senator BENNETT. No, I am not, as a matter of fact. I wonder if it would be possible to distribute that $7.8 billion among the various tax brackets on the basis of the relationship of the present rates. As to the man who is now paying 20 percent tax and we are giving him $20 per 100 and if he has a wife and three children, we are giving him $80 exemption, we might find that in order to make that up by distributing the burden over comparable changes in rates that we would actually be assessing him more money and collecting more money from him than we would from the men in the top brackets. While you can laugh about it, actually you cannot increase the present ceiling of 91 percent very much further.

The CHAIRMAN. On this whole subject that has been touched on and on the general criticism that we are doing things to favor the rich at the expense of the poor, I would like to read this into the record. I am assuming a single person with no dependents.

A $5,000 man has 1.7 times the income of a $3,000 man, but he pays 1.9 times as much tax. A $10,000 man has 3.3 times as much income as a $3,000 man, but pays 4.9 times as much tax. A $20,000 man has 6.7 times as much income, but pays 14.2 times as much tax. A $50,000 man has 16.7 times more income than a $3,000 man, but pays 54.1 times more tax. A $100,000 man has 33.3 times more income than a $3,000 man, but pays 136.9 times as much tax. A $500,000 man has a 166.7 times as much income, but pays 979.7 times more tax than a $3,000 man.

Senator FREAR. Mr. Chairman, I think that is entirely right, and I think that is why we have a graduated scale in our personal income tax. I might also say that if we raise the first bracket from 20 to 25 percent, or only a 5 percent increase, it would produce much more income into the Federal Treasury than if we increased the brackets that are now at 87 percent up to 97 percent, would it not?

Mr. FOLSOM. Oh, sure.

Senator FREAR. Then we cannot say that a 27½ percent thing across the board is too accurate. In other words, we have to raise that in percentage to our income from personal income taxes, but it does mean a 27½ percent increase on the 20-percent bracket.

Mr. FOLSOM. That is where the big money is.

Senator FREAR. And that is why an increase in a percentage there means much more than its direct relation to the 27½ percent on the overall, does it not?

Mr. FOLSOM. It means you are going to have to increase it in those lower levels, if you are going to get the money.

Senator FREAR. I want to commend the Senator from Utah on his depreciation recommendation. I think if he would read a bill we have here, he would like to be a sponsor to it.

Senator LONG. Have you made a study to see what the cost would be to the Government if we had a shutoff at about 60 or 65 percent as the top bracket on personal income taxes? It occurs to me we are not gaining much revenue by going above that point.

Mr. FOLSOM. We have a number of estimates on that. We could give that to you very quickly.

Secretary HUMPHREY. If they cut off at 50 percent, it would be $900 million. If we cut off at 65, it would be about $300 million.

Senator LONG. It occurred to me that these higher brackets are so discouraging to a person who is earning a high income that he usually finds some way to pass the profit off until the next year or to postpone the taking of a profit or else seek one way or the other of splitting his income up so he does not wind up paying that income bracket that in the main we might do better to have a lower ceiling on the income rates.

I would like to see some breakdown on what it would cost to shut the rates off at 60 and 65 percent.

Secretary HUMPHREY. We will get those for you.

The CHAIRMAN. Will you supply those figures?

Mr. FOLSOM. We will be glad to.

(The information requested follows:)

Revenue loss from reducing top individual income tax rates (from present schedule with top rate of 91 percent)

[In millions of dollars]

Under 1954 rates limit the top rate to—	*Revenue loss*
50 percent	925
60 percent	461
65 percent	314
70 percent	211
75 percent	130

The CHAIRMAN. Are there any questions of the Secretary?

Senator LONG. I would like to ask one question of the Secretary. Isn't it true that most of your plant expansions of recent date, Mr. Secretary, have occurred out of retained income, rather than equity in investments?

Secretary HUMPHREY. That's right, Senator, because it was the only way they could with the very high taxes. A large percentage had to be through retained income.

Senator LONG. Of course, they had to pay the corporation tax, even though they retained the income, didn't they?

Secretary HUMPHREY. The corporations did, oh, yes.

Senator LONG. A high personal income tax rate does discourage the declaring of dividends, particularly if the stockholders, or the major ones, have a very high income tax to pay to the dividend declared.

Secretary HUMPHREY. That's right.

Senator BENNETT. Will the Senator yield before you leave that question? I think there is a third source of plant expansion which he has overlooked.

I am not sure it is not the most important of the three. That is borrowing. I think there has been tremendous plant expansion based on borrowing.

Secretary HUMPHREY. The Senator, of course, is absolutely right, and not only that, but what has happened is that people just didn't have the money to invest and, frankly, with the double tax on the dividends, there was very little inducement to invest in equity securities. The result has been that money has gone into these funds. A man, instead of investing in equity, bought debt of the corporation. The great money of America today, the great investment money, is in the big funds, in insurance funds, the pension funds, and the big accumulations of funds. Those funds almost universally have been taking debt, and now the pension funds and some others are beginning to have to swing to buy some equities.

Senator LONG. Is it not also true that with regard to the expansion of business, based on borrowed capital, that many of these large concerns are not permitted by law to buy equity capital, to invest their money in investments?

Secretary HUMPHREY. Some of the insurance companies, but the laws are being changed because they just have to be under the circumstances. There is no other way to get the money. That money belongs to the great mass of the people of America, the insurance people and the pension people and all of that. That is the great mass of the people of America. They are moving now to try to change the laws so that these funds can be released.

Senator LONG. As the law stands, today, in the main these are State laws, rather than Federal laws.

Secretary HUMPHREY. That's right.

Senator LONG. In the main these State laws make it impossible for many of the large insurance companies and many of the larger pension funds to invest their money in equity investments in corporations.

Secretary HUMPHREY. They can only buy certain percentages.

Senator LONG. So, by and large, they are compelled to invest in terms of bonds.

Secretary HUMPHREY. That's right.

Senator LONG. Will not the effect of having a provision for double dividends on taxation encourage the declaring of dividends?

Secretary HUMPHREY. I think it will.

Senator LONG. In other words, if a corporation found that they were paying very high taxes and the stockholders found it almost prohibitive to pay the income tax on personal income, they would be less inclined to declare a dividend than they would be if they could feel that that would mean that their stockholders would have a very favorable tax setup when they received their dividends.

Secretary HUMPHREY. I think, Senator, that we are very apt to find, as a result of reducing the double taxation on dividends (we can't count on it because you can't count your chickens before they are hatched), but I think we would be apt to find that the reduction of the double taxation of dividends would actually net us more taxable income on dividends than we are now receiving. At least we would make back a good part of our loss because of the fact that more dividends would be declared with that amount. You see, the high income bracket man is not relieved of the payment of the tax on his dividends except for the 10 percent. That is all. He still pays 91 percent of the dividends if he is in that bracket, except for just this first 10 percent. But all of the other stockholders of the company, all of the lower-income stockholders of the company, when they find that they don't have to pay the double tax on the dividend, are going to demand more dividends be paid and the high income fellow is just going to have to take it and pay his tax.

Senator LONG. It occurs to me, however, that when you are trying to expand your plants and your productivity facilities, that on the one hand this double dividend proposal encourages the money to be declared out in dividends and that that is going to reduce the amount that is available for plant expansion, although it would encourage, in some respects, the further investment of funds in corporations.

Secretary HUMPHREY. That's right. What it will tend to do, Senator, is to give more opportunity for smaller companies, for new enterprises, to get some equity capital.

Today a company retains its money and gets bigger. If it pays out the dividends it wouldn't get so big, but the thousands of stockholders will have money they can invest in smaller and growing enterprises. It will tend to encourage investment in smaller industry. It will promote small industry at the expense of larger industry, which is a very wholesome thing in our whole economy.

Senator LONG. Rather than encouraging less borrowing, you might in some respects encourage more. A corporation might say it now has the right tax setup to declare dividends so it will declare more dividends than it would otherwise have declared, and instead of expanding out of earnings it would borrow more money and thereby expand out of borrowings.

Secretary HUMPHREY. They will not borrow money if they can get equity money at anything like a reasonable rate. You only borrow when you can't get equity money at a decent rate. No prudent management of any company is going to borrow money if it can get equity money at a comparable rate.

The CHAIRMAN. May I interrupt? Is it not correct that if you borrow money and cannot pay you finally find yourself in the hands of the banker or whoever loans the money?

Secretary HUMPHREY. That's right.

The CHAIRMAN. Is it not also true that the interest must be paid when due as distinguished from paying dividends when you can when you are supported by equity capital?

Secretary HUMPHREY. That is exactly right.

The CHAIRMAN. And that is why people who are sound and sensible like to keep their borrowings down. In bad times they may not be able to meet the interest rate, and pretty soon the sheriff's flag is out in front of their place of business.

Secretary HUMPHREY. Not only that, Senator, but it goes through the whole economy. If you get a company in trouble where it has borrowed too much money and it just has to reduce, that is where your worst unemployment comes from. That is where your lack of expansion comes from. That is what causes your real trouble in America.

There is no way that America as a whole, our whole economy, can get in more trouble than having too many people owing too much money.

Senator LONG. The corporation tax will go down under this bill to 47 percent next year. Without any legislation at all, it would go to 47 percent immediately. What consideration has the Treasury given to the idea of reducing the corporation tax to 50 percent, either now or next year, in view of the deficit situation of the Government? In other words, here you are recommending certain tax reductions but you are saying that you can't afford to stand a revenue loss of the corporation tax going down to 47 percent. I know there must have been some consideration to splitting the difference, letting the corporation tax go down to 50 percent instead of some of these other proposals that are contained here.

Secretary HUMPHREY. That's right. We thought it was better. What we have sought to do throughout this entire bill is to do those things which will be best for the whole economy of America, which will simulate the greatest development of the whole economy of America.

First we picked out some things which were just manifestly unfair, which weren't right, which should be corrected, which were drawn up in a wrong way and were manifestly wrong and should be changed, or where they were causing an injustice, improper charges. Those things were corrective measures which we have discussed today. The whole tax program was based on taking what we thought we could afford to give up. The way we determined what we could afford to give up was by finding out how much we had saved. I don't think that you can cut taxes more than you cut spending and not get yourself into trouble. I think that the determination of how much dollar tax relief you give must be related to the total saving that you make in Government expenditures. Having made a saving in Government expenditures, you then had so many dollars that could be let go of to go back to the people in tax relief.

We took those things and went at it in a way to distribute that return of money as broadly as we could throughout the entire economy to all classes of people in ways which we thought would do the most to stimulate consumer buying and to stimulate investor buying to keep the production of the whole country going and make the greatest possible number of jobs.

Senator LONG. What do you think is the best way to stimulate consumer buying?

Secretary HUMPHREY. The best way is to give them more money. The more money we could give the consumers, the more they could spend.

Senator LONG. If some of these tax reductions were spread more generally so that just the average wage earner received more of the tax reduction, wouldn't that have a tendency to create more consumer buying?

Secretary HUMPHREY. Yes, sir, and it would reduce the other buying. We have to have the men working in heavy industry just as much as we need them in the consumer business. It doesn't do a bit of good to have them working in consumer industry if you are going to throw them out of heavy industry because you are causing unemployment and taking the consumers off the rolls. Every time a man loses a job you lose a consumer. We would rather have them work in their jobs and be consumers.

Senator LONG. There is some merit to the other side of the argument, however, isn't there? In other words, if you presume that you distributed another $3 billion or $4 billion of purchasing power among persons in low-income brackets, the figures show that those people don't save much. They are almost compelled to spend their entire income. That would mean that you would have at least $3 billion or $4 billion of direct consumer buying on consumer items, wouldn't it? That would in turn require more production to meet that demand.

Secretary HUMPHREY. I think the worst thing we could do in America would be to add another three or four billion dollars of tax relief at this time, because by doing that we have to increase our deficit. The worst thing we could do in America at this time, in my opinion, would be to greatly increase the deficit that we are running. I think it would tend more to slow up business, to cause difficulty. Not only that, but the very consumer who got the money would very soon be hurt by the depreciation of his dollar, so that his cost of things would more than offset the little tax reduction that he got. He would not be able to buy as much at the higher prices which would prevail, because of the smaller value of his dollar through the depreciation of the currency, as he would save in the taxes that he got from the extra $3 billion.

Senator LONG. At this particular moment, you are not worried about further inflation, are you?

Secretary HUMPHREY. I would be very worried about it if you put another $3 or $4 billion worth of deficit on our present deficit; yes, sir.

Senator LONG. You do have prices coming down in many fields.

Secretary HUMPHREY. You would stop them awfully quick if you started running larger deficits. Everything we have done to straighten this thing out would be jeopardized, and we would be on the way to turning right back to the pattern we have been following in America for 6 or 8 years, which is fatal.

Senator LONG. What is your feeling about the excise tax reduction of a billion dollars that went into effect a few days ago?

Secretary HUMPHREY. I think it was too much.

Senator LONG. You think it was a mistake?

Secretary HUMPHREY. Yes. I don't think it should have been that much. I think it was all right to bring down the excise taxes to what we could afford, but when we brought down those excise taxes by just simply increasing our deficit, I think it was a mistake to do it, and I said so all the time.

Senator LONG. Mr. Secretary, you assumed what my position was in a statement you made here today. I would like to make it clear, as far as I am concerned, I would like to have further tax reduction as far as the income tax is concerned for the man making $600 or $700 or $800 a year. I would like to see us raise his exemption. I also would like to see us have some of these reductions in terms of the depreciation reductions you have in mind. I find the same consideration coming into my vote on these bills that you find when you make the decision as to what to recommend to us. The question is, with the Government running a deficit, what can we afford? I have supported this administration in every reduction of any major consequence that has been recommended. You may recall that last year the Democrats and Republicans had a battle over this Air Force budget. I think I did as much speaking in favor of the reductions as anyone did. I notice that in 1952 the proposal was made when Senator Taft and General Eisenhower met that this administration would have a goal of a $60 billion budget in this fiscal year, fiscal 1955. If we had that, we would be able to have these tax reductions without running a deficit. Would you give us your judgment as to why we can't have a $60 billion budget?

Secretary HUMPHREY. Yes, I will be glad to. The reason we can't now is because we haven't yet been able to figure out a way to afford the country sufficient security—and what you are talking about is security—to make the reductions as rapidly as that suggestion required. We have gotten down to a $65 billion budget. We have come from $75 billion to a $65 billion budget. That is a very substantial reduction. There is this other thing that you have to take into account, that you must remember, Senator, when you are up on this very high level and coming down. It is what I said in my statement. The only way the Government saves money is by putting people out of work. That is a very hard statement to make, but it is a fact. The only way we can save money is by either discharging Government employees and putting them off the Government rolls so that they have to go and seek other employment, or to stop buying goods that the Government is buying.

Senator LONG. You don't mean that as a long-run statement, Mr. Secretary?

Secretary HUMPHREY. I mean that the only way to save money that I know of is to do what I say, either discharge Government employees or stop buying things the Government is buying.

Senator LONG. Don't you mean that as a short-run statement? It is possible, in my judgment, for the Government to save money. It might mean employing less people and buying less for now, but if the ideal is accomplished, it would mean that those people would go into private industry and we would have just as many jobs and just as much production as we have, if not more.

Secretary HUMPHREY. That is exactly correct, but that takes this transition that I have been talking to you about. You must make this transition. When the Government no longer hires a man or no longer buys the goods that that man was making, that man is out of work and he has to get to working for the people on the other goods. The words I said before were, if he stops making guns, things for killing, he has to make refrigerators or other things for living. You have that transition that you must make. I don't think you can cut $20 billion in 1 year and make the transition, because it is just too many people to move fast enough.

I think we have done as much as we can do now. We have cut $7 billion. We have taken $7 billion out of paying people for the Government and we are putting $7 billion for all the rest of you to hire those fellows back. I think you will do it. I think that transition is going on and going on very well, as evidenced, as I said before, by the fact that we still have this very, very high employment in America. But you can't overdo it, you see. You must bring this down in steps. It must come down gradually in trying to make this transition. More than that, you can't do it and preserve your security. You just can't go in and cut $20 billion out and preserve the kind of security we have to have with the kind of threat that we have in the world today.

Senator LONG. You aren't cutting any $20 billion out of spending.

Secretary HUMPHREY. No, we cut $7 billion out, and I think that is about as far as we could go. You were asking a question based on the proposition that we might be able to cut out another $5 billion. I am sure we can't cut out another $5 billion and still maintain security, because we tried it. I don't know that we could have done it and maintained the transition that would be required, even if we had found a way to do it.

Senator LONG. In what year are you spending $7 billion more than $65 billion?

Secretary HUMPHREY. There is a reduction of $7 billion in the program for spending this year and in the actual amount we expect to spend this year.

Senator LONG. As far as reducing spending over previous spending, there is no $7 billion reduction, is there? You are talking about $7 billion from something someone estimated you would spend this year, I take it.

Secretary HUMPHREY. The reduction next year will be $8½ billion of actual reduction in dollars spent.

Senator LONG. That was from the high point when?

Secretary HUMPHREY. When we got here until now.

Senator LONG. That $8 billion would be next year?

Secretary HUMPHREY. That is right. The program is cut $7 billion, now. The whole program over a period is cut $12 billion. The program over a year is cut $7 billion..

Senator LONG. You haven't made this statement, Mr. Secretary, but I wonder if it could be inferred from your statement that you feel that a certain amount of deficit financing might be necessary in an adjustment period, to adjust from a war production with a large armed service, to a lesser armed force and less arms production?

Secretary HUMPHREY. The only kind of deficit spending that I can support is this: I have likened it many times to a family. I don't think America is any different than one big family. That is what it is. It is just a group of all of these families put together. We are looking after the collective finances of all of these families. In a family, you know perfectly well that you can't run deficit financing. You know you can't overspend your income and keep on doing it.

You know that when you have done it for a while and have accumulated some debts, that that limits how much more of it you can do. As a family, we have gone along and we have been spending more than we have collected for a long time. We have got an awfully big debt. That limits what we can do in the future. But in a family, what do you do? If you have a great sickness or a great illness or some catastrophe, you come to a time when you have to spend more money than you get in for a period. You then run deficit financing to meet that great emergency.

But it has to be a great emergency for you to do it. The same thing is true of America. If we get into a war, if we get into a great emergency, we may have to do as the collective family just what your family would do if you had terrible sickness in one year and had to spend more that year thtan you took in. But the more we owe, the harder it is to do it.

The CHAIRMAN. Are there any further questions?

Senator WILLIAMS. Mr. Chairman, I have this statement here which we were having incorporated in the record. I might say that that statement showed that a 100-percent tax on all income over $10,000 would only provide an additional $5.2 billion. If you confiscated all incomes over $15,000, it would be $3.2 billion. All over $20,000 would provide $2.2. Those figures, then, are based upon the assumption that all men would keep working as hard to earn money in order to pay a 100 percent tax as they are now working, which is something we know is not true.

(The information referred to follows:)

Rough approximation of the revenue increase involved in taxing at 100 percent all surtax net income of individuals over certain specified amounts—Increase in individual income-tax liability as compared with present law

Tax at 100 percent all surtax net income over:[1]	Billions
(a) $10,000 ($20,000 for joint returns)	$5.2
(b) $15,000 ($30,000 for joint returns)	3.2
(c) $20,000 ($40,000 for joint returns)	2.2
(d) $10,000 (for all returns)	9.7
(e) $15,000 (for all returns)	6.9
(f) $20,000 (for all returns)	4.5

[1] Adjusted gross income less deductions and personal exemptions.

NOTE.—The 1st group of figures recognizes that on joint returns the total income is presumptively divided equally between husband and wife, and therefore a $20,000 reported income is in effect treated as 2 incomes of $10,000 each.

The 2d group of figures ignores income splitting and is based on the taxable income reported on the returns.

Source: Office of the Secretary of the Treasury, Analysis Staff, Tax Division.

Secretary HUMPHREY. Does that mean, Senator, that if nobody got more than $20,000, it would just pay the amount of the $100 exemption? A $100 exemption is $2½ billion.

Senator WILLIAMS. That is right. If we took all incomes over $20,000, we would only get $2.2 billion, which would not make up that increase in the exemption. I might say that was proposed once in our memory, but I think it was overwhelmingly repudiated by the American people.

Secretary HUMPHREY. We have not given credit for recoups in these figures. We didn't do it because those were so speculative that we were unable to measure them and we thought you gentlemen could guess them as well as we could and as long as it was so terribly speculative, we went on what we knew was going to happen.

Senator FREAR. That is quite right. You may not agree with our guessing, however.

Secretary HUMPHREY. You make your guess and we will make ours.

The CHAIRMAN. Gentlemen, we have one more witness before we close here.

Senator LONG. Mr. Chairman, I refer to some figures about stock ownership. I would like to submit a memorandum for the record.

(The information referred to follows:)

MEMORANDUM

The fact: Six-tenths of 1 percent of the earning units (families) in this country own 80 percent of publicly held stock.

The source: The book, Effects of Taxation on Investment. Author, Butters, Thompson, and Bollinger, at page 25.

Note: This is a recent study. We believe it came out in 1951, but we are checking.

The CHAIRMAN. Mr. Hughes, will you identify yourself for the purposes of the record?

STATEMENT OF ROWLAND R. HUGHES, DEPUTY DIRECTOR, BUREAU OF THE BUDGET, ACCOMPANIED BY WILLIAM F. McCANDLESS, ASSISTANT DIRECTOR, OFFICE OF BUDGET REVIEW; AND J. WELDON JONES, ECONOMIC ADVISER

Mr. HUGHES. This is a very short statement, Mr. Chairman. The Secretary of the Treasury has covered all of the ground pretty well.

Mr. Chairman and members of the committee, in connection with your consideration of H. R. 8300, a bill to revise the revenue laws of the United States, the Secretary of the Treasury has presented the administration's position on the merits of this long-overdue reform of our revenue laws. Such a basic reform inevitably in the short run means a loss in tax receipts and an unfavorable effect on the budget. This is the price that must be paid to achieve a more equitable tax system which will encourage economic growth—both production and consumption, both investment and jobs.

I am appearing here today at the request of the committee, to try to bring you up-to-date information on the budget outlook, and the effect H. R. 8300 would have on that outlook if it were enacted. And, of course, you also remember that that must be somewhat of a speculation at the present date, fiscal year 1954. In that connection, I should first like to mention budget expenditures for the fiscal year 1954.

Under our present more accurate system of reporting receipts and expenditures, the final monthly figures through March 31 will be available on April 15.

As you know, in the January budget document, 1954 expenditures were estimated to be $70.9 billion. However, it now appears that the final results may be somewhat lower than the January estimate. The final results will largely depend on the total for Department of Defense military functions, the mutual military programs, the Atomic Energy Commission, and the stockpiling of strategic and critical materials. As usual, a number of other, relatively smaller, changes from the January estimates—both increases and decreases—can be expected in other expenditure programs of the Government.

Changes not now foreseen can occur between now and the end of the fiscal year. Nevertheless, it is quite possible that even if the actual receipts should be lower, expenditures for 1954 may also be below the January estimate and if the changes are in approximately the same general range, we could come out close to the estimated $3.3 billion deficit projected last January for the fiscal year 1954.

In that connection, I might remind you, Mr. Chairman, that in 1953, when the administration took over, there was a great effort made to reduce expenditures all around, and through that effort, something over a billion dollars was cut. At the end of the year, when the crop program suddenly hit us, it was all wiped out, and we ended the year with an even-Stephen balance, so that just shows the danger of making estimates even when you are making progress in a large number of fields.

For the fiscal year 1955, it is certainly too early to make any changes in the expenditure estimates. As you know, they were estimated last January to be $65.6 billion. Until the appropriation acts and the

President's legislative proposals have been acted upon by the Congress, a revision of these figures would be purely speculative.

We hope to make such a revision as soon as possible after the close of the present session of Congress—a statement similar to the review of the 1954 budget made last August 27.

A few observations can be made now, however, with respect to the fiscal year 1955. First, the excise-tax bill which recently became law will reduce net budget receipts by about $1 billion from the level estimated in the budget for 1955. Unless a comparable reduction can be made in expenditures, this reduction in revenues will cause a greater budget deficit than previously expected.

The enactment of H. R. 8300, according to its revenue effect as reported, will result in no net loss in revenue in 1955 as a direct result of the bill itself, because the net loss estimated from the tax-revision provisions is approximately equaled by the increase calculated from including in the bill the extension of the corporation tax rate at 52 percent. However, the incentives provided by the tax revision in the bill now before you will help create more jobs and more business, thus leading to higher personal income and higher profits.

I appreciate the opportunity to appear before you and thank you for your attention. That concludes my statement, Mr. Chairman.

The CHAIRMAN. Thank you very much.

We will meet again at 10 o'clock tomorrow morning.

(By direction of the chairman, the following is made a part of the record:)

CIGAR MANUFACTURERS ASSOCIATION OF AMERICA, INC.,
New York, N. Y., April 5, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: The Cigar Manufacturers Association of America, Inc., is a trade association composed of cigar manufacturers located throughout the United States who produce in unit and dollar volume approximately 80 percent of the entire United States production of cigars.

The undersigned association hereby endorses the proposal of the Ways and Means Committee set forth in H. R. 8300 insofar as it relates to the collection and administration of excise taxes on tobacco, cigars, cigarettes, cigarette papers and tubes, namely, chapter 52 thereof, section 5701 to 5763, inclusive, and urges its adoption by your committee.

The proposal of the Ways and Means Committee is in substantial conformity with the original proposal of this association made before the Ways and Means Committee at its public hearing on August 10, 1953, and attached hereto is the statement of a representative of this association made at said hearing.

This association also supports the findings of the Ways and Means Committee made in connection with proposed chapter 52 of H. R. 8300 and which is set forth at page 94 et seq. of the committee's report to accompanying said H. R. 8300.

Wherefore, the undersigned respectfully recommends the adoption of proposed chapter 52 of H. R. 8300.

Respectfully submitted.

ED. J. REGENSBURG, *President.*

Mr. Chairman and gentlemen of the committee, my name is Leon Singer. I am a member of the law firm of Blumberg, Miller, Singer & Heppen, who are and have been general counsel to the Cigar Manufacturers Association of America for many years.

The Cigar Manufacturers Association of America is a trade association composed of cigar manufacturers located throughout the United States. Its members consist of large, medium, and small manufacturers, who collectively produce approximately 80 percent in unit and dollar volume of all cigars manufactured in continental United States. Many of these firms have been in business continuously since before the turn of the century and many are successor companies whose predecessors were likewise in business before that time.

Since then, the process of manufacturing cigars has changed from what was once entirely a hand operation to predominantly a machine belt line production. The packaging and merchandising of the finished product has likewise substantially changed. Fifty years ago practically all cigars were packaged only in wooden containers. Other types of containers such as cardboard, tin, glass, and plastics were gradually adopted by the industry, with the result that today only a small portion of cigars are packaged in all-wood containers. Yet the statutes relating to the packaging of cigars require that they be packed in wooden cigar boxes unless the Commissioner of Internal Revenue gives specific permission for the use of a different form of container.

During the last 50 years the statutes relating to the collection of excise taxes on cigars have remained practically unchanged, taking little or no cognizance of the changing economy of the industry. They reek in antiquity.

Many of these statutes were first enacted in 1868 and last revised in 1897. When these statutes were enacted shortly after the close of the Civil War, most cigars were manufactured in a one-story building where the back room was the factory and the front portion the retail establishment. There were no nationally advertised cigars and most cigars were manufactured for local consumption, except in the rural districts where peddlers carried their wares in a horse- or mule-drawn wagon or in a basket and sold cigars on a house-to-house basis. And so we find many of these statutes still relating to the trafficking of cigars by peddlers, notwithstanding that this method of retailing (in vogue in the days of our great-grandfathers) has long passed into limbo. Thus, a peddler who did not affix on his wagon, "a sign painted in oil colors or gilded giving his full name and collection district," as the statute requires, was liable to have his horse, or mule, wagon and its contents, seized for forfeiture.

Cigar manufacturers, like peddlers, are still subject to these antiquated statutes. There is a similar section of the code which requires every cigar manufacturer to keep on the side of his factory a sign with letters of not less than 3 inches "painted with oil colors or gilded giving full name and business." Thus, it would be a violation of the Internal Revenue Code for a cigar manufacturer instead, to put up a neon sign or to use plastic paint or any other type of sign other than one painted with oil paints or gilded.

Since the Civil War days a cigar manufacturer has been required to imprint on his cigar box the collection district in which his factory was located. Cigar manufacturers having factories in more than one collection district have been unable, without specific approval of the Commissioner, to transfer empty cigar boxes from one collection district to another, even where there was a surplus of inventory in one factory and a shortage of boxes in another.

Cigar manufacturers are often obliged to withdraw cigars from the market on which the tax has been paid through the media of a tax stamp affixed to the box. To obtain a redemption of the stamp, the code requires the destruction of the cigar box in the presence of a representative of internal revenue.

Many cigar manufacturers have been reluctant to package their cigars in expensive containers such as plastic boxes because to obtain a redemption of the stamp often requires destruction of a box more valuable than the stamp. Unlike some other commodities, subject to the same restrictions, cigars are perishable and, therefore, the frequency of returns greater.

For more than a century the statutes have prescribed the number of cigars which may be packaged in a statutory or legal container. Thus, a manufacturer of cigars, who for economic reasons may desire to pack 60 cigars in a box, would be in violation of the law because no statutory container exists for 60 cigars. Similarly, a cigar manufacturer who may desire to send samples of one or two cigars in the mail to prospective customers would be in violation of the law because the smallest permissible statutory container is three cigars. The proud father of a newborn child desiring to announce the birth of his offspring and mailing an announcement to which was attached a single cigar, would be in violation of the statutes, notwithstanding that he may have originally purchased a box of 50 cigars in a stamped tax container from which he removed the cigars. The statutes provide for seizure of a container of cigars on which no stamp is affixed.

These laws intended for the merchandising of handmade cigars by a peddler with a mule and wagon contain numerous administrative statutes prescribing, for example, the kind of book in which manufacturers and vendors of tobacco products are required to make detailed entries daily of matters no longer of any value to internal revenue. These statutes have imposed administrative hardship not only on the modern manufacturer and vendor, but on the Internal Revenue Department requiring the employment of unnecessary administrative personnel. They have rendered administration impossible.

Even the very concept of a cigar tax stamp is archaic and has long outgrown its usefulness, causing administrative hardships to both the cigar manufacturer and the Treasury Department entailing needless expense to the Government in imprinting, issuance, accounting, and redemption.

We are offering a complete recodification of the existing statutes relating to the collection of excise taxes on cigars, which we have filed with the clerk of your committee. Briefly, the proposals of our association are:

1. The compete elimination of the requirement of the collection of excise taxes through the mediums of stamps, and the substitution of provisions which would require the payment of the tax and the filing of returns similar to the collection of manufacturers' excise taxes on such articles as automobiles, tires, radios, television sets, refrigerating apparatus, gasoline, and lubricating oils.
2. The complete elimination of the statutes relating to peddlers.
3. The granting of broader power to the Secretary of the Treasury to adopt and promulgate, from time to time, rules and regulations for the payment, collection, and administration of excise taxes on cigars as he may deem advisable.

Our proposals, I assure you, gentlemen, are not made for the purpose of relaxation of any controls relating to the collection of taxes by our Government. Instead of a compendium of laws encompassing some 90 statutes, we are submitting for your consideration what we believe to be a streamlined, workable, and comprehensive body of laws which will insure to the Government the collection of every penny of revenue due it.

Our proposed recodification, I should like also to assure you, is not a haphazard, hastily drawn instrument. In its preparation I was assisted by the controllers from a cross section of the cigar industry, men whose daily task it has been to live with the statutes and regulations promulgated thereunder. And it was these men who impressed upon me the hardship imposed upon the industry through the use of stamps, which not only must be purchased in advance of production, thereby unnecessarily tying up capital, but incurring needless expenditure in affixing them to the cigarbox.

The regulations, promulated by the Treasury Department, of necessity being circumscribed by an antiquated code, have been almost impossible of rectification. For many years this association has suggested to the Treasury Department that they change their "hamstringing" and outmoded regulations, but we have always been met with a justifiable "brushoff" that they are bound by the statutes. It was, therefore, with a sigh of anticipated relief when we learned that this committee was considering a revision of the entire code. We urge you to remove the yoke of antiquity which for many years has shackled and hampered this industry and prevented it from keeping pace with modern merchandising methods. The time for a change is here.

WALGREEN DRUG STORES,
Chicago 30, Ill., April 1, 1954.

SENATE FINANCE COMMITTEE,
Joint Committee on Internal Revenue Taxation,
New House Office Building,
Washington, D. C.

DEAR SIRS: I enclose in triplicate a statement recommending that Congress grant relief from an inequity in the imposition of income and estate taxes on pension and profit-sharing payments to surviving beneficiaries of deceased employees. I would appreciate it very much if you would insert this statement in the record of the hearings that will be held before the Committee on Finance and Banking of the Senate when the new revenue bill is taken up by that committee.

Previously on January 12, 1954, I wrote to you on the same subject transmitting a somewhat similar statement which I asked you to insert in the record of the hearings before the Committee on Ways and Means of the House of Representatives. The statement which I now enclose has been modified to take into account changes which have been incorporated in H. R. 8300. In my prior statement I pointed out that section 22 (b)-2 (c) granting relief in the case of payments under employees' annuity contracts to survivor annuitants discriminated in favor of pension and profit sharing plans funded by insurance or annuity contracts. In section 72 of H. R. 8300, the treatment accorded payments to survivor annuitants has been revised and the comments in my prior statement relating to such payments are no longer pertinent.

My enclosed statement points out that sections 402 and 691 of H. R. 8300 do not specifically allow a deduction for estate taxes with respect to pension or profit-sharing payments (other than payments under an annuity contract) included in the income of a beneficiary of a deceased employee and I recommend that the revenue bill be revised to clearly indicate that a deduction for estate tax is allowable with respect to such payments. I believe that it will be necessary to so revise the current revenue bill in order to carry out the announced policy of the Committee on Ways and Means of the Internal Revenue with respect to the treatment to be accorded income in respect to decedents as set forth in the excerpt from the report of the committee which I have quoted in my statement.

Very truly yours,

S. J. Bowyer.

Statement by S. J. Bowyer, Vice President of Walgreen Co., re Taxability of Amounts Distributed Under Pension and Profit Sharing Plans to Beneficiaries of Deceased Employees

Both Federal estate tax and income tax are imposed in some instances upon amounts distributed under pension and profit sharing plans to beneficiaries of deceased employees participants. (See sec. 22 (b) (2) (C) and sec. 165 (b) I. R. C.; sec. 30.22 (b) (2)-2 and 5 and sec. 39.165.6 of Treasury Department Regulations 118; and G. C. M. 27,242, 1952-1 C. B. p. 160.)

Income items other than pension and profit sharing payments in respect of decedents which are received after the decedent's death by his estate or his beneficiaries also are subject to both estate and income tax. Items of this sort are includible in the recipient's gross income by virtue of section 126 (a) I. R. C. but in computing the recipient's net income an offsetting deduction is allowed under section 126 (c) I. R. C. in an amount equal to the estate tax attributable to the items so included in gross income. The Commissioner of Internal Revenue, however, has taken the position that a similar deduction is not allowable under section 126 (c) I. R. C. with respect to pension or profit sharing payments received by a beneficiary of a deceased employee on the ground that an item of that sort is not includible in the recipient's income or taxed under section 126 (a) I. R. C. but instead is includible in income under section 165 (b) I. R. C. and is taxed under section 22 (b) 2 (B) I. R. C. (See Prentice-Hall Pension and Profit Sharing Service, par. 5308.)

Section 691 of H. R. 8300, as introduced in the House of Representatives on March 9, 1954, would reenact section 126 of the present Internal Revenue Code with certain modifications, not material to the point under discussion.

The report of the Committee on Ways and Means of the House of Representatives to accompany H. R. 8300 reporting on the treatment of income in respect of decedents, on pages 64 and 65, House Report 1337, reads in part as follows:

"Your committee's bill also extends a treatment provided for income in respect of a decedent to several forms of income not now eligible. This treatment is extended to that part of the value of a survivor's annuity included in the estate-tax base of the decedent annuitant which represents the interest accumulation for the survivor annuity since the annuity's purchase. This treatment is also extended to the value of unexercised 'restricted stock options' included in the gross estate of the decedent employee and to payments to a deceased partner by a partnership which are includible in the income of the estate or beneficiary of the deceased partner. This treatment is provided for these new forms of income as a part of your committee's policy of providing that all property or property rights included in a decedent's gross estate for estate-tax purposes either receive a new basis at the date of his death or, if subsequently to be reported as income when that event occurs receive a deduction for the estate tax paid in the decedent's estate attributable to such property."

The treatment provided in H. R. 8300 with respect to the income of decedent is extended to the value of a survivor's annuity, the value of unexercised restricted stock options and payments to a deceased partner by a partnership, as stated in the foregoing excerpt from the House report, by the specific provisions of section 72 (j), section 421 (d) (6) (B) and section 691 (c), respectively.

Section 402 (a) (1) of H. R. 8300 dealing with the "taxability of beneficiary of employee's trust" reads in part as follows:

"* * * the amount actually distributed or made available to any distributee by any employer's trust described in section 501 (e) which is exempt from tax under section 501 (a) shall be taxable to him in the year in which so distributed or made available, under section 72 as if it were an amount received as an annuity, the consideration for which is the amount contributed by the employee * * *."

This provision is the same as the corresponding part of section 165 (b) of the present Internal Revenue Code, and it should be noted that section 402 is in no way cross-referenced to section 691 entitled "Recipients of Income in Respect to Decedents."

Inasmuch as the pertinent provisions of section 402 relating to taxability of beneficiary of an employee's trust and section 691 relating to recipients of income in respect of decedents of H. R. 8300 are substantially the same as sections 165 (b) and section 126, respectively, of the present Internal Revenue Code, and since section 72 of H. R. 8300 corresponds somewhat with section 22 (b) (2), the Commissioner of Internal Revenue, notwithstanding the announced policy of the Committee on Ways and Means as quoted above from pages 64 and 65 of House Report 1337, may take the same position with respect to section 402, section 691, and Section 72 of H. R. 8300 as he has taken with respect to section 165 (b), section 126, and section 22 (b) (2), and hold that a deduction for estate tax is not allowable with respect to pension or profit-sharing payments received by and included in the taxable income of a beneficiary of a deceased employee.

In order to make certain that the announced policy of the committee is carried out, it is respectfully suggested that section 691 of H. R. 8300 be revised to clearly indicate that a deduction for estate tax is allowable with respect to pension or profit-sharing payments included in the taxable income of a beneficiary of a deceased employee.

Statement in Opposition to Section 359 (b) (1) and (c) (1) of Proposed Internal Revenue Code of 1954

PRESENT LAW

Section 112 of existing law treats as a tax-free reorganization any statutory merger or consolidation of 2 or more corporations, and any transaction in which 1 corporation, in exchange solely for shares in its own voting stock, acquires substantially all the assets, or 80 percent of all classes of stock, of another. The theory of this provision is that when one corporation is merged with another, and all that the merging corporation or its stockholders receive is stock in the continuing corporation, they have merely exchanged their old stock for new stock of the same general kind, and should not be required to pay a capital gains tax until they have sold their new stock.

PROPOSED CHANGE

Section 359 (b) (1) and (c) (1) of the proposed new code would change the law by treating the transaction as a taxable exchange unless the stockholders of the acquired corporation receive at least 20 percent of the stock in the continuing corporation. The only exception would be where both corporations are "publicly held," as this term is defined in section 359 (a). However, as no corporation in which members of 10 families own as much as 50 percent of the stock is regarded as "publicly held," the exception would apply to few cases where either party was a small- or medium-sized corporation.

REASONS FOR OPPOSING THE CHANGE

The net effect of the proposed change is to except from the general rule, which treats corporate reorganizations as tax free, most transactions in which 1 corporation merges with another which is more than 4 times its size. We submit that this is unsound for the following reasons:

1. There is no valid economic reason for imposing a discriminatory tax on mergers between smaller and larger corporations. Such transactions usually result from economic considerations just as compelling and just as meritorious as similar transactions between corporations of nearly the same size. A smaller company manufacturing a particular product may find it essential to merge with a

larger company offering a fuller line of products, in order to be competitive with other concerns offering a full line. Or a smaller company operating in a particular area may find it desirable to join forces with a larger company operating in a broader area, in order to be able to compete in a national market. These are normal business transactions, and there is no reason why they should be burdened with a special tax penalty.

2. The fundamental basis for permitting tax-free exchanges is that, when a taxpayer exchanges property for other property of like kind, the recognition of taxable gain should be deferred until he sells the property which he received. In a merger between a smaller and a larger corporation, the stockholders of the smaller corporation—even where they receive only 15 percent, 10 percent, 5 percent, or even less, of the new stock—continue as part owners of a similar, though larger, business. In any realistic sense, their new stock is property of the same kind as their old stock, and should be so treated taxwise.

3. The present law is not a loophole for tax avoidance. The stockholder of the merged corporation can receive nothing tax-free except stock in the continuing enterprise. As soon as he sells his stock, he must pay a capital gains tax, measured by the full difference between his cost basis for his old stock, and the price he receives from the new. This is in accord with the salutary principle of imposing the tax at the point where the taxpayer derives money with which to pay it.

4. There is no adequate basis for treating mergers between corporations which are not publicly held less favorably than mergers between corporations which are publicly held. While, as indicated in the House report, some mergers between nonpublicly held corporations may be motivated by tax purposes, most of such mergers are the result of economic considerations just as legitimate as those which motivate the mergers of publicly held corporations.

5. As a matter of fact, imposing a tax on a merger in which only stock is received imposes a greater hardship where the corporations are not publicly held than it would where they are publicly held. The recipient of stock in a publicly held corporation can generally sell part of it at a fair price to get money to pay the tax, although he must dilute his interest to do so. However, the recipient of stock in a closely held corporation often finds, if he has to sell part of it to get money for the tax, that he can sell it, if at all, only at a sacrifice price, as the stock is not listed on any exchange, and there is no ready market.

6. The present law has operated to permit owners of the stock of successful small corporations to convert their holdings into the more marketable stock of a larger corporation, without undue tax penalty. We see no reason why this opportunity should be removed.

For the above reasons, we submit that section 359 (b) (1) and (c) (1) should be deleted from the bill.

RUFUS W. DAY, Jr.,
(For McAfee, Grossman, Taplin, Hanning, Newcomer & Hazlett.)

CLEVELAND, 15, OHIO.

(See supplemental letter, p. 642.)

SMITH & JAMESON,
Washington, April 1, 1954.

Re proposed amendments to H. R. 8300 (Internal Revenue Code of 1954)

Hon. HOMER FERGUSON,
United States Senate,
Washington, D. C.

MY DEAR SENATOR: Pursuant to conversation with Mr. Dompierre, I am enclosing two proposed technical amendments to the pension and profit-sharing trust provisions of the above bill, now pending before the Senate Finance Committee.

These proposals affect a good many pension and profit-sharing plans now in existence, as well as many to be established in the future. They were developed during conferences in Detroit last Friday and Saturday with Mr. Lloyd A. Aspinwall, C. L. U., insurance actuary and pension plan consultant, 3400 David Stott Building, Detroit. Mr. Aspinwall has prepared a detailed memorandum setting forth the reasons why the amendments are necessary, and copy of same is also enclosed.

If you can see your way clear to introducing a bill containing the proposed amendments, it would be greatly appreciated. I assume same would be referred to the Finance Committee for study and consideration. Should the committee so desire, Mr. Aspinwall would be pleased to come to Washington at the committee's convenience and testify in support of the amendments.

With every assurance of my highest personal regard and esteem, I am,

Very respectfully,

WILLIAM P. SMITH.

H. R. 8300, 83D CONGRESS, 2D SESSION

Amend section 505 (a) (3), on page 123, by striking out all after "(3) annuity contracts, or" and inserting in lieu thereof the following: "life insurance contracts (including retirement income contracts) with life insurance protection payable on the death of the employee participants;"

Amend section 501 (e) (3) (A), on page 120, by inserting the following immediately preceding the last sentence thereof: "Notwithstanding any other provision of this paragraph none of the classifications specified in clauses (i) through (vi) shall be considered discriminatory provided that 90 percent or more of such regular employees in this classification are participants in the plan."

REVENUE ACT OF 1954 (H. R. 8300)

AMENDMENT PROPOSED TO SUBTITLE A, CHAPTER 1, SUBCHAPTER F, PART I

Section 505 (a) Allowable Investments.

In the case of a trust described in section 501 (e), exemption under section 501 (a) shall be denied for the taxable year unless at the close of each quarter of the taxable year, all of its assets are represented by—

Strike out:

"(3) Annuity contracts, or retirement income contracts in which the face amount does not exceed 100 times the monthly annuity payable at normal retirement age under the plan;"

And insert therefor:

"(3) Annuity contracts, or life insurance contracts (including retirement income contracts) with life insurance protection payable on the death of the employee participants;"

NOTE.—All of the words to be inserted except "annuity contracts" are exactly the same as in section 402 (a) (4), H. R. 8300, which provides manner of taxation to employee or beneficiary if a trust described in 501 (e) exempt under 501 (e) purchases such contracts.

The amendment proposed should be adopted because

1. It will permit a trust described in 501 (e), exempt from tax under 501 (a) to—

(*a*) Own as assets life insurance contracts which it is permitted to purchase under section 402 (a) (4).

(*b*) Use any of several media of funding the cost of pensions which are permitted under present law, and which are most safe and economical for smaller employers.

(*c*) Use an investment medium in a profit-sharing trust which will provide the participant a means of receiving all of the accumulations to his credit in the form of a life income after retirement, while providing a death benefit prior to retirement.

2. It will permit a trust established under section 165 (a) of the present code (which, by reason of sec. 403 (c) (1) (A) and (B) of H. R. 8300, will have to comply with sec. 505) to continue the investment program heretofore established.

3. Both the employer and the employee participants will benefit greatly with no adverse effect on the tax revenue.

Detailed advantages of proposed amendment

I. The proposed amendment will permit a trust described in section 501 (e), exempt from tax under section 501 (a), to own any type of life-insurance contracts, whereas the present wording permits such a trust to own only "retirement-income contracts."

A. Definitions:

1. "Retirement income contract." This type of policy is issued to mature at a stated age (usually 55, 60, 65, or 70). It provides for a face amount, and, commencing at maturity an annuity continuing for life of $10 per month for

each $1,000 of face amount. Thus, the face amount is 100 times the monthly annuity payable at normal retirement age.

The amount payable to the beneficiary in event of the death of the insured prior to maturity date is the face amount, or the cash value if larger.

The cash value at maturity is usually from 50 to 60 percent in excess of the face amount, in the case of contracts for males maturing at age 65. Contracts maturing at younger ages have larger cash value, and contracts for females have larger cash values than for those for males maturing at the same age.

The premiums are high enough to accumulate the cash value, and to provide the insurance protection for the amount by which the face amount exceeds the cash value during the earlier years of the contract.

2. "Endowment contract," "Limited payment life contract," "Ordinary life contract." The endowment contract is issued to mature for the face amount at an age specified or after a stated number of years. The limited payment life and ordinary life contracts pay the face amount only at death (or age 100).

These contracts all provide that the owner (the trustee of a trust) may elect to have the cash value paid as an annuity commencing at the retirement age elected and continuing for life. Most of these contracts also permit the owner to convert the contract to a retirement income or annuity contract under the terms stated in the contract. In many contracts the owner may, by the deposit of the required additional cash value, convert the contract into a retirement income contract providing an annuity income of $20 or $30 per month for each $1,000 of face amount. Thus, the face amount may be less than 100 times the monthly annuity payable at normal retirement age.

The amount payable to the beneficiary in the event of the death of the insured prior to the conversion of the contract to an annuity is only the face amount, for the cash value will not exceed the face amount.

The cash value is substantially less than that of a retirement income contract. It is lowest in case of an ordinary life contract. For a contract issued at age 45, the cash value at age 65 is approximately 30 percent of the cash value of the retirement income contract. For the limited payment life contracts the shorter the premium-paying period the higher the cash value, except that after the end of the period all contracts will have the same cash value at the same age. The endowment contracts, having a maturity value equal to the face amount, have a correspondingly higher cash value.

The premiums are sufficient to accumulate, in each case, the required cash value and provide the insurance protection afforded. The premium for the ordinary life contract is approximately 60 percent of the premium of a retirement income contract maturing at age 65 issued for a male at age 35 for the same fact amount.

B. The advantages of contracts other than "retirement income contracts" in pension trusts.

1. The amount of insurance may be less than 100 times the monthly pension. It may be 20 or 30 or 50 times the pension instead of the fixed amount of 100 times provided by the retirement income contract. The amount of death benefit may be expressed as 1 year's salary, rather than being related to the monthly pension benefit.

2. The funds to convert the ordinary life or limited-pay contract to an annuity may be accumulated in the trust and the employer may have the advantages of—

(a) Higher interest earnings.

(b) More favorable mortality experience.

(c) Opportunity to adjust deposits to conditions (as permitted by section 403 (a) (1) (C) of the code) which is not available under the fixed premium of the retirement income contract.

3. The employer will have the present guaranty of the insurance company to pay the pension benefits in consideration of a presently guaranteed cost. Because the cost of annuities has increased 100 percent in the last 20 years, a small employer with few employees particularly values such a guaranty.

4. Larger benefits may be provided at the same cost, or the same benefits at a lower cost.

A retirement income contract for a male aged 40 might cost $55.36 per year to provide an income of $10 per month at age 65, with a death benefit prior to age 65 of $1,000 or the cash value if greater (as it would be after about age 58).

An ordinary life contract to provide the same death benefit of $1,000 (except the cash value would never be greater) would require an annual premium of $29.76. To accumulate the fund sufficient to convert the ordinary life contract into an annuity at age 65 to pay $10 per month would require a level deposit of $23.17. The combined deposits would be $52.93.

The employer, therefore, could provide the same death benefit (except the cash value would never exceed $1,000 and the same retirement benefits, and have the insurance company guarantee to pay the annuity, for an annual outlay approximately 4.39 percent less. For the same cost, benefits 4.6 percent greater could be provided.

C. The advantages of contracts other than "retirement income contracts" in profit sharing trusts.

1. The trustee of a profit-sharing trust does not know what the future contributions will be, and so cannot undertake the purchase of any contract requiring an annual outlay for premiums, unless such premiums represent only a portion of the fund.

2. The trustee cannot undertake to pay a life annuity income with the funds accumulated at the time an employee retires.

3. The trustee, by the purchase of an ordinary life insurance contract containing an option to be converted to an annuity by the deposit with the insurance company of such additional funds as may have been accumulated in the trust at the time the employee retires, can provide the employee:

(a) With a larger death benefit than only the funds accumulated to the extent of the face amount of the insurance in excess of funds in the trust less premiums paid, in the event the employee dies during the early years of participation when his family needs are usually greater.

(b) With a vehicle under which all funds accumulated at retirement may be paid in the form of an annuity at rates determined when the employee's contract was purchased, if it be decided to so use the option. (Current Treasury regulations require that it be used.)

II. The proposed amendment will permit existing trusts to continue present approved investment policies.

A. Many pension plans now provide that the death benefit be provided by means of ordinary life insurance policies. These plans also provide for employer deposits to the trust to be made and accumulated in an amount sufficient to convert such contracts to annuities for those employees who live and continue in employment to normal retirement date.

While the new proposed bill does not appear to apply to investments made prior to March 1, 1954, it would appear to prevent the continuance of the existing medium of funding.

B. Many profit-sharing plans now provide for the trustee to purchase ordinary life, or limited-payment life contracts which give the trustee the right to use the funds accumulated in the trust for the participant's account, and to convert the contract into an annuity at the time the employee retires.

If the purchase of such contracts be not permitted, there will be a considerable difference in benefits for those who became participants prior to March 1, 1954, and those who become participants thereafter.

III. The proposed amendment will benefit employer, employee-participants, and have no adverse effect on tax revenue.

A. The employer will be able:

1. To provide identical benefits with a lower annual cash outlay.

2. To have guaranties as to the ultimate sums required to provide the pension benefits—

(a) Without disbursing such a large portion of pension reserves to beneficiaries of employees who die.

(b) Without providing death benefits, as large as 100 times the monthly pension benefits.

B. The employees will have—

1. In pension plans, death benefits in plans which otherwise might have none.

2. In profit sharing plans, the opportunity to have a life income guaranteed after retirement of a larger sum than could otherwise be obtained.

C. The tax revenue will not be adversely affected.

1. The employer cost for pension plans, for the same benefit, will be less, and the tax deduction claimed will be less, with less loss of revenue.

2. The employer, under proposed section 402 (a) (4), will be taxed on all funds received regardless of whether such sums represent the proceeds of "insurance at risk," as under the present law. There is, therefore, no difference taxwise between the various types of insurance contracts.

PROPOSED AMENDMENT REVENUE ACT OF 1954 (H. R. 8300) SUBTITLE A, CHAPTER 1, SUBCHAPTER F, PART I, SECTION 501 (E)—EMPLOYEES' PENSION TRUSTS, ETC.

The following organizations are referred to in subsection (a): A trust created or organized in the United States and forming part of a stock bonus, pension, or profit sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries—

"(3) NONDISCRIMINATORY CLASSIFICATIONS.—

"(A) REQUIREMENTS.—If the trust, or two or more trusts, or the trust or trusts and annuity plan or plans are designated by the employer as constituting parts of a plan intended to qualify under this subsection which benefits the regular employees—

"(i) Who are compensated on a hourly basis;

"(ii) Who are compensated on a salary basis;

"(iii) Who have been employed for a minimum period, not exceeding 5 years;

"(iv) Who are compensated at an annual rate in excess of a specified amount, which amount does not exceed $4,000;

"(v) Who have reached a specified age, which age is not more than 35;

"(vi) Who are employed in a designated plan, division, department, or other operating unit, of the employer; or

"(vii) Who qualify under any other classification set up by the employer, including any classification which is a combination of any of the classifications specified in clauses (i) through (vi):

Provided, That any classification is not discriminatory in favor of employees who are shareholders or key employees. A classification shall be considered discriminatory only if more than 30 percent of the contributions under the plan are used to provide benefits for shareholders or more than 10 percent of the participants in the plan are key employees, except that a classification shall not be considered discriminatory in any case if, in the case of an employer having not more than 20 regular employees, 50 percent or more of all such regular employees are participants in the plan, and in the case of an employer having more than 20 regular employees, 10 of such regular employees or 25 percent or more of all such regular employees whichever is greater, are participants in the plan. A plan shall be considered as meeting the requirements of this paragraph during the whole of any taxable year of the plan if on 1 day in each quarter it satisfied such requirements."

It is proposed that the above subsection be amended by inserting an additional sentence following the end of the next to the last sentence.

The sentence to be inserted reading:

"Notwithstanding any other provision of this paragraph, none of the classifications specified in clauses (i) through (vi) shall be considered discriminatory provided that 90 percent or more of all such regular employees in this classification are participants in the plan."

Section 501 (e) (3) (A) should be amended by inserting a sentence reading: "Notwithstanding any other provision of this paragraph, none of the classifications specified in clauses (i) through (vi) shall be considered discriminatory provided that 90 percent or more of such regular employees in this classification are participants in the plan.", immediately following the end of the sentence next to the last sentence, because—

I. The present provisions of H. R. 8300 discriminate against the smaller employers.

A. Under the present restrictions no employer can establish a plan for any of the classifications (i) through (vi) unless:

1. The classification contains less than 10 percent of "key employees,"

2. The classification contains over 1,000 employees, or

3. The classification contains over 25 percent of all "regular employees."

NOTE.—In all except very large corporations (those with 5,000 employees or more).

(a) Any classification except (i) in most all instances will contain more than 10 percent of "key employees."

(b) Classification (ii) will generally not include 25 percent of the regular employees if the employer has both hourly paid and salaried employees.

II. The present law (section 165 (a) (5)) provides that a classification shall not be considered discriminatory merely because it is limited to salaried or clerical employees.

A. Under the proposed law such a plan could not in most instances be established in any company having both salaried and hourly paid employees, except one having many thousands of employees, because—

1. Such a classification will practically always include more than 10 percent of the "key employees," and

2. Such a classification generally will not include 25 percent of the "regular employees."

B. If amended, as proposed, the same classification would be permitted as at present provided at least 90 percent of those in the classification were participants.

III. The amendment proposed—

A. Will permit classifications permitted under present law with greater restrictions to prohibit discrimination.

B. Will permit the use of the classifications permitted in H. R. 8300 without the discrimination in favor of very large corporations which currently exists in that bill.

MEMORANDUM BY CHARLES W. TYE, NEWARK, N. J., SUBMITTED WITH RESPECT TO DISCRIMINATORY PROVISIONS OF H. R. 8300 AS RESPECTS CAPITAL STOCK LIFE INSURANCE COMPANIES

This memorandum, filed for and on behalf of our clients having life insurance company interests, is directed to the following provisions of H. R. 8300 which illogically and inequitably discriminate against capital stock life insurance companies and their stockholders:

1. Sections 34 (e) (1) and 116 (b) which deny to individual stockholders of such insurance companies the newly provided relief from double taxation of dividends; and

2. Section 246 (a) (1) in which the 85-percent dividends received credit, to which corporate stockholders (including corporate stockholders of such insurance companies) are now entitled under existing law, and which the bill continues as a deduction for corporations generally, would be completely eliminated with respect to capital stock life insurance company dividends received by corporate stockholders.

These companies are now subject to tax under sections 201 to 203 of the Internal Revenue Code, and for the past 3 years have been taxed under temporary provisions which apply a flat rate tax of 3¾ percent on the first $200,000 and 6½ percent on amounts in excess of $200,000 of net investment income with certain adjustments. These reduced rates are intended to be equivalent to the application of the ordinary corporate rates of 30 percent on the first $25,000 and 52 percent on income above $25,000, after applying "the reserve and other policy liability credit."

H. R. 8300 provides for the extension of these provisions for 1 year (newly numbered 801 and following), with minor changes to permit use of the accounting method, for tax purposes, employed by the company on its annual statement. Accordingly, stock life insurance companies are taxable, not tax-exempt organizations, and the Congress has chosen to tax them, as aforesaid, pending adoption of a long-range taxing formula.

The provisions of H. R. 8300, aforesaid, as presently drafted, would deny a corporate stockholder which receives a dividend from a stock life insurance company the 85-percent dividends received deduction to which it is presently entitled as a credit under section 26 (b) of the Internal Revenue Code. Moreover, an individual stockholder receiving a dividend from a stock life insurance company would be denied the new credit provided by sections 34 and 116 of the Revenue Code of 1954. There appears to be no basis or logic to such denial, and significantly there is no expressed intention in the Ways and Means Committee report to abolish the present 85-percent dividends received credit for dividends from stock life insurance companies, nor does there appear to be any equitable reason why dividends from insurance stocks held by individuals should be discriminated against in an attempt to lessen the impact of double taxation. In fact, the effect of these provisions (34 (e), 116 (b), and 246 (a) (1)) create more double taxation than now is possible under the existing law. It is inconceivable that this type of discriminatory class legislation could have had the serious consideration of the House of Representatives, but on the contrary has all the aspects of a "sleeper" which should never have been included in the first place had there been advance deliberations and hearings with respect thereto. The fact that stock life insurance companies are subject to tax, and presumably will continue to be subject to Federal taxation in the future, makes these proposed provisions all the more incomprehensible.

The philosophy of H. R. 8300, as respects the dividend situation, is intended to mitigate the effect of double taxation of corporate profits. Sections 34 (c), 116 (b), and 246 (a) provide limitations with respect to the credit and deduction provided in those sections. These limitations are intended to eliminate the credit and deduction in situations when no double taxation in fact occurs. Thus, on page 6 of the Report of the Committee on Ways and Means, congressional intent is expressed as follows:

"The relief offered by the dividend-received credit is limited to situations in which double taxation actually occurs. Accordingly, the dividend-received credit is not allowed with respect to dividends paid by foreign corporations or tax-exempt domestic corporations."

In the light of this expressed intent, it is submitted that these limitations could not have been intended to apply to any domestic corporation which, in fact, is subject to the Federal income tax and actually pays such a tax. If they were intended, then they must have been enacted by reason of misconception as respects the taxability of stock life insurance companies. It is submitted that, whatever the unexpressed reason for discrimination against stock of a life insurance company, the philosophy is entirely fallacious and illogical since there can be no distinguishing as between domestic taxpaying corporations of different types merely because they are not all taxed in identically the same way. The only situation where this is feasible is where a dividend paid credit is allowed such as in the case of certain operating utility preferred stocks. No such dividend paid credit is allowed a stock life insurance company under the present Internal Revenue Code nor under H. R. 8300. Further, there is no logical basis for denial of such credits and deductions on some theory of the degree of double taxation involved. Such an approach could just as logically apply to practically every type of corporation in view of tax-exempt interest income, depletion allowances, amortization of facilities, etc. The fact of the matter is that there is now double taxation as respects the corporate profits of a stock life insurance company, the degree of which cannot be measured from a comparable standpoint any more than the degree of double taxation could be measured as between the corporate profits of a bank, industrial or mercantile corporation. Yet, the provisions of H. R. 8300, aforesaid, if enacted in their present form, would deny life company stockholders, both corporate and individuals, relief from such double taxation whereas all other nonexempt domestic corporation stockholders would receive such benefits. It is submitted that such discrimination is entirely unwarranted under the circumstances.

If the provisions contained in H. R. 8300 are enacted in their present form, the economic consequences to the insurance industry will be exceedingly drastic.

The stock of life insurance corporations is widely held by corporate investors which at present receive the 85 percent credit allowable under section 26 (b) with respect to dividends on such stock. This benefit is removed in the proposed Internal Revenue Code of 1954. The removal of the benefit would, of course, tend to depress the market value of the stocks of life insurance corporations and place such corporate investors in such stocks at a decided disadvantage. The net yield from such stocks would, of course, be greatly diminished. It would also hamper efforts of existing companies to acquire additional capital and make more difficult the formation of new stock life insurance corporations, as compared with mutual companies in particular and other corporations in general. Also, the attractiveness of such stocks now owned will disappear with the resulting depressing effect on the market as selling-off occurs.

In addition, existing companies having life subsidiaries would be adversely affected. In order to reap an adequate benefit from their investments in subsidiaries, they would be required to file consolidated returns and suffer the 2 percent addition to tax imposed as a privilege for filing such return. Moreover, by virtue of the definition of affiliated groups, not all closely allied corporate groups are eligible to file consolidated returns. Thus, a life company may only consolidate with another life company. It cannot consolidate under present law with a noninsurance affiliate or parent.

It is, therefore, respectfully requested that sections 34, 116 and 246 of H. R. 8300, as well as any other similar subsections wherein discriminatory treatment is accorded stock life-insurance companies (such as sec. 923 (d) (2) and 951 (c) (4)), be amended to continue the present 85 percent dividend received credit in the form of a deduction for corporate stockholders and that the benefits of the newly proposed relief from double taxation of dividends to individual stockholders of insurance companies be extended to such stockholders.

Respectfully submitted,

JOSEPH FROGGATT & CO.,
By CHARLES W. TYE.

MEMORANDUM SUBMITTED WITH RESPECT TO DISCRIMINATORY PROVISIONS OF H. R. 8300 AS RESPECTS CAPITAL STOCK FIRE, CASUALTY, SURETY, AND MARINE INSURANCE COMPANIES

This memorandum, filed for and on behalf of stock fire, casualty, surety, and marine insurance companies, is directed to the following provisions of H. R. 8300 which illogically and inequitably discriminate against capital stock insurance companies and their stockholders:

1. Section 34 (c) (1) and 116 (b) which deny to individual stockholders of such insurance companies the newly provided relief from double taxation of dividends;

2. Section 246 (a) (1) in which the 85 percent dividends received credit, to which corporate stockholders (including corporate stockholders of such insurance companies) are now entitled under existing law, and which the bill continues as a deduction for corporations generally, would be completely eliminated with respect to capital stock insurance company dividends received by corporate stockholders;

3. Section 923 (d) (2) which denies to such insurance companies the credit provided in section 37 with respect to business income from foreign sources;

4. Section 951 (c) (4) which denies to such insurance companies the right to make an election with respect to the treatment provided by part IV of H. R. 8300 with respect to deferred income from sources within foreign countries.

These companies, in common with hundreds of other like companies, are now subject to tax under section 204 of the Internal Revenue Code and, in accordance therewith, pay the full 30 percent normal tax and the full 22 percent surtax on their entire net income from underwriting and investments. Thus, these companies, under present laws, pay Federal income taxes at precisely the same rates as do manufacturing corporations, mercantile corporations and other corporations generally.

Under the provisions of H. R. 8300 these companies would be subject to the tax to be imposed under proposed section 831, which, in part, provides: "Taxes computed as provided in sectoin 11 shall be imposed for each taxable year on the taxable income of every insurance company (other than a life or mutual insurance company) * * *." Section 11 imposes a normal tax of 30 percent of taxable income and a surtax of 22 percent on certain taxable income in excess of $25,000.

Thus, if H. R. 8300 is enacted, capital stock casualty and surety companies will continue to pay a Federal income tax on their entire net profits at present regular corporation income-tax rates. Such companies do not now, nor have they in the past, enjoyed any special tax advantage, and no special tax advantage is granted them under H. R. 8300.

Accordingly, it is grossly inequitable that stockholders of capital stock casualty, fire, marine, or surety companies should be denied the relief from double taxation newly proposed in the bill with respect to individual stockholders of corporations and now provided by law with respect to corporate stockholders. In fact, double taxation will exist where it did not before.

In recent years the insurance business, as well as business generally and the national economy, has grown tremendously, and all indications point to a continuation of this growth. Such growth requires, and will continue to require, large sums of additional capital. Obviously, the discrimination with respect to dividends paid on the stock of insurance companies would seriously impair the desirability of such stock, thereby making it difficult to acquire additional capital to meet the needs of expanding business. Also, the attractiveness of such stocks now owned will disappear, with the resulting depressing effect on the market as selling off occurs.

While, due to the time limitations, it is not possible to determine fully the effect of the discrimination against insurance companies with respect to business income from foreign sources, as provided in section 923 (d) (2) and section 951 (c) (4), it is, nevertheless, a discrimination that has no basis in reason or equity and should, therefore, be eliminated.

It is, therefore, respectfully requested that section 246 be amended to continue the present 85-percent dividends received credit in the form of a deduction for corporate stockholders and that section 34 be amended to extend the benefits of the newly proposed relief from double taxation of dividends to individual stockholders of insurance companies which would be subject to the tax imposed by section 831 of H. R. 8300.

It is also respectfully requested that section 923 be amended by eliminating the denial to capital stock insurance companies of the credit provided in section 37 with respect to business income from foreign sources, and that there be eliminated from section 951 the denial to such companies of the right to make an election with respect to the treatment provided by part IV with respect to deferred income from sources within foreign countries.

Appropriate amendments should eliminate the patently inequitable discrimination proposed by H. R. 8300 against insurance companies subject to section 831 of H. R. 8300 and their stockholders, both corporate and individual.

Respectfully submitted.

JOSEPH FROGGATT & CO.,
By CHARLES W. TYE.

STATEMENT SUBMITTED BY JOSEPH D. PEELER, MUSICK, PEELER & GARRETT, LOS ANGELES 17, CALIF.

APRIL 7, 1954.

MEMORANDUM RE PROPOSED AMENDMENTS TO SECTIONS 34 (C) (1) AND 246 (A) (1), H. R. 8300, RELATIVE TO DIVIDENDS PAID ON STOCK OF CALIFORNIA TITLE INSURANCE COMPANIES

I. Proposed amendments

It is submitted that the following provisions should be substituted for the provisions proposed under H. R. 8300 for the following subsections:

"SECTION 34. DIVIDENDS RECEIVED BY INDIVIDUALS.

"(c) NO CREDIT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS. Subsection (a) shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following), unless (a) its tax is computed as provided in section 11, and (b) its net income as computed under subchapter L is not substantially different from its net income as computed without reference to subchapter L."

"SECTION 246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED.

"(a) DEDUCTION NOT ALLOWED FOR DIVIDENDS FROM CERTAIN CORPORATIONS. The deductions allowed by sections 243, 244, and 245 shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following), unless (a) its tax is computed as provided in section 11, and (b) its net income as computed under subchapter L is not substantially different from its net income as computed without reference to subchapter L."

II. Reasons for the proposed amendments

A. Purpose of provisions.—As explained in the House committee report the general purpose of section 34 is to afford some relief from the double taxation of corporation dividends. The purpose of subsection (c) of section 34 is explained on page 6 of the report as follows:

"The relief offered by the dividend-received credit is limited to situations in which double taxation actually occurs. Accordingly, the dividend-received credit is not allowed with respect to dividends paid by foreign corporations or tax-exempt domestic corporations. Thus, it does not apply to dividends of exempt farm cooperatives or to distributions which have been allowed as a deduction (in effect treated as interest) to a mutual savings bank, cooperative bank, or building and loan association. Moreover, the dividend-received credit is not available to nonresident alien individuals not subject to the regular individual income tax."

Section 34 contains provisions not in the present law, allowing to individual stockholders a dividends-received credit for part of the dividends received from corporations subject to the regular tax rates. Section 243, 244, and 245 contain provisions, similar to those in section 26 (b) of the present law, allowing to corporate stockholders deductions for a portion of the dividends on stock received from corporations subject to the regular tax rates.

Undoubtedly, it was for the purpose stated in the above quotation that the House committee inserted in section 34 (c) (1) and in section 246 (a) (1) the limitation regarding "an insurance company subject to a tax imposed by subchapter L (sec. 801 and following);"

As will be shown clearly below, however, the language used is too broad in its operation and will include insurance companies which are subject to the income tax and surtax rates applicable to corporations in general and whose dividends presently are subject to double taxation.

B. Taxation of insurance companies.—Subchapter L of chapter 1 contains the provisions for taxation of insurance companies, under four separate parts, as follows:

Part I covers life-insurance companies and in general continues for 1 year the present provisions of the law.

Part II covers mutual insurance companies (other than life or marine or fire insurance companies issuing perpetual policies) and in general continues the present provisions of the law.

Part III covers other insurance companies and in general continues the present provisions of the law.

Part IV covers provisions of general application and in general continues the present provisions of the law.

Under the present law and under the House bill, insurance companies which are covered by parts I and II, in general life insurance and mutual companies, are not subject to the regular corporation income-tax rates. On the other hand, section 831 of the House bill provides as to other companies covered by part III as follows:

"(a) IMPOSITION OF TAX.—Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company (other than a life or mutual insurance company), every mutual marine insurance company, and every mutual fire insurance company exclusively issuing either perpetual policies or policies for which the sole premium charged is a single deposit which (except for such deduction or underwriting costs as may be provided) is refundable on cancellation or expiration of the policy."

Section 11 covers the tax imposed on corporations in general. Accordingly, insurance companies covered by part III pay the regular corporation tax rates.

C. Title insurance companies.—These companies are covered in part III and pay the regular corporation tax rates. Section 832 provides, as does the present law, that the gross income of such companies shall include (A) the gross amount earned during the year from investment income and from underwriting income, (B) gain during the year from the sale or other disposition of property, and (C) all other items constituting gross income under subchapter B. Deductions are allowed for losses incurred, expenses incurred, and other deductions comparable to the deductions allowed to ordinary corporations.

By reason of the nature of their business, title insurance companies in the State of California operate in the same manner as corporations in general. They maintain extensive title records and before a title policy is issued a careful search of the record is made. A single premium is charged for the policy and the entire amount immediately constitutes taxable income. A title policy is not renewable at stated intervals, like most insurance policies, but continues in force indefinitely. Accordingly, there is no problem of "unearned premiums."

Because of the extensive research in connection with each title policy, the largest item of expense is labor, in common with corporations in general. As a result of this and efficient title practices, losses rarely exceed 2 percent of annual premiums and thus do not present any unusual accounting problems. California title insurance companies do not use reserves in determining loss deductions for the purpose of computing net income. A loss deduction is determined on each separate situation in the light of the particular facts, and is taken only when the amount is definitely ascertained.

Accordingly, the net income of a California title insurance company, as computed under section 832 of the House bill (which is substantially the same as sec. 204 of the present Internal Revenue Code), would be the same if its income were determined under other provisions of the law applicable to corporations in general.

California title insurance companies do not receive any special tax benefits or favored treatment; their income tax burden is fully as heavy as that of corporations in general. They do not receive any special benefits such as, for example, percentage depletion deductions afforded to natural resource companies.

Any fair minded survey of the facts will disclose clearly that title insurance companies in the State of California bear their full share of the Federal income tax burden. They definitely present a situation "in which double taxation actually occurs" and there is no sound basis in logic or equity for discriminating against them, as the House bill does.

D. Title insurance and trust company.—The California Land Title Association, on whose behalf this memorandum is filed, is a trade association with membership including 15 California title insurance companies. To illustrate the impact of this legislation on the title industry in California, it will be helpful to examine in some detail its effect on one company, the Title Insurance & Trust Co. of Los Angeles. This company is the largest title insurer in California, but it differs from the other companies chiefly in its size, and it may be regarded as representative. Title Insurance & Trust Co. is a California corporation, located at 433 South Spring Street, Los Angeles 13, Calif. Its activities include a title insurance business in southern California, a trust and escrow business, and the ownership and operation of a large office building in Los Angeles. The principal source of revenue is derived from its title insurance business. In addition, it owns stock of other corporations, some of which are engaged solely in the title insurance business and from which it receives substantial dividends. Accordingly, it is vitally concerned with the provisions of the House bill here considered, both as a corporate stockholder of title insurance companies and on behalf of its many stockholders to whom it pays regular dividends.

A review of this company's Federal income tax returns for recent years discloses clearly that its income tax burden would have been substantially the same if its taxable net income had been determined under the provisions of the law relating to "corporations in general" instead of the provisions of section 204 of the present code relating to other insurance companies. Since, as stated on page A240 of the committee report, the provisions of section 832 of the House bill "correspond without change of substance" to the present provisions of the law, there is every reason to assume that in the future its tax burden under the proposed new law would not be reduced by treatment as an insurance company.

Accordingly, if no change is made in the provisions here in question, this company will continue to be subject to double taxation in the same manner as corporations in general, without any relief whatever to its stockholders. We respectfully submit that this treatment would be grossly inequitable and discriminatory and, we believe, would be contrary to the real intention of the legislators.

In this connection, it should be noted that under the present law this company is allowed a dividends-received deduction for dividends received from its title insurance subsidiaries while under the proposed House bill it would be allowed no deduction. Accordingly, the House bill not only would deny the new dividends-received credit to its shareholders, but would add a very great tax burden on the company itself which is not imposed by the present law.

This is not a situation in which a taxpayer is afforded tax relief by electing to be taxed as an insurance company. Under the House bill, as well as under the present law, it has no choice but must compute its net income under subchapter L as an insurance company, even though it obtains no tax benefit from such treatment.

As an alternative, in the event that the provisions here in question are not changed so as to remove this discrimination, title insurance companies, including this company, should be permitted to elect whether to be taxed under the provisions of subchapter L (with the corresponding burdens relative to dividends received from other title insurance companies and relative to dividends paid to its shareholders) or whether to be taxed under the general provisions relating to corporations in general. Without the right to make such an election, a title insurance company is forced to file its returns in a manner which affords it no tax benefits or relief, while at the same time subjecting it and its stockholders to tax burdens which do not apply to corporations in general.

Conclusion.—It is respectfully submitted that the provisions of sections 34 (c) (1) and 246 (a) (1) of House bill 8300 would result in unjust discrimination as to California title insurance companies and should be amended. It is believed that their inclusion in the exceptions was due to a misunderstanding or to an oversight.

STATEMENT ON SECTION 274 OF THE REVENUE CODE OF 1954, INDUSTRIAL DEVELOPMENT REVENUE BONDS, BY HARRY W. WOLKSTEIN, CERTIFIED PUBLIC ACCOUNTANT AND TAX PRACTITIONER, OF NEWARK AND ASBURY PARK, N. J.

Mr. Chairman and members of the Senate Committee on Finance, my name is Harry W. Wolkstein. I am a practicing certified public accountant of New Jersey and New York, acting as senior member of Harry W. Wolkstein & Co., a firm of certified public accountants having offices in Newark and Asbury Park, N. J.

My presentation will be largely devoted to the subject of industrial development revenue bonds and section 274 of the Revenue Code of 1954, which was recently enacted by the House of Representatives.

In the statement which I submitted to the House Committee on Ways and Means on August 6, 1953, I called attention to the growing economic war among our individual States and municipalities across the country in competing unfairly with one another for new industries by offering them special subsidies in the form of donations of land and buildings, leasing plants at nominal rentals, and full or partial tax exemptions.

Unless these questionable tax-avoidance plans are halted by closing the tax loopholes existing within the Internal Revenue Code, we shall surely witness the undermining of our country's taxing structures and our system of competitive enterprise with the end result of state capitalism and socialism facing all of us. As part of these income-tax avoidance plans, a number of municipal governments in certain States have managed to lure new industries away from other States by means of constructing new plants for them through the issuance of tax-exempt industrial development revenue bonds, which bonds are not backed by the full faith, credit, and taxing power of the issuing government.

Within the past 3 years New England, New York, and New Jersey have lost a large number of industries that have moved to the South, having been lured there by the unfair bait of donated plants, real estate tax exemptions, and nominal rentals. Our Federal laws seriously criticize unfair competition among private industries engaged in interstate commerce; however, our present Federal income tax laws actually serve to encourage the aforementioned unfair and highly questionable competition among our individual State governments for new industry.

In response to a recent test case that I brought before the Commissioner of Internal Revenue pertaining to industrial development revenue bonds that were issued in 1952 by the city of Florence, Ala., for the benefit of Stylon Corp. in the amount of $1,800,000, the Commissioner issued a ruling that, under existing laws, the interest on such revenue bonds was exempt from income tax unto the bondholder, despite the fact that the city in no way pledged its faith, credit, or taxing power.

Accordingly, in my testimony before the House Committee on Ways and Means, I recommended that section 22 (b) (4) of the Revenue Code be amended to impose income taxation upon the interest of such industrial development revenue bonds. On January 20, 1954, Representative Reed, chairman of the House Committee on Ways and Means announced that the committee had agreed to amend the Revenue Code to remove the existing Federal income tax exemption with respect to the interest received on future issues of these bonds of State and local governments in such cases where the bonds are not supported by the full faith and credit of the issuing government. It appears that his announcement was followed by pressures from certain local and State governmental officials to the effect that such an amendment to the code would serve to interfere with the sovereignty of their State and municipal government.

As a result of these pressures, the Internal Revenue Code of 1954 as finally enacted by the House of Representatives in February contains a new section 274 which disallows as a deductible expense any rental payments made by a private industrial firm to "a State, Territory, possession of the United States, or a political subdivision thereof, or the District of Columbia, as payments for the use or occupancy of property acquired or improved by such State or Territory with the proceeds of any industrial development revenue bond. The bonds covered by this section are any obligations issued to finance the acquisition or improvement of real property which is to be used to any substantial extent by nonpublic lessees for manufacturing articles which do not pledge the full faith and credit of the issuing authority for the payment of interest and principal. * * * A public utility producing electricity or gas would not be 'manufacturing articles.' * * * Obligations issued for the acquisition or improvement of real property used principally for recognized governmental purposes shall not be considered industrial development revenue bonds even though a minor portion of the property may be availed or for manufacturing purposes incidental to the primary activity for which the entire property is used. * * * The section applies only to rental payments paid or accrued on property acquired or improved with the proceeds of any bonds issued after February 8, 1954."

I respectfully urge the members of the Senate Committee on Finance to vote favorably upon section 274 of the Revenue Code of 1954. This new section of the code will prevent a manufacturer from taking unfair advantage of his competitors through these lower operating costs and unfair tax deductions, resulting from his enjoying the benefits of the local government's tax exemption.

I believe it is necessary, however, to stress the fact that the new section 274 solves only part of the public financing problems that are attached to industrial development revenue bonds. Under section 274, a person owning such bonds will not be compelled to pay income tax on the interest which he received on these questionable bonds—bonds which in reality are no more than commercial bonds with the fictional veneer of municipal obligations. If the issuing city is in no way financially responsible for these questionable bonds, then how can we define them as governmental obligations entitled to the privilege of income-tax exemption? The bondholder cannot look to the municipal government for security, his only collateral being the rental income which the manufacturer will pay to the city, the financial stability of the manufacturer, and the industrial property.

In issuing these bonds for the purpose of constructing industrial property, the city is engaging in a proprietary purpose in competition with taxpaying private enterprise. And, may I note that the United States Supreme Court has ruled in cases involving the States of New York, South Carolina, and Ohio that "* * * whenever a State engages in a business of a private nature it exercises nongovernmental functions, and the business though conducted by the State is not immune from the exercise of the power of taxation which the Constitution vests in Congress."

I respectfully call to the attention of the members of the Senate Finance Committee that our Federal Government cannot continue to extend the privilege of income-tax exemption unto the interest on these industrial development revenue bonds for the following reasons:

(*a*) Such practice is in contravention of public policy.

(*b*) It amounts to discriminatory taxation, since it forces remaining taxpayers to shoulder an inequitable share of the Federal income-tax burden.

(*c*) It violates the equal protection clauses and the due-process clauses of our Federal Constitution.

(*d*) It serves to encourage local governments to subsidize private industry at the expense of other municipal governments and State governments and other taxpaying corporations.

In the event of a major economic depression, we shall probably witness a widespread default in these industrial development revenue bonds with an impairment of the credit of these local and State governments.

It is my further opinion that, since these industrial development revenue bonds are not secured by the full faith, credit, and taxing power of the issuing authority, these securities should be subjected to the control and jurisdiction of the SEC in order to protect the investing public of our country.

STATEMENT OF HOWARD E. MUNRO, LEGISLATIVE REPRESENTATIVE, THE CENTRAL LABOR UNION AND METAL TRADES COUNCIL AFL OF THE PANAMA CANAL ZONE ON H. R. 8300, A BILL TO REVISE THE INTERNAL REVENUE LAWS OF THE UNITED STATES

Mr. Chairman and members of the committee, my name is Howard E. Munro. I am the legislative representative of the Canal Zone Central Labor Union and Metal Trades Council. I am an employee of the Panama Canal Company and have lived on the Canal Zone since May 1943. At present I am on leave without pay from the Panama Canal Company.

The organizations which I represent are the central bodies of the 26 unions affiliated with the American Federation of Labor. The membership of these unions are the United States citizens employed by the United States Government to operate, maintain, and protect the Panama Canal.

I appear here today in support of section 152 (b) (3) which defines the term "dependent."

BACKGROUND

Section 262 of the Revenue Act of 1921 approved November 23, 1921 (42 Stat. 227, 271) changed to section 251 by the Revenue Act of May 29, 1928, exempts the citizens of the United States from income tax under certain conditions. To cover this section the Deputy Commissioner of Internal Revenue issued the following decision on May 23, 1922:

"A citizen of the United States entitled to the benefits of section 262 will not be required to file returns of income to the United States unless he is in receipt of income from sources within the United States or unless he receives within the United States, income from sources without the United States.

"Employees of the Panama Canal who receive no other income than the compensation received for services in the Canal Zone and who do not receive any portion of such compensation within the United States will not be liable for returns."

Therefore, the definition of "dependent" was of no import to the United States citizens on the Canal Zone.

Section 220 of Public Law 814, 81st Congress, however, reversed the Deputy Commissioner's directive by adding subsection J to section 251:

"(j) EMPLOYEES OF UNITED STATES. For the purpose of this section, amounts paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall be deemed to be derived from sources within the United States."

DEFINITION OF DEPENDENTS

The addition of subsection J to section 251 brought to our attention a discriminatory definition of dependents.

Section 25 (b) (3) states in part "The term 'dependent' does not include any individual who is a citizen or subject of a foreign country unless such individual is a resident of the United States or of a country contiguous to the United States.

The Canal Zone is not the United States nor is it contiguous to it.

CASE HISTORY

There are many cases of United States citizens residing in the Canal Zone who otherwise could qualify for exemptions but are deprived the exemptions because neither the Canal Zone nor the Republic of Panama are in the United States nor a country contiguous to it.

In addition to the cases where the dependent resides in the Canal Zone, there are numerous cases where the dependent resides in the Republic of Panama which is contiguous to the Canal Zone.

The present language of section 152 (b) (3) will, in our opinion, give the same exemption consideration to the United States citizen taxpayers of the Canal Zone as they would receive had they resided in the United States instead of the Canal Zone. We, therefore, urge the committee to concur in this section.

I wish to thank the committee for the opportunity of being heard on this section and will be available should additional information be desired.

STATEMENT OF H. CECIL KILPATRICK IN SUPPORT OF PROPOSED AMENDMENT TO SECTION 512 OF H. R. 8300, RELATING TO DEDUCTIONS ALLOWABLE TO CHARITABLE TRUSTS

This statement is filed on behalf of the estate of Harry C. Trexler, a testamentary charitable trust, of Allentown, Pa., which is exempt from income tax under section 101 (6) of the Internal Revenue Code, but apparently is subject to the tax on unrelated business income provided by sections 421 and 422 of the Internal Revenue Code. Except for amounts accumulated for protection against losses in principal assets, all of the income of this trust is distributed to the city of Allentown for its parks and to hospitals, churches, the YMCA, the YWCA, and other similar organizations.

The amendment we propose relates to the charitable contributions deduction allowable to a charitable trust under section 512 (b) (11) of H. R. 8300, to cure what we believe is an unintentional discrimination against such a trust, as compared with the deduction allowed an individual under 170 (b) (1) (B) of the bill.

The legislative history of existing law with reference to the taxation of the unrelated business income of charitable trusts and related organizations, and the allowance of a deduction for contributions made by them is as follows:

Section 301 of the Revenue Act of 1950 incorporated the provisions of supplement U (sec. 421, et seq.) in the Internal Revenue Code. Among other things, section 422 imposed a tax upon the unrelated business income of certain otherwise tax-exempt organizations, including charitable trusts of the type described in section 101 (6) of the code.

In commenting upon the new provisions, the Ways and Means Committee report (H. Rept. No. 2319, 81st Cong., 2d sess., pp. 36-37), said:

"The problem at which the tax on unrelated business income is directed here is primarily that of unfair competition. * * *

"Your committee's bill does not deny the exemption where the organizations are carrying on unrelated active business enterprises, or require that they dispose of such business, but *merely imposes the same tax on income derived therefrom as is borne by their competitors*." [Emphasis supplied.]

Consistently with this objective, section 422 (a) (9) (B) provided that a trust taxable at individual rates might have the same charitable deduction as that given individuals by section 23 (o), such deduction not to exceed 15 percent of the "unrelated business net income computed without the benefit of this subparagraph." Section 23 (o) at that time limited the individual's contribution deduction to the same 15 percent of the taxpayer's "adjusted gross income."

Public Law 465, 82d Congress, 2d session, raised this percentage in the case of individuals to 20 percent, but, apparently through oversight, did not change the percentage limitation in the case of charitable trusts.

The counterpart of section 422 (a) (9) (B) in H. R. 8300 is section 512 (b) (11). That section gives the trust a deduction limited by 20 percent of the unrelated business income otherwise computed, just as section 170 (b) (1) (B) puts a general limitation on the individual of 20 percent of his adjusted gross income.

In the case of the individual, section 170 (b) (1) (A) gives the taxpayer an additional allowance (not given by existing law) of not to exceed 10 percent of adjusted gross income for contributions to churches, educational organizations and hospitals. However, no provision is made in section 512 for a similar deduction in the case of a charitable trust subject to the tax on unrelated business income.

The failure to extend equal percentage limitations to the trust as to the individual probably was the result of oversight. No reason appears to justify this difference in treatment. The Ways and Means Committee's report on H. R. 8300 (H. Rept. No. 1337, 83d Cong., 2d sess.) explains the additional 10 percent allowance as follows (p. 25):

"This amendment is designed to aid these institutions in obtaining the additional funds they need, in view of their rising costs and the relatively low rate of return they are receving on endowment funds."

In commenting on section 512, the same report states (p. A170) that "no substantial changes have been made."

It would seem to follow that there was no intention to depart from the principle stated in the report on the Revenue Act of 1950 (quoted at p. 2 above) that the provision as to the unrelated business income of such organizations "merely imposes the same tax on income derived therefrom as is borne by their competitors."

Consistently with such congressional intent, the following amendment to section 512 (b) (11) of H. R. 8300 is proposed:

To strike from that paragraph the concluding sentence which reads as follows: "The deduction allowed by this paragraph shall not exceed 20 percent of the unrelated business taxable income computed without the benefit of this paragraph.", and substitute therefor the following: "For the purposes of this paragraph, the percentage limitations prescribed by section 170 (b) (1) (A) and (B) shall be applied to the unrelated business taxable income computed without the benefit of this paragraph."

STATEMENTS SUBMITTED BY CHARLES GOODWIN, JR., SHEARMAN, STERLING & WRIGHT, NEW YORK, N. Y.

PROPOSED AMENDMENT TO H. R. 8300 TO PERMIT REGULATED INVESTMENT COMPANIES TO PASS TAX-FREE INTEREST THROUGH TO SHAREHOLDERS

Regulated investment companies are generally taxed, or exempted from tax, under both the present Internal Revenue Code and that proposed in H. R. 8300 on the "conduit" theory. In other words, no corporate tax is imposed upon income or long-term capital gains received by a regulated investment company and distributed to its shareholders. Congress has seen fit to remove the corporate tax in this situation in order to place the shareholders as nearly as possible in the same situation they would be in if they owned directly a proportionate share of the investment company portfolio. This makes it possible for the small investor to obtain the very important advantages of expert management and diversification of risk at very low cost without the burden of triple taxation.

Congress in H. R. 8300 has reduced to some extent the double taxation of corporate earnings later distributed to the stockholders in the form of dividends. The continuing exemption from corporate tax of regulated investment companies eliminates a third tax which might have been imposed on those same earnings if the investment had been made through an investment company rather than directly. Also consistent with the conduit theory, long-term capital gains retain their character as such when distributed by a regulated investment company to its shareholders. The new bill, in line with recommendations from the President and the Randall Commission, has taken steps to permit such companies to pass their foreign tax credit through to their shareholders. See section 853.

It has been proposed that the same treatment should be accorded tax-free interest on municipal obligations. The investment company should be treated as a conduit and the tax-free interest received by it should be excluded from the income of its shareholders when distributed rather than making the distribution of such interest subject to ordinary income tax in the hands of the shareholders.

In order to accomplish this, a new subsection should be added immediately following section 852 (b) (3) of H. R. 8300 in order to extend the conduit theory of taxation of regulated investment companies to tax-free interest received and distributed by such companies:

"(4) TAX-FREE INTEREST.

"(A) Treatment of Tax-Free Interest Dividends by Shareholders. A tax-free interest dividend shall be excluded from the gross income of the shareholders.

"(B) DEFINITION OF TAX-FREE INTEREST DIVIDENDS. A tax-free interest dividend means any dividend, or part thereof, which is designated by the company as a tax-free interest dividend in a written notice mailed to its shareholders at any time prior to the expiration of 30 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including tax-free interest dividends paid after the close of the taxable year described in section 855) is greater than the interest received by the company during the taxable year on obligations the interest on which is not included in gross income under section 103 (relating to certain governmental obligations), the portion of each distribution which shall be a tax-free interest dividend shall be only that proportion of the amount so designated which such interest bears to the aggregate amount so designated."

Section 301 (b) (2) should also be amended to provide that distributions of tax-free interest by regulated investment companies should not be applied in reduction of the basis of the stock of such companies in the hands of its shareholders, as follows:

"(2) DISTRIBUTIONS APPLIED AGAINST BASIS. That part of a distribution determined under subsection (a) which does not constitute a dividend *or a tax-free interest dividend under section 852 (b) (4)* shall be applied against and reduce the adjusted basis of the stock, as provided in part II of subchapter O, relating to basis rules of general application. (Material italized is new.)

Section 852 (a) (1) and (b) (2) (D) must also be amended to eliminate the deduction of dividends paid out of tax-free interest, as follows:

"(1) The deduction for dividends paid during the taxable year (as defined in section 561, but without regard to capital gains dividends *or tax-free interest dividends*) equals or exceeds 90 percent of its investment company taxable income for that taxable year (determined without regard to subsection (b) (2) (D)), and

* * * * * * *

"(D) A deduction shall be allowed for the dividends (other than capital gain *and tax-free interest* dividends) paid during the taxable year computed in accordance with the rules provided in section 562." (Material italicized is new.)

Section 854 (a) should also be amended to exclude tax-free interest dividends from the dividends-received credit, as follows:

"SECTION 854. LIMITATIONS APPLICABLE TO DIVIDENDS RECEIVED FROM REGULATED INVESTMENT COMPANY.

"(a) CAPITAL GAIN AND TAX-FREE INTEREST DIVIDENDS. For purposes of section 34 (a) (relating to credit for dividends received by individuals), section 116 (relating to an exclusion for dividends received by individuals), and section 243 (relating to deductions for dividends received by corporations, *neither* a capital-gain dividend (as defined in section 852 (b) (3)) *nor a tax-free interest dividend (as defined in section 852 (b) (4))* received from a regulated investment company shall [not] be considered a dividend." [Material italicized is new; word in brackets is omitted.]

PROPOSED AMENDMENT TO H. R. 8300 CLARIFYING DEFINITION OF INCOME FROM SOURCES WITHIN PUERTO RICO

Section 933 of H. R. 8300 excludes from gross income and exempts from tax, in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, income derived from sources within Puerto Rico. It is suggested that the proposed law be amended to eliminate existing ambiguities by specifically stating that dividends and interest paid by a corporation incorporated outside of Puerto Rico where all, or substantially all (i. e., more than 95 percent) of the gross income of such corporation was derived from sources within Puerto Rico shall be deemed to be derived from sources within Puerto Rico in the hands of the stockholders. This can be accomplished by adding the following sentence at the end of paragraph (1) of section 933:

"Income derived from sources within Puerto Rico within the meaning of this paragraph shall include dividends and interest paid by a corporation incorporated outside of Puerto Rico if more than 95 percent of the gross income of such corporation for the 3-year period ending with the close of its taxable year preceding the payment of such dividends and interest (or for such part of such period as the corporation has been in existence) was derived from sources within Puerto Rico."

PROPOSED AMENDMENT TO H. R. 8300 TO PERMIT REGULATED INVESTMENT COMPANIES TO TAKE ADVANTAGE OF FOREIGN TAX CREDIT

Under present law regulated investment companies ordinarily get no benefit from the provisions of section 131 which permit taxpayers generally to either deduct foreign taxes paid or take them as a credit against the United States tax on such income, whichever is most beneficial. The reason this election does not benefit regulated investment companies generally is that they ordinarily distribute all or substantially all of their income and therefore pay little or no United States tax. As a result, the limiting ratio based upon a comparison of foreign income with United States normal tax net income inevitably makes it completely inadvisable for such a company to elect the credit method. This has been a substantial deterrent to foreign investments by regulated investment companies.

Both the Randall Commission in its report and President Eisenhower in his budget message came out with approval in principle of new legislation to permit the foreign tax credit to be passed by a regulated investment company through to its shareholders, consistent with the "conduit" taxation of such companies. The House Ways and Means Committee has implemented their recommendations in part by the inclusion of section 853 in H. R. 8300, the proposed new Internal Revenue Code. However, because of the administrative difficulties present when only small amounts are involved, the benefit of the new provision has been restricted to regulated investment companies with more than 50 percent of their assets invested in foreign securities. This has the effect of making the new relief provision inapplicable to almost all presently existing regulated investment companies since the bulk of their assets is ordinarily invested in United States securities.

In order to afford such regulated investment companies partial relief without unnecessary administrative difficulty it is proposed that the restricting ratio in their case be relaxed so as to permit them to offset foreign taxes paid against United States taxes on undistributed ordinary income or capital gains. This might permit such companies to accumulate enough income or gains to use up the credit for foreign taxes paid and would have the effect of partially removing the present substantial disadvantage inherent in foreign investment by such companies. Also, it would place them upon an equal footing in this respect with ordinary domestic corporations which are entitled to a dividends received credit.

In order to accomplish the foregoing general aim it is proposed that section 904 (b) of H. R. 8300 be amended to read as follows, the material in (2) being new:

(b) TAXABLE INCOME FOR PURPOSE OF COMPUTING LIMITATIONS. For purposes of computing the limitations under subsection (a)—

"(1) the taxable income in the case of an individual shall be computed without any deduction for personal exemptions under section 153, and

"(2) the entire taxable income in the case of a regulated investment company which meets the requirements of section 852 (a) for the taxable year shall be its investment company taxable income, computed under section 852 (b) (2)."

MEMORANDUM IN SUPPORT OF PROPOSED AMENDMENTS TO H. R. 8300 TO PROVIDE FOR TRANSFERABLE FOREIGN CREDIT CERTIFICATES

President Eisenhower in his budget message delivered on January 21, 1954, recommended as follows:

"Regulated investment companies concentrating on foreign investments should be permitted to pass on to their stockholders the credit for foreign taxes which would be available on direct individual investments."

The Randall Commission in its report dated January 23, 1954, also recommended remedial legislation along this line, as follows:

"Under present law an individual investor can credit foreign taxes which are imposed directly on his income from abroad. The individual investor can, for example, credit the 15 percent Canadian withholding tax on dividends paid to a United States investor. This credit is lost, however, when the United States citizen invests through an investment trust. Provision should be made for the investment trusts, not only to receive, but to pass on to the individual shareholder the credit for foreign taxes available to investors."

In order to carry out the above recommendations, it is desirable that specialized regulated investment companies be organized in the United States which will concentrate on foreign investments, and further, that ordinary regulated investment companies which rarely make any foreign investment be encouraged to participate in the financing of such specialized investment companies. H. R. 8300 as passed by the House encourages the formation of specialized regulated investment companies concentrating on foreign investment, but makes it practically impossible for ordinary regulated investment companies to participate in their financing. Regulated investment companies hold in excess of \$5 billion of assets turned over to them for investment by more than 1½ million investors. Unless this vast and growing pool of capital is available to help finance regulated investment companies specializing in foreign securities, it is unlikely that the provisions of the new bill will lead to the formation of any such companies.

Since 1938 regulated investment companies have been exempted from Federal tax on their income and long-term capital gains to the extent that such income and gains were promptly distributed to their shareholders. By treating the regulated investment company as a mere conduit, their thousands of small shareholders have been put in substantially the same position from a tax standpoint as those investors wealthy enough to obtain market diversification and continuing expert management on an individual basis. Small investors have been permitted to pool their funds for investment without Federal tax penalty.

Although the conduit theory has been effective in the case of investments in domestic securities, it has not been equally effective in the case of foreign investments. The election to treat foreign taxes withheld as a credit against the United States tax is rarely, if ever of any benefit to a regulated investment company itself because, due to the conduit theory, it is seldom called upon to pay taxes.

Accordingly, up to now, regulated investment companies have not been suitable vehicles for foreign investments; only a very few specialized investment companies have been formed, and these to invest primarily in Canada where the withholding tax is only 15 percent and therefore has but a limited effect on the United States investor.

Subchapter M of chapter 1 of subtitle A in the Internal Revenue Act of 1954 as passed by the House of Representatives continues the existing conduit theory of taxation of regulated investment companies. It also contains an entirely new section, 853, which was evidently designed to carry out the recommendations of the president and the Randall Commission as it permits a regulated investment company, more than 50 percent of whose assets consist of foreign securities, to pass through to its shareholders its foreign tax credits for application by them against their individual income taxes. However, where the shareholder of such a company is itself a regulated investment company investing only an incidental portion of its assets in the specialized regulated investment company, it is impossible for it to effectively pass on to its thousands of stockholders the foreign tax credit. Unless this can be accomplished, the regulated investment company will have no inducement to participate in the financing of a regulated investment company specializing in foreign investments.

The report of the House Ways and Means Committee discussing section 853 does not deal adequately with the problem here presented. In referring to the requirement to qualify under section 853 that more than 50 percent of the assets of regulated investment companies must be invested in foreign securities, it stated that there were "administrative reasons to deny the passing of the credit where only incidental holdings of foreign securities are involved." The Ways and Means Committee, however, entirely overlooked the fact that the stockholders of the specialized regulated investment companies might be other regulated investment companies investing only a small portion of their assets in the stock of the specialized regulated investment company holding foreign securities and that some practical way must be found under which the full benefit of the foreign tax credit can be realized by the regulated investment company for the benefit of its own thousands of stockholders. Otherwise it is very unlikely that section 853 as passed by the House will result in any substantial increase in the flow of American capital abroad.

It is believed that the administrative difficulties referred to in the report of the Ways and Means Committee can readily be avoided by making the foreign tax credit transferable as a unit to another taxpayer rather than requiring that it be broken up into minute fragments and passed on to the hundreds and thousands of investors technically beneficially interested. The transferee or purchaser of the tax credit would be entitled to surrender it to the tax authorities in satisfaction of a Federal income tax liability. The proceeds of the sale of the tax credit would be treated as additional dividend income to the regulated investment company, and would be distributed as such to its shareholders, and accordingly subject to tax as income to them.

It is taken for granted that the administration and the Congress will wish to take every appropriate step to quicken the flow of American private investment abroad to fill in the gap left by declining public grants. It is believed that the formation of regulated investment companies specializing in foreign investments is a sound step toward this end. The small American investor, directly, or as a shareholder of a regulated investment company itself a shareholder of a regulated investment company specializing in foreign investments, will thus have an opportunity to invest abroad with the safety that only diversification and continuous trained investment management can provide. However, unless such a company can turn to the present regulated investment companies for financial encouragement, participation and support, it is unlikely that they will come into being.

There are attached proposed amendments to H. R. 8300 designed to accomplish the foregoing purposes.

CHARLES GOODWIN, Jr.,
New York City.

PROPOSED AMENDMENTS TO H. R. 8300 TO PROVIDE FOR TRANSFERABLE FOREIGN TAX CREDITS IN THE CASE OF REGULATED INVESTMENT COMPANIES

Renumber sections 854 and 855 as 855 and 856, respectively, and insert new section 854 following section 853, as follows:

"SEC. 854. FOREIGN TAX CREDIT CERTIFICATES.

"(a) GENERAL RULE.—A regulated investment company—

"(1) less than 10 percent of the value (as defined in section 851 (c) (4)) of whose total assets at the close of the taxable year consists of stock or securities in foreign corporations and stock or securities of corporations which meet the requirements of section 853 (a) for the taxable year and elect the application of section 853, and

"(2) which meets the requirements of section 852 (a) for the taxable year,

may, for such taxable year, sell, assign, exchange or otherwise dispose of its credit with respect to income, war profits, and excess profits taxes described in section 901 (b) (1) (A) which are paid or accrued by the investment company during such taxable year to foreign countries and possessions of the United States, including those deemed paid by the investment company in accordance with the provisions of section 853 (b) (2) (A). Such credit shall be computed without regard to the provisions of section 904 but shall not exceed the aggregate of amounts computed by multiplying the investment company's taxable income from each of such foreign countries and possessions of the United States, including therein income deemed to be therefrom under section 853 (b) (2), by a percentage equal to the sum of the normal tax rate and the surtax rate prescribed in section 11 for such taxable year.

"(b) EFFECT OF DISPOSITION OF CREDIT.—If its credit with respect to a taxable year is disposed of by a regulated investment company pursuant to the provisions of subsection (a), the regulated investment company—

"(1) shall not apply such credit against the tax imposed on it by this chapter,

"(2) shall be allowed a deduction with respect to such taxable year under section 164 (a) for taxes to which subsection (a) is applicable, and

"(3) shall include in its taxable income for the year of disposition as additional dividends received the amount realized from the disposition of the credit.

"(c) MANNER OF DISPOSING OF CREDIT.—A credit which is the subject of disposition by a regulated investment company as provided in subsection (a) shall be represented by a certificate issued by a custodian for the investment company certifying that such custodian is qualified to act as such under the Investment Company Act of 1940, that the investment company has paid income, war profits, and excess profits taxes described in section 901 (b) (1) (A) for a particular taxable year in an amount specified, and that the amount so specified does not exceed the credit computed as provided in subsection (a), which certificate shall be validated by the Secretary or his delegate in the internal revenue district in which the investment company has filed or expects to file its income tax return for the taxable year to which such certificate relates. The form of certificate issued by such custodian and the procedure for validation thereof shall be such as the Secretary or his delegate may prescribe by regulations.

"(d) TREATMENT OF EXCESS CERTIFICATION.—In the event that the amount of the credit with respect to a taxable year disposed of in accordance with the provisions of subsection (a) exceeds the amount of the credit computed thereunder, the amount of such excess shall be treated in all respects as a deficiency in the income tax of the investment company for such taxable year."

Amend section 6312 to read as follows:

"SEC. 6312. PAYMENT BY UNITED STATES NOTES AND CERTIFICATES OF INDEBTEDNESS *AND BY FOREIGN TAX CREDIT CERTIFICATES.*

"(a) GENERAL RULE.—It shall be lawful for the Secretary or his delegate to receive, at par with an adjustment for accrued interest, Treasury bills, notes and certificates of indebtedness issued by the United States in payment of any Internal Revenue taxes, or in payment for Internal Revenue stamps, *and to receive, at face value without interest, validated foreign tax credit certificates issued pursuant to the provisions of section 854, but only within the period of two years* *from the expiration of the regulated investment companies' taxable years to which they relate, in payment of any taxes imposed by subchapter A of chapter 1 of subtitle A*, to the extent and under the conditions provided in regulations prescribed by the Secretary or his delegate." [Portion in italic is new.]

Add a new subparagraph (6) to section 1221 to exclude foreign tax credit certificates from capital gain tax treatment, as follows:

"SEC. 1221. CAPITAL ASSET DEFINED.

"For purposes of this subtitle the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

* * * * * * *

; or

"(6) *A foreign tax credit certificate issued pursuant to the provisions of section 854.*"

STATEMENT SUBMITTED BY C. STANLEY MCMAHON, 163 ½ CENTER STREET, WINONA, MINN., IN BEHALF OF J. R. WATKINS CO., ON EFFECT OF H. R. 8300 ON DENATURED ALCOHOL

The purpose of this memorandum is to point out certain serious objections to various provisions of H. R. 8300 relating to denatured alcohol which we believe should be amended.

Our first objection relates to section 5331 (a) (1). This section reenacts without substantial change section 1 of the Denatured Alcohol Act of June 7, 1906. This old act has long since been radically changed by subsequent legislation and by departmental construction.

Its provisions are directly in conflict with other provisions of the law as they now exist and are also in direct conflict with other provisions of H. R. 8300, as we will later point out.

As a revision of present law, the inclusion of these obsolete provisions is indefensible. The avowed purposes of H. R. 8300 as set forth in House Report No. 1337, page 1, are "deletion of obsolete material" and a restatement of the laws "in a more understandable manner." Both of these purposes are defeated by the sections to which we now object.

These obsolete provisions, if reenacted, must be interpreted as new law, and as a change by Congress of the law as it presently exists and a reversion of the practices of 1906, which have long since been abandoned.

The effect will be to give the Internal Revenue Service a law which it does not want, and to impose upon the users of denatured alcohol restrictions which will be ruinous.

We refer particularly to the following provision of section 5331 (a), H. R. 8300:

"Domestic alcohol * * * may be withdrawn from bond * * * provided such alcohol shall have been mixed * * * with methyl alcohol or other denaturing material * * * which destroys its character as a beverage and renders it unfit for liquid medicinal purposes;"

The effect of this language is to prohibit the use of tax-free denatured alcohol for any liquid medicinal purposes; yet the Bureau of Internal Revenue has permitted alcohol to be used in liquid medicinal preparations for more than 35 years. If the status quo is to be preserved, the new law ought to say exactly what it means in understandable language.

When the 1906 act was passed, the Commissioner and the Treasury Department construed this identical language to mean what it very clearly says, i. e., that liquid medicines, without qualification as to internal or external use, cannot be made with denatured alcohol. Treasury Decision 1070 dated October 16, 1906, denied the use of denatured alcohol to manufacturers of sulfuric ether because it was a liquid medicinal preparation. To correct this situation, in 1907 Congress amended the 1906 act to permit the manufacture of ether and chloroform with denatured alcohol although they were liquid medicines. This appears as section 5331 (b) in H. R. 8300.

The Commissioner also denied the use of denatured alcohol in liniment, Treasury Decision 1074 dated November 10, 1906; in liquid medicinal soap, Treasury Decision 1203 dated July 18, 1907; in rubbing alcohol, Treasury Decision 1496 dated May 14, 1909. All of these products are liquid medicines and the decisions are based on that ground. In our opinion, these Treasury decisions correctly interpreted section 1 of the 1906 act as it was then written and they would properly apply to section 5331 (a) of H. R. 8300 as now written. The pertinent language is identical.

The Tariff Act of 1913 created "industrial distilleries" for the production of alcohol for denaturation. This act was repealed and superseded by title III of the National Prohibition Act in 1919. This latter act created a complete system for the production, storage, and denaturation of industrial alcohol. All alcohol is today produced and denatured under that act.

Neither the 1913 act nor title III of the National Prohibition Act contain the prohibition against the use of denatured alcohol in liquid medicines that the 1906 act did. The only requirement is that it be unfit as an intoxicating beverage. See section 5303 in H. R. 8300.

Under these later laws, various Commissioners of Internal Revenue have permitted and permit now the use of specially denatured alcohol in the manufacture of a great number of medicinal preparations. These include rubbing alcohol compounds, tincture of iodine, liniment, antiseptics, mouthwashes, and other proprietary pharmaceuticals. If section 1 of the 1906 act is reenacted as section 5331 (a) of H. R. 8300, the Commissioner will have to recall these formulas for medicinal preparations. No Commissioner of Internal Revenue can issue a permit to anyone to violate a law of the United States.

We feel confident that neither the Internal Revenue Service nor Congress desires to disrupt this industry by changing the existing law as above indicated.

It has been suggested that the objections above set forth can and will be eliminated by departmental construction on the theory that H. R. 8300 merely reenacts the present law and the presently authorized operations may be continued.

But, the problem is not that simple. These very rulings of the Service are now being questioned in pending litigation. It is true that a district court has, in an interlocutory order, held that they cannot be questioned where the issues involved only alleged internal medicinal use, but the court did say:

"As stated, the reason for the relaxation by the Commissioner in his ruling as to the use of denatured alcohol for external medicinal purposes may not be entirely clear."

An appellate court might very well be more specific and say that such rulings are clearly illegal or may hold that the 1906 act was not in effect as to alcohol at all. In fact, in the above-quoted opinion the court said:

"A detailed scheme of control had been already set up under the 1906 act, and therein the use of denatured alcohol was forbidden in both internal and external liquid medicinal preparations."

It is our opinion that the act of June 7, 1906, was repealed by subsequent legislation or rendered inoperative as to alcohol. If so, administrative rulings permitting the use of denatured alcohol in medicines is authorized by law. Otherwise, it is not. If a court should ultimately sustain this position, the reenactment of the 1906 act as set forth in H. R. 8300 will result in hopeless confusion. No departmental construction of H. R. 8300 would then avail the industry.

Even if a court should not sustain this position, there is still a problem. Administrative rulings cannot permit denaturated alcohol to be used in external medicines when the law says that it cannot be used in any medicines.

This obvious lack of harmony and confusion is emphasized and increased by the Report of the Ways and Means Committee, page A-384, which reads in part as follows:

"SEC. 5331. WITHDRAWAL FROM BOND FREE OF TAX

* * * * * * *

"The language contained in this section is substantially in the form in which it was originally enacted in 1906, as amended in 1907.

"This section is intended to apply to alcohol produced at industrial alcohol plants and withdrawn for denaturation."

If the sentence underlined above is the intent of Congress, then denatured alcohol must be denatured to render it "unfit for liquid medicinal purposes" as well as intoxicating beverage purposes and the use of such alcohol in medicine is at an end.

If this report should be construed to show congressional intent retroactively, and it could be so contended because the statutory language is unchanged, then the manufacturers of liquid medicinal preparations and, indeed, the denaturing plants themselves, will be exposed to criminal and tax liability for past usage.

There is an obvious conflict between the report of the Ways and Means Committee and the long-established practice of the Bureau of Internal Revenue.

Which, then, shall prevail in the administration and construction of section 5331 (a) if it becomes the law?

That the emphasized language in the report above quoted is not accidental is further illustrated by the comments on section 5310 (a) in H. R. 8300. This section provides that, "Alcohol produced at any industrial alcohol plant * * * may * * * be withdrawn tax free, as provided by existing law * * *," and House Report 1337 states in part:

"The term 'existing law' in subsection (a) is intended to include 'section 5331.'" (P. A-362 of H. Rept. 1337, 83d Cong., 2d sess.)

This emphasizes the intent of Congress that all denaturing in industrial alcohol denaturing plants shall render the alcohol unfit for any liquid medicinal purpose. Whether or not the 1939 Code was intended to have this same effect is a question now in litigation. It is because of this possibility that the intent expressed above as to this bill may be given retroactive effect in the interpretation of prior law that we are compelled to submit this memorandum. That very real possibility should also be of grave concern to all manufacturers and users of denatured medicinal alcohol.

Treasury representatives have assured us that it is not their intent to use this report in pending litigation. The report of the Senate Finance Committee then should clearly state that H. R. 8300 should not be given consideration in construing the law as it existed before its enactment.

Section 5331 (a) (1) is further objectionable because it uses expressions which on their face authorize actions which are contrary to existing law and to regulations of the Internal Revenue Bureau which have been in force since 1919.

We refer to the expression (*a*) "withdrawn from the distillery warehouse" and (*b*) "such denaturing to be done on the application of any registered distillery."

The terms "distillery warehouse" and "registered distillery" are terms having a specific and well-known meaning to officers of the Internal Revenue Service administering the revenue laws relating to alcohol. They pertain to distillers engaged in making beverage spirits as distinguished from those making industrial alcohol.

Since the passage of the National Prohibition Act in 1919, distiller of beverage spirits have been specifically prohibited (except in wartime) from producing or warehousing alcohol for industrial uses and from denaturing such alcohol.

Again, we do not believe that it is the intention of the Congress, nor the desire of the Internal Revenue Service to change such prohibitions. In fact, section 5194 (a) in H. R. 8300 specifically continues the exclusion of alcohol produced at registered distilleries from use as industrial alcohol by providing "except as provided in subsections (b) and (c), such spirits may not be withdrawn for denaturation."

Thus, there is an irreconcilable inconsistency between section 5331 (a) (1) which authorizes registered distilleries to denature alcohol and section 5194 (a) which prohibits them from doing so.

There is another irreconcilable conflict in H. R. 8300. Section 5308 specifies one requirement for denaturation. Section 5331 (a) (1) specifies a different requirement. The latter requires that alcohol be denatured so as to be unfit for use as a beverage and as a liquid medicinal preparation. The former requires only that it be unfit for use as an intoxicating beverage and is silent as to any medicinal criterion.

Which controls?

There is also a very serious objection from the enforcement point of view to section 5647 in H. R. 8300. This section reenacts verbatim section 2 of the Denatured Alcohol Act of 1906. This is badly worded and ambiguous at its best.

The second clause of section 5647 penalizes the use of "alcohol withdrawn from bond" for manufacturing a beverage or a liquid medicinal preparation. The third clause penalizes the sale of a beverage or liquid medicinal preparation made from such alcohol.

Do these provisions apply to denatured alcohol or to alcohol before denaturation?

There is only one judicial opinion answering this question. It is by a district court and is not yet reported. Adopting the argument of the Internal Revenue Service, the court there held that, as used in section 3072 of the present Internal Revenue Code (which is identical with section 5647 in H. R. 8300), the term "withdrawn free of tax" in clause 1 means undenatured alcohol and the term "withdrawn from bond" means denatured alcohol.

This is a distinction without a difference and an appellate court may well construe the statute differently.

However, if this construction is correct, it must also mean conversely that the offenses in clauses 2 and 3 would not apply to undenatured alcohol. The result would be that anyone, other than the person who withdrew alcohol for denaturation, could use such alcohol for manufacturing a beverage without incurring criminal liability under this section. Neither would sale of such a beverage be a violation.

This leaves a startling loophole in section 5647.

These sections as now written with their uncertainties and contradictions are indefensible. It is no excuse to say that some of these are in the same language as the 1939 code. That was a compilation and not a revision. There was no intention in 1939 to change existing law. (See Report of the Committee on Ways and Means, January 20, 1939, to accompany H. R. 2762 and Report of the Committee on Finance, January 30, 1939, to accompany H. R. 2762.)

Therefore, in interpreting the act of 1906, proper consideration could be given to subsequent legislation on the same subject matter. But H. R. 8300 is a revision. It is one law, all of its parts constituting a whole and must be construed as such. The result is not only uncertainty and ambiguity but spells the potential ruin of a part if not all of the industrial alcohol industry.

The undersigned are attorneys for the J. R. Watkins Co. of Winona, Minn., which is under indictment for alleged misuse of denatured alcohol. The case involves liniment produced under permit as an external medicinal preparation and which was not used as a beverage. The Government's theory is that while it is all right for specially denatured alcohol to be used in the manufacture of medicines for external use, such manufacture becomes a crime if that preparation is also incidentally used by some of the consuming public in small doses for internal medicinal purposes.

This is the first case of its kind ever to be presented to the courts since enactment of the law in 1906. Questions are involved in this case which have never before been raised. They should receive consideration by the courts without being affected by H. R. 8300 or by reports of the committees having charge of that bill.

Furthermore, the product involved in the pending case is only one of a number of medicinal preparations made by the J. R. Watkins Co. with denatured alcohol. While these other products have not been questioned under the present code, they too will be in jeopardy if H. R. 8300 is enacted with its numerous contradictions and uncertainties as hereinabove pointed out. This important revision should state the law clearly and in understandable language. This it does not do in the sections discussed here. If it is not the intent of Congress to cripple the industrial alcohol industry, these sections must be amended and this can easily be done.

In an appendix we submit suggested amendments to sections 5331 (a), 5647, 5308, and 5310 which, if adopted, will preserve the status quo in the use of denatured alcohol, under permit, in medicinal preparations.

We are informed that for policy reasons the Treasury wishes to prevent the use of denatured alcohol in medicines for internal use even though no beverage question is involved. It is our opinion that such authority does not now exist and that Congress has never concerned itself with the use of denatured alcohol in medicines except to prevent beverage use. However, what the law was or is is not particularly significant now. The important question is, What should the law now be and how should it be stated so it is clear and understandable?

If Congress should determine that the Treasury should have authority to limit or prohibit the use of specially denatured alcohol in internal medicines, it can delegate that power. In appendix B appears a suggested amendment to grant that authority.

Giving the Treasury the power to make such regulations would give it all the control over medicinal preparations that could be desired. It would also solve the present time problem by affording an opportunity to the industrial alcohol industry to be heard before such regulations are promulgated. Such an opportunity to be heard was not afforded the industry on H. R. 8300 as now written.

This industry is entitled to operate under workable and understandable laws and regulations. It cannot well survive under the uncertainties, contradictions, and ambiguities of H. R. 8300 as it is now written.

Respectfully,

GEORGE, BREHMER & MCMAHON,
By C. Stanley McMahon,
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APPENDIX A

PROPOSED AMENDMENT TO H. R. 8300

(Words set forth as [distillery] are to be deleted and italicized words are new)

"SECTION 5331. WITHDRAWAL FROM BOND FREE OF TAX.

"(a) FOR INDUSTRIAL USE—

(1) DENATURATION REQUIRED.—Domestic alcohol of such degree of proof as may be prescribed by the Secretary or his delegate, may be withdrawn from bond without the payment of internal revenue tax, for use in the arts and industries, and for fuel, light, and power, provided such alcohol shall have been mixed in the presence and under the direction of an authorized Government officer, after withdrawal from the [distillery] warehouse, with methyl alcohol or other denaturing material or materials, or admixture of the same, suitable to the use for which the alcohol is withdrawn, but which destroys its character as a beverage [and renders it unfit for liquid medicinal purposes]; such denaturing to be done on [the] application [of any registered distillery] *to be approved by the Secretary or his delegate* in *authorized* denaturing [bonded warehouses] *premises* specially designated and set apart for denaturing purposes only, and under conditions prescribed by the Secretary or his delegate."

EXPLANATION

1. The term "distillery warehouse" is too restrictive. It has a special meaning under laws and regulations of many years standing. At present, it means *beverage* distilleries only. Under H. R. 8300, as proposed, it is contemplated that alcohol may be withdrawn for denaturation (1) from industrial alcohol bonded warehouses under Section 5310 (a) and (2) from customs bonded warehouses under Section 5311. Deletion of the word "distillery" makes it clear that Section 5331 (a) may cover such withdrawals of alcohol and yet will not conflict with Section 5331 (c) which provides for the withdrawal from beverage distilleries of *rum* for denaturation.

2. The phrase "renders it unfit for liquid medicinal purposes" is deleted. For many years alcohol to be denatured specifically for use in medicines has been authorized. If the quoted phrase is deleted, all doubt that denatured alcohol may continue to be used for medicines will be removed.

Elimination of the quoted phrase removes all question of inconsistency between the kind of denaturing which is required by this section and the kind of denaturing which is required by Section 5803 of the bill. It is unnecessary that two different sections of the bill cover the kind of denaturation that is required.

Since 1919, except in the case of denatured rum, all denaturing has been done by proprietors of *industrial alcohol plants* in denaturing plants operated by them. The only thing that *registered distillers* have denatured is rum, and this is continued because Section 5331 (c) makes subsection (a) applicable to denaturation of rum. Section 5331 (a) should be broad enough to cover both operations and the proposed amendments are for that purpose.

Since 1919, "registered distillers" have been prohibited from denaturing alcohol and this prohibition is continued by Section 5194 (a) of this bill. The amendment proposed would remove the inconsistency of having Section 5331 (a) authorize registered distillers to something that Section 5194 (a) prohibits.

The more general term "premises" should be used, rather than "denaturing bonded warehouses" or even "denaturing plants" since these terms have restrictive meanings.

Yet, the proposed amendments would retain complete Government control of all denaturing by requiring approval of applications to denature.

"SECTION 5303. ESTABLISHMENT OF [INDUSTRIAL ALCOHOL] DENATURING PLANTS.

"On the filing of application and bond and issuance of permit, denaturing plants may be established on the premises of any industrial alcohol plant, or elsewhere, and shall be used exclusively for [the] denaturation [of alcohol by the admixture of such denaturing materials as shall render the alcohol, or any compound in which it is authorized to be used, unfit for use as an intoxicating beverage]."

EXPLANATION:

The coverage of this section should be limited to the *establishment of denaturing plants.*

The deleted matter deals with denaturing processes and articles that may be denatured. These belong elsewhere and are fully covered by Section 5331 (a) and (c) and Section 5194 (c).

Section 5331 (a) is intended to be the law on how the denaturing shall be done and, with Section 5331 (c) and Section 5194 (c), limits the articles which may be denatured. All requirements with respect to the kind of denaturing and the articles to be denatured are set forth in those sections.

This has been done by amendments heretofore suggested and explained in connection with Section 5331 (a).

"SECTION 5647. PENALTY AND FORFEITURE FOR UNLAWFUL USE OR CONCEALMENT OF DENATURED ALCOHOL.

"Any person who withdraws alcohol free of tax under the provisions of Section 5331 (a) *or 5310 (a)* and regulations made in pursuance thereof, and who removes or conceals same, or is concerned in removing, depositing, or concealing same for the purpose of preventing the same from being denatured under Governmental supervision, and any person who uses alcohol withdrawn from bond under the provisions of said sections*, or alcohol denatured under internal revenue laws and regulations*, for manufacturing any beverage [or liquid medicinal preparation], or knowingly sells any such beverage [or liquid medicinal preparation] made in whole or in part from such alcohol *or denatured alcohol*, or knowingly violates any of the provisions of Section 5331 (a) or 5332 or (except as provided in Section 5332) who shall recover or attempt to recover by redistillation or by any other process or means, any alcohol [rendered unfit for beverage or liquid medicinal purposes under the provisions of Section 5331 (a)] *from such denatured alcohol*, or who knowingly uses, sells, conceals, or otherwise disposes of alcohol so recovered or redistilled, shall on conviction of each offense be fined not more than $5,000, or imprisoned not more than 5 years, or both, and shall, in addition, forfeit to the United States all personal property used in connection with his business, together with the buildings and lots or parcels of ground constituting the premises on which said unlawful acts are performed or permitted to be performed."

EXPLANATION

This is a penal section, and since criminal laws are strictly construed in favor of the defendant, this section ought to be very clear and explicit.

As it is proposed in H. R. 8300, there is serious question whether the offense of manufacturing and selling a beverage applies to a product made with denatured alcohol or when made with alcohol withdrawn tax free but that has not been denatured. Clearly, it does not apply to both.

The suggested amendment will eliminate this question.

As H. R. 8300 is written, there are two sections which authorize tax-free withdrawal of alcohol for denaturation, to wit, sections 5331 (a) and 5310 (a). The latter section applies specifically to withdrawals from industrial alcohol plants and industrial alcohol warehouses. Such withdrawals are far greater in volume than withdrawals for denaturation under section 5331 (a). There are actual enforcement cases on record where alcohol was withdrawn from industrial alcohol plants and diverted in tank-car lots prior to denaturation. Such diversions would not be punishable under section 5647 because, as now written, it is specifically limited to withdrawals under section 5331 (a). The penal section making it an offense to divert such alcohol so that it will be denatured should apply to both such withdrawals.

"SECTION 5310. WITHDRAWAL OF ALCOHOL FREE OF TAX.

"(a) FOR DENATURATION. Alcohol produced at an industrial alcohol plant or stored in any bonded warehouse may, under regulations, be withdrawn tax-free, [as provided by existing law] from any such plant or warehouse for transfer to any denaturing plant for denaturation, or may, under regulations, before or after denaturation, be removed from any such plant or warehouse for any lawful tax-free purpose. Alcohol lawfully denatured may, under regulations, be sold free of tax either for domestic use or for export."

EXPLANATION

The words "as provided by existing law" are deleted as unnecessary and for clarity.

This section is intended to authorize tax-free withdrawals from certain specified plants for transfer to denaturing plant. Authority to do so is sufficiently stated without the words "as provided by existing law".

APPENDIX B

SUGGESTED AMENDMENT AS AN ADDITIONAL SECTION TO SECTION 5331, H. R. 8300

Medicinal preparations.—The Secretary or his delegate may by regulations limit or prohibit the use of specially denatured alcohol in medicinal preparations for internal human use.

NOTE.—This section would give authority to prohibit the use of specially denatured alcohol in internal medicines even though they were unfit for beverage purposes.

Present practices in granting permits could be continued or modified in the discretion of the Secretary or his delegate.

STATEMENT SUBMITTED BY FORTESCUE W. HOPKINS, ROANOKE, VA.

PROPOSED AMENDMENT TO SECTION 166 (D) (2) OF H. R. 8300 TO RESTRICT THE DEFINITION OF A NONBUSINESS BAD DEBT SO THAT, UNDER CERTAIN CONDITIONS, CORPORATE CREDITORS OTHER THAN TRADE CREDITORS WILL BE ALLOWED A FULLY DEDUCTIBLE LOSS ON WORTHLESS CORPORATE DEBTS RATHER THAN CAPITAL LOSS AS NOW PROVIDED UNDER EXISTING LAW

Section 166 should be amended by adding the following paragraphs:

"SECTION 166. BAD DEBTS.

* * * * * * *

"(d) NONBUSINESS BAD DEBTS.—

* * * * * * *

"(2) NONBUSINESS DEBT DEFINED.—For purposes of paragraph (1), the term 'nonbusiness debt' means a debt other than—

* * * * * * *

"'(C) A debt created or acquired (as the case may be) between a stockholder, employee, or officer, and the corporation with which he is connected as a stockholder or full-time employee or officer, respectively, provided the debt is not subordinated to the claims of trade creditors, generally, and further provided that the stockholder, who is not, also, a full-time employee or officer, is the owner of 80 percent of the outstanding common stock at the time the debt is created or acquired.

"'(D) For the purpose of (C), above, in determining the ownership of stock, section 311 shall be applicable.

"'(E) The definitions contained in (A), (B), (C), above, are made applicable for all taxable years open to assessment.'"

For some time it has been recognized that the interpretation of section 23 (k) (4) of present law has been extended perhaps beyond the scope intended by Congress (General Review Revision hearings, topic No. 32, pt. III). In such cases as *Commissioner* v. *Smith* (208 F. 2d 310 (C. A. 2, 1953)), *Jan G. J. Boissevain* (17 T. C. 325), etc., the courts have determined that employees, officers, and stockholders who are in business through the medium of a corporation and who have made loans to their corporation to cover deficits from its operation or to maintain necessary operating capital, are not entitled to a fully deductible loss when their corporation ultimately becomes bankrupt and is unable to repay such loans.

It was recognized in the hearings held by the Ways and Means Committee on technical revision that the foregoing inequity existed and that amendments were necessary to eliminate the inequity and to stem the increasing amount of litigation developing over this question. At the same time, it is recognized that there may exist a possibility of abuse if the provision is not properly restricted in that stockholders, officers, or employees may be tempted to make capital contributions in the form of loans rather than purchasing stock; viz., the use of loans to purchase new plant facilities, etc. The foregoing proposed amendment has been specifically designed to eliminate the possibility that employee, officer, or stockholder loans would be made for any purpose other than to maintain or provide necessary operating capital.

Excluding the above proposed bad debts from the definition of a nonbusiness bad debt, of course, does not automatically make such debts fully deductivle as a business bad debt; on the contrary, the loss therefrom is not considered as a loss from the worthlessness of a debt at all, but must qualify as a loss allowable under the provisions of section 165 (c) (2) of H. R. 8300 (sec. 23 (e) (2) of existing law) as a loss incurred in a transaction entered into for profit. It would follow, therefore, under present legal interpretation, if the loan was in substance a gift or a capital contribution, the loss therefrom would be treated as a gift or a capital loss respectively. The fact that a debt which qualifies under this proposed amendment and is thereby no longer considered a bad debt (either nonbusiness or business) must also stand the test of whether in fact such debt represents a capital contribution or an advance to maintain operating capital, makes it doubly certain that the foregoing amendment will not encourage abuses in the nature of "thin" capitalization.

The purpose of the stock-ownership limitation upon the stockholder is to insure that the stockholder who lends money to his own corporation has a sufficient interest in his crporation to warrant the unmistakable inference that he is conducting his business through the medium of a corporation and not merely investing his money in stock. Thus, an objective test is proposed in lieu of a subjective test, thereby eliminating any possibility of uncertainty in the application of this amendment.

In deciding upon the advisability of the foregoing proposed amendment, consideration should be given to the fact that under present law, *Pollak* v. *Commissioner* (——F. 2d——, (C. A. 3, 1953)), a guaranty loss may qualify as a fully deductible loss under the provisions of section 165 (c) (2) of H. R. 8300. Therefore, those employees, stockholders, or officers who are fortunate enough to lend their credit rather than money to their companies which ultimately fail, receive the benefit of a fully deductible loss rather than a capital loss. Obviously there is no great difference in principle, if any, between lending one's credit and lending one's money, since in substance, the same result is achieved. Therefore, the passage of this amendment would bring a greater fairness to our taxing system by eliminating the advantage of form over substance in this respect.

In view of the foregoing, it is recommended that this proposed amendment be enacted into law and thereby alleviate a patent inequity.

STATEMENT BY CHARLES W. BRIGGS, CHAIRMAN, FOREST INDUSTRIES COMMITTEE, WASHINGTON, D. C., IN OPPOSITION TO CHARGES IN THE CAPITAL GAINS TREATMENT ACCORDED INCOME FROM THE CUTTING OR DISPOSAL OF TIMBER UNDER SECTIONS 631 AND 272 OF H. R. 8300 PRESENTED BY THE FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION IN BEHALF OF FOREST OWNERS AND OPERATORS

Sections 631 and 272 of H. R. 8300 would require that certain administrative and other expenses (including interest and taxes) which are presently deductible from gross income be added to the adjusted basis for depletion in computing capital gains from the cutting of timber or the disposal of timber under a cutting contract.

We are unalterably opposed to this requirement for the following reasons:

1. It would seriously discriminate against timber owners entitled to capital-gains treatment under these sections, as compared to other taxpayers with capital gains who are permitted to deduct similar expenses from gross income.

Further, it would discriminate against such timber owners as compared to those timber owners who dispose of their timber by outright sale.

2. It would create extremely complex accounting and expense-allocation problems, especially for small timber owners and operators who cannot afford expensive legal and accounting advice.

3. It would seriously lessen the incentive on the part of private owners to develop and continually improve the long-term forest-management plans necessary to assure adequate timber resources upon which the Nation can depend for its future requirements of forest products.

4. It would defeat the major purposes of the proposed comprehensive revision of the revenue laws as stated by the Ways and Means Committee.

We therefore urge that the Senate Committee on Finance amend H. R. 8300 by striking out references to timber in section 272 and by amending section 631 so it will retain the provisions of section 117 (k) of the present Internal Revenue Code insofar as they relate to timber.

In a supplemental statement appended hereto the foregoing objections and our recommendations for amending H. R. 8300 are explained in detail.

SUPPLEMENTAL STATEMENT OF THE FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION ON H. R. 8300 WITH RESPECT TO REVISION OF SECTION 117 (K) OF THE INTERNAL REVENUE CODE

The Forest Industries Committee on Timber Valuation and Taxation is representative of groups in all parts of the United States interested in or dependent upon timber, including forest owners, tree farmers, timber operators, loggers, pulpwood producers, naval stores operators, manufacturers of lumber, plywood, pulp and paper, and others vitally concerned with wise use and long-term management of our timber resources.

With respect to timber, section 631 and 272 of H. R. 8300 would make substantial and harmful changes in section 117 (k) of the Internal Revenue Code. Section 631 is the counterpart of section 117 (k) which treats certain income from timber or coal for tax purposes as a capital gain.

Section 631 (a) coupled with section 272 (a) provides that administrative and other expenses, incurred in the taxable year in which timber is cut, in connection with the holding and quantity measurement of timber shall be added to the adjusted basis of such timber for the purpose of computing capital gain. Section 631 (b) coupled with section 272 (b), applies to both timber and coal, and provides that expenditures attributable to the making and administering of a contract under which timber or coal is disposed of and to the preservation of the economic interest retained under such contract, shall be added to the taxpayer's adjusted basis for the purpose of computing capital gain. Under these new provisions, these expenditures would no longer be deductible from ordinary income of the taxpayer, as they now are.

We respectfully urge that the Senate Finance Committee amend H. R. 8300 so as to retain the provisions of section 117 (k) of the present code insofar as they relate to timber. The changes which would be made by H. R. 8300 are objectionable for the following reasons:

1. Discrimination between similarly situated taxpayers would result

Timber owners are singled out by sections 272 and 631 for discriminatory treatment in that while a timber owner who cuts his own timber or disposes of it under a cutting contract is accorded capital-gains treatment, he is denied the right to deduct taxes, interest, and other expenses from ordinary income. Every other taxpayer, even though he may have capital gains, has this right. Obviously there is an inconsistency here. Even a timber owner who realizes capital gains from an outright sale of timber is allowed these deductions. For example:

(*a*) Taxpayers selling property used in trade or business, other than timber, may deduce from ordinary income such ordinary expenses as insurance, fire-protection costs, taxes, and interest.

(*b*) In the sale of mortgaged property, or in the sale of securities, taxpayers may deduct from ordinary income such items as interest, taxes, investment counseling services, and the like.

2. Extremely complex accounting problems would be created

Sections 272 and 631 of H. R. 8300 would create extremely complex accounting problems, especially for small-timber owners and operators, in that it would be required that the expenses in question must first be allocated, and the part attributable to timber cut or to a cutting contract be charged to the capital gain and the balance charged to ordinary income.

The average small-forest landowner, tree farmer, woodlot owner, or timber operator is neither an accountant nor a tax lawyer. His knowledge of accounting and allocation techniques, to say the least, is meager. The determination of the holding expenses attributable to the timber cut in any year would be immensely complex and at best would produce an artificial result. For example, it would be extremely difficult to allocate—

(*a*) Fire protection and insect and disease control costs;

(*b*) General expenses between different species and different stands of timber;

(*c*) Expenses attributable to salvage, prelogging, and felling of snags;

(*d*) Interest on money borrowed by a taxpayer expending funds for timber, land, and manufacturing facilities;

(*e*) Taxes and assessments imposed by State and local agencies for a variety of purposes;

(*f*) Costs of communications facilities, which may be borne in cooperation with other individuals, and may be related to both normal business operations and for protection and management of timber.

These few examples reveal that the allocation requirements of section 272 and section 631 would be harassing to forest owners and timber operators. About three-fourths of the Nation's 344 million acres of privately owned forest land is held by "small" owners—and more than half of these small holdings—some 139 million acres—are held by farmers who have an average of 43 acres each. These small owners were given an incentive to protect, conserve, and restock their forest lands by section 117 (k) of the present code. It would be extremely unfortunate to thrust upon them so cumbersome an expense allocation procedure as would be required by sections 272 and 631 of H. R. 8300.

3. The incentive to develop forest resources would be lessened

Sections 272 and 631 of H. R. 8300 would seriously lessen the incentive of private forest owners to develop and continually improve their long-term forest management plans which are necessary to assure the future of our timber resources.

Timber is unique in that it is a renewable resource. However, the growing of trees is an unusually hazardous venture. Not only does it take a minimum of 15 to 40 years or more to grow pulpwood, and from 40 to 80 years or more to bring trees to minimum sawtimber size, but all during these long periods of growth the tree grower must run the risk of losing his investment through such natural hazards as fire, insects, disease, and storm. These hazards and the substantial expenditures required for annual protection costs and taxes, as well as the uncertainty of the value of timber when ready for harvest are factors ever to be kept in mind.

Spurred by the incentive afforded by section 117 (k), and acting in reliance upon it, private forestry has made phenomenal progress during the past decade. Recognition of this progress was given by the President's Materials Policy Commission in 1952 when, after an exhaustive study of the future of our natural resources, it reported that the capital gains treatment given timber by Congress in 1944" * * * has encouraged investment and reinvestment in timber property."

The Commission urged retention of section 117 (k).

Here is a brief summary of accomplishments of private forestry since section 117 (k) was enacted:

(*a*) Large additional areas of forest land have been brought under good management; ownership of forest property has been stabilized, and forest practices greatly improved.

(*b*) Heavy investments have been made in land, plants, and capital equipment and large expenditures have been made for research in new and improved products which permit a fuller utilization and thereby extends our timber supply.

(*c*) Industry-sponsored programs, including the keep-green and tree-farm programs, have resulted in improved protection and forest cutting practices on large and small forest ownerships.

(*d*) The employment of professional foresters by industry has grown so rapidly it now exceeds the number in public employment. The number of private consulting foresters is also increasing rapidly.

4. The major objectives of the code revision would be defeated

Sections 272 and 631 would defeat the major objectives of the overall revision of the income-tax laws proposed by H. R. 8300. The report of the Committee on Ways and Means (H. Rept. 1337, pp. 1, 2) states the purpose of H. R. 8300 is to—

"remove inequities;

"to end harassment of the taxpayer;

"to reduce barriers to future expansion of production and employment;

"to create an environment in which normal incentives can operate to maintain normal economic growth."

The changes in the tax treatment of income from timber proposed in H. R. 8300 violates each of these objectives. As shown above, sections 272 and 631 create rather than remove inequities because of their discriminatory effect, they harass the taxpayer by imposing impractical and unreasonable accounting and allocation requirements; and they lessen the incentive to engage in the growing and management of timber resources over the long period necessary to develop forest resources for our Nation's future needs.

For the foregoing reasons we urge that H. R. 8300 be amended so as to retain section 117 (k) of the present code insofar as it relates to timber.

When section 117 (k) was enacted in 1944 it related only to timber. In 1951 this section was amended to extend the capital-gain treatment to royalties from the leasing of coal properties. However, because of the substantial differences in the nature of these two resources, some of the new language added by the 1951 amendment relates only to coal. These differences clearly justify the treatment of these two resources in separate paragraphs in H. R. 8300.

There are compelling reasons for such separate treatment. In almost every respect, timber involves problems entirely different from coal with respect to management, protection, conservation, severance, and processing—in time, effort, and expense. A highly technical tax problem of the kind being dealt with here should be solved by adopting one provision designed to fit circumstances peculiar to coal and a different provision applicable to timber. No single provision can be designed to meet adequately the diverse problems of a renewable resource and a depletable deposit.

Under the present code, persons receiving capital gains are entitled to determine their tax under the so-called alternative computation under which ordinary expenses may be deducted only from ordinary income. Apparently many coal lessors have no ordinary income against which to offset their expenses. The amendments proposed in sections 272 and 631 would solve the problem of such coal lessors.

Most timber owners do have ordinary income against which to charge the expenses referred to. They should not be required to deduct such expenses from capital gains.

AMENDMENTS PROPOSED TO H. R. 8300

The proposal of the Forest Industries Committee on Timber Valuation and Taxation for amending H. R. 8300 as passed by the House is simple. It is urged that the Senate Committee on Finance—

1. Strike out references to timber in section 272.
2. Amend section 631 so that it will retain the provisions of section 117 (k) of the present Internal Revenue Code and provide separately for timber and coal in the subsections thereof.

A draft of the proposed amendment to these sections is attached.

We respectfully urge your favorable consideration.

EXHIBIT A

PROPOSED AMENDMENT TO SECTIONS 272 AND 631 OF H. R. 8300

SEC. 272. [CUTTING OF TIMBER AND] DISPOSAL OF COAL [OR TIMBER].

[(a) Where the cutting of timber by a taxpayer is considered a sale or exchange under section 631 (a), no deduction shall be allowed for administrative and other expenses, incurred in the taxable year such timber is cut, in connection with the holding and quantity measurement of such timber.]

[(b)] Where the disposal of coal [or timber] by the taxpayer is covered by section 631 [(b)] *(c)*, no deduction shall be allowed for expenditures attributable to the making and administering of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract. This subsecton shall not apply to any taxable year during which there is no production, or income, under the contract.

SEC. 631. GAIN OR LOSS IN THE CASE OF TIMBER OR COAL.

(a) ELECTION TO CONSIDER CUTTING AS SALE OR EXCHANGE.—If the taxpayer so elects on his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than 6 months before the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. If such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the fair market value of such timber, and the adjusted basis for depletion of such timber in the hands of the taxpayer. [plus the deductions disallowed under section 272.] Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this subsection, such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding on the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Secretary or his delegate, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this subsection except with the consent of the Secretary or his delegate.

(b) DISPOSAL OF TIMBER [OR COAL] WITH A RETAINED ECONOMIC INTEREST.—In the case of the disposal of timber [or coal (including lignite),] held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber [or coal,] the difference between the amount realized from the disposal of such timber [or coal,] and the adjusted depletion basis thereof [plus the deductions disallowed for the taxable year under section 272] shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber [or coal. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal. In the case of coal, this subsection shall not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal, and the word owner means any person who owns an economic interest in coal in place, including a sublessor. The date of disposal of such coal shall be deemed to be the date such coal is mined. In determining the gross income, the adjusted gross income or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, in the case of coal, for purposes of applying subchapter G, relating to corporations used to avoid income tax on shareholders (including the determination of the amount of the deduction under section 535 (b) (6) or section 545 (b) (5)).]

[(b)] (c) DISPOSAL OF [TIMBER OR] COAL WITH A RETAINED ECONOMIC INTEREST.—In the case of the disposal of [timber or] coal (including lignite), held for more than 6 months before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such [timber or] coal, the difference between the amount realized from the disposal of such [timber or] coal and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such [timber or] coal. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal. [In the case of coal,] This subsection shall not apply to income realized by any owner as a coadventurer, partner, or principal in the mining of such coal, and the word owner means any person who owns an economic interest in coal in place, including a sublessor. The date of disposal of such coal shall be deemed to be the date such coal is mined. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, [in the case of coal,] for purposes of applying subchapter G, relating to corporations used to avoid income tax on shareholders (including the determination of the amount of the deduction under section 535 (b) (6) or section 545 (b) (5)).

CHANGES IN SECTION 117 (K), INTERNAL REVENUE CODE, PROPOSED IN H. R. 8300, 83D CONGRESS

NOTE.—Words in present law proposed to be omitted are shown in black brackets; new language is shown italicized.

SEC. [117 (k)] *631.* GAIN OR LOSS IN THE CASE OF TIMBER OR COAL.

[(1)] (a) ELECTION TO CONSIDER CUTTING AS SALE OR EXCHANGE.—If the taxpayer so elects [upon] *on* his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than 6 months [prior to] *before* the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. [In case] *If* such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the *fair market value of such timber, and the* adjusted basis for depletion of such timber in the hands of the taxpayer [and the fair market value of such timber] *plus the deductions disallowed under section 272.* Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this [paragraph] *subsection*, such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding [upon] *on* the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the [Commissioner] *Secretary or his delegate*, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this [paragraph] *subsection* except with the consent of the [Commissioner] *Secretary or his delegate.*

[(2)] (b) DISPOSAL OF TIMBER OR COAL WITH A RETAINED ECONOMIC INTEREST.—In the case of the disposal of timber or coal (including lignite), held for more than 6 months [prior to] *before* such disposal, by the owner thereof under any form or type of contract by virtue of which [the] *such* owner retains an economic interest in such timber or coal, the difference between the amount [received for] *realized from the disposal of* such timber or coal and the adjusted depletion basis thereof *plus the deductions disallowed for the taxable year under section 272* shall be considered as though it were a gain or loss, as the case may be [upon] *on* the sale of such timber or coal. Such owner shall not be entitled to the allowance for percentage depletion provided [for] in section [114 (b) (4)] *613* with respect to such coal. *In the case of coal* this [paragraph] *subsection* shall not apply to income realized by [the] *any* owner as a coadventurer, partner, or principal in the mining of such coal, *and the word owner means any person who owns an economic interest in coal in place, including a sublessor.* The date of disposal of such coal shall be deemed to be the date such coal is mined. In determining the gross income, the adjusted gross income, or the [net] *taxable* income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this [paragraph] *subsection.* This [paragraph] *subsection* shall have no application, in the case of coal, for [the] purposes of applying [section 102 or] subchapter [A of chapter 2] *G, relating to corporations used to avoid income tax on shareholders* (including the [computation] *determination of the amount of the deduction* under section [117 (c) (1) of a tax in lieu of the tax imposed by section 500] *535 (b) (6) or section 545 (b) (5)*).

* * * * * * *

SEC. 272. CUTTING OF TIMBER AND DISPOSAL OF COAL OR TIMBER.

(a) Where the cutting of timber by a taxpayer is considered a sale or exchange under section 631 (a), no deduction shall be allowed for administrative and other expenses, incurred in the taxable year such timber is cut, in connection with the holding and quantity measurement of such timber.

(b) Where the disposal of coal or timber by the taxpayer is covered by section 631 (b), no deduction shall be allowed for expenditures attributable to the making and administering of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract. This subsection shall not apply to any taxable year during which there is no production, or income, under the contract.

EXCERPTS FROM REPORT OF HOUSE WAYS AND MEANS COMMITTEE ON H. R. 8300 (H. REPT. 1337)

(P. 59)

"K. GAIN OR LOSS IN THE CASE OF TIMBER OR COAL (SECS 272, 631)

"Under present law a taxpayer who owns or has contract rights to cut timber may elect to treat the cutting of timber as a sale or exchange. Similarly a taxpayer who owns timber or who receives coal royalties may treat his receipts from the disposition of timber and coal as capital gain. There has been uncertainty as to the tax treatment of expenses incurred in connection with the capital gains arising from such timber or coal royalties. In some cases the taxpayer may have no income except capital gains, and the right to deduct business expenses from ordinary income is of no avail to him. Your committee has adopted a provision identifying the expenses in connection with the sales or with the receipts of royalties from leases, which are proper offsets against capital gain and which are properly applicable against ordinary income. In addition the word 'owner' in the case of certain sales of coal has been defined to mean any person who owns an economic interest in coal in place, including a sublessor.

"In the year of cutting timber, the expenses incurred in connection with the holding and quantity measurement of the timber are to be added to the adjusted basis and will reduce the amount of the capital gain. Only that portion of these expenses which is allocable to the timber actually cut may be added to the adjusted basis. However, expenses incurred in actually cutting timber will continue to be deductible as business expenses. Expenditures of a timber or coal owner attributable to making and administering the contract under which the disposition of the coal or timber occurs and expenditures necessary to preserve the economic interest retained under the contract, will also be added to the adjusted basis of the coal or timber in computing capital gain or loss. The expenses which serve to reduce the amount of these capital gains are not to be deductible in computing ordinary taxable income."

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(P. A 67)

"SECTION 272. CUTTING OF TIMBER AND DISPOSAL OF COAL OR TIMBER

"Section 272 has no counterpart in the 1939 code. Subsection (a) thereof provides that where the cutting of timber is considered to be a sale or exchange of such timber under section 631 (a), no deduction shall be allowed on account of certain expenses of the taxpayer incurred in connection with the holding and quantity measurement of the timber cut. To the extent the taxpayer pays them, such expenditures include ad valorem taxes imposed by State or local authorities, costs of fire protection (including patrolling, signposting, building of firebreaks, costs of communication facilities necessary to such fire patrolling, equipment necessary for fire prevention or control, development of water facilities for fire fighting), insurance costs of all kinds relating to the property (not including liability insurance), costs incurred in administering a timber lease (including costs of bookkeeping and technical supervision), costs of timber measurement (including surveying), and interest on loans attributable to the timber. It is intended that only that portion of such expenditures allocable to the timber cut will be disallowed as a deduction. The remainder of such expenditures shall be treated as if section 631 (a) were not applicable, and as under present law, may be deducted from other income as a business deduction, or depending upon the application of section 266, to the particular expenditure, may be capitalized at the election of the taxpayer.

"Subsection (b) thereof provides that where the disposal of timber or coal is covered by section 631 (b), no deduction shall be allowed for expenditures of the owner attributable to the making and administering of the contract under which such coal or timber is disposed of and to the preservation of the economic interest retained therein. Such expenses include those enumerated above and expenses of flood control as they may apply to timber or coal in section 631 (b). In addition such expenses, to the extent the owner pays them, include the legal and technical expenses attendant to the making of the contract, the expenses of measuring and checking quantities disposed of under the contract. It is intended that the entire amount of such expenses shall be disallowed as a deduction, if there is any production of income under the contract, without regard to the fact that no timber or coal may actually have been disposed under the contract. If there is no production of income under the contract, section 272 (b) will not be applicable, and as under present law, such expenses may be deducted from other income as a business expense, or depending upon the application of section 266 to the particular expense, may be capitalized at the election of the taxpayer.

"If the contract under which the coal or timber is disposed of is terminated and, although income may have been received under the contract, no coal or timber was actually disposed of, and amended return shall be filed for each year in which such income was received, and in the computation of tax for such year, section 272 (b) shall not be applicable. In such case, as under present law, such expenses may be deducted from other income as a business expense, or depending upon the application of section 266 to the particular expense may be capitalized at the election of the taxpayer.

"Taxes are unlike other expenses in that taxes paid are generally deductible while expenses are only deductible if incurred in transactions entered into for profit. Therefore, under your committee's bill, taxes paid by the owner on land subject to a coal or timber lease will first be apportioned between the value of the land attributable to the coal (or timber) covered by the lease and the value attributable to other things, i. e., to any buildings on the land. To the extent that the apportioned part of such taxes plus the taxpayer's other expenditures disallowed by this section exceed his income from the coal or timber lease the taxes will be deductible from other income in the same manner as other taxes. In making this computation the income from the lease will first be reduced by the other expenditures and then by the taxes."

* * * * * * *

(P. A 189)

"SECTION 631. GAIN OR LOSS IN THE CASE OF TIMBER OR COAL

"Section 631, while reenacting the substance of section 117 (k) of the 1939 code, in subsection (a) makes one change with respect to section 117 (k) (1) of such code, relating to the treating of the cutting of timber as a sale or exchange, and in subsection (b) makes two changes with respect to section 117 (k) (2) of such code, relating to the disposal of timber or coal.

"Subsection (a) resolves the uncertainty under present law, with respect to the treatment of certain expenditures of the taxpayer in the year of the cutting of timber, not attributable to the actual cutting. It is provided that in cases where the election is made to treat the cutting of timber as a sale or exchange thereof the expenditures for which deductions are disallowed by section 272 (a), incurred by the taxpayer in the year of cutting in connection with the holding and quantity measurements of the timber cut, must be added to the adjusted depletion basis of such timber, in order to determine the amount of gain or loss to be realized on account of such cutting of timber. It is intended that only that portion of such expenses which is allocable to the timber actually cut may be added to the adjusted depletion basis thereof. Any excess of adjusted depletion basis plus the allocable portion of such expenses over the value of such timber may be treated as a capital loss carryover under section 1212. The balance of such expenses may be deducted from other income of the taxpayer as business expenses as under present law, or depending upon the application of section 266 to the particular expense involved, may be capitalized at the election of the taxpayer. That portion of the expenses allocable to the timber cut is disallowed as a deduction from gross income, under section 272 (a). Expenses directly related to the cutting of timber are not affected by this section and continue to be deductible as business expenses, without regard to the basis or value of the timber cut. For a description of the expenditures disallowed as deductions by section 272 (a), see section 272 of this report.

"Subsection (b) extends the benefits of section 117 (k) (2) of such code, with respect to coal, to any person who owns an economic interest in the coal in place, including a sublessor. This reverses the position that a sublessor of a coal property is not an owner of such coal, but is not intended to alter such position with respect to a sublessor of a timber property.

"Subsection (b) also resolves the uncertainty under present law with respect to the treatment of certain expenditures of an owner, relating to the coal or timber disposed of. Subsection (b) provides that in determining the gain or loss realized from the disposal of coal or timber, the expenditures of the owner for which deductions are disallowed by section 272 (b), attributable to the making and administering of the contract under which the coal or timber is disposed of, and attributable to the preservation of the economic interest which such owner retains under the contract, shall be added to the adjusted depletion basis of the coal or timber disposed of. For a description of the expenditures disallowed as deductions by section 272 (b), see section 272 of this report. Unlike the application of subsection (a), the entire amount of such expenditures of the owner in the taxable year, shall be added to the adjusted depletion basis of the coal or timber disposed of in such year. As long as payment was received under the contract any such expenditures shall be added to basis, even though no coal or timber was actually disposed of under the contract. If no payments were received, such expenditures may be deducted from other income as business expenses or depending upon the application of section 263 to each expense, may be capitalized, as under present law. If there is any production of income by the operation of the contract and no coal or timber is disposed of, then such expenditures provide the only offset against such income. Any excess of the sum of the adjusted depletion basis of the coal or timber disposed of and such expenditures (subject to certain limitations in the case of taxes, explained in sec. 272 of this report) shall be treated as a capital loss carryover under section 1212.

"If the contract under which the coal or timber is disposed of is terminated and, although income may have been received under the contract, no coal or timber was actually disposed of, an amended return shall be filed for each year in which such income was received, and in the computation of tax for such year, section 272 (b) shall not be applicable. In such case, as under present law, such expenses may be deducted as business expenses from other income, or, depending upon the application of section 263 to the particular expense, may be capitalized at the election of the taxpayer."

LAS CRUCES, N. MEX., *April 2, 1954*.

Hon. Senator CHAVEZ,
Washington, D. C.:

We would like to express our concern about the proposed tax exemptions and deductions for college students. We feel there are many young men and young women that are being deprived of a college education due to a lack of funds. The Associated Students of New Mexico School of Agriculture and Mechanic Arts would like to recommend that the college tax exemption and deductions be given utmost consideration.

ASSOCIATED STUDENTS, NEW MEXICO A. AND M.

LAS CRUCES, N. MEX., *April 6, 1954*.

Senator DENNIS CHAVEZ,
Senate Office Building,
Washington, D. C.

SIR: The tax laws concerning college students are unfair. It is too burdensome on those of us who work and on parents of those who don't work to forfeit exemption rights and pay income tax on amounts over $600. Vote for reduction in tax rates or increase in exemption.

LAMBDA CHI ALPHA FRATERNITY, STATE COLLEGE, N. MEX.

SHELTON, WASH., *April 7, 1954.*

HON. TOM PELLY,
House of Representatives,
Washington, D. C.:

Understand H. R. 8300, Revenue Code, 1954, being considered by Senate Committee on Finance. As now drawn, act includes two sections, 272 and 631, which tend reduce effectiveness and clarity of income-tax provisions with respect to gain by cutting timber as embodied in section 117 (k) present Internal Revenue Code. Section 117 (k) as now defined is important incentive to practice better forestry. Proposed changes would reduce benefit thus gained by present 117 (k) as which was originally intended to equalize capital gains on timber in same manner extended to other extracting industries. Any help you can give with Senate Committee on Finance to end that section 631 is recommended, and eliminate reference to timber in section 272 as set forth in preceding paragraph will be greatly appreciated.

SIMPSON LOGGING CO.,
GEORGE L. DRAKE.

AMERICAN LIFE CONVENTION,
LIFE INSURANCE ASSOCIATION OF AMERICA,
New York 22, N. Y., April 23, 1954.

To the Members of the Senate Finance Committee:

Following a careful study of the provisions of H. R. 8300, the Internal Revenue Code of 1954, the joint committeees of the American Life Convention and the Life Insurance Association of America have, on behalf of the life insurance companies, proposed for your consideration certain amendments. These amendments are of substantial importance to the millions of policyholders who have placed their savings in life insurance, endowment, annuity, and health and accident policies.

The two associations have a combined membership of 245 insurance companies domiciled in the United States and Canada, which have in force 98 percent of the legal reserve life insurance in the United States. They maintain a Washington office at 1000 Vermont Avenue NW., Washington 5, D. C.

Respectfully submitted.

CLARIS ADAMS,
Executive Vice President and General Counsel, American Life Convention.
EUGENE M. THORÉ
General Counsel, Life Insurance Association of America.

PROPOSED AMENDMENTS TO H. R. 8300, THE INTERNAL REVENUE CODE OF 1954, PRESENTED TO SENATE FINANCE COMMITTEE ON BEHALF OF THE LIFE INSURANCE COMPANIES BY THE AMERICAN LIFE CONVENTION AND THE LIFE INSURANCE ASSOCIATION OF AMERICA, APRIL 23, 1954

Section 34 (c); section 116 (b); section 246 (a) (1)

Section 34 of the proposed Internal Revenue Code, as it passed the House of Representatives, provides that an individual is allowed a credit against tax imposed for the taxable year of an amount equal to a percentage of the dividends received from domestic corporations which are included in gross income. Under section 116, dividends not in excess of certain specified amounts are not includible in an individual's gross income. Section 243 provides that, in the case of a corporation, there shall be allowed as a deduction in computing taxable income an amount equal to 85 percent of the amount received as dividends from a domestic corporation.

However, the benefit of these three sections is denied to owners of insurance stocks, either personal or corporate, by express exclusion (secs. 34 (c) (1), 116 (b), and 246 (a) (1)).

The individual tax credit and exclusion from gross income are new. The corporate deduction, except for the treatment of dividends of insurance companies, is substantially a continuation in different form of the same tax treatment accorded in the present law to corporate holders of stocks in domestic corporations gen[illegible]y.

No exp[illegible]on of this change in the law denying deductions in the case of dividends p[illegible] on insurance stocks to corporations as proposed in section 246 (a) is made in the report of the Ways and Means Committee; in fact, the subject is not mentioned. Neither is any reason given for eliminating dividends on insurance stocks from the credit and exclusion granted to individual stockholders under sections 34 and 116. The disallowance of the dividend received credit is rationalized in the case of certain corporations, but insurance stocks are treated with mysterious silence (report of Ways and Means Committee, p. 6).

The report does say that "the relief offered by the dividend-received credit is limited to situations in which double taxation actually occurs." It then gives a list of corporations the dividends of which are not allowed the credit and recites the reasons therefor. These as outlined in the report fall into three classes: (1) Those which are tax exempt, (2) those which are not taxable in the United States, (3) those where so-called dividends represent a mere distribution of interest earned which the corporation has already taken credit for as a deduction in its tax return.

Insurance companies fall within none of these categories. Neither does the general statement of principle contained in the committee report validly apply to insurance stocks. Stock companies doing a property insurance business are taxed on a basis closely comparable to that on which all corporations are taxed. They deal in contracts of short duration. Their liabilities are ascertainable within reasonable limits of accuracy. Therefore, their earnings are currently calculable with a fair degree of exactitude by appropriate formula. Upon these earnings they pay the same taxes as those levied upon corporations generally.

Life-insurance companies by the very nature of their business, which involves long-term contracts, cannot logically be fitted into the general corporate tax pattern. Because their business is fundamentally different from other businesses, it is taxed differently. However, it is not tax exempt. It is taxed heavily. The earnings of life-insurance companies and, therefore, the corporate funds from which dividends are paid to stockholders are diminished by their corporate income taxes just as in the case of other enterprises. Neither does any part of the dividends paid by them to their stockholders represent a distribution of interest for which credit already has been taken as a deduction in their corporate tax returns. Not in any sense do they fall within the class of concerns described in the report of the Ways and Means Committee which are not entitled to the dividend-received credit.

From 1914 to 1921 life-insurance companies were taxed upon an adaptation of the general corporate income tax. This method proved to be wholly unsuitable and entirely unsatisfactory, particularly to the Treasury. Life-insurance companies deal in contracts of long duration, not in commodities currently manufactured and designed for early sale. They assume obligations which may easily extend over a period of 50 years, or they may have to be discharged within 24 hours. Their liabilities are determined by forecast which is amazingly accurate over long periods of time, but is derived from the law of averages which requires large numbers and long periods for their validity. Currently there is often appreciable deviation from the normal. Their assets consist of investments the value of which fluctuate with a market that is geared to changing economic conditions. Therefore, annual statements of profit and loss are not truly reflective of actual earnings. You cannot apply with accuracy a short-term measure to the results of a long-term business. The abortive attempt to do so resulted in many administrative difficulties, much litigation, and very little revenue.

In 1921 the Treasury suggested an individual formula designed to apply with greater appropriateness to the actualities of this complex and unique enterprise. Both the reports of the committees and the debates in Congress will show that there was no intention of lowering taxes on life-insurance companies. The purpose was to substitute a sound and workable tax structure for an awkward, unsuitable, and ineffectual one. The 1921 law was not a tax relief measure. It established a new tax base in substitution of the old one which had proved unsatisfactory to all concerned, most of all to the Government.

Since then, for more than 30 years, life-insurance companies have been taxed under an individual formula modified from time to time with changing conditions, and recently greatly simplified according to a method originally suggested by the previous Treasury. No revenue law affecting life-insurance companies has been a tax relief measure. The taxes levied have been imposed in lieu of the general corporate tax in a manner and at a level determined by congressional judgment to be equitable and appropriate in view of the nature of the business.

The present law is temporary. However, a special subcommittee of the House

Ways and Means Committee has been appointed to review the situation and directed to report to the next session on a permanent plan. We have high hopes that after full study of the subject this subcommittee will conclude that the present tax basis is a sound, practical and equitable one and that at least when taxes are lowered upon other corporations that our rate may be reduced. In any event the plan which they do recommend will reflect their judgment as to the best manner of taxing such companies and the appropriate rate. Until then it is wholly illogical and unfair to assume that the present law which lays an impost in lieu of the general corporate tax, constitutes a tax preference which justifies depriving the holders of life-insurance stocks of the benefit of the personal income tax credit and the corporate tax deduction and exclusion granted to similar holders of stocks in other corporations.

For many years life-insurance stocks have constituted a normal and legitimate field of investment for those to whom conservatism and safety have been paramount considerations. They have been favored particularly by modest trusts where stability was more important than the higher yields of speculative securities. Such stocks are widely held in small amounts. No intimation had ever come to them or to us that a tax discrimination against the ownership of life-insurance stocks was contemplated, until it appeared in the current bill. It was inserted in the measure without hearing, and presented without explanation. This has no basis in logic and no justification in equity. Since doubtless the vast majority of life-insurance stockholders are still in ignorance of the matter and naturally expect the same tax treatment as the legitimate holders of stock in any other legitimate enterprise, we feel that it is the duty of the life-insurance companies themselves to register a protest in their behalf. Accordingly, we recommended that the express exclusion clauses of H. R. 8300 (sec. 34 (c) (1), sec. 116 (b) and sec. 246 (a) (1)) be deleted.

Section 72 (d) (1)

Change the final clause of the first sentence, and the second sentence, to read as follows:

"(1) EMPLOYEE'S CONTRIBUTIONS RECOVERABLE IN 3 YEARS.—Where—

"(A) part of the consideration for an annuity, endowment, or life-insurance contract is contributed by the employer, and

"(B) during the 3-year period beginning on the date (whether or not before January 1, 1954) on which an amount is first received under the contract as an annuity, the aggregate amount receivable by the employee under the terms of the contract is equal to or greater than the consideration for the contract contributed by the employee,

then all amounts received under the contract *as an annuity* shall be excluded from gross income until there has been so excluded (under this paragraph and prior income tax laws) an amount equal to the consideration for the contract contributed by the employee. Thereafter all amounts *so* received under the contract shall be included in gross income."

Purpose.—To avoid a possible conflict with section 101 (a).

Comment.—As it now stands, it is not clear that this subparagraph deals solely with annuities.

Section 72 (d) (1) (B)

Change this subsection to read as follows:

"(B) during the [3-year] period beginning on the date (whether or not before January 1, 1954) on which an amount is first received under the contract as an annuity *and ending 3 years after the annuity starting date*, the aggregate amount receivable by the employee under the terms of the contract *during such period* is equal to or greater than the consideration for the contract contributed by the employee, * * *"

Purpose.—To reduce the number of life-expectancy calculations on employee annuities already commenced by January 1, 1954, and to avoid spreading very nominal amounts of exclusion credits over the entire remaining lifetime of the annuitant.

Comment.—The separate treatment of employee annuities provided in those cases where the employee's contributions are recoverable in 3 years can be justified on the grounds that employee considerations recoverable in 3 years are too small to warrant their being spread over the whole of the annuitant's lifetime. This separate treatment should also apply to employee annuities in cases where the employee's contributions were originally recoverable in more than 3 years, but because the annuity commenced before January 1, 1954, the contributions remaining to be recovered on January 1, 1954, will be recovered within 3 years. Otherwise, lifetime exclusions of a few cents a year will result in some instances.

Section 72 (e) (2) (A)

Change this subsection to read as follows:

"(A) any amount received, *whether in a single sum or in installments*, under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract; and"

Purpose.—To make it clear that the special rules of this paragraph refer not only to one sum cash refunds, but to installment refunds as well.

Comment.—Under this subparagraph as it now reads, it would appear that only the last of a series of installment payments under a refund provision would be "in full discharge of the obligation under the contract."

Section 72 (f)

Change this subsection to read as follows:

"(f) SPECIAL RULES FOR COMPUTING EMPLOYEE'S CONTRIBUTIONS.—In computing, for purposes of subsection (c) (1) (A) *and subsection (e) (2)*, the aggregate amount of premiums or other consideration paid for the contract, for purposes of subsection (d) (1), the consideration for the contract contributed by the employee, and for purposes of subsection (e) (1) (B) *and subsection (e) (2) (A)*, the aggregate premiums or other consideration paid, amounts contributed by the employer shall be included, but only to the extent that—"

Purpose.—To avoid adjusting in subsection (c) (2) for refund features purchased by employer, rather than employee, money, and to deal correspondingly with such refund features in subsection (e) (1) (B).

Comment.—As this section is presently drafted, the adjustment for refund features in subsection (c) (2) is apparently to be made, in the case of refunds partly or wholly attributable to employer contributions, as if to compensate for the excludibility of the entire refund, rather than only that part attributable to employee contributions. If, however, the refund is actually taxable to the beneficiary to the extent that it exceeds employee contributions not previously recovered, the excess will have been taxable both to the beneficiary and (through the adjustment of subsection (c) (2)) to the employee as well.

This additional cross-reference to subsection (c) (2) does, however, compound the complexity of the system of cross-references in section 72, and a longer but more direct amendment might be more appropriate. One such direct amendment would be to change the last sentence of section 72 (c) (2) as follows:

"For purposes of this paragraph and of subsection (e) (2) (A) the term 'refund of the consideration paid' includes amounts payable after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain, *but does not include, in the case of employee annuities, that part of any payment to a beneficiary (or to the estate of the annuitant) attributable other than to that portion of the consideration for the contract contributed by the employee.*"

Section 72 (h) (1)

Change this subsection to read as follows:

"(1) a contract provides for payment of a lump sum in full discharge of an obligation under the contract, subject to an option to receive an annuity, *with or without the right of later commutation of unpaid installments*, in lieu of such lump sum;"

Purpose.—To make it clear that subsection (h) applies in the case of an installment settlement election within 60 days, where the installment settlement itself includes a later right of commutation.

Comment.—In many contracts the option to receive amounts in installments contains the right in later years to commute the remaining installments and receive the commuted value in a lump sum. In order to realize this commuted value the beneficiary must forfeit the right to receive further payments, and in so doing she relinquishes any further accretion in value which she might otherwise realize. When the commuted value is received it would be taxable as an amount not received as an annuity.

Under the wording of the bill it might be contended that the right of commutation calls for the application of the doctrine of constructive receipt at the time the option is elected. While this is not a proper situation for the application of the doctrine of constructive receipt, rulings of the Internal Revenue Service would indicate that this doctrine might be applied in the case of annuity contracts with right of commutation. Explicit language to the contrary should be employed in the new code in this subsection.

Section 72 (j) (1).

Change the last sentence of this section by striking out the final exception as follows: "This exclusion shall be allowed in each year in which an amount is received as an annuity by such survivor under such contract[, except that the total amount of exclusions to any survivor under this subsection shall not exceed the estate tax attributable to such excess]."

Purpose.—To provide consistent treatment with respect to other exclusions determined by dividing by the annuitant's life expectancy.

Comment.—If these words are not stricken, the net effect will be to confine the full exclusions to those survivor annuitants who live less than their life expectancy. If the life expectancy theory is carried to its logical conclusion, those who live longer than their life expectancy should also continue to receive annual exclusion based on the original calculation, in order to compensate for those who live less than their life expectancy. Otherwise, the duplication of estate and income taxes will not be wholly overcome.

Section 101 (b) (2) (B)

Change this subsection to read as follows:

"(B) NONFORFEITABLE RIGHTS.—Paragraph (1) shall not apply to amounts with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (other than total distributions payable, as defined in section 402 (a) (3), which are paid to a distributee, by a *pension*, profit-sharing or stock bonus trust described in section 501 [(a)] (*e*) which is exempt from tax under section 501 (a), *or under an annuity contract which meets the requirements of section 401 (b)*, within one taxable year of the distributee by reason of the employee's death)."

Purpose.—To remove the distinction between the treatment of profit-sharing and stock-bonus plans on the one hand, and pension plans and other employer purchased annuities on the other hand.

Comment.—The exception accorded profit-sharing and stock-bonus trusts should be extended to pension plans, both trusteed and nontrusteed, because:

1. Allowance of the $5,000 exclusion lump-sum payments under pension plans only where there is a nonforfeitable right discourages the vesting of pensions. This is directly contrary to sound tax policy, which should encourage vesting in order that the existence of the pension plan will not artificially tie employees to the employment of one employer in possible conflict with their other best interests.
2. Where vesting is nevertheless provided under a pension plan, the older workers will be discriminated against. In general, vesting under pension plans is provided only for the older workers.
3. The terminal parenthetical expression in the section as presently written discriminates in favor of profit-sharing and stock-bonus plans, as against pension plans.

Section 101 (d) (1) (B)

Death-benefit installments received under a life-insurance policy have always been exempt from Federal income taxation. There are good reasons for the total exclusion of these installments. Life insurance is traditionally the main or sole support of the families of decedents, and the need for providing for their continued support is best answered by an arrangement which continues regular payments over the years after the death of the family provider.

The total exclusion of installment proceeds has been questioned in recent years. In 1950, a proposal that the entire interest element be subject to tax, contained in H. R. 8920 of the 81st Congress, was deleted by the Senate Finance Committee after representations on behalf of the life-insurance business to the effect that elections to receive the insurance proceeds in installments should be encouraged. Once again the question is up for consideration. Section 101 (d) (1) (B) of H. R. 8300 would now tax death-benefit installment interest in excess of $500 a year in the case of a widow, and $250 a year in the case of a child, ancestor, etc. This section recognizes that it is socially desirable to grant a tax incentive to encourage the settlement of death benefits in installments, but it establishes $500 and $250 a year ceilings on the interest element presumably on the proposition that large life-insurance estates payable in installments should not be fully tax exempt.

The life-insurance business has always believed that it is in the best interest of the public to continue the present tax treatment of death-benefit installment payments. However, this question has been reviewed twice in the past 5 years. This has produced an element of uncertainty in the minds of many policyholders and beneficiaries. Instead of encouraging death-benefit installment settlements, the continuing threat of a change in this provision has tended to discourage such settlements. Consequently, the life-insurance business would like to see the question settled and if the Senate Finance Committee reaches a conclusion that there should be ceilings established on the amount of interest that should be exempt, we submit that the ceilings contained in H. R. 8300 are inadequate and should be increased substantially so that the tax incentive to elect installments would apply to most middle-sized life insurance estates.

The installment exclusions in H. R. 8300 are based upon the assumption that interest on life-insurance estates payable in installments in excess of $50,000 should be taxable. A $50,000 death benefit, payable in installments and taxable under the new annuity rule, will produce average annual interest of $750 to $800 a year, depending on the length of the installment period, assuming a 3 percent per annum rate. The beneficiary of such an estate is almost invariably the widow, but under the provisions of the bill a widow would receive an annual interest exclusion of only $500.

In order to provide an interest exclusion of, say, $750, the policyholder would have to split the death benefit and provide for the payment of a part of it to a child. This is neither practical nor desirable. In most cases, the widow should have all the income in order to provide for the family. Proceeds left to a minor child cannot be paid without guardianship in many States, and generally cannot be used for benefits of the entire family. It is therefore clear that the provisions of H. R. 8300 do not carry out the intent of providing an interest exemption on life-insurance death benefits up to $50,000.

If a $100,000 death benefit is left to a widow and she elects to receive it in installments over a period of 20 years, the total monthly income produced would be approximately $552 per month, and under the new annuity rule the annual taxable interest included would be approximately $1,625, or $1,500 in round figures. The widow should be encouraged to make such elections; otherwise she may be persuaded to take the single sum settlement and speculate with it. Since the interest exclusion is intended to act as an incentive to elect installments, we believe that it will be especially effective in the case of life-insurance death benefits between $50,000 and $100,000. We mention also that many middle-sized insurance estates have been purchased in the past with benefits payable in installments due to the exclusion under existing law. Many are now being paid in installments because of this favorable tax treatment. Both from the standpoint of these existing contracts and those that will be completed in the future, we feel that it is important to preserve the exclusion with respect to at least $100,000 of death benefits. This would mean that the taxable interest ceiling established for a widow in H. R. 8300 should be about $1,500 per year.

The exclusion for children will be of practical significance only when the widow predeceases the policyholder or survives him and dies before all the installments have been paid. To take care of that situation, the law should provide an exclusion for children, and we recommend that this exclusion be not less than $500 per annum per eligible beneficiary. In the case of a family with three children, the aggregate exclusion would be equal to that available to a widow.

When the life-insurance companies appeared before the Senate Finance Committee in 1950, it was pointed out that the revenue loss as a result of the exclusion of death-benefit installment payments was not very large, probably less than $5 million per year. We still feel that the loss of this revenue is justified since the exclusion helps preserve insurance proceeds for surviving dependents and thereby makes Government assistance unnecessary. The revenue which would be collected on death proceeds in excess of $50,000, as provided in H. R. 8300, would be relatively small compared with the total revenue loss we estimated in 1950.

We urge that any change in the tax exclusions of existing law be limited to interest in excess of $1,500 per year in the case of a widow, and $500 in the case of a child, ancestors, etc.

Section 105

We strongly believe that this section should be deleted in its entirety (except for the provision of a $100 weekly limit on amounts received as compensation for loss of wages and attributable to contributions of the employer which were not includible in the gross income of the employee).

The provisions of section 105 (other than the $100 weekly limit just mentioned) seem to be occasioned only because the tax exclusions for accident and health insurance benefits are proposed to be opened up to uninsured benefits provided by an employer for his employees. This, in itself, is an extension to which we object. We do not believe that uninsured benefits provided by an employer should be accorded the same exclusions as insured benefits so provided, because:

1. In practice, the change would benefit only the larger employers. Only the larger employers have the facilities for establishing, within their own organizations, insurance departments to parallel the operations of an insurance company. Furthermore, no substantial purpose is served by the larger employers providing their own insurance arrangements, except to the extent that they may thereby be relieved of that part of the premiums which they would otherwise pay insurance companies because of the Federal income taxes and State premium taxes on the insurance companies. The result may be a substantial shift from insured to uninsured plans, with resulting loss of tax revenues both to the Federal Government and to the States.

2. Uninsured benefits are not subject to the restraints imposed by underwriting considerations on insured benefits. Practically all insurance companies limit the level of disability insurance, particularly that in compensation for loss of wages, so as to avoid financial incentives to the stretching of disabilities. Otherwise, it is easy for benefits not subject to tax to represent more take-home pay than the taxable salary or wages they replace. Furthermore, insurance companies require objective tests of disability not under the employer's control. These restraints, brought about by the fact that the pocketbook of a third party is involved, are not usually present when the employer provides his own benefits subject to conditions largely under his personal control.

3. The rights enforceable by an insured employee will not necessarily be duplicated under uninsured plans. It is one thing to enforce a right against a third party insurance company, and quite another to enforce a right against one's own employer. Furthermore, it is one thing to enforce a right established under a contract supervised by a State insurance commissioner, and another thing to enforce a right not so established.

If it is deemed absolutely essential to retain this section:

1. The qualification procedure should be restricted to benefits received as compensation for loss of wages or salary, and apply (except for the $100 weekly limit) only when uninsured. The qualification procedure seems to be particularly inappropriate for hospital, surgical, and medical care plans. Presumably only a minute fraction of existing hospital, surgical, and medical care plans would be denied qualification. It would hardly seem worthwhile to set up an elaborate system to catch this small number of plans, in such a way as not to discriminate between the service type of plan (Blue Cross-Blue Shield) and the cash-payment type of plan customarily provided by insurance companies.

2. The detail changes proposed on the following pages should be made.

Section 105 (b)

Change this subsection to read:

"(b) EXCLUSION LIMITED IN CASE OF COMPENSATION FOR LOSS OF WAGES.—Amounts to which subsection (a) applies and which—

"(1) are received as compensation for loss of wages, and

"(2) are attributable to contributions of the employer which were not includible in the gross income of the employee,

shall be excluded from gross income under subsection (a) only to the extent that such amounts are payable at a weekly rate which does not exceed *$100* [an amount equal to the excess of $100 over the weekly rate of any nonqualified compensation (as defined in subsection (c) (2)) for the same period]."

Purpose.—To provide a tax-free amount up to $100 weekly, without reference to any additional amounts paid which are taxable.

Comments.—There should be no sound objection to allowing extra amounts of sick leave pay to be paid outside a $100 limit, provided they are currently taxable. Circumstances will move the employer to provide individually for the various needs of his employees. Not all contingencies can be foreseen in setting up an accident and health program. If extra amounts are to be provided only at a tax loss to other benefits, the employer may feel required to maintain unwise amounts of insurance in order to ward off all contingencies.

It would seem more advisable to provide tax exclusions to $100 weekly in any event, without penalty for supplementary provision on an individual basis to meet unforeseen circumstances.

Section 105 (c) (1)

Change this subsection to read as follows:

"(1) QUALIFIED EMPLOYER'S ACCIDENT OR HEALTH PLAN.—For purposes of this section, the term 'qualified employer's accident or health plan' means a plan of an employer *or employers* for the exclusive benefit of his *or their* employees *(or employees and their families—)*"

Purpose.—(a) To make it possible to insure the families of employees under the plan, particularly as to hospitalization and surgical insurance, and

(b) To make it clear that multiple-employer plans can qualify.

Comments.—Employee hospital, surgical, and medical care plans now in effect provide almost without exception for the employees' families as well as for the employees themselves. These should be recognized, unless of course the qualification restrictions are limited to benefits received as compensation for loss of wages.

Permission to set up multiple-employer plans is essential, not only to take care of the Taft-Hartley type of situation, but in order to embrace the common situation where the plan of a parent company is extended to its subsidiaries, or the plan of a subsidiary is extended to its affiliates.

The word "exclusive" should also be eliminated. Otherwise a plan which is found not to qualify on some technical ground, such as the inclusion of a proprietor or a partner as generally allowed by State laws governing employee-group insurance, would render taxable not only the offending features but also the remainder of the plan on bona fide employees.

Section 105 (c) (1) (C)

Delete this subsection.

Purpose.—To avoid redtape and uncertainty which is inherent in subjecting group accident and health insurance plans to the nondiscrimination tests applicable to pensions.

Comment.—The nondiscrimination tests of section 501 (e) are peculiarly inappropriate to group accident and health insurance plans. Quite often benefits are varied by classes of employees determined according to job classifications, rather than directly by wages or salary. These classifications could not be permitted under section 501 (e) (4), because of the requirements that benefits bear a constant relationship to wages or salaries. Even if the scale of benefits were always related to wages or salaries, broad groupings would not be permitted because the lowest paid employee in one salary classification would receive more proportionately than the highest paid employee in the salary classification immediately below.

Even if the standards of section 501 (e) are restricted to benefits received as compensation for loss of wages, the expense and inconvenience of making certain that a plan qualifies will act as a damper to the further spread of the voluntary health insurance movement.

This subsection should therefore be removed entirely.

Section 105 (c) (1) (D)

Change this subsection to read as follows:

> "(D) which, if it provides for the payment of compensation for loss of wages during a period of sickness, provides a waiting period before the time when payments are to begin under the plan *(to the extent that such a waiting period does not conflict with state law to which the plan may be subject)*."

Purpose.—To cover the situation of plans qualified under the California cash sickness law, which requires the waiver of the waiting period in the event of hospitalization.

Comment.—It is reasonably possible that the three State cash sickness laws other than California's will be amended to provide similar waiver of waiting periods in the event of hospitalization.

Section 106

Change this section to read as follows:

"Gross income does not include contributions by the employer to accident or health plans for compensation (through insurance or otherwise) to his employees *(or to his employees and their families)* for personal injuries or sickness."

Purpose.—To provide for family members, as in the case of hospitalization and surgical insurance.

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Comment.—Approximately 17 million family members are now insured for group hospital expense insurance, and approximately 16 million are now insured for group surgical expense insurance. Other family members are insured under Blue Cross and Blue Shield plans. The employer is now paying part or all of the premiums for family members in at least half of these plans.

Generally, the family members who are insured are dependents of the employee, but they may not always meet the financial support requirements of section 152. Therefore, the term "families" is preferred over the term "dependents."

Section 264

Change the last paragraph to read as follows:

"For purposes of paragraph (2), a contract shall be treated as a single premium contract if substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or if an amount is deposited *after March 1, 1954* with the insurer for payment of a substantial number of future premiums on the contract. Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954.

Purpose—To prevent the retroactive application of the new law to existing premium deposit accounts set up in connection with life insurance or endowment policies.

Comment—The change suggested would be necessary in order to protect the interests of those who have entered into premium deposit arrangements prior to March 1, 1954. Since these agreements were consistent with the revenue laws when they were entered into, there is no good purpose served in penalizing the participants at this time. Rather, existing law should be continued with respect to these premium deposit arrangements, just as existing law is continued with respect to annuity contracts purchased before March 1, 1954.

Section 401

Add a new subsection (d) as follows:

"(d) *Certain Life Insurance Contracts.—If an employer, as part of a pension or annuity plan which meets the requirements of section 501 (e) (3) and (4) and which requires that refunds of contributions with respect to contracts purchased under the plan be used to reduce subsequent premiums on the contracts under the plan, purchases a life insurance or endowment contract or contracts (including retirement income contracts) with life insurance protection payable on the death of the employee participants, the cost, determined by regulations as prescribed by the Secretary or his delegate, of the current life insurance protection in excess of the cash values (or the reserves if no cash values are provided) under such contracts, after deducting so much of the contributions of the employee participants as may be allocated to such life insurance protection, shall be taxable to the employee participants in the year when paid. The proceeds of such contracts, when distributed shall be taxable under subsection (a) or subsection (b) of this section to the extent of such cash values or reserves. This subsection shall not apply to group term insurance contracts.*"

And also amend subsections (a) and (b) to correspond, as follows:

"(a) GENERAL RULE.—Except as provided in subsection (b), if [an annuity] *a* contract *providing an annuity* is purchased by an employer for an employee, or if any part of the cost of such a contract is paid by the employer, the employee shall include in his gross income the amounts received under such contract for the year received; except that if the employee paid any of the consideration for the annuity, any amount received as an annuity under such [annuity] *a* contract shall be included in his income as provided in section 72, the consideration for such annuity being considered the amount contributed by the employee (determined by applying section 72 (f)).

"(b) CAPITAL GAINS TREATMENT FOR CERTAIN DISTRIBUTIONS.—

"(1) GENERAL RULE.—If—

"(A) [an annuity] *a* contract *providing an annuity* is purchased by an employer for an employee under a plan which meets the requirements of section 501 (e) (3) and (4);

"(B) such plan requires that refunds of contributions with respect to [annuity] contracts purchased under such plan be used to reduce subsequent premiums on the contracts under the plan; and, * * *"

Purpose.—To preserve the tax treatment of nontrusteed group permanent pension plans now provided by P. S. No. 65, and to parallel the treatment of corresponding trusteed plans as provided in section 402 (a) (4).

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Comment.—The entire section 401 has apparently been added for the primary purpose of according amounts payable under group annuity contracts purchased by an employer for his employees the same tax treatment as amounts payable under trusteed pension plans. This parallelism should be continued for group permanent insurance pension plans, which provide supplementary life insurance protection very much after the manner of the life insurance contracts referred to in section 402 (a) (4).

Section 402 (a) (4)

Change this subsection to read as follows:

"(4) CERTAIN LIFE INSURANCE CONTRACTS.—If a trust described in section 501 (e) *or section 403 (c)* which is exempt from tax under section 501 (a) purchases life insurance *or endowment* contracts (including retirement income contracts) with life insurance protection payable on the death of the employee participants, [or pays any part of the cost of such insurance contracts, no part of the premiums paid on such insurance contracts] *the cost, determined by regulations as prescribed by the Secretary or his delegate, of the current life insurance protection in excess of the cash values (or the reserves if no cash values are provided) under such contracts, after deducting so much of the contributions of the employee participants as may be allocated to such life insurance protection*, shall be taxable to the employee participants *in the year when paid, and* [but] the proceeds, when distributed, shall be taxable under paragraph (1) *or paragraph (2)* of this subsection *to the extent of such cash values or reserves.* This paragraph shall not apply to group term insurance contracts."

and amend the last sentence of section 101 (a) as follows:

"(a) PROCEEDS OF LIFE INSURANCE CONTRACTS PAYABLE BY REASON OF DEATH.—Except as otherwise provided in subsection (d), gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured. *That part of the* [The] proceeds of life insurance contracts which [are] *is* includible in gross income under *section 401 (d) or* section 402 (a) (4) shall not be excluded by this subsection but shall be treated as amounts to which subsection (b) applies."

Purpose: To revert to the present plan of taxation of life insurance purchased by a pension trust, as provided for under P. S. No. 58 Revised and I. T. 3993.

Comment: A canvass has been made of life insurance companies underwriting pension plans affected by this subsection. It is the general consensus that the present plan of taxation in P. S. No. 58 Revised and I. T. 3993 is preferred over that of section 402 (a) (4) as presently written, because:

1. The proceeds of the life insurance protection payable to the beneficiary should not be appreciably impaired by taxation (except in later years after substantial reserves have been accumulated).
2. Taxes on the current term insurance cost with respect to the amount of insurance protection in excess of the reserve should be paid by the employee over a number of years, rather than by his beneficiary in a single lump sum at his death.
3. The present method would in all probability be preferred by the great majority of employees and their beneficiaries.

Specific provision should be made in this section for employee contributions allocated to the life insurance protection. Otherwise, such contributions will be taken into consideration in determining the taxable amounts received as an annuity, rather than in determining the taxable amounts for the current life insurance protection.

Section 403

In various places in this section reference is made to the "purchase of retirement annuities." To avoid the possible interpretation that only retirement annuity contracts may be purchased, and to parallel the suggested changes in sections 401 (a) and 401 (b), these references should, instead, be to "purchase of contracts providing annuities."

Section 403 (a) (1) (A)

Change this subsection to read:

"(A) An amount not in excess of 10 percent of the compensation otherwise paid or accrued during the taxable year to all the employees under the trust, but the percentage applying to the compensation of employees with respect to whose benefits the past service costs have been fully funded and deducted may not exceed the normal cost applicable to their benefits, as determined under regulations prescribed by the Secretary or his delegate. In determining whether past service costs have been fully funded and deducted, [separate computations need not be made for] individual covered employees or classes of employees *may be considered as a group or groups*, except where different rates or types of benefits apply *in any such group* or where the nominal rates of benefits are subject to being offset by benefits provided under some other plan or program."

Purpose: To make it clear that the amount deductible will not be affected when past service benefits are funded first for the older employees and then for the younger employees, as opposed to funding the past service benefits for all employees concurrently.

Comment.—The standard method of funding past service credits covered by a group annuity contract is to fund all past services for employees one by one, in the order of their respective nearnesses to normal retirement. To do this, separate computations need to be made for individual covered employees. This method of funding facilitates the guaranteeing of pensions by the time of retirement, a characteristic of insurance company underwritten plans. The funding of past service credits under uninsured plans, which give no guaranties to retired employees, can just as well be done otherwise, such as concurrently for all employees. In order, therefore, not to discriminate against insured plans underwritten by group annuity contracts, it should be made clear that the actual order of purchase for individual employees is not a factor in determining employer deductions.

This subsection (A) takes on added importance with the change of the 5 percent rate to 10 percent from its counterpart in the present code. In general, subsection (A) will now represent the maximum rate of funding, rather than subsection (C) as heretofore.

Alternately, the provision for gradually lowering the 10 percent maximum rate of funding as past service benefits are purchased could appropriately be dropped in favor of a simple 10 percent limit until all past service is purchased, with a "normal cost" limit thereafter.

Section 501 (e) (3) (A) (iv)

The life insurance business objects to the key employee provision under which a classification is considered discriminatory if more than 10 percent of the participants in the plan are key employees. The provision will not cause too much difficulty in some plans covering a large number of employees, although many will be adversely affected. As applied to the small employer the rule is exceedingly unsatisfactory. For example, on both large and small employers:

1. Insurers estimate that as high as 50 percent of existing plans would be disqualified under the key employee rule. This does not mean, however, that such plans necessarily discriminate in favor of key employees.
2. The application of the rules in the bill produces absurd results in no way related to discrimination. It precludes any salaried employee plan if the employer employs a large proportion of hourly workers, or a large proportion of union employees who may not be covered under the plan because of their specific choice to the contrary. Also, provision is made for classifications excluding those earning under $4,000, but the key man rule may nullify this classification.

Because of the shortness of time, the life insurance business does not have a specific amendment to propose. We do mention the following possible changes:

1. Remove the key employee test entirely, and rely solely on the seven classifications described in section 501 (e) (3) (A).
2. Apply the key employee test separately to each of the classifications under section 501 (e) (3) (A).
3. Apply the key employee test only to classifications (vi) and (vii) of section 501 (e) (3) (A), excluding from the test, however, combinations of classifications (i) through (v).

Section 501 (e) (4) (A)

Change this subsection to read:

"(A) in the case of a pension or annuity plan, the contributions or benefits of or on behalf of the employees under the plan do not bear a higher ratio to compensation for any covered employee than for any other covered employee *of the same length of employment with the employer, same length of coverage under the plan, and same normal retirement age*, whose compensation is lower, except that the first $4,000 of annual compensation may be disregarded; or"

Purpose.—To continue to permit variations in rates of benefit to reflect different lengths of employment with the employer, different lengths of coverage under the plan, and different normal retirement ages.

Comment.—The present subsection, as interpreted by such comments as the first full sentence on page A168 of the committee report, would appear to preclude many common types of pension plans. For example, it would apparently not permit a lower rate of benefit for past service before the plan begins than for current service after the plan begins. Also, the subsection may be interpreted as precluding downward adjustment for short service with the employer, in the case of plans based on final salary.

The amendments above would confine the tests of discrimination between those in like circumstances as to the factors, other than wages and salaries, which customarily affect the amount of individual pensions. These factors are length of employment with the employer, length of coverage under the plan, and normal retirement age.

It is assumed that the regulations will authorize the use of wage and salary groupings of rates of contributions and benefits. If, however, this subsection is to be interpreted strictly so as not to permit such groupings, it should be further amended to authorize them specifically.

Section 501 (e) (4) (B)

Change this subsection to read:

"(B) in the case of a profit-sharing or stock bonus plan, at least 75 percent of the employer's contributions each year, and all of the amounts arising from forfeitures on termination of service or for any other reason, are allocated in such a manner that the allocated amounts *or benefits purchased* do not bear a higher ratio to compensation for any covered employee *of the same length of employment with the employer and same length of coverage under the plan,* whose compensation is lower, and the remaining employer contributions, if any, are allocated in such a manner that the total allocation *or benefits purchased,* as a percentage of compensation, to *or for* any covered employee under the plan in any year does not exceed twice the minimum allocated to *or purchased for* any other covered employee *of the same length of employment with the employer and same length of coverage under the plan,* whose compensation is lower."

Purpose.—(*a*) To continue the present provisions of section 165 (a), as applied to profit-sharing plans, whereby tests designed to prevent discrimination by amount apply either to contributions or benefits.

(*b*) To parallel the proposed change in section 501 (e) (4) (A), with respect to employees of the same length of employment with the employer and the same length of coverage under the plan.

Comment.—A number of sound profit-sharing plans have been established under present law under which the benefits purchased, rather than the amounts allocated, bear a constant ratio to compensation for all participants. It is highly desirable that permission to set up these plans be continued, since in many cases the plan is improved, from a social point of view, by the purchase of constant amounts of retirement income rather than by the distribution of constant amounts of cash. Present law permits these plans.

Also, the amendments for length of employment with the employer and length of coverage under the plan should have their parallels under this subsection dealing with profit-sharing plans.

Section 505 (a) (3)

Change this subsection to read as follows:

(3) annuity contracts, or *life insurance or endowment contracts* (*including* retirement income contracts) [in which the face amount does not exceed 100 times the monthly annuity payable at normal retirement age under the plan];"

Purpose.—To recognize life insurance and endowment contracts as qualified assets for a pension or profit-sharing trust, and to eliminate the restriction in the bill applicable to the face amount of insurance under retirement income contracts.

Comments.—The permissible investments under this subsection should not be restricted simply to annuity contracts and retirement income contracts, because:

1. Life insurance and endowment contracts are qualified assets for pension and profit-sharing plans under existing law.

2. Many existing pension and profit-sharing trusts have actually purchased insurance company contracts other than annuity contracts and retirement income contracts. Lack of provision for these other types of contracts in this section 505 (a) (3) would disqualify these plans.

3. Life insurance and endowment contracts are desirable assets for employee trusts. We know of no sound reason for disqualifying them as permissible investments. Provision in section 505 (b) (2) that existing investments of qualified plans may still be held without disqualifying the plan does not solve the problem, because life insurance policies require continuing investments in the form of renewal premiums.

In the plans which utilize life insurance, endowment, and retirement income contracts, there should be no statutory limit (such as 100 times the monthly annuity) on the face amount of insurance. Under section 402, either as now written or as proposed, there can be no tax avoidance in plans utilizing life insurance. Therefore, there is no tax reason for placing a restriction on the amount of life insurance protection purchased by an employee trust.

Section 803 (a) (2)

Change this subsection to read as follows:

"(2) Gross income.—The term "gross income" means the gross amount of income received [or accrued] during the taxable year from interest, dividends, and rents."

Comment.—The general rule for reporting taxable income, as set forth in section 446 of H. R. 8300, is that it shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. This is comparable with the general rule of present section 41, I. R. C.

In Form 1120L of 1951, and for some years prior thereto, the following instruction appeared:

"C. Basis of return.—A return on this form shall be rendered on a cash receipts and disbursements basis in conformity with the annual statement made to the State Insurance Department, instead of the accrual basis."

This instruction was clear and unambiguous until the form of annual statements required by State insurance departments was changed from the modified cash basis theretofore in use to the revenue or accrual basis, beginning with the statement of 1951.

In recognition of this change in the annual statement form from the cash to accrual basis the 1952 edition of Form 1120L included the following instruction:

"C. Basis of return.—A return on this form shall be rendered on a cash receipts and disbursements basis or the accrual basis, whichever conforms with the annual statement made to the State Insurance Department."

This instruction might have been construed to mean that life insurance companies should shift from a cash to an accrual basis in computing their Federal income-tax returns, beginning with the calendar year 1952.

The instruction in the tax return Form 1120L, however, was discussed with officials in the Bureau of Internal Revenue in November 1952. The life insurance companies were assured at that time that the change in instruction C was not intended as a shift from the cash to the accrual basis, but merely to give them the option provided their choice could be backed up by a return submitted to a State insurance department.

Parenthetically, it should be said that whereas the present form of annual statements required by State insurance departments calls for the use of the revenue or accrual basis in the main part of the financial statement, nevertheless it contains in exhibit 3 a reconciliation between the cash and accrual basis with respect to interest, dividends, and real-estate income. Thus it could be said that both bases are used in the annual statement.

Beginning with section 803 of H. R. 8300, all reference to items of income and disbursements of life insurance companies are amended to call for the "received or accrued," "paid or accrued," "paid or incurred" basis. Apparently, the purpose was to carry forward into the statute the flexibility that was thought to be provided by instruction C in the 1952 edition of Form 1120L. This is borne out by the report of the Ways and Means Committee of the House on H. R. 8300, which, on page A239 contains the inference (unfortunately erroneous) that the new form of statement blank called for by the National Association of Insurance Commissioners "permits" certain items to be reported on an accrual rather than a cash basis. The report then indicates that the objective in the changes in the revenue bill is to tie the reporting of taxable income to this "permissive" basis of the annual statement. Since the main part of the annual statement, however, requires rather than permits items to be reported on an accrual basis, the language of the report is confusing.

The best way to overcome this confusion is to eliminate from section 803 the reference to the accrual basis so that it will be understood that income is reportable on a paid basis.

Section 901 (b) (1) (B), section 903, and section 841

At the present time, life insurance companies pay three different types of taxes in Canada, as follows:

(A) A 2-percent tax upon premium receipts in Canada, payable to the Dominion Government which, in turn, apportions the proceeds among the Provinces, except Quebec.

(B) A 2-percent tax on premiums received in the Province of Quebec payable to that Province. (This tax is allowed as an offset against tax (A), above.)

(C) A nonresident income tax on investment income in excess of that necessary to carry on Canadian operations.

Section 131 (a) of the present Internal Revenue Code permits life insurance companies of the United States to credit tax (C) above and section 131 (h) permits them to credit taxes (A) and (B) above. Thus, presently, all three of these taxes paid in Canada can be offset against the Federal income tax paid to the United States.

Section 901 of H. R. 8300, in providing for foreign tax credits, introduces a new concept of "principal tax," which is described in section 903. Section 901 would allow the taxpayer to credit against his United States Federal income tax either his "principal tax" paid in Canada to that national government or the amount of any income, war profits and excess-profits taxes paid to the Dominion Government of Canada. Thus, a life insurance company of the United States operating in Canada would have the choice of crediting against its Federal income tax in the United States either the tax on excess investment income paid to Canada or the premium tax paid to the Dominion Government. It could not offset both. It is also doubtful whether it could offset the premium tax paid to the Province of Quebec.

It is not believed that there is any intention to restrict the foreign tax credits permitted life insurance companies today. That would appear to run counter to the basic philosophy of encouraging foreign trade and commerce.

This inadvertence should be corrected by the following amendments to section 901 (b) (1) (B) and section 903:

"SEC. 901.

"(b) (1) * * *

"(B) the amount of any principal tax described in Section 903 for each separate trade or business of the taxpayer paid or accrued during the taxable year to the national government of such foreign country or possession *plus the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to such foreign country or possession on income not attributable to any trade or business with respect to which such principal tax is imposed by such foreign country or possession*, plus the amount of any income, war profits, and excess profits taxes paid or accrued to any political subdivision of such foreign country or possession during the taxable year;"

"SEC. 903. PRINCIPAL TAX.

"For purposes of this subtitle, the term 'principal tax' means that one tax paid or accrued during the taxable year to the national government of a foreign country or of a possession of the United States which is attributable to the operation of a trade or business regularly carried on by the taxpayer and which constitutes for such year the principal source of tax revenue to such government from such trade or business, except that—

"(1) no sales, turnover, property, or excise tax, which is generally imposed by such government and

"(2) no social security, income, war profits, or excess profits tax,

shall be included as a principal tax or be considered for the purpose of determining such principal source of tax revenue. *In determining the amount of such principal tax paid or accrued during the taxable year to the national government of such foreign country or possession there shall be included any amount paid or accrued during the taxable year to any political subdivision of such foreign country or possession and allowed by such foreign country or possession as a* *credit against the amount of principal tax otherwise payable to the national government.* For purposes of section 901 (b), the amount of such principal tax shall not exceed an amount computed by multiplying the taxpayer's taxable income from such trade or business for such year by a percentage equal to the sum of the normal tax rate and the surtax rate prescribed in section 1 or 11 which apply to such taxpayer's taxable income for such year."

Section 841

Section 841 of H. R. 8300 provides that insurance companies taxed under subchapter L shall be entitled to the foreign tax credit provided to other domestic corporations by section 901. In section 904, however, a limit is imposed on the foreign tax credit which depends upon, and refers to, the tax rate applicable to individuals and general corporations. This reference does not fit life insurance companies, with the result that the foreign tax credit limit for them is obscure. This should be corrected by the following amendment to section 841:

"SEC. 841. CREDIT FOR FOREIGN TAXES.

"The taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of a domestic insurance company subject to the tax imposed by section 802, 821, or 831, to the extent provided in the case of a domestic corporation in section 901 (relating to foreign tax credit). For purposes of the preceding sentence, the term "taxable income" as used in section**[**s 903 and**]** 904 **[**and the tax rates therein referred to**]** mean**[**s**]**—

"(1) in the case of the tax imposed by section 802, the taxable income (as defined in section 803 (g)) **[**and the applicable tax rates specified in section 802;**]**

"(2) in the case of the tax imposed by section 831, the taxable income (as defined in section 832 (a))."

Section 1036

No change necessary in this section of the proposed code, but it is believed that clarifying language such as the following should be added to the committee report:

insurance contract

"The exercise of a contract right to convert an endowment, annuity or life insurance contract to any one of the contracts defined in subsection (b) is a continuation of the original contract and therefore is not an exchange of one contract for another."

Purpose.—To avoid the interpretation that the term "exchange" includes the exercise of an option under an endowment policy.

Comment.—The new section 1036 recognizes tax-free exchange of life insurance annuity and endowment contracts but does not afford similar tax treatment to "exchanges" of endowment policies for life insurance policies. The bill does not define the word "exchange." It is presumed that the drafters had in mind the exchange of totally separate policies. Through interpretation, however, it is possible that the exercise of an option under an endowment policy to receive a lump sum and a paid-up life-insurance policy would be construed to be an exchange. Language in the committee report should make it clear that this is not intended.

Section 2039

Change subparagraphs (c) (1) and (c) (2) as follows:

"(1) an employees' trust forming part of a pension, stock bonus, or profit-sharing plan which, at the time of the decedent's separation from employment (whether by death or otherwise) met the requirements of section 501 (e) *or section 403* (c); or

"(2) a retirement annuity contract purchased by an employer (and not by an employees' trust) pursuant to a plan which, at the time of decedent's separation from the employment (by death or otherwise) met thet requirements of section 501 (e) *or section 403* (c)."

Purpose.—To extend the exemption to trusts and annuities exempt under section 403 (c).

Section 2042

Add the following:

"*Notwithstanding the foregoing, if the only incident of ownership possessed by the decedent at his death consists of a possibility that an interest in such a policy may vest in the decedent or his estate, and if such possibility could have been defeated during decedent's life, by anyone other than the* *decedent, through the exercise of a general power of appointment (as defined in section 2041) which in fact was exercisable immediately prior to the decedent's death, the decedent shall not be considered as having possessed at his death any of the incidents of ownership."*

Purpose.—To apply the same rules of reversionary interest to life-insurance policies as to other property in the estate.

Comment.—The proposed addition will make the treatment of a "reversionary interest" parallel to that found at section 2037. There is no reason for the application of one set of rules to life insurance and another to all other types of property, as is recognized by the overall intent of the new section 2042.

Section 2500 (c) (2) (B)

Change this subparagraph to read as follows:

"(B) in the event the donee dies before attaining the age of 21 years, be payable to the estate of the donee, or as he may appoint [by will] under a general power of appointment as defined in section 2514 (c), *whether exercisable under a will or otherwise.*"

Purpose.—To permit completed gifts of life-insurance policies to minors without the requirement that the power of appointment be exercised by will.

Comment.—Life-insurance policies transferred for the benefit of a minor may give the minor the power to appoint his own beneficiary. Such a right to appoint is exercisable outside a will, but under this section such a contract power of appointment would not qualify.

Section 7701 (a) (20)

Change this subsection to read as follows:

"(20 EMPLOYEE.—For *the purpose of applying the provisions of sections 105 and 106 with regard to accident and health plans and section 101 (b) with regard to employee's death benefits, and for* the purpose of applying the provisions of subtitle A with respect to contributions to or under a stock bonus, pension, profit-sharing, on annuity plan, and with respect to distributions under such a plan, or by a trust forming part of such a plan, the term "employee" shall include a full-time life-insurance salesman who is considered an employee for the purpose of chapter 21, or in the case of services performed before January 1, 1951, who would be considered an employee if his services were performed during 1951.

Purpose.—To classify life-insurance salesmen as employees, for accident and health insurance plans and employer-provided death benefits, as well as for pensions.

Comment.—Life-insurance salesmen have been recognized as employees for the special purposes of inclusion in social-security coverage and for exempt employee pension plans. The new code recognizes two additional forms of employee welfare plans, accident and health and death-benefit plans, much more fully than heretofore, and it should specifically recognize life-insurance salesmen for these other plans as well.

STATEMENT OF WILLIAM H. HARRAR, RE H. R. 8300, PROPOSED INTERNAL REVENUE CODE OF 1954: SECTION 542 (B)—PERSONAL HOLDING COMPANIES IN CONSOLIDATED RETURNS

My office address is 11 West 42d Street, New York 36, N. Y.

I represent various corporations filing consolidated returns.

For several years, the Internal Revenue Service has taken the position that any member corporation of a closely held affiliated group filing consolidated returns can be singled out and taxed separately as a personal holding company if 80 percent or more of its gross income comes from intercompany dividends or capital gains realized on transactions wholly within the group. In effect, this departmental denial of the protection otherwise afforded by the consolidated returns regulations against taxation of income from intercompany transactions discriminates against those affiliated groups whose managements desire to move funds through the group for the wholly legitimate purpose of financing the business operations of the several affiliates or the common parent.

Suppose, for instance, affiliate A, owning all the stock of prosperous affiliate B, wishes to embark on a new venture, such as starting a factory in a new location. B has more earnings than it needs and A does not wish to incur the interest charges and other difficulties attendant upon an outside loan. The most expedient plan is for B to declare a dividend to A. If this is done and A has no other income, or if the B dividend is more than 80 percent of A's gross income from all sources, A at once becomes liable for the crushing personal holding company surtax. This unwarranted result can happen to the common parent or to any affiliate attempting to obtain financing through intercompany dividends, rents, royalties, etc., and certainly is a painful and needless consequence of the present departmental attitude.

The House of Representatives has recognized the injustice and has sought to provide a remedy in section 542 (b). The purport of the new bill is that the personal holding company surtax will not apply to any member of any group filing consolidated returns unless the group as a whole has consolidated gross income sufficient to meet the statutory tests for a personal holding company. Unfortunately, however, this relief is made to depend on a condition which renders it all but nugatory: the new treatment is not to apply unless the common parent corporation "derived 80 percent or more of its gross income for the 3 years immediately preceding the taxable year" from another member or members of the same group (sec. 542 (b) (2) (A)).

If that limitation becomes law, there are only two ways that any group can get relief, both of them costly. For a 3-year period the parent must extract 80 percent of its gross income from other members of the group and then (1) either redeclare the moneys so received to the parent's stockholders or (2) retain the moneys and in all probability pay substantial personal holding company surtaxes thereon. Furthermore, once the relief is thus arduously achieved, the common parent will have to continue drawing money up into itself, like a sponge, year after year, in order to meet the continuing requirement of having derived 80 percent of gross income for the 3 years prior to the tax year from its affiliates. This would mean either a top-heavy and unnecessary accumulation of funds in the parent company, or forced distribution to individual stockholders of the parent's earnings, both of which would preclude expeditious and economical financing of the business operations of the several affiliates. Since any well-advised group has hitherto carefully avoided allowing the common parent to meet the 80 percent test, it is indeed doubtful whether any significant number of consolidations can meet the conditions of section 542 (b) at the present time; the proposed law may thus be a dead letter from inception. Finally, the concentration on the parent's situation with regard to gross income gives no recognition to the possibility that the trouble may lie somewhere else in the chain of intercorporate ownership. Affiliate C may wish to receive a large dividend from its immediate subsidiary D for financing purposes, but unless the common parent keeps on meeting the 3-year, 80 percent test, no corporation in the group will be safe from the personal holding company surtax.

It is likely the House wrote in the 3-year, 80 percent test in order to make doubly certain that no corporation which is a personal holding company by reason of an outside investment portfolio can escape the surtax by joining in a consolidated return. But this contingency is amply precluded by the explicit language of section 542 (b) (2) (B).

The 3-year, 80 percent test of section 542 (b) (2) (A) should be abandoned, in the interest of extending the proposed relief in a workable and realistic manner to corporations filing consolidated returns. No corporation joining in a consolidated return should be liable for personal holding company surtaxes attributable to intercompany items.

STATEMENT BY THE WESTERN UNION TELEGRAPH CO. URGING LIBERALIZATION OF SECTION 381 OF H. R. 8300

Section 381 of H. R. 8300, as introduced in the Senate on March 23, 1954, and referred to this committee, contains provision for carryovers in certain corporate acquistions.

This section is aimed at providing long-needed rules to clarify the tax consequences attendant upon tax-free reorganizations, as to which doubts and ambiguities have been created by a host of irreconcilable judicial decisions and administrative rulings. (Compare *New Colonel Ice Co., Inc.*, v. *Helvering*, 292 U. S. 435 (1934) with *Helvering* v. *Metropolitan Edison Co.*, 306 U. S. 522 (1939), and *Standard Paving Company* v. *Commissioner*, 190 F. 2d 330 (10th Cir. 1951) cert. denied, 342 U. S. 860 (1951) with *Stanton Brewery, Inc.* v. *Commissioner*, 176 F. 2d 573 (2d Cir. 1949), and *P. S. 62* with all 4 cases.

To achieve this purpose section 381 imposes rigid and narrow rules. For example:

First: Carryovers are limited to situations involving (i) the complete liquidation of 80 percent or more owned subsidiaries, (ii) tax-free exchanges qualifying under section 359 (c), or (iii) tax-free statutory mergers or consolidations qualifying under section 354 (b).

Second: Tax-free exchanges under section 359 (c)—assets for stock are subject to various limitations, including a limitation on the relative sizes of the participant corporations which in effect prevents the exchange being tax-free if 1 corporation is more than 4 times the size of the other (the 25 to 400 percent requirement).

Western Union feels that section 381 is too narrow in scope. The 3 situations section 381 embraces by no means cover all the tax-free exchanges authorized by H. R. 8300, and no good and sufficient reason suggests itself for limiting section 381 to these 3. In addition the 25 to 400 percent relative size limitation appears unrealistic, arbitrary, and without precedent in current or earlier law.

The feature which Western Union feels to be most objectionable, however, is that the tests which must be met, whether the exchange occurred before or occurs after the enactment of the law, are the new rigid tests prescribed by section 381 (a). In other words, though a particular corporate acquisition was completely tax-free under the Internal Revenue Code of 1939, if it did not, by coincidence, happen to meet the new tests, the carryover relief prescribed by section 381 will not be available.

This Western Union believes to be unfair and unjustifiable.

Western Union in 1943 acquired all of the assets of the old moribund Postal Telegraph system in exchange for Western Union stock and an assumption of certain liabilities of Postal. The Bureau ruled the exchange to be tax-free under section 112 (b) (4) and section 112 (g) (1) (C) of the Internal Revenue Code of 1939. Among the obligations assumed by Western Union (which assumption did not reduce the consideration otherwise agreed to between the parties) was Postal's obligations to its retired pensioners and their beneficiaries under the Postal pension plan. The effect of H. R. 8300 unless appropriately modified by this committee would appear to deny Western Union a deduction under the Internal Revenue Code of 1954 for pensions paid Postal's former employees and their beneficiaries. This retroactive effect is wholly unjustified and calls for prompt and authoritative correction.

This necessary correction can effectively be made in either of two ways.

First, amend section 381 (a) (2) by adding thereto the following new subparagraph:

"(C) a reorganization qualifying under section 112 (g) of the Internal Revenue Code of 1939, as amended, with respect to which no gain or loss was recognizable under section 112 (b) (3) or section 112 (b) (4) of the 1939 Code, as amended."

Second, amend section 381 (c) (16) by inserting as the second sentence of that paragraph the following:

"A corporation acquiring the assets of one or more transferor corporations in a transaction constituting a reorganization under section 112 (g) of the Internal Revenue Code of 1939, as amended, upon which the recognition of neither gain nor loss was properly recognized, is an acquiring corporation under this section, and such an acquiring corporation shall, without otherwise qualifying under subsection (a) hereof, be entitled to apply this paragraph with respect to amounts paid or accrued after December 31, 1953, on account of such obligations of the distributor or transferor corporation or corporations."

A third way to effect the necessary correction would be removal of the irrational 25 to 400 percent requirements contained in section 359 (c) (1). The limitation upon the time within which any transferor must be liquidated which is contained in section 359 (c) (2) should also be removed. Western Union mentions this as an alternative method, but does not urge it, inasmuch as it goes beyond what is necessary to do equity in this case.

OFF-SHORE FISHING VESSEL OWNERS ASSOCIATION,
Astoria, Oreg., April 5, 1954.

Re H. R. 6721

Senator GUY CORDON,
Senate Office Building,
Washington, D. C.

DEAR SENATOR: We understand Mr. King of California has introduced the above-numbered bill wherein fishermen will be classified with farmers as to their filing estimated tax returns, and which would clear up a lot of arguments we have here with the Internal Revenue Code.

As you know, tuna fishing particularly does not start until about July 1, which is the third quarter, and many boats do not settle with the canneries until Thanksgiving or later. It is impossible for them to technically comply with the Internal Revenue Code and we are continually arguing regarding this matter.

It would be appreciated greatly if the omnibus revision bill could be amended to include this provision. Trusting you understand the difficulties of our fishermen.

Yours very truly,

A. H. WRIGHT,
Managing Secretary.

[H. R. 6721, 83d Cong., 1st sess.]

A BILL To extend to fishermen the same treatment accorded farmers in relation to estimated income tax

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 60 (a) of the Internal Revenue Code is hereby amended by inserting after the word "farming" the words "or fishing".

SEC. 2. Section 294 (d) (2) of the Internal Revenue Code is hereby amended by inserting after the word "farmers" wherever appearing therein, the words "or fishermen".

SEC. 3. The amendments made in sections 1 and 2 shall be effective for taxable years beginning after December 31, 1952.

TENSION ENVELOPE CORP.,
New York, N. Y., April 6, 1954.

Senator WARREN G. MAGNUSON,
Senate Office Building, Washington, D. C.

DEAR SENATOR MAGNUSON: Thank you very much indeed for your most cordial letter of March 22, in answer to mine of March 11, in which I sent you my suggested method of eliminating double taxation on dividends.

I have sent a copy of this to every Member of the Senate, but I would like very much indeed to have this placed in the files at the hearing of the Senate Finance Committee.

I was advised to contact Mrs. Elizabeth B. Springer, who is chief clerk of the Senate Finance Committee, in order to present my case, but I am not doing so because time and energy are not sufficient for the purpose. Enclosed are additional copies of the plan, and I would deeply appreciate it if you would present these to the Senate Finance Committee with your recommendation that they be placed in the records.

There is one consistent criticism of my plan, and that is such relief from taxation to corporations it might be regarded as a tax on undistributed profits which was thrown out in the 1930's. This is not a valid criticism for the following reasons:

1. A small corporation can dividend out all of its profits and avoid corporate taxes and have its stockholders, after paying their personal taxes, reinvest the net receipts in the corporation in the form of additional stock on a book value basis. This will enable them to eliminate the double taxation and yet maintain working capital.

2. Calling this a tax on undistributed profits is simply a matter of reverse thinking. This is not an additional tax but a reduction from a present tax to avoid double taxation on the same income. Corporations should pay taxes on profits not distributed just as partners have to pay the personal income taxes on profits of partnerships even though such funds are retained in the partnership. If and when the corporation dividends these previously undistributed profits, in any other year up to the extent of the profits made in that year, the corporation will obtain full tax credit.

3. My suggestion is fair to all corporations, large or small, and is simple to understand by the taxpayer and is easy to audit by the Treasury Department.

If possible I would appreciate hearing from you at my New York address, which is the Warwick Hotel, 65 West 54th Street, New York 19, N. Y., where I will be until April 12.

Kindest regards,

Cordially,

WALTER J. BERKOWITZ.

TENSION ENVELOPE CORP.,
Kansas City, Mo.

Subject: House Ways and Means Committee Consideration of Revenue Revision Bill of 1954.

DEAR SIR: The Ways and Means Committee has presented a recommendation for tax changes, and this badly needed reform will probably be approved by the House of Representatives to the extent that the Government budget will permit.

I would like to call your attention to one seemingly small but very important part of the tax program—the proposed relief from double taxation on dividends.

Unquestionably, the corporations should be relieved of part if not all of this double taxation, but the Ways and Means Committee has suggested that tax relief should go to the individual stockholders and not to corporations and this is the point I wish you would examine most carefully.

Bear in mind that there are 50 million taxpayers and only 6 million stockholders, so that the proposed relief affects only a small percentage of the voting public of this country. But the 6 million stockholders, most of whom are employed, are far more dependent on the prosperity of the corporations who employ them than on whether they have a tax saving on their dividends. Jobs are their social security, and whatever can be done to protect and increase the number of jobs in this country is far more important to our economic welfare than a reduction in taxes on dividends received.

Based on research by the Brookings Institution, corporations produced over one-half of our national income in 1948 (54.3 percent), noncorporate income was about one-third (33.6 percent), and Government and other income was 12.1 percent. Of the 594,243 corporations in that year, 94.17 percent had incomes of less than $100,000. And less less 1 percent of them had incomes of $1 million or more. So corporations are not all big businesses.

Corporations in that year paid in wages and salaries, including officers, 40.3 percent of the national income, while noncorporate business paid 11.4 percent. The profits of corporations totaled 13.8 percent of the national income of which 5.8 percent was paid in taxes, while noncorporate income showed profits of 17.8 percent of national income, and nothing was paid in taxes.

These two types of enterprise, corporate and noncorporate, are competing with each other, and the fairness of your legislative action should be to relieve the corporations of part, at least, of this burden of taxes which partnerships do not have to pay.

Corporations now pay tax on all profits whether paid out in dividends or retained in surplus. Partnerships pay no tax as such, but the partners must pay tax on all of their share of the profits, even if retained as working capital in the partnership. The double taxation on corporate dividends occurs only when dividends are paid and then the stockholder must pay a personal tax on such dividends which are part of the profits on which the corporation has already paid its corporate income tax.

A perfectly fair method of treating corporations would be to relieve them of corporation taxes on that part of their earnings which were paid in dividends. In other words, regard dividend payments, when figuring taxes, exactly as if they were expense items such as interest on bonded indebtedness. The receiver of the dividends then pays full taxes on them.

Dividends paid by corporations in 1952 were a little over $8 billion, and if they are the same in 1954 and corporate income taxes remain the same at 52 or 47 percent or any compromise in between, the Federal Government will be collecting from the corporations on dividends paid approximately $4 billion, while on similar profits from partnerships on noncorporate organizations they would collect nothing.

If tax relief were given to the corporations on dividends paid, this relief could begin at 25 percent, then 50 percent, then 75 percent, and then 100 percent as the Federal Government could afford to do so, but every reduction in taxation in this field would increase the financial strength of the corporations and would help insure continuing jobs and an expanding economy in both production and distribution. That is the basis of our prosperity, and anything we could do toward fostering the welfare of these corporations would benefit our entire economy.

The proposal of the Ways and Means Committee to give tax relief to the receiver of dividends would, in my opinion, lead to further confusion.

We already have the absurd situation where income from State and municipal bonds are tax-free, while income from Federal Government bonds are fully taxable. This really is a Federal Government subsidy to States and municipalities in order to enable them to borrow money at a lower rate. If constitutionally possible, this absurd situation should be corrected and income from State and municipal bonds should pay the same tax as Federal Government bonds.

Income from wages and salaries and from corporate bonds and corporate stocks now have the same rate of taxation. Why should the dividends from corporation stocks of these 6 million stockholders pay a lower rate of taxation than the 50 million taxpayers pay on income from wages and salaries?

It is quite possible to foresee the complete elimination of double taxation on dividends if this reduction in taxes is given to corporations but limiting it to that part of their profits which are paid out in dividends and on which the Federal Government then collects personal income taxes. But it is hard to conceive a tax situation where dividends on stocks would be completely tax exempt. If that situation arose, who would buy bonds of any kind, including Government bonds, and pay taxes on the income? It would stimulate speculation in the stock market, and would depress the bond markets, and lead to losses by those who put their confidence in unsound corporations but who were overeager for tax savings.

If stock dividends were tax free, or if the recommendations of the House Ways and Means Committee were put into effect, business managers who had accumulated enough stock to pay them a reasonable tax-free income would be tempted to retire at an early age and get their incomes from tax-free corporate dividends rather than fully taxable wages or salaries.

To foster the American way of life, the tax relief should not favor receivers of dividends over the workers' salaries and wages. Double taxation on dividends is unfair, and this situation should be corrected by giving partial or full tax relief to corporations, but only on that part of their earnings which are actually paid in dividends.

Please consider this logical, sound basis of relieving or eliminating double taxation on dividends paid as preferable to the method suggested by the Ways and Means Committee which is simply a stopgap subsidy and not a permanent cure and may lead to other situations as unfair or more so than the ones we are trying to correct.

Cordially yours,

WALTER J. BERKOWITZ.

CORPORATIONS AND NONCORPORATE BUSINESS

(By Walter J. Berkowitz, secretary-treasurer, Tension Envelope Corp., Kansas City, Mo.)

To the average person, and in accordance with the expressions of the average news editor, the word "corporation" connotes large business with large profits, while noncorporate business, such as partnerships, refers to the little fellow trying to get along in a difficult world.

Let us compare corporations and noncorporate business from the standpoint of income compared to our national income. And the years 1929, 1940, and 1948 are excellent for this purpose.

The following figures are based on a Brookings Institution pamphlet dated 1954, titled "Big Enterprise in the Competitive System" by A. D. H. Kaplan:

The national income in 1929 was about $80 billion, and was nearly the same in 1940. But in 1948 it had increased to $215 billion.

The origin of this national income was:

	1929	1940	1948
	Percent	*Percent*	*Percent*
From corporations	51.7	51.9	54.3
From noncorporate business	36.5	32.9	33.6
From Government and other sources	11.8	15.2	12.1

This shows a rising tendency in the national income from corporations, and a declining one from noncorporate business.

Wages and salaries paid:

	1929	1940	1948
	Percent	*Percent*	*Percent*
Corporations (not including officers)	34.6	35.8	37.3
Corporations (including compensation to officers)	38.4	39.4	40.3
Noncorporate business	10.8	10.6	11.4

This indicates that corporations are paying an increasing share of the wages and salaries while noncorporate business remains at pretty much the same level.

Compensation of officers of corporations, which usually is thought of as a tremendous amount in the minds of the public, actually—in terms of national income, has declined from 3.8 percent in 1929 to 3.6 percent in 1940 to 3.0 percent in 1948. Salaries of corporation officers are kept separate in making this comparison because in noncorporate businesses very often the wages of management, which correspond to compensation of officers in corporations, is combined with profits.

The surprising comparison, however, is in profits:

	1929	1940	1948
	Percent	*Percent*	*Percent*
Corporation net profits after taxes	9.9	7.5	8.0
Corporation net profits after taxes plus compensation to officers	13.7	11.1	11.0
Noncorporate profits	15.9	15.6	17.8

Corporation profits after taxes, including compensation of officers, are declining in terms of national income, while profits from noncorporate business are increasing and are actually far greater in total amount than profits from corporations. In 1948 there were 594,243 corporations of which 94.17 percent had profits of less than $100,000, and less than 1 percent had incomes of $1 million or more.

Federal income taxes on profits in terms of national income:

	Percent
Corporations:	
1929	1.6
1940	3.5
1948	5.8
Noncorporate business	None

From these figures we can readily see that the economy of this country in terms of wages and salaries paid is dependent upon corporations over three times as much as noncorporate business, yet corporations are heavily taxed and noncorporate business, as such, is not taxed at all. Corporation profits in 1948 were only about one-half those received by noncorporate business.

Another interesting comparison of these figures: In the year 1948 the net profits of corporations (after taxes plus the compensation of officers) were only 30 percent of wages and salaries paid to corporate employees, while in noncorporate business the profits were 156 percent of compensation paid to its employees.

How much of this unbalance is due to the tax program of the Federal Government can only be estimated, but it seems perfectly obvious that the double taxation on dividends and the high corporate tax, has made many profitable business enterprises (which could do so) avoid the corporate for the noncorporate structure.

Pinpointing the comparison of corporations to the noncorporate business, it is obvious that for many years corporations have been penalized by excessive taxes, not only normal and surtaxes, but excess-profits taxes. Then the stockholders of these corporations who received dividends paid a second tax. Compared to this, the partnerships and other noncorporate business, as such, paid no tax whatever to the Government, and the owners of noncorporate businesses paid only one tax which was their personal income tax.

The first relief in this excessive taxation on corporations has already been accomplished with the elimination of the excess-profits tax. From the standpoint of fairness we should not count that in our comparison, because that was simply an added burden placed on corporations because they were taxable and the Government needed money. It was not done from the standpoint of fairness. It was grossly unfair. Corporations simply bore the burden of war costs out of all proportion to their rightful responsibility, just as those men in the armed services bore a far greater burden of the war than the average citizen who was not in any of the armed services. It was "just one of those things."

Now how can corporation taxes be reduced, and how can double taxation on dividends be partially or fully eliminated so as to be fair to corporations who are furnishing such a vast percentage of our national income in wages and purchasing of goods and services, and such a vast percentage of the Federal tax income on which the Government operations depend? Bear in mind that in the year 1952 corporations paid over $21 billion in taxes of the total income to the Government of $67 billion, and partnerships and noncorporate business paid nothing.

Individual income taxes for both the corporate stockholders and the owners of noncorporate businesses have already been reduced 10 percent. Corporation taxes, which are still at the 52 percent level, should be reduced to 47 percent and they probably will if the Government can afford to be without this tax income. But from the standpoint of justice and not expediency, the corporations should be placed on a 47 percent tax basis for the year 1954.

The difficult problem is how to partially or completely eliminate the double taxation on corporate dividends. This solution is now offered: The Federal Government should allow corporations to regard as expenses in calculating taxes for any fiscal year, all dividends paid in that fiscal year.

This change might have to take place gradually, beginning now with 25 percent of dividends paid, next year 50 percent, and the next year 75 percent, and the next year 100 percent. Dividends paid by corporations in 1952 totaled over $8 billion. If the same dividends were paid in 1954, and the entire amount were allowed to be deducted as an expense, and corporation taxes were approximately 50 percent, the Government would reduce its income by approximately $4 billion. If now only 25 percent of the dividends paid were allowed as a business expense deduction, then the Government income from this source would be reduced only $1 billion. But the relief from double taxation on corporate dividends would have been started, and step by step full elimination of this double taxation could be accomplished.

All corporation profits are taxed. The double taxation on these profits occurs only when dividends are paid. Therefore, the elimination of this double taxation can logically be accomplished by deducting as corporate expense the amount of dividends paid, which then becomes subject to personal income taxes by the receivers of these dividends.

Such tax relief to corporations will encourage dividend payments more effectively than the threat of section 102, and thus increase taxes from personal incomes. It will give such relief only in periods when profits are made, because the reduction is only in corporate income taxes. It will not cause dividends from reserves in a nonprofit period to make tax reductions at a time when the Government needs income desperately.

There is a plan of tax relief before Congress today which would give a reduction in taxes to the individual who receives corporation dividends. It would make corporation dividends partially tax exempt while income from wages and salaries were fully taxable. It is an unwise method of solving this problem, although it is an honest attempt to eliminate the unfairness of double taxation on dividends. But it will not help the corporations who are the backbone of our economic strength and the largest source of Federal revenue.

Business needs more working capital to expand our economy, create more jobs, maintain and increase our living standards. Individuals with funds are seeking investment. The New York Stock Exchange is advertising "Own your own share of America business," meaning to invest in common stock of corporations listed on stock exchanges.

But during the past 7 years, corporations have borrowed from banks, insurance companies, and the issuance of bonds, $40 billion while they have raised only $11 billion from the sale of their stocks.

Double taxation on dividends surely accounts for the trend by the corporations who want to secure money with interest expensed at a great tax saving. When corporate taxes totaled 82 percent, a $4 interest charge reduced surplus only 72 cents. With corporate taxes now at 52 percent, a $4 interest charge reduces surplus by less than $2. A $4 dividend reduces surplus by the full $4.

Corporations offer investment opportunity and the stronger the corporations are financially the safer is this investment. A tax reduction to corporations on dividends paid is a constant incentive for corporations to pay more dividends and the stock becomes that much more profitable to its owner.

It is safer for a corporation to obtain working capital from stock sales which do not have to be refunded than from bonds or notes that must be repaid at a definite time. Eliminating corporate taxes on dividends paid will allow corporations to afford to sell more stock and pay higher dividends.

Economic security is the crying need of today—both by the individual, by business, and by the Government. All are depending on each other, and their interests are the same from the overall economic picture. Individuals want assurances of livable incomes now, after retirement, and during unemployment. Corporations have no assurance of continued profitable operation.

The Federal Government has taken upon itself not only to insure bank deposits but in fact to underwrite the entire economy. But there is no insurance that the Federal Government income can be maintained in good times and in bad. When the income does not equal the outlay, the Government relies on its credit to balance the budget. It is now seeking ways and means to increase its debt limit at a time when our economy is in high gear.

This suggested plan for eliminating double taxation on dividends will help stabilize Federal tax income by adding financial strength to corporations who are the most important source of Federal tax income.

This suggested plan is easy to understand and apply and simple to audit and could and should be put into effect partially or wholly at the earliest possible time, and the groundwork for it should be laid by the 85th Congress.

Laws To Stabilize Our Economy

(By Walter J. Berkowitz, secretary-treasurer, Tension Envelope Corp., Kansas City 8, Mo.)

It should be possible, by wise legislation, to stop inflationary tendencies without causing any marked deflation.

For example, some price supports of agricultural products, excessive payments of unemployment insurance which cause marginal cases of malingering (and consequent reduced production), the use by banks of the ownership of Federal bonds to increase their lending rates, and the excess-profits tax or high corporation taxes insofar as they encourage profligate spending beyond sound business judgment to avoid its payment, are inflationary facts which were fostered by former legislation.

Repealing or amending these laws will reduce the inflationary impetus without encouraging a real deflation, such as a national economic collapse or a lack of confidence in the value of our dollar or in the financial stability of our Federal Government, or a rumor (based on some facts) that a depression was imminent.

We must assume that at this particular time we need to stabilize the value of the dollar without a great disturbance in the value of commodities and services. Labor wants to hold its gains in hour rates, but does not want to lose its purchasing power by increases in prices. Industry wants to keep costs at no higher than present levels, yet wants no break in its price levels for goods and services. The consuming public wants to retain its income and be able to buy at least the same goods and services as at the present time.

So the most important act in keeping the inflationary and deflationary forces in balance is to repeal or amend all legislation that in itself is tending to unbalance the price level in the present and future as it has in the past.

We all agree that peace is preferable to war and have learned to ignore the interests of the comparative few who profit by war for the benefit of the many who are aided by peace.

The same attitude should be taken toward inflation and deflation—both benefiting a few (but not necessarily the same few), and bringing harm to many. Both must be avoided if possible, and the course of legislation must be to make no new laws that would cause either inflation or deflation, and correct all present laws which are now upsetting the delicate balance.

During the past two decades many acts of Congress were definitely and willfully inflationary. In the early thirties these were necessary to pull the country out of a devastating deflationary period. But once the balance was attained, the laws should have been changed.

The medicine that cures a fever in a patient should be discontinued when the patient's temperature becomes normal.

Federal laws which are based on our Constitution must and should be fair to all citizens. Corporations, partnerships, pensioners, trust estates, life-insurance policyholders, investors in stocks, investors in corporate bonds, investors in State and municipal bonds, and investors in United States Government bonds and other securities are all citizens or represent the rights and property of citizens. Legislation should not favor one over another, even though any individual might have rights in several of these classifications.

LAWS TO STABILIZE OUR ECONOMY

Writing of laws that are constitutional and hence fair to all is a difficult task and the men who make them must be sincere and wise and of honest purpose. Knowledge of economic laws is vital in this process.

The need for revenue must not blind our legislators to the fairness of any law to all its citizens or to the ultimate results of such law on our economy. They must remake old laws and draft new ones to carry out the farsighted plans for a strong economy to support a healthy, educated, liberty-loving people capable of defending their country and its freedom at all times.

THE NATIONAL BANK OF MIDDLEBURY,
Middlebury, Vt., April 2, 1954.

Re Nondeductibility for income tax of gifts to many Vermont cemetery associations

Hon. GEORGE D. AIKEN,
Senator From Vermont,
Washington, D. C.

DEAR SENATOR AIKEN: As you know, Vermont has many small cemeteries cared for by nonprofit and nonsalaried associations, except for labor, and not connected with any church. Where the cemetery is under any church gifts via the latter are deductible.

A substantial gift was received a few years ago by the West Cemetery in Middlebury Village and when the donor was later informed that his gift was not deductible he stopped giving to the cemetery although he has made frequent gifts to a local church, the community house, and the hospital.

I am treasurer of the little cemetery just south of New Haven Mills. Since 1927 we have been able to accumulate an endowment of over $4,000. Though most of the families with relatives buried there are gone and lost track of and new burials are rare.

It would be a fine thing for our State (and other States) if the cemeteries were given greater care. I feel sure that tax deductibility of gifts would help to bring this about and would seem to be the spirit of the law if not the legal interpretation of it.

Do you think it feasible to have the internal revenue law changed so that gifts to nonprofit cemetery associations, similar to many in Vermont, are deductible?

Sincerely,

PHELPS N. SWETT.

UNITED STATES SENATE,
COMMITTEE ON ARMED SERVICES,
April 6, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Finance Committee,
United States Senate, Washington, D. C.

DEAR MR. CHAIRMAN: Enclosed is a memorandum submitted by Mr. Merrill R. Bradford of Bangor, Maine with respect to the capital gains treatment to timber interests, section 117 (k) (2) of the Internal Revenue Code.

I would appreciate it if the Finance Committee would give full consideration to the memorandum and to Mr. Bradford's proposed change of section 631 (b) of the proposed Internal Revenue Code of 1954. This is a matter of most serious concern to one of the most important industries in the State of Maine.

Sincerely yours,

MARGARET CHASE SMITH,
United States Senator.

TAX TREATMENT OF TIMBER PROCEEDS UNDER SECTION 631 (B) OF H. R. 8300

In addition to perpetuating the present discriminatory tax treatment accorded timber owners and other persons having the right to cut and sell timber for their own account, section 631 (b) of H. R. 8300, as presently drawn, would add still another form of discrimination against such persons. No explanation was given for the discriminatory treatment accorded timber proceeds when the timber provisions of the Internal Revenue Code were amended in 1951, and no explanation has been given for this new form of discrimination. It is submitted that there is no satisfactory or rational explanation for this discriminatory treatment and it is strenuously urged that both of these discriminatory provisions be changed so that timber proceeds receive equality of treatment.

Under the present tax law[1] taxpayers owning timber or having the right to cut and sell timber for their own account are discriminated against in the following respect:

Where a contract to mine coal is executed, the coal mined thereunder is not regarded as having been disposed of until it is actually removed from the mine. Thus, the seller is taxed at capital-gain rates as to all coal removed more than 6 months after the mine or the right to mine and sell such coal was acquired. However, where a contract to cut timber is executed the timber is regarded as being disposed of at the time of the execution of the contract, rather than when the timber is cut and removed. Thus, if the seller owned the timberland or the right to cut and sell the timber for less than 6 months, he is foreclosed from ever receiving capital-gains treatment for any payments received under that contract.

For example, on January 2, 1954, A acquires ownership of timberlands or the right to cut and sell timber for his own account. On February 1, 1954, A grants cutting rights to B, the sales to take place and purchase price to be paid as the timber is cut. The proceeds of all sales are now taxed at ordinary income rates even though such sales occur more than 6 months after January 2, 1954. A's cutting contract with B may run for many years, and no timber may in fact be cut until years after the contract is executed. Nevertheless, if such contract is executed within 6 months of A's acquisition of the timberland or the right to cut and sell such timber for his own account all of the proceeds from timber cut and sold 25 or 50 years later will be taxed at ordinary income rates.

The provisions covering the disposal of timber and coal are found in section 117 (k). Section 117 (k) (2) was enacted to foreclose the Treasury from taking the position that payments under timber cutting contracts were taxable as ordinary income upon the ground that such cutting contracts were really leases of the timberland.[2] To prevent this result, Congress provided in section 117 (k) (2) that as the timber was cut the gain attributable thereto should be considered gain upon the sale of timber. To describe the periodic cutting of timber, Congress referred to "the disposal of timber."

The Tax Court, in Springfield Plywood Corporation,[3] however, as an alternative ground for its decision, erroneously took the position that "disposal" does not refer to timber as it is actually cut, but instead refers to the contract of sale. The decision may be explained by an erroneous concession by taxpayer that the case would be lost if the word "disposal" did not mean sale. It is plain from the statute that the word "disposal" does not mean sale. The phrase "disposal of timber," however, refers to the actual cutting of timber.

In 1951 this error was compounded. The Senate Finance Committee, in an effort to prevent discrimination between coal and timber, added a provision to section 117 (k) (2) to the effect that the date of disposal of coal or timber should be deemed to be the date the coal is mined or the timber is cut rather than the date of the contract.[4] However, when the revenue bill of 1951 went to the committee of conference of the House and Senate, the amendment was retained with regard to coal, but omitted with regard to timber. No explanation for this is given by the report of the conferees.

In addition to denying capital-gains treatment wherever a contract to cut timber is entered into less than 6 months prior to the acquisition of the timberland or the right to cut such timber, this interpretation of section 117 (k) (2) also denies capital-gains treatment to any taxpayer who acquires timberlands

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[1] Sec. 117 (k) (2).
[2] Revenue bill of 1943, S. Rept. 1044 Cum. Bull. 098.
[3] 15 T. C. 697 (1950).
[4] Revenue Act of 1951, supplemental report of the Committee on Finance. United States Senate, 1951 Cum. Bull. 488.

subject to a cutting contract, or who acquires a cutting contract already in existence. The disposal of timber would have occurred when the contract was originally made, at which time the taxpayer did not own the timber or have the right to cut it. Thus, he cannot be regarded as having disposed of the timber.

For example, A contracts to sell timber under a cutting contract over a 10-year period. Three years later, A dies and B inherits the cutting contract. B cannot report gain on the sale of the timber as capital gain under section 117 (k) (2) because the timber is regarded as disposed of when A obtained the cutting contract, and therefore, there can be no disposal by B. B, thus, is taxed at ordinary income rates on his gain. If this had been coal which B had sold, he would have been taxed at capital-gain rates. All transferees of timber-cutting contracts, whether by purchase, liquidation, gift or death, are denied capital-gains treatment for gains realized under cutting contracts—notwithstanding the fact that section 117 (k) (2) was passed to insure that payments under cutting contracts would receive capital-gains treatment.

Section 631 (b) of H. R. 8300 not only perpetuates this discriminatory treatment of timber proceeds, but also adds a new form of discrimination, as follows: Where a contract to mine coal is executed by any person who owns an economic interest in coal in place, including a sublessor, capital-gains treatment is available under section 631 (b) of H. R. 8300. But where a similar contract to cut timber is executed by a person having the right to cut and sell timber for his own account, the benefits of section 631 (b) of H. R. 8300 are not available.[5]

Under the existing statute (sec. 117 (k) (2)), a person having the right to cut and sell timber for his own account is not foreclosed from establishing that he was an owner within the meaning of the statute and hence entitled to its benefits. At the present time the Treasury is reportedly attempting to construe the term "owner" very narrowly. Nevertheless, persons having the right to cut and sell timber for their own account who dispose of their rights under cutting contracts whereby the timber is cut and paid for periodically will almost certainly be able to establish, either to the ultimate satisfaction of the Treasury, or to the satisfaction of the courts, that they are owners within the meaning of the statute and therefore entitled to its benefits.

As has been already noted, section 117 (k) (2) was originally enacted to prevent the Treasury from holding that the timber-cutting contract is in reality a lease and hence the payments under it must be taxed as ordinary income. This argument would apply as well to any person having the right to cut and sell timber for his own account and who sold or assigned his rights under a so-called cutting contract—the Treasury could argue that this was in reality a sublease.[6] Therefore, it is clear that Congress intended the word "owner" to include persons having the right to cut and sell timber for their own account and who sell or assign such rights under cutting contracts.

Moreover, under the present statute it can be argued very forcefully that any person who holds an economic interest in timber must be regarded as an owner under section 117 (k) (2).[7] The holder of a contract right to cut timber has an economic interest in the timber for purposes of the depletion deduction.[8] It is very difficult to see why a different standard should be applied here, so that such a person would be denied the benefits of section 117 (k) (2).

Section 631 (b) of H. R. 8300, therefore, will probably prevent a very substantial group of taxpayers from enjoying in the future the benefits of the timber-cutting provisions which are now available to them. At the same time, section 631 (b) extends the benefits to persons possessing exactly the same rights in respect of coal, despite the fact that there is absolutely no basis upon which to distinguish between these two groups of taxpayers.

Even if it could be said that under the present law persons having a contract right to cut timber for their own benefit could not enjoy the benefits of the timber provisions (a very remote possibility), there is no basis for extending such treatment under the new code to coal interests and denying it to timber interests.

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[5] Internal Revenue Code of 1954, House report, p. A190.

[6] It is clear that so-called cutting contracts and like agreements are not leases or subleases, and that it is the intention of Congress that they not be so construed. However, in the interests of avoiding all future litigation and disputes with the Treasury, and in view of the terminology used in sec. 631 (b) of H. R. 8300 with respect to coal, the same terminology, including the term "sublessor," has been employed in part in the proposed amendment to sec. 631 (b) of H. R. 8300 submitted below.

[7] Steel, Timber Cutting and Timber Sales Under Sec. 117 (k) of the Internal Revenue Code, 30 Oreg. L. Rev. 306, 317–318 (1951).

[8] S. R. 7705, V–1 Cum. Bull. 260 (1926).

The encouragement of proper conservation practices with regard to timber has become more and more important for this country. The long-term cutting contract plays a leading role in any conservation program. In view of this fact it is particularly unfortunate that the owner of such a contract—whether as original owner of the land or as a transferee of such a contract—is discriminated against in these respects.

LEGISLATIVE REMEDY

It is respectfully submitted that the third, fourth, and fifth sentences of section 631 (b) of H. R. 8300 should be amended to read as follows (language to be omitted from the House bill is bracketed and additions are in italics):

"[In the case of coal,] This subsection shall not apply to income realized by any owner *of coal* as a co-adventurer, partner, or principal in the mining of such coal [, and the word owner means any person who owns an economic interest in coal in place, including a sublessor]. In the case of coal, the word owner means any person who owns an economic interest in coal in place, including a sublessor, *and in the case of timber, the word owner means any person who owns an economic interest in standing timber, including a sublessor or any person having the right to cut and sell timber for his own account.* The date of disposal of such *timber or* coal shall be deemed to be the date *such timber is cut or* such coal is mined."

It is further respectfully submitted that such amendment be applicable to taxable years ending after December 31, 1950 (whether the contract was made on, before or after such date), and to all amounts received or accrued after such date. This was the applicable date of the Revenue Act of 1951 which amended the statute as to coal. Such an effective date would remove all traces of discrimination between coal and timber.

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT,
Philadelphia 7, Pa., April 5, 1954.

Hon. EUGENE D. MILLIKEN,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKEN: On behalf of the Committee on Revision of the Laws of the Judicial Conference of the United States, of which committee I am chairman, I desire to present to your committee some suggested amendments, mostly perfecting in nature, to H. R. 8300, the bill to revise the internal revenue laws which recently passed the House of Representatives and is now before your committee for consideration.

Our committee has been particularly concerned with assisting in the program of Congress to revise and enact into positive law the various titles of the United States Code. This is a program of great interest and value to the bench and bar of the United States. H. R. 8300 completely revises and enacts the subject matter of the present title 26 of the United States Code but as passed by the House of Representatives does not refer to that title or purport to enact it into law. On the contrary it makes a confusing and ambiguous description of the act as comprising the "Internal revenue title." Our committee accordingly strongly recommends that the preliminary enacting section of the bill be amended so as specifically to enact the provisions of the bill as "Title 26, Internal Revenue," of the United States Code.

Our other suggestions for amendment have to do with certain provisions relating to the Tax Court of the United States. Two of these are purely perfecting in nature. In section 7444 (c) the judge who is to preside in a division of the court of more than one judge is designated as "chief." This is an inappropriate designation and is also ambiguous in view of the existence of the office of chief judge of the court. We suggest that the designation "presiding judge" be substituted. In section 7446 the word "meetings" is used to denote the sessions of the Tax Court and its divisions for the hearing of cases. "Meetings" is not an appropriate word for this purpose and we suggest the substitution of "sessions." I think that both of these are inadvertent survivals from the language used when the court was called the Board of Tax Appeals and should be changed in line with present nomenclature.

In section 7483 periods of 3 and 4 months are prescribed for instituting proceedings for the review by a court of appeals of a Tax Court decision. The use of months as a measure of time for this purpose is unfortunate since it creates an ambiguity in view of the varying lengths of individual months. In the Federal Rules of Civil and Criminal Procedure days are used as the measure for determining the period for appeal. This provides a precise standard. We suggest that this precedent be followed and that 90 and 120 days be substituted for 3 and 4 months in this section.

Finally we suggest that the customary notice of appeal be substituted for the petition for review as the method of instituting a proceeding for the review of Tax Court decisions. Under section 7482 (a) of the bill those decisions are to be reviewed "in the same manner" as the decisions of the district courts in nonjury cases with which they are closely analogous and in which review is by notice of appeal filed in the trial court. The petition for review of a Tax Court decision is not a true petition since no answer is ever filed to it, and no allowance of it is ever required. It is in reality no more or less than a notice of appeal setting out the jurisdictional facts. In order to carry out the mandate of section 7482 (a) for uniformity of procedure in tax cases and to avoid all ambiguity we would, therefore, suggest that sections 7481 (1), 7481 (2), 7482 (c) (2), 7482 (c) (4), 7483, and 7485 (a) be amended to substitute "notice of appeal" for "petition for review."

To accomplish the changes above suggested the relevant sections of H. R. 8300 might be amended as follows:

1. Amend the enacting section on pages 1 and 2 of the printed bill to read:

"*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,* That (a) CITATION.—

"(1) The provisions of this Act set forth under the heading [Internal Revenue Title'] *'Title 26, Internal Revenue'* may be cited as *'Title 26, United States Code'* or the 'Internal Revenue Code of 1954'.

"(2) The Internal Revenue Code enacted on February 10, 1939, as amended, may be cited as the 'Internal Revenue Code of 1939'."

"(b) PUBLICATION.—This Act shall be published as volume 68A of the United States Statutes at Large, with an appendix and index, but without marginal references. The date of enactment, bill number, public law number, and chapter number, shall be printed as a headnote.

"(c) CROSS REFERENCE.—For saving provisions, effective date provisions, and other related provisions, see chapter 80 (sec. 7801 and following) of the Internal Revenue Code of 1954.

"(d) ENACTMENT OF [INTERNAL REVENUE] TITLE INTO LAW.—The [Internal Revenue] Title referred to in subsection (a) (1) is *enacted into law as Title 26 of the United States Code* as follows:

"[INTERNAL REVENUE TITLE] *TITLE 26, INTERNAL REVENUE*

* * * * * * *"

2. Amend classification of chapter 75, subchapter C, part I, preceding section 7441 to read:

* * * * * * *

"SEC. 7446. TIMES AND PLACES OF [MEETINGS] *SESSIONS*."

* * * * * * *

3. Amend the first sentence of section 7444 (c) to read:

"(c) DIVISION.—The chief judge may from time to time divide the Tax Court into divisions of one or more judges, assign the judges of the Tax Court thereto, and in case of a division of more than one judge, designate the [chief] *presiding judge* thereof."

4. Amend section 7446 to read:

"SEC. 7446. TIMES AND PLACES OF [MEETINGS] *SESSIONS*.

"The times and places of the [meetings] *sessions* of the Tax Court and of its divisions shall be prescribed by the chief judge with a view to securing reasonable opportunity to taxpayers to appear before the Tax Court or any of its divisions, with as little inconvenience and expense to taxpayers as is practicable."

5. Amend classification of chapter 75, subchapter D, preceding section 7481 to read:

* * * * * * *

"SEC. 7483. [PETITION FOR REVIEW] *NOTICE OF APPEAL*.

* * * * * * *

6. Amend section 7481 (1) to read:

"(1) Timely [Petition for Review] *Appeal* Not Filed. Upon the expiration of the time allowed for filing [petition for review] *notice of appeal*, if no such [petition] *notice of appeal* has been duly filed within such time; or

7. Amend section 7481 (2) to read:

"(2) Decision Affirmed or [Petition for Review] *Appeal* Dismissed.—

"(A) Petition for certiorari not filed on time.—Upon the expiration of the time allowed for filing a petition for certiorari, if the decision of the Tax Court has been affirmed or the [petition for review] *appeal* dismissed by the United States Court of Appeals and no petition for certiorari has been duly filed; or

"(B) Petition for certiorari denied.—Upon the denial of a petition for certiorari, if the decision of the Tax Court has been affirmed or the [petition for review] *appeal* dismissed by the United States Court of Appeals; or

"(C) After mandate of Supreme Court.—Upon the expiration of 30 days from the date of issuance of the mandate of the Supreme Court, if such Court directs that the decision of the Tax Court be affirmed or the [petition for review] *appeal* dismissed."

8. Amend section 7482 (c) (2) to read:

"(2) To make rules.—Such courts are authorized to adopt rules for the filing of the [petition for review] *notice of appeal*, the preparation of the record for review, and the conduct of proceedings upon such review."

9. Amend section 7482 (c) (4) to read:

"(4) To impose damages.—The United States Court of Appeals and the Supreme Court shall have power to impose damages in any case where the decision of the Tax Court is affirmed and it appears that the [petition] *notice of appeal* was filed merely for delay."

10. Amend section 7483 to read:

"SEC. 7483. [PETITION FOR REVIEW] *NOTICE OF APPEAL*.

"The decision of the Tax Court may be reviewed by a United States Court of Appeals as provided in section 7482 if a [petition for such review] *notice of appeal therefrom* is filed by either the Secretary (or his delegate) or the taxpayer within [3 months] *90 days* after the decision is rendered. If, however, a [petition for such review] *notice of appeal* is so filed by one party to the proceeding, a [petition for review of] *notice of appeal from* the decision of the Tax Court may be filed by an adverse party to the proceeding within [4 months] *120 days* after such decision is rendered."

11. Amend section 7485 (a) to read:

"(a) Upon [Petition for Review] *Appeal*.—Notwithstanding any provision of law imposing restrictions on the assessment and collection of deficiencies, the review under section 7483 shall not operate as a stay of assessment or collection of any portion of the amount of the deficiency determined by the Tax Court unless a [petition for review] *notice of appeal* in respect of such portion is duly filed by the taxpayer, and then only if the taxpayer—

"(1) on or before the time his [petition for review] *notice of appeal* is filed has filed with the Tax Court a bond in a sum fixed by the Tax Court not exceeding double the amount of the portion of the deficiency in respect of which the [petition for review] *notice of appeal* is filed, and with surety approved by the Tax Court, conditioned upon the payment of the deficiency as finally determined, together with any interest, additional amounts, or additions to the tax provided for by law, or

"(2) has filed a jeopardy bond under the income or estate tax laws.

If as a result of a waiver of the restrictions on the assessment and collection of a deficiency any part of the amount determined by the Tax Court is paid after the filing of the review bond, such bond shall, at the request of the taxpayer, be proportionately reduced."

We trust that the foregoing suggestions may be helpful to your committee.

Sincerely yours,

Albert B. Maris.

Mississippi Title Insurance Co.,
Jackson, Miss., April 8, 1954.

Hon. John C. Stennis,
United States Senator, Washington, D. C.

Dear Senator Stennis: The new tax bill provides for a dividend tax credit (5 percent this year and 10 percent in 1955 and later). There is another section in the bill which expressly denies the new dividend tax credit to stockholders of all insurance companies.

The argument apparently was that insurance company earnings get easier tax treatment than other corporate earnings. This argument may apply to life insurance companies. It certainly does not apply to title insurance companies or to fire or casualty companies. Title insurance companies are not only taxed just like other corporations, but in fact have long actually been discriminated against in that they are not permitted any deductions for unearned premiums. To now further burden such companies by denying to their stockholders the benefit of the new dividend tax credit would be grossly unfair and unjust.

The casualty and fire companies are making an effort to remove the inequity insofar as such companies are concerned. What we fear is that in writing any amendment for such companies no one will think to include by specific designation title insurance companies. These companies do not maintain a lobby there and are generally forgotten when revisions are made.

In addition to the above the new law should provide where State statutes require title insurance companies to set up reserves for losses or unearned premiums that such amounts are not subject to income tax.

You will know just the right persons with whom to personally confer to secure results and any special help you can give us now will be greatly appreciated.

Sincerely yours,

O. B. Taylor,
President.

The Titusville Herald,
Titusville, Pa., March 9, 1954.

Senator James H. Duff,
Senate Office Building, Washington, D. C.

Dear Senator Duff: There appears to be a very serious omission in the tax package approved by the Ways and Means Committee of the House and I am writing to you to see if the matter can be corrected when the legislation reaches the Senate.

The bill allows corporations to make a fast tax writeoff of money they spend to buy new production machinery. As far as it goes this is a fine thing and will definitely help to spur business out of the present mild recession. The writeoff provision should be broadened, however, by including new building—new plants, new factories which will house production machinery.

The obsolescence of plant in this Nation will no doubt be found far greater than the obsolescence of production machinery. Thus, any incentive for a new industrial building should result in tremendous activity.

Especially here in Pennsylvania, one of the older States, do we realize how out of date our industrial buildings are. In New England it is even worse. In the more newly settled parts of the country there was a great deal of war-born construction, much of it spurred by the quick writeoff device. Pennsylvania is in competition with those regions and greatly needs any stimulus for new construction.

Many times editors write on subjects about which they do not possess too much knowledge, but in this instance I know what I am talking about. The Herald is published in a building that is 86 years old this year. We could do a better job in a new plant but we can't afford to do it under the present schedule of taxes. Two other industries about which I am well informed in this little town are earning hundreds of thousands of dollars annually but they cannot put aside enough money to expand their plant. They are forced to borrow. If the proportion of industry with building problems on its mind is as great throughout the State as it is here in this community of 9,000—and I have no doubt that it is—a provision in the tax laws to spur new building should certainly touch off a business expansion the likes of which this great old State has not seen since the days when it was growing out of its clothes every year.

I ask that you give this matter your most serious attention.

Very truly yours,

James B. Stevenson,
(For the Titusville Herald.)

UNITED STATES SENATE,
April 5, 1954.

Hon. EUGENE MILLIKIN,
United States Senate,

DEAR GENE: Enclosed is a memorandum which has been furnished me, outlining the necessity for excluding personal service partnerships having no capital and owning no assets from the provisions of section 736 of H. R. 8300. There is some question whether personal service partnerships are within the scope of section 736, and if the intent is to exclude them, the section may require a clarifying amendment.

Sincerely yours,

HUGH BUTLER, U. S. S.

MEMORANDUM RE H. R. 8300

The following discussion relates to section 736 and 751 (more particularly sec. 736) of H. R. 8300.

In reading these sections in the light of the report of the Committee on Ways and Means, it is believed:

(1) That these sections do not apply to a personal service partnership having no capital and owning no assets; that, if so, then in the interest of clarification, subparagraph (B) of paragraph (1) of (a) of section 736 should be amended with the prefatory words, "except as to personal service partnerships having no capital and owning no assets," so that such paragraph (B) shall read:

"Except as to personal service partnerships having no capital and owning no assets, with respect to payments made more than 5 years after the partner's retirement or death, be included in the distributive share of the remaining partners (without increasing the adjuliisted basis of their interest in the partnership) and excluded from the gross income of the recipient."

(2) In the event that the foregoing sections, and particularly section 736, should be considered to include personal service partnerships having no capital and owning no assets, then and in that event, in order to recognize the realities in connection with such a partnership and the well established law of the country, said paragraph (B) heretofore referred to should be amended as above set out.

In reading sections 736 and 751 in the light of the report of the Committee on Ways and Means, it is apparent that, inherent in these sections is contemplated a partnership possessing capital or assets, or both. The discussion of the intent of the Ways and Means Committee with respect to the foregoing begins on page 70 of the report of that committee. It is stated on page 70: "* * * and at the same time to prevent the use of the sale of an interest in a partnership as a device for converting rights to income into capital gain."

As appears clearly from a reading of pages 70, 71, and 72 of the report, this basic purpose was to be accomplished by treating certain enumerated types of income separately insofar as taxes are concerned, from the sale of a retired or deceased partner's interest in the partnership. This is made apparent in paragraph (B) above referred to of (a), section 736, by the words in parenthesis, "(without increasing the adjusted basis of their interest (of remaining partners) in the partnership)."

In paragraph (1) on page 70 of the report, the committee states:

"Under present decisions the sale of a partnership interest is generally considered to be a sale of a capital asset, and any gain or loss realized is treated as capital gain or loss. It is not clear whether the sale of an interest whose value is attributable to uncollected rights to income gives rise to capital gain or ordinary income."

Basically, it is apparent that the committee was considering the item of "uncollected rights to income". The committee made it clear by this expression that it had reference (par. (2), p. 70 of the report) to unrealized receivables or fees, and/or substantially appreciated or depreciated inventory or stock in trade.

In the third paragraph on page 71 of the report, in referring to "unrealized receivables or fees", the committee stated:

"The provision is applicable mainly to cash basis partnerships which have acquired a contractual or other legal right to income for goods or services."

Obviously, since the committee uses as a basis of its considerations under paragraph (1), page 70 of the report, "uncollected rights to income," and the right of the partnership which represented a contractual or other legal right to income for goods or services, it meant at the retirement or death of a partner where goods had been sold, but not paid for, and the consideration was represented by an unrealized receivable or the services had been rendered but the fee not paid at the time of retirement or death, these, along with defined appreciated or depreciated inventory or stock in trade, as referred to in third paragraph on page 71, constituted the basis of section 736 of H. R. 8300.

Here is a statement by the committee of its intent with respect to section 736 that what it was dealing with in this section of H. R. 8300 was certain things, and only these things, exclusive of actual purchase and sale of retired or deceased partner's interest in the partnership, and these things consisted of appreciated or depreciated inventory or stock in trade and unrealized receivables and unrealized fees. All of these things were predicated upon an existing condition at the time of retirement or the death of a partner.

In the second paragraph, on page 71 of the committee's report, it states: "A decedent partner's share of unrealized receivables and fees will be treated as income in respect of a decedent."

That is, in the case of a retired or deceased partner, if goods had been sold and there existed at the time an unrealized receivable, or if services had been rendered at the time but there exists in payment therefor, an unrealized fee, that for 5 years, under subparagraph (A) of paragraph (1) of (a), section 736, the payments when received for a period of 5 years would be treated as income to the recipients, but after 5 years, these limited sources of income as enumerated above, would no longer be taxable to the recipients under ordinary income-tax rates, but would be taxable to the remaining partners without the right of deduction as to amounts paid to the designees of a deceased partner or to a retired partner. This is made again manifest by (E) at the bottom of page 71 of the report, in which it is stated, in referring to section 736:

"When a partner retires or payments are made to the estate or heir of a deceased partner, the amounts paid may represent several items. They may, in part, represent the withdrawing partner's capital interest in the partnership; they may include his pro rata interest in unrealized receivables and fees of the partnership and its potential gain or loss on inventory."

Again, on page 72 of the report, among other things, the committee stated:

"For this purpose payments for a 'capital interest' do not include amounts attributable to a partner's interest in unrealized receivables and fees, amounts paid for substantial appreciated or depreciated inventory, and amounts paid for good will in excess of its fair market value."

The committee further states:

"A different treatment is provided for the portion of payments to a withdrawing partner which is not made in exchange for capital interest of such partner. Such payments are treated as distributive share of partnership income to the withdrawing partner. Thus, they are taxable to the withdrawing partner in the same manner as if he continued to be a partner and are excluded in determining the income of the remaining partners."

This is, under the bill, permitted for a period of 5 years and thereafter, the remaining partners, without a purchase or sale, are taxed at ordinary income-tax rates, and without the right of deduction with respect to such unrealized receivables and fees and appreciated or depreciated inventory or stock in trade.

Section 736, undoubtedly, recognizes the rule that the property, of whatever character, which becomes part of the estate of a deceased for estate-tax purposes, is property owned by the deceased at the time of his death. Manifestly, this section recognizes the contractual ownership of a deceased partner in unrealized receivables and unrealized fees and appreciated or depreciated inventory or stock in trade at the time of death, and that, therefore, these items would become a part of the estate of the deceased and would be subject to estate tax. In other words, this section is dealing with items that are owned, or in which the deceased partner has a contractual right at the time of his death. All of this becomes clear in the statement of the committee, second paragraph, page 71:

"A decedent partner's share of unrealized receivables and fees will be treated as income in respect of a decedent. Such rights to income will be taxed to the estate or heirs when collected, with an appropriate adjustment for estate taxes."

Thus, it is apparent that the plain intent of the committee was to deal with a partnership having capital or assets, or both, and that the intent was to separate specifically unrealized receivables and unrealized fees, as defined above, and appreciated or depreciated inventory or stock in trade, from the assets of the partnership, which would be the subject of a purchase and sale.

This memorandum, however, deals, not with a partnership possessing capital or assets, or both, but only with a personal service partnership that possesses neither capital nor assets. With respect to unrealized receivable or fees, in the absence of subparagraph (A), of paragraph (1) of (a), section 736, such items would be treated as part of the assets of the partnership and would be the subject of purchase and sale. Subparagraph (A) changes the situation for a period of 5 years. This memorandum, however, treats only with distributions from a personal service partnership having neither capital nor assets, of future unearned contingent profits, which would eventuate, if ever, following the retirement or death of a partner. They would have no relationship to a transaction that occurred prior to the retirement or the death of a partner. They would constitute, under the definition and discussion of the committee, unrealized receivables or fees, and, naturally, could not refer to appreciation or depreciation of inventory or stock in trade, since such a partnership would have no inventory or stock in trade.

Clearly, if personal service partnerships, having no capital and owning no assets, were covered by section 736 and section 751, there would be a plain discrimination between such partnerships and those having capital and assets, because in the case of the latter, the partnership agreement could provide for the payments of unrealized receivables and unrealized fees and appreciated and non-appreciated inventory or stock in trade, for a period of 5 years, with the right of the remaining partners to deduct from the income of the partnership arising from such sources, amounts paid to the recipients, and then provide, at the end of 5 years, a purchase and sale of the retired or deceased partner's interest. Thus, after 5 years, where the remaining partners could not deduct payments to the retired partner or deceased partner's estate, they would, in turn, get the assets that belonged to the retired or deceased partner, whereas, with respect to a personal service partnership, without capital or assets, there could be no sale, since there is nothing to sell and the remaining partners would pay income taxes at ordinary income-tax rates on future contingent unearned profits for the period of the agreement. Manifestly, this would be not only unsound but very unfair.

The purpose of this memorandum is neither to evade nor avoid taxes. Its purpose is solely, with respect to any payments of future possible contingent profits earned, if ever, after the retirement or death of a partner by a personal service partnership having no capital nor assets, to establish that, under those circumstances, income tax at ordinary income tax rates should be paid by the recipients of such future contingent profits, and not by the remaining active partners.

This is in line with the realities with respect to such a partnership and according to the well-established law of this country for the following reasons:

In the case of a personal service partnership having neither capital nor assets, there can be—

(1) No sale of the interest of a partner in a personal service partnership, having neither capital nor assets.

Bull v. *United States* (295 U. S. 247, 79 L.Ed. 1421, 1426).

Whitworth v. *Commissioner* (204 Fed. (2d) 779, 783 (C. C. A. 7th), cert. denied, 98 L. Ed. 64).

Boyd C. Taylor Estate (17 T. C. 627. Decision 18,560. Affirmed, 200 Fed. (2d) 561 (C. C. A. 6th) (on authority of *Bull* v. *U. S.* supra).

(2) Future unearned speculative profits are wholly contingent and cannot be income or property at time of death or retirement.

United States v. *Safety Car Heating and L. Co.* (297 U. S. 88 L. Ed. 500, 504, 507).

North American Oil Consolidated v. *Burnet* (286 U. S. 417, 76 L. Ed. 1197, 1200).

Workman v. *Commissioner* (41 Fed. (2d) 139, 140, 141 (C. C. A. 7th)).

Carol F. Hall, et al. v. *Commissioner* (19 T. C. 445, Decision 19346. Promulgated December 11, 1952).

Commissioner v. *Oates* (207 Fed. (2d) 711 (C. C. A. 7th), affirming 18 T. C. 570).

Commissioner v. *Edwards Drilling Co.* (95 Fed. (2d) 719, 720 (C. C. A. 5th)).

(3) No good will attaches to the person of a partner in a personal service partnership.

M. M. Gordon, et al. v. *Commissioner* (9 T. C. 203. Decision 17,547 (M). Entered March 14, 1950).
The Danco Company (14 T. C. 276. Decision 17,503).
John Q. Skunk v. *Commissioner* (10 T. C. 293. Decision 16,253).
Providence Mill Supply Co. (2 B. T. A. 791, 793).
Northwestern Steel and Iron Corp. (6 B. T. A. 119, 124).

(4) To include such partnerships in the proposed sections would violate the "Claim of Right" doctrine.

North American Oil Consolidated v. *Burnet* (286 U. S. 417, 424, 76 L. Ed. 1197, 1200).
Commissioner v. *Wilcox* (327 U. S. 404, 408; 90 L. Ed. 752, 755).
In re Lashells' Estate (208 Fed. (2d) 430, 435. (C. C. A. 6th). December 4, 1953).

(5) The contingent right to future contingent income or profits is not a capital asset. (See cases under point (2) supra.)

It is apparent from the foregoing that if personal service partnerships having no capital or owning no assets, should not be covered by sections 736 and 751, that to prevent misunderstanding and confusion, the amended paragraph (B) as set out on page 1 hereof should be adopted.

Respectfully submitted.

WESTERN WRITERS OF AMERICA,
Minneapolis 7, Minn., April 7, 1954.

Mrs. ELIZABETH B. SPRINGER,
Clerk, Senate Finance Committee,
Washington, D. C.

Dear Mrs. SPRINGER: Our paper this morning carries the information that public hearings on the omnibus tax revision bill will start before the Finance Committee day after tomorrow, and I would like to submit a statement for the hearings, which I hope can be incorporated in the compiled record.

We—meaning members of the Western Writers of America, and 14,000 other writers who have endorsed our work on tax spread—are very much disappointed that the House Ways and Means Committee has ignored every bit of testimony we have offered in regard to the leveling of income. The old section 107 (b) is incorporated as the new section 1302 in H. R. 8300, and it seems a little bit astonishing that the members of the House committee allowed me to spend several hundred dollars of my own money making a trip to Washington, when it seems rather obvious that they did not pay any attention to the testimony which was offered.

It is manifestly unfair that a few writers—in this case some 20,000—are required to pay far more than their share of taxes. These conditions we have endured ever since the income-tax laws became a part of the revenue structure.

There are two reasons why this situation should not be allowed to continue: 1, it is unfair to assess one man's efforts on the sole basis of the time at which he receives the money for his efforts, because those efforts may extend back many years; 2, a writer's income is highly fluctuating, and this is a situation over which he has no control; our records show that members of the WWA may expect a fluctuation of 300 percent to 400 percent yearly. Due to the fact that a given piece of writing may produce income from any one of a dozen different sources, writing income may and generally does bunch up and cause excessive income in 1 year, during which the writer is forced to pay income tax at a very high rate; the following year he may be back down into a very nominal income bracket.

It seems to me the failure of the Ways and Means Committee to give us any relief in this matter stems from a lack of understanding that we are asking relief for professional writers. This is the crux of the entire situation. A professional writer makes his living from writing. But section 107 (b) or section 1302 is so arranged that it applies only to amateur, casual, or incidental writers. This section might apply to a college professor who has spent 20 years or more on a book, and in this case his writing is actually more of a hobby or an incidental result of his primary occupation. But the professional writer makes his living from writing.

This section 1302 provides that if a writer spends 36 months on one work and if he gets 80 percent of his income from that work in 1 year, then he can spread it over a period of 3 years. I would like to point out with emphasis that a professional almost never spends 36 months on 1 book, and except in rare instances he does not get 80 percent of his income from that book in 1 year. We have men in the Western Writers of America who are now selling reprint rights from material that was first printed in the 1920's.

The average full-fledged professional writer figures on writing about three books a year. If all of these were sold on schedule and steadily, then there would be no difficulty with income. But that is not true. It happens occasionally, but more often books fail to sell and hang fire in New York for a long time and then the writer is deluged with a group of sales that come all at once.

The writer is an independent contractor. His real difficulty is that he contracts almost entirely on speculation. A book that he writes today and for which he thinks he has a market, may not sell for 15 or 20 years. In July, 1953, I had one of those unusual accumulations of sales. At that time I made 6 book sales in 15 days. Two of these had been written in 1953, two in 1952, one in 1951, and one in 1946. How can the treasury or anybody else hold that the income from this work which had been done as much as 9 years before should be assessed at the same time as work which was done in the current year?

This is not an exceptional situation. Sales very often bunch up on a write. They also spread out and there may be long periods of time when a writer does not sell anything. It is manifestly unfair, therefore, to assess all the proceeds of his work in previous years in one lump at the current rate, which runs him into very high brackets. Earning statements from our members show that about 50 percent of the members may expect a fluctuation of 300 to 400 percent a year, and more than once the comment has been made that, "my income is just average, it varies from five to fifteen thousand dollars."

Another situation which makes for high fluctuation in writing income is the sale of subsidiary rights: movie, pocket book, foreign, serial, and others—and these too may hold off for many years and then suddenly break all at once.

This kind of taxation destroys incentive. If a man has had a number of lean years and then out of the blue has a good year from the work of former years, it is not equitable to tax him as if his income were at a steadily high bracket. We have at least one member in the WWA who limits himself to two serials a year, saying that the third one will net him only about $6,000 instead of the usual $25,000.

I enclose a list of case histories of actual earnings of members of the WWA. It seems to me the statistics offered here speak more loudly than anything I can say.

Our tax proposal, as presented to the Ways and Means Committee in Washington on August 12, provided that a reasonable base be established for a writer's average income (perhaps the previous 5 years) and that his income that exceeds such a base be deferrable under regulations to be established by the Bureau of Internal Revenue. That this deferred income be withdrawable at any subsequent time, the tax thereon to be paid either at the current rates or at the prevailing rates at the time such income was deferred.

This proposal has been endorsed by organizations totaling 14,000 writers: the National Writers Club, the Colorado Authors League, the Minneapolis Writers Workshop, the Tucson Press Club and Tucson Writers Club, the California Writers Guild, the National League of American Pen Women, the Oregon Free Lance Club, the Omaha Writers, and the following branches of the NLAPW: Eugene, Oreg.; Tulsa, Okla.; Oklahoma City, Okla.; St. Joseph, Mo.; Springfield, Ill.; Seattle, Wash.; and Reno, Nev.; and the Oklahoma State Writers, and new endorsements are coming in constantly.

Writers and other similar workers in the artistic profession have long labored under these difficulties of taxation. Cannot we convince the members of Congress that we are entitled to an honest to goodness income-leveling provision that will apply to professional writers?

I would like to point out that royalties as such are not our main source of income—this to forestall any error in legislation that might be written to cover royalties from writing. Our bigger sources of income are from serial sales in big magazines and movie sales. Most foreign sales are made on a cash basis and even some domestic hard cover sales are made on a cash basis. Therefore a provision covering royalties would leave us still out in the cold.

I would like to point out also that section 1302 takes note of "artistic work." The old section 107 (b) took note of writers, composers and artists. Therefore the Congress has taken note that men in these classes of work labor under peculiar conditions and are entitled to some tax relief. I might say it is a very strange thing to me that in the new section 1302, inventors have been given a 5-year spread as opposed to the writer's 3-year spread. Also I repeat emphatically that the 36-month and 80 percent provision does the professional writer no good whatever. In my 2 years of working in connection with income leveling I have found no professional writer whose book could come under this provision. Therefore we feel justified in asking that the Congress put us on an even basis with other taxpayers.

Sincerely yours,

NOEL M. LOOMIS, *President.*

MANUFACTURERS AND MERCHANTS MUTUAL INSURANCE CO.,
Concord, N. H., March 31, 1954.

Senator STYLES BRIDGES,
145 Senate Office Building, Washington, D. C.

DEAR SENATOR BRIDGES: The present income-tax law allows corporations to deduct from taxable income amounts equal to 85 percent of the dividends received from most corporations. However, I understand that a section of the tax revision measure specificaly denies this deduction in the case of dividends received from insurance companies. The argument, I believe, is that insurance company earnings get easier tax treatment, than other corporate earnings. However, this is not true of stockholder-owned fire and casualty companies, because we are paying Federal income tax on the same basis as other corporations, and therefore this section of the bill unfairly discriminates against such companies.

Therefore I respectively request that you look into this matter very carefully, and I sincerely hope that you will favor the elimination of the fire and casualty companies from this section of the tax bill.

Respectfully,

CARL GESEN, *Vice President.*

PEAT, MARWICH, MITCHELL & CO.,
Newark 2, N. J., April 2, 1954.

Hon. EUGENE D. MILLIKIN,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: Mr. Watson and I wish to thank you for your courtesy in making your time available to us yesterday noon.

We are convinced that, in practice, the 30-day election requirement of section 112 (b) (7) of the Internal Revenue Code has caused substantial hardship to certain shareholders of smaller corporations who have misunderstood its provisions. Our recommendation with regard thereto is set forth in the separate letter attached hereto. We shall most certainly appreciate your favorable consideration.

Sincerely yours,

IRVING J. ANGELL.

PEAT, MARWICK, MITCHELL & CO.,
CERTIFIED PUBLIC ACCOUNTANTS,
Newark, N. J., April 2, 1954.

HON. EUGENE D. MILLIKEN,
Chairman, Senate Finance Committee
Senate Office Building,
Washington, D. C.

DEAR SENATOR MILLIKIN: There appears to be a very definite inequity in the operation of section 112 (b) (7) of the Internal Revenue Code of 1939. This section was designed as a relief provision, but relief has been denied in many cases because of the requirements as to the time and manner of filing elections. The requirement has often been misunderstood, thus resulting in denial of relief on a technicality, with the end result that taxpayers have been caught in the predicament of having no cash with which to pay the tax, and the requirement has operated to defeat the basic purpose of the section, with the result that relief has been denied to the taxpayers contrary to the intent of Congress.

Stated in the simplest possible terms this section provides, in substance, that if a corporation was completely liquidated within any calendar month in 1951, 1952, or 1953, pursuant to a plan of liquidation adopted after December 31, 1950, the shareholders might elect to defer the recognition of taxable gain on all, or a portion, of the assets distributed to them. It was designed to encourage the liquidation of small companies. In practical application, section 112 (b) (7) was used only in cases where the corporation had but a very few shareholders, where the value of its assets greatly exceeded the cost basis of its stock in the hands of its shareholders, and where the accumulated and undistributed earnings were relatively small. Many of the corporations to which this section applied were family businesses which had sold out or contracted their commercial activities and found themselves to be personal holding companies, although there never was any intention to become "incorporated pocketbooks."

The section was not applicable, and relief has been denied unless the holders of 80 percent of the voting stock filed elections with the Commissioner of Internal Revenue, on form 964, within 30 days from the adoption of the plan of liquidation. This did not mean 30 days from the date of the distribution of the assets, but 30 days from the date on which the shareholders voted to liquidate the corporation. There have been cases where the benefits were denied to the shareholders solely because of the failure to file form 964 within the 30-day period. It seems clear that this 30-day requirement has operated to defeat the purpose of section 112 (b) (7); that it has placed an extreme hardship on the shareholders, and that there is no valid reason for such a limited period of time.

The Bureau has a printed form letter for the sole purpose of denying relief under section 112 (b) (7) because the so-called election form 964 was not timely filed. This fact, standing by itself, is sufficient proof that in practice many shareholders have been denied the benefit of section 112 (b) (7) because of the 30-day limitation period.

Realizing the inherent injustice of this situation, the Commissioner of Internal Revenue (John B. Dunlap) appeared before the Joint Committee on Internal Revenue Taxation on April 4, 1952, and reported that there were some 600 taxpayers, the former shareholders of 200 corporation, who were in this predicament. Of these totals, 340 shareholders of 112 corporation had placed their written elections in the mail on or before the 30th day after the adoption of the plan of liquidation, but these elections had not been received in the Bureau until after such 30th day. Mr. Dunlap stated that these shareholders would be taken care of by a ruling (T. D. 5898) which would announce that an election, if placed in the mail on or before midnight of the 30th day, as shown by the postmark, would be considered, by the Bureau, as timely filed. This concession, however, did not apply to the 260 shareholders of 88 corporations where the elections were not mailed within the 30-day period. Undoubtedly this number has grown to some extent since the date of the Commissioner's announcement. In this connection, it is significant that, on average, the 200 corporations (which must be deemed to be typical of those to which section 112 (b) (7) was intended to apply had but 3 shareholders.

If Congress is to grant relief to any taxpayers by retroactive amendment to the Internal Revenue Code of 1939, to cover situations where experience has shown that the provisions thereof have been inequitable, the matter discussed herein should be given serious consideration. It is believed that the Internal Revenue Code of 1939 should be amended by eliminating the requirement that the election to be taxed under section 112 (b) (7) should be made and filed "within 30 days after the adoption of the plan of liquidation" and inserting, in lieu thereof, the requirement that the election must have been made "on or before the due date of the return of the shareholder for the taxable year during which the corporation was liquidated." As a matter of justice to the 260 taxpayers, referred to above, the proposed amendment should be made effective for all liquidations made in pursuance of a plan of liquidation adopted after December 31, 1950.

The effect on the revenues of the Treasury would be insignificant, inasmuch as the number of taxpayers involved is small, and the net effect of section 112 (b) (7) is only to defer the realization of taxable income until such time as the property received on the liquidation of the corporation shall have been sold. In principle, this treatment is similar to the basic concept set forth in section 331 of H. R. 8300. Congress has often granted retroactive relief when it appeared necessary to the equitable administration of the tax laws, certain provisions of the Revenue Acts of 1942 and 1951 being noteworthy examples.

This amendment would place the election under section 112 (b) (7) on the same basis as other elections. In general, it appears that Congress, by specific provision in the code, and the Commissioner, by his regulations, have provided that elections which taxpayers are required to make, if they are to be entitled to various forms of relief, shall be made and filed with the tax return for the taxable year as to which such election is made. Attached hereto as appendix I is a list of some of the more common elections which are required to be made with such returns.

It is interesting to note that a similar proposal appears in the Recommendations for Improvement of Federal Tax Legislation and Administration submitted to the Committee on Ways and Means of the House of Representatives by the American Institute of Accountants under date of January 5, 1953. Recommendation No. 31 states, in part, as follows:

"Section 112 (b) (7) (D) required that shareholders desiring to enjoy the benefits of the section file a written election within 30 days after the adoption of the plan of liquidation. The present requirement is too rigorous and does not allow enough time for many taxpayers desiring to enjoy the advantages of section 112 (b) (7) to inform themselves about the plan. It is recommended that shareholders, or the liquidating corporation, be allowed to exercise the election privilege up to the time of the filing of the return for the taxable year involved. This needed correction should be made effective for years beginning after December 31, 1950."

To afford relief to those taxpayers who have been caught in the "trap" of section 112 (b) (7), as it is now written, it is recommended that section 391 (a) (1) of H. R. 8300 shall be amended, as set forth on appendix II, to read as follows:

"(1) Part II of this subchapter shall be effective only with respect to distributions made in pursuance of a plan of partial or complete liquidation adopted after March 1, 1954, *and the provisions of the Internal Revenue Code of 1939 shall be applicable to distributions made in pursance of a plane of liquidation adopted before March 1, 1954, except that the last sentence of section 112 (b) (7) (D) thereof shall be read as if, effective as to plans of liquidation adopted after December 31, 1950, the words 'on or before the due date of the return of the shareholder for the taxable year during which the corporation was liquidated' had been substituted for the words 'within thirty days after the adoption of the plan of liquidation;' and*"

Words italicized added to language of bill as passed by the House.

Respectfully submitted,

IRVING J. ANGELL.

APPENDIX

PARTIAL LIST OF ELECTIONS TO BE MADE WITH RETURN

Code section	*Election relative to—*
22(b)(9)	Income from discharge of indebtedness.
22(d)	Adoption of elective (lifo) method of valuing inventories.
23(k)	Adoption of reserve method for bad debts in case of banks (Mim. 6247).
23(bb)	Capitalization of circulation expenses by newspapers (or January 1, 1952, if first return filed prior to that date).
23(cc)(2)	Development expenses of mines.
24(a)(7)	Capitalization of real-estates taxes and carrying charges.
28(d)	Consent dividends credit (but not later than due date of return).
42(b)	Increment on United States savings bonds.
44(c)	Adoption of installment basis of accounting.
112(f)	Involuntary conversions (presumably based on language of House Committee report on Revenue Act of 1951).
112(m)	Gains from sales to effectuate policies of Federal Communications Commission (or 6 months after enactment of Revenue Act of 1943 as to transactions prior to January 1, 1944).

PARTIAL LIST OF ELECTIONS TO BE MADE WITH RETURN—Continued

Code section	*Election relative to—*
117(k)	Capital gain on cutting of timber.
124(b)	Deduction of amortization of emergency facilities.
125(c)	Amortization of bond premiums.
141	Filing of consolidated returns by affiliated corporations.
162(c)	Deduction of expenses of estate of decedent.
361	Taxation as a regulated investment company.
437(b)	Computation of excess profits credit on historical invested capital method.
449	Exemption of personal service corporation from excess profits tax.
455	Use of accrual method of accounting by taxpayers on installment sales basis—for excess-profits-tax purposes.

Four elections may be exercised or changed after the return has been filed, as follows:

Code section	*Election relative to—*
23(aa)	Standard deduction—with return but election may be changed after filing of return at any time prior to the running of the statute of limitations (with certain limitations).
51(g)	Joint return of husband and wife—with return, but election may be changed within 3 years from due date of return (with certain limitations).
131(a)	Foreign tax credit—at any time prior to the running of the statute of limitations on claim for refund.
451	Capitalization of advertising expenditures for excess-profits-tax purposes—6 months from due date of first return due after June 30, 1950.

APPENDIX II

PROPOSED AMENDMENT TO H. R. 8300

Section 391(a)(1) should be amended to read as follows:

"(1) Part II of this subchapter shall be effective only with respect to distributions made in pursuance of a plan of partial or complete liquidation adopted after March 1, 1954, *and the provisions of the Internal Revenue Code of 1939 shall be applicable to distributions made in pursuance of a plan of liquidation adopted before March 1, 1954, except that the last sentence of section 112 (b) (7) (D) thereof shall be read as if, effective as to plans of liquidation adopted after December 31, 1950, the words 'on or before the due date of the return of the shareholder for the taxable year during which the corporation was liquidated' has been substituted for the words 'within thirty days after the adoption of the plan of liquidation;' and*"

Words italicized added to language of bill as passed by the House.

THE NATIONAL INDEPENDENT MEAT PACKERS ASSOCIATION,
Washington, D. C., April 2, 1954.

SENATE FINANCE COMMITTEE,
Washington, D. C.

GENTLEMEN: You have announced that you will receive written statements on the subject of tax revision. We have two points to make.

First, the transportation as applied to agricultural products seems to conflict with what we understand to be the policy of our Government; namely, to give consumers more spending power. The transportation tax on live animals, meat and meat products tends to increase the cost to consumers of these basic food items. Why should it be made difficult for farmers to market readily the products of the farm? And why should it be made more expensive for people to buy food?

Second, the tax on luggage should be eliminated. To place a burden on the hides used in luggage hurts not only the consumers but the producers and processors of live animals.

Yours very truly,

WILBUR LA ROE, JR.

DRAFT OF STATEMENT BY GENE DIXON FOR THE SENATE FINANCE COMMITTEE—PERCENTAGE DEPLETION FOR KYANITE

I am Gene Dixon, president and treasurer of Kyanite Mining Corp. in Cullen, Va. My company and Commercialores, Inc. in Clover, S. C., are the only two producers of domestic kyanite. Kyanite is very similar in chemical composition and end use and is generally used to improve the properties of ball clay, sagger clay, china clay, and refractory and fire clay. My purpose in appearing before you is to urge you to extend to kyanite the 15 percent depletion rate which is now allowed to these minerals I have just named.

Kyanite is used as a major ingredient in the production of welding rod coating, refractory fiber glass, electrical porcelains, Mullite lines of refractory, crucibles, glass tanks, and automatic glassmaking machine parts, superduty plastics, 2,800 degrees to 3,000 degrees insulators, saggers, kiln furniture, vitreous china bodies, cements and mortars, and undoubtedly in the production of aircraft jet engines, since some of the orders we receive carry priority and are marked 100 percent aircraft.

Kyanite is used in the manufacture of superduty refractories. Although these refractories represent only a small percentage of the total tonnage of refractories used in the United States, they occupy a most important position in that field because of their special properties. Some of these properties are the high melting point, the low coefficient of expansion, and the resistance to loads at high temperature, to thermal shock and to the corrosive action of certain fluxing agents.

Suitable deposits of kyanite are comparatively rare in the United States, the only two deposits now being exploited commercially are in Clover, S. C., and Cullen, Va. Prior to the development of these domestic deposits, the United States was completely dependent on imported kyanite. India and Kenya, East Africa, are the only two countries to export substantial quantities of the material. During the last few years, however, exports from both of these countries have been dwindling seriously both in quality and quantity, and the importance of domestic kyanite correspondingly increased.

The Munitions Board has included kyanite among the minerals listed as strategic and critical, and it is one of the materials which has been stockpiled when available. On two occasions it has been placed under allocation. In 1951, the National Production Authority organized a Kyanite and Mullite Industry Advisory Committee.

It is imperative that the producers of this mineral have advantage of percentage depletion in order to continue to supply our nation with its ever-increasing demand for this most important, strategic, and critical material and to encourage continued exploration and search for additional suitable deposits.

Furthermore, the percentage depletion allowance should be extended to kyanite as a matter of justice. Kyanite is used in competition with, and along with, many other minerals already enjoying percentage depletion, such as bauxite, graphite, vermiculuite, bentonite, feldspar, talc, pyrophyllite, and ball, sagger, china, refractory, and fire clay. It is very similar in chemical content to bauxite, ball, sagger, china, refractory, and fire clay, all of which are, as is kyanite, combinations of aluminum oxide and silicon dioxide. All of these silicate materials are used as refractory products in the steel, glass, chemical, and other industries.

Kyanite is in fact considered and used as a "refractory clay" by the ceramic industry. For this reason, application was made to the Bureau of Internal Revenue last year to determine whether kyanite could be classified as refractory and fire clay for the purpose of the percentage depletion allowance. While conceding that on the basis of use Kyanite should be included in the general classification of refractory and fire clay, the Bureau ruled that it could not be so included because mineralogically kyanite is not clay. Thus we are denied equal treatment with producers of competitive materials almost identical to ours only because, to quote from the Bureau's ruling, "Kyanite is a natural metamorphic mineral with a definite composition, while clay is a residual or sedimentary mixture of minerals, although both are basically aluminum silicates and may be used for the same purpose in some cases * * *."

Our hazards of mining our deposits are generally much more complex and involved than that of mining bauxite and other minerals now receiving the 15 percent depletion allowance.

We, therefore, ask that kyanite be accorded equal treatment and that it be included in the list of minerals entitled to 15-percent depletion allowance.

CRYSTAL PALACE ROLLER RINK, INC.,
Philadelphia, Pa., April 4, 1954.

Senator EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR MILLIKIN: Allow me to commend and thank you for your, and the Finance Committee's, championing the cause of tax-burdened children inasmuch as the swimming-pool and skating-rink industry is concerned; as recorded in the Congressional Record of Wednesday, March 24, 1954, in your presentation of H. R. 8224 to the Senate (p. 3536, 1st col., 2d last par.). Believe me, Senator Millikin, we are grateful.

In all of our presentations to the House Ways and Means Committee and to Mr. Gemmill of the Treasury Department, we stressed the fact that our industry pledged itself as far as possible to revert the tax reduction back to these children. I have attached hereto a photograph of a poster which I posted in my place of business last Wednesday, March 31, 1954; and can assure you of cooperation in the greater portion of our industry throughout the Nation.

Even though H. R. 8224 (excise-tax-reduction bill) has given the majority of our industry tax relief, I find that in H. R. 8300 (Internal Revenue Code of 1954) again the inequity has been inserted on page 445, under chapter 33, subchapter (a), section 4233, exemptions, paragraph 4:

"MUNICIPAL SWIMMING POOLS, ETC.—Any admissions to swimming pools, bathing beaches, skating rinks, or other places providing facilities for physical exercise, operated by any State or political subdivision thereof or by the United States or any agency or instrumentality thereof—if the proceeds therefrom inure exclusively to the benefit of the State, political subdivision, United States, agency, or instrumentality. For the purposes of this subsection the term "State" includes Alaska, Hawaii, and the District of Columbia * * *"

The inequity still remains, and since those that are still taxed are dealing just as much with children and helping to curb juvenile delinquency as those of our industry that have been freed from the tax burden, and the amount of revenue loss to the Government would be negligible (approximately $200,000), this inequity should be erased.

It is plain that an advantage is being taken of these children who have a tax imposed upon them by the Federal Government for the privilege of participating in the sports of skating and swimming where that sport happens to be the one of their choice. In no other participating sport does this imposition exist. And this also is imposed upon them only if they decide to patronize a privately owned, instead of municipally owned and operated, enterprise.

I am attaching an editorial from our monthly magazine, The Skating News of April 1954, which I think you will find interesting.

Again I ask you, Senator Millikin, to please consider removing this tax burden from the children and at the same time erase the gross inequity as far as private enterprise is concerned, in the Finance Committee study of H. R. 8300. This can be done simply by using the wording of H. R. 3421, a copy of which I have also attached.

I feel that the committee will be quite busy with the hearings, and therefore will not take any of its time for oral testimony unless it would be desired. However, I would like to file a statement for the record.

Thanking you for your indulgence in so long a letter, but I think you feel we have a just cause.

Very truly yours,

ARTHUR E. LITZENBERGER,
Chairman, Legislative Committee, R. S. R. O. A. of America, and Participating Sports Association of America.

[H. R. 3421, 83d Cong., 1st sess.]

A BILL To amend section 1701 (d) of the Internal Revenue Code to provide that the tax on admissions shall not apply in the case of admissions to privately operated swimming pools, skating rinks, and other places providing facilities for physical exercise

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 1701 (d) of the Internal Revenue Code (relating to exemptions from the admissions tax in the case of municipal swimming pools, etc.) is hereby amended to read as follows:

"(d) SWIMMING POOLS, ETC.—Any admissions to swimming pools, bathing beaches, skating rinks, or other places providing facilities for physical exercies; or".

SEC. 2. The amendment made by this Act shall apply only with respect to amounts paid on or after the first day of the first month which begins more than ten days after the date of enactment of this Act for admission on or after such first day.

WASHINGTON, D. C., *April 7, 1954*.

Tax testimony

Senator EUGENE D. MILLIKIN,
Senate Office Building,
Washington, D. C.

DEAR SENATOR MILLIKEN: I herewith enclose testimony which I wish to present for your hearing at the present time on the new proposed tax system. Because of the number of people testifying, I was not granted permission to give this in person; so I request that it be printed in full in the findings. Many thanks.

Sincerely,

ISABEL C. MOORE.

TESTIMONY PRESENTED TO SENATE FINANCE COMMITTEE ON LOGICAL AND EQUITABLE TAX STRUCTURE FOR THE UNITED STATES BY (MRS. W. W.) ISABEL C. MOORE, DISTRICT OF COLUMBIA

A great deal of time and money has been spent overhauling the present tax system which hasn't been changed since the turn of the century, and the proposed new plan is just as antiquated, illogical, impractical, and complicated, as the present one. Like many apparently difficult problems, this one is extremely simple and could be solved in a short time, with no extra expense at all. But in our present stepped-up technological age, many people cannot comprehend the fact that anything can be done simply, and so cause themselves and millions of others great labor, hardship, and expense, unnecessarily.

With the great advances in knowledge and efficiency that the world has accomplished, our cumbersome method of acquiring taxes for public funds is unintelligent beyond all understanding. It is an excellent example of horse-and-buggy thinking in an atomic age. It is time we shook off some of the procedures of the past that don't make sense, and one of the most effective mediums through which such reforms can be accomplished, is legislators of enlightenment and vision, so I urge the Congress of the United States to give this testimony its most intelligent and conscientious consideration, and have the fortitude to take the steps which any such radical change always makes difficult, and win the unending gratitude of the people.

The first steps to take in solving any problem is to: (1) Face facts; (2) analyze them; (3) then begin at the beginning and do something.

The first fact to face is there is no such thing as taxing one classification of people to the exclusion of others. Money, to perform its function, must circulate among all people, so taxes placed on any group eventually affects all others. The money rich corporations have, comes from the average people who buy their products and invest their money in them; and then it flows back to the people in wages, taxes, and welfare grants.

The second most important fact is that all tax money comes out of the same place—the pockets of the people, and goes into the same place—local and National Government, so it is most impractical to cause people to spend countless hours and dollars in figuring, and the Government likewise in administering and enforcing, multiple taxes. In the past when people were less bright, spreading taxes over many things might have fooled some, but it deceives no one now.

The third fact is that one tax on income will ultimately be adopted, as it is the only one that makes sense, so people might as well get the benefits now.

The fourth and most important fact is that the only logical, equitable, and economical method of obtaining public funds is to have a single, uniform, tax on income with practical exemptions, which would be many less than there are now, and a reasonable floor that would insure a decent living wage intact. A part of this should be used locally and the rest nationally. The percentage of this tax should be the same, regardless of the source or amount of income. A larger percentage of larger incomes penalizes industriousness and thrift, stultifies business expansion, dangerously reduces funds needed to be set aside for future emergency and loss; it causes cheating and graft, with its accompanying large expense of law enforcement; it causes waste through unnecessary spending for bonuses, entertaining, gifts, etc., to prevent paying taxes. If people are allowed to keep money from high incomes, it is not lost to the country, but is usually put to good use through investment, business development, promotion of human welfare, etc. Adequate laws should prevent excessive profits from occurring in the first place. This money comes primarily from the general public, not corporations: and money should not be drained out of the pockets of people, especially in lower income brackets, and then taken over by the Government and spent or wasted on people, sometimes all over the world, who did nothing to earn it.

This single tax on income plan would have to be assisted with Government subsidies to prevent loss in businesses, until our economy becomes adjusted to it. This could be done by having businesses and industries sell products at the new prices established under the new tax setup, and then collect from the Government the loss they sustained through prices they had paid for products under the old tax plan.

Advantages of single tax on income system: (1) Ability to pay should be the first principle of taxation. People only have so much money to spend. If it is eaten up under a system of uncontrolled, multiple taxes, their purchasing power is reduced, and sometimes public assistance has to be given them, requiring more taxes to pay for it.

(2) It is efficient, eliminating the enormous waste of money, time, and manpower and the exasperation, the present complicated system of endless taxes takes to administer, and by individuals in figuring. This saving of money would mean a substantial reduction in tax money needed; and manpower saved could be diverted into other understaffed fields.

(3) This would be a safeguard against overtaxing anyone to the point of hardship, such as forcing people, especially in old age when income is greatly reduced, to lose their homes when they cannot pay real-estate taxes; and through sales taxes which are a hardship on large families with low incomes.

(4) A single, uniform tax would prevent many duplications and inequities now existing. Present exorbitant inheritance tax is legalized theft. To take a very large part of the earnings of a lifetime, gotten together by hard work and sacrifice, usually for the security of families, and on which income taxes have already been paid, is unjust and dishonest beyond expression.

(5) Inequitable rates for taxes on real-estate, manufactured goods, etc., could no longer exist. These cause business upsets, by diverting trade into adjoining States which have lower taxes, instead of taxes going into the States providing public services to their residents. It would prevent the moving of businesses from one location to another, with its consequent upheaval, unemployment, and hardships. It would prevent cutthroat competition. Bootlegging would be reduced as absence of taxes on liquor would cause less people to get dangerously unsupervised untaxed liquor.

(6) Present large losses of taxes to the Government through graft, fraud, and error, would be reduced, as a single tax would provide less opportunity.

(7) This system would eliminate one of the occupational hazards legislators have to bear from pressure groups, who are constantly besieging them to give their industries favorable tax consideration. Millions are spent for this, which, as always, the public pays for, in higher prices of products. The present system brings about a most undemocratic procedure in a country where everyone is supposed to have equal rights, and legislators are often helpless to do much about it, as they are required to carry out the wishes of their constituents.

(8) Multiple taxation is a vicious cycle. The more people are taxed, the more they have to be taxed, as one tax piles up on another, increasing prices for Government, businesses, and individuals, which increases the need for higher wages and more taxes to pay higher prices.

(9) A single, uniform tax helps to stabilize prices and wages, as one less fluctuating element in the establishing of cost of production and living would have to be figured. It would be much easier to figure revenue obtainable for public works. It would be more flexible when changes in the amounts of taxes are needed. Just one percentage on one tax would have to be raised or lowered.

(10) The single-tax system would end the conflict caused by being legal residents of one State, and actual residents of another. People would simply pay taxes where they actually reside, and the exact time they reside there, in return for public facilities provided them. This should apply, regardless of source of employment, such as Government officials and legislators in Washington. Additional salary or a special fund should take care of losses through dual residence because of national legislative occupation.

(11) The single tax would make a very simple matter of filling in tax forms. However, to make it as little confusing as possible, a separate item should be listed for each source of income and exemption, so that people would not have to consult books or experts on how to fill in their forms.

Respectfully submitted.

POWERS & HALL,

ROWLAND, MORRIS, BUSSE, CAIN, NEFF AND SIMON,
Detroit 26, Mich., March 15, 1954.

Hon. HOMER FERGUSON,
United States Senator,
Washington, D. C.

DEAR SENATOR: There is a proposed new provision in the 1954 income tax revision bill giving a formula for the determination of gain or loss on the foreclosure of a mortgage. A copy of the press release is attached.

Michigan, as you know, uses land contracts in lieu of mortgages and the press release on this proposed amendment gives no indication that this new provision would apply to land contracts.

As a matter of fact, the release seems to infer a mortgage arising from a loan, and not a purchase money mortgage.

The proposed change is very desirable and should be applied to purchase money mortgages as well as mortgages given to secure a loan.

And particularly for the protection of Michigan taxpayers and those residing in other States where the land contract is used, the new provision should specifically cover land contracts as well as mortgages.

I am writing to you with the hope that you may contact some member or members of the House Ways and Means Committee and have them include land contracts in this new provision so that Michigan taxpayers will receive treatment comparable to taxpayers in other States.

With my very best personal regards,

Very sincerely yours,

WILLIAM C. ROWLAND.

TRANSCRIPT FROM PRESS RELEASE BY HOUSE WAYS AND MEANS COMMITTEE OF FEBRUARY 10, 1954

"GAIN OR LOSS ON THE SALE OF PROPERTY—

* * * * * * *

"(8) The committee adopted a new treatment for mortgage foreclosures. Under the bill this recognition of gain or loss on the property foreclosed is postponed until the creditor disposes of the property. At present the creditor recognizes gain or loss on acquiring the property held as security for a loan. His gain or loss is based on the difference between the market value of the property and the basis of the loan satisfied by the creditor's artificial bid. To the extent the loan is not satisfied the creditor has a bad debt.

"Under the bill the creditor would carry over to the property acquired his basis for the loan and his gain or loss on the sale of the property would be computed on this basis. The gain or loss recognized would, or would not, be a capital gain or loss, depending on whether the original loan was a capital asset."

NEW YORK 17, N. Y., *April 7, 1954.*

Re section 270 of proposed Internal Revenue Code of 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR: This letter does not urge a revision of section 270 but only a clarifying statement in the Senate report on H. R. 8300. This action appears highly desirable because of conflicting views and uncertainty within the Internal Revenue Service.

The proposed section 270, like its prototype section 130 in the existing Internal Revenue Code, provides generally that if an individual has over $50,000 in losses in a trade or business for 5 consecutive years his taxable income for such 5 years shall be recomputed in a specified manner.

The question at hand is how to apply the $50,000 limit if a husband and wife are engaged in the same trade or business and they file a joint return. May each have losses up to $50,000 as they could if they filed separate returns or are they limited to $50,000 between them?

The statutory language seems clearly to apply the $50,000 to each individual and not to the "entity" which files a joint return. For example, similar language appears in other parts of the proposed Internal Revenue Code and in one such instance the House report specifically explains that where a joint return is filed the effect is the same as if separate returns were filed.

Thus section 116 of the proposed code excludes from gross income certain amounts "received by an *individual* as dividends". And with respect thereto the House report states:

"In cases of taxpayers who file joint returns, the exclusion will be applicable to dividends of each of the husband and wife, so that if in 1956 a husband receives $200 of dividends and his wife $100, the wife's will be fully excluded and $100 of the husband's will also be excluded in computing the aggregate income on a joint return. The same result in the case of exclusion will of course follow if separate returns are filed by the husband and wife."

Similarly section 34 (a) of the proposed Code provides in part that "there shall be allowed to an *individual*, as a credit * * * an amount equal to [a specified percentage of certain dividends received]."

The section about which this letter is written, i. e. the proposed section 270, similarly speaks of the losses of "an *individual*".

No reason occurs to us why in this instance a husband and wife should constitute "an individual" if they filed a joint return.

A recent case (*Fred MacMurray et al.* v. *Commissioner*, 21 T. C., No. 2, CCH Decision No. 19928, Oct. 9, 1953) held that it is the deductions allowable to each individual which determine whether the said section 130 is applicable. The court's opinion reads in part as follows:

"The provisions of section 130 can be applicable here only if the deductions of both spouses are blended together, for the ranch losses of each spouse for any 5-consecutive-year period under consideration were not sufficient to bring section 130 into play. Petitioners argue that the deductions of the spouses cannot be treated as a unit and point to the language of the statute, which speaks of deductions 'allowable to an individual * * * and attributable to a trade or business carried on by him.' We think that the petitioners must prevail on this issue. Here, the ranch deductions 'allowable' to Fred MacMurray simply did not meet the statutory requirement. * * * Certainly, if Fred MacMurray had operated the ranch properties in partnership with some third person, his share of the losses of the enterprise would be determinative criterion in the application of section 130 to the computation of his net income. So much has already been unambiguously stated in a recent ruling" (Revised Ruling 155, referred to above).

In view of the uncertainty within the Internal Revenue Service it is suggested that the explanation of section 270 in Senate report include the following:

"If a joint return is filed by a husband and wife who are in the same trade or business each may incur losses up to $50,000 just as if separate returns were filed."

This letter is not written for pay or other consideration or in behalf of any particular person or organization.

Respectfully,

ALBERT H. MONACELLI.

SUPPLEMENTAL STATEMENT OF ALBERT H. MONACELLI RELATING TO SECTION 71 OF H. R. 8300 DEALING WITH ALIMONY PAYMENTS

The writer is a member of the bar of the State of New York and is engaged in the practice of law in New York City.

The purpose of this statement is to point out the need of a further addition to section 71 in order effectively to carry out the intent of Congress as manifested in the Revenue Act of 1942 and as further implemented by section 71 of H. R. 8300. The proposed amendment closes an avenue which appears to evade the intent of Congress and which is currently becoming known and popular with some attorneys for some wives.

The loophole is utilized in the following manner by a wife who is living apart from the husband but not legally separated or divorced. She institutes a suit against the husband for necessaries and when a judgment is obtained the amount paid is tax free to her and not deductible by the husband.

Such a suit may be instituted by the wife annually or at such longer or shorter intervals as she in her sole discretion determines.

Section 71 (a) (2) extends the congressional philosophy on the taxation of alimony to cover payments made pursuant to a written separation agreement even though no decree of separation is obtained. This extension is made, first, because by virtue of the enactment of the privilege of filing joint returns there is no longer need to tie the alimony deduction to court cases which pass judicial inspection in order to avoid collusion between husband and wife, and, second, to prevent discrimination against husbands and wives who are separated although there is no decree of divorce or separation.

To prevent such amendment from fostering further discrimination by encouraging wives to institute actions or series of actions to recover a judgment or series of judgments against the husband for support or necessaries instead of entering into written separation agreements, in order to receive tax-free payments in satisfaction of such judgments, section 71 should be amended to make payments (whether or not periodic) in partial or full satisfaction of judgments taxable to the wife and deductible by the husband.

Since lump-sum payments provided for in judgments for support and for necessaries are awarded in satisfaction of past-due rights to support and do not involve any payment for relinquishment of marital rights in properties in contrast to written separation agreements which usually include such relinquishments, there is no necessity for application of the periodic payment rule to such payments. Moreover, the cases hold that, when a husband pays in a lump sum in 1 year several years' arrears in alimony imposed in a decree of divorce or separation, such payment is taxable to the wife in such year of payment and deductible by the husband in the same year. Now that the requirement of a decree of divorce or separation is being eliminated, the same rule applies to lump-sum payments or arrearages under written separation agreements. Since a judgment for support and/or necessaries is premised upon the theory that the husband failed to make support payments in the past, and since it is the wife who controls the time of instituting suit and thus the length of past periods of time to which the judgment relates, there is no reason to distinguish between the tax treatment of payments in satisfaction of such a judgment and payments of arrearages in alimony.

The foregoing may be accomplished by amending sections 71 and 682 of H. R. 8300 as follows:

Amend section 71—

(1) By adding to subsection (a) an additional paragraph to read as follows:

> "(3) JUDGMENTS FOR SUPPORT.—If a wife is separated from her husband and obtains a judgment against him (regardless of the period of time to which such judgment relates) in an action or proceeding to enforce the legal obligation of the husband arising from the marital or family relationship to support or furnish necessaries to her, the wife's gross income includes any payments received by her (or attributable to property transferred, in trust or otherwise) in partial or full satisfaction of such judgment regardless of whether such payments are not periodic payments. This paragraph shall not apply if the wife is divorced or legally separated from her husband under a decree of divorce or separate maintenance, or if there is a separation agreement, or if the husband and wife make a single return jointly."

(2) By striking the word "or" before the word "agreement" in the third and seventh lines of subsection (b) and adding after the word "agreement" in such lines the words "or judgment," so that subsection (b) reads as follows:

"(b) PAYMENTS TO SUPPORT MINOR CHILDREN.—Subsection (a) shall not apply to that part of any payment which the terms of the decree, instrument, agreement, or judgment fix in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the husband. For purposes of the preceding sentence, if any payment is less than the amount specified in the decree, instrument, agreement, or judgment, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support."

Amend section 682—

(1) By adding at the end of the language within the parentheses in the fourth line of subsection (a) the following: "or who is separated from her husband and obtains a judgment for support or necessaries";

(2) By adding the word "judgment" after the word "agreement" in the eleventh and fourteenth line of subsection (a); and,

(3) By striking the word "periodic" in the fifth line of subsection (b), so that section 682 reads as follows:

"SEC. 682. INCOME OF AN ESTATE OR TRUST IN CASE OF DIVORCE, ETC.

"(a) INCLUSION IN GROSS INCOME OF WIFE.—There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance (or who is separated from her husband under a written separation agreement or who is separated from her husband and obtains a judgment for support or necessaries) the amount of the income of any trust which such wife is entitled to receive and which, except for this section, would be includible in the gross income of her husband, and such amount shall not, despite any other provision of this subtitle, be includible in the gross income of such husband. This subsection shall not apply to that part of any such income of the trust which the terms of the decree, written separation agreement, judgment or trust instrument fix, in terms of an amount of money or a portion of such income, as a sum which is payable for the support of minor children of such husband. In case such income is less than the amount specified in the decree, agreement, judgment, or instrument, for the purpose of applying the preceding sentence, such income, to the extent of such sum payable for such support, shall be considered a payment for such support.

"(b) WIFE CONSIDERED A BENEFICIARY.—For purposes of computing the taxable income of the estate or trust and the taxable income of a wife to whom subsection (a) of section 71 applies, such wife shall be considered as the beneficiary specified in this part. A payment under section 71 to any portion of which this part applies shall be included in the gross income of the beneficiary in the taxable year in which under this part such portion is required to be included.

"(c) CROSS REFERENCE.—

"For definitions of 'husband' and 'wife', as used in this section, see section 7701 (a) (17)."

Respectfully submitted.

ALBERT H. MONACELLI,
Attorney at Law, New York 17, N. Y.

STEWART, BURGESS & MORRIS,
Houston 2, Tex., April 7, 1954.

In re Sections 6321, 6322, 6323, H. R. 8300, revised Internal Revenue Code of 1954

Hon. EUGENE D. MILLIKIN,
United States Senator, Chairman, Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: We are general counsel for Stewart Title Guaranty Co. of Texas, and have had furnished to us a copy of sections 6321, 6322, 6323 of H. R. 8300 now before the Senate Finance Committee. We are especially concerned about the wording of subsection (c) (1) of section 6323, which reads as follows:

"(c) Lien valid without notice in certain cases. The lien imposed by section 6321 shall be valid, without the filing of notice thereof, as against any mortgagee, pledgee, purchaser or judgment creditor, if—

"(1) in the case of a mortgage, pledge or purchase, such mortgagee, pledgee or purchaser had *notice* or knowledge of the existence of such lien at the time the mortgage, pledge, or purchase was made—." [Italics ours.]

We have some concern over the meaning of the word, "notice" as used herein, and are not sure just what meaning or interpretation is intended. The word could mean constructive notice from the mere levy of the assessment or demand for payment without the mortgagee or purchaser having any knowledge or information whatsoever about the levy or demand. It could also mean constructive notice from a levy of distraint and the giving of notice to the owner and the publication of notice thereof in a newspaper or by posting at the nearest post office. The words, "knowledge" or "notice" are not synonymous. "Knowledge" means actual knowledge, while "notice" means that one is legally chargeable with knowledge and includes both actual and constructive notice.

We feel that the word "notice" should be eliminated so as to remove any doubt as to the meaning intended, and so as to remove the implication that constructive notice was intended. By so doing, innocent purchasers and mortagees will be afforded the same protection they now enjoy under section 3672, title 26, United States Code Annotated.

Cordially,

CARLOSS MORRIS.

TROUTMAN, SAMS, SCHRODER & LOCKERMAN,
Atlanta, April 6, 1954.

In re proposed amendment to section 6531 of H. R. 8300 so that the provisions thereof may apply to all taxpayers in the United States regardless of the judicial district in which they resided prior to effective date of new revenue code

Hon. EUGENE D. MILLIKIN,
Chairman, Finance Committee,
United States Senate, Washington, D. C.

DEAR MR. CHAIRMAN: Under the present statute of limitations dealing with offenses against the internal revenue, the last paragraph of section 3748 (a), I. R. C., provides, inter alia, as follows:

"* * * The time during which the person committing any of the offenses above mentioned is absent from the district wherein the same is committed shall not be taken as any part of the time limited by law for the commencement of such proceedings. * * *"

Section 6531 of H. R. 8300 amends the foregoing as follows:

"* * * The time during which the person committing any of the various offenses arising under the internal revenue laws is outside the United States, or is a fugitive from justice within the meaning of section 3290 of title 18 of the United States Code, shall not be taken as any part of the time limited by law for the commencement of such proceedings. * * *"

Section 7851 (d) of the House bill applies the foregoing amendment prospectively. This leaves all the taxpayers in the United States who live in one judicial district, and who filed their returns prior to the effective date of the House bill with a revenue office in another judicial district, without the benefit of any statute of limitations because they were absent from the district wherein they might be charged at any time in the future of having wilfully filed false and fraudulent returns.

I respectfully submit that these taxpayers are entitled to the same parity of response in respect to the statute of limitations as are the taxpayers who resided in the judicial districts containing the collectors' offices. This inequality of treatment is clearly illustrated by the fact that citizens of the District of Columbia may, under the present law, never invoke the statute of limitations as a protection against the charge of attempted tax evasion by filing false and fraudulent returns in the collector's office in Baltimore in the judicial district of Maryland.

The undersigned was for almost 7 years regional (or enforcement) counsel of the chief counsel's office for the Southern States, and in charge of processing, preparing, and forwarding for prosecution all offenses against the revenue involving gift, estate, and income taxes. He never recommended prosecution in a single case where prosecution of the alleged offense was outlawed by the statute of limitations, regardless of the judicial district in which the alleged offender lived. I believe this was also true of the other three regional counsel.

But it seems to me, Mr. Chairman, that the protective rights of the law of the statute of limitations should be clearly enacted into law rather than entrust such rights to the discretion of an administrative functionary. As it now stands, the potential for mischief is unlimited. The Government keeps its records, reports, and papers of an evidentiary character many many years. Its investigative witnesses are also available to the prosecution for a long time. The situation of the average taxpayer, who might be charged with the crime of tax evasion 10, 20, or 25 years after the alleged offense, is entirely different, and while completely innocent may not still have available to prove his innocence any evidence whatever.

It seems clear to me that the protective rights of all taxpayers should be uniform and clearly stated by law. That is the only sure way under our system in which equality of treatment may be guaranteed and enforced. That may be done in this matter by amending retroactively the House amendment to insure uniform and equality of application of the statute of limitations to all taxpayers. I suggest that this be done by striking the last paragraph of section 6531 of the House bill and inserting in lieu thereof the following:

"The time during which the person committing (or who committed on or before the date of the enactment of this amendment) any of the various offenses arising under the internal revenue laws is (or was) in the United States (and not a fugitive from justice within the meaning of section 3290 of title 18 of the United States Code) shall be taken as part of the time limited by law for the commencement of such proceedings. Where a complaint is instituted (after the enactment of this amendment) before a commissioner of the United States within the period above limited, the time shall be extended until the date which is 9 months after the date of the making of the complaint before the commissioner of the United States. For the purpose of determining the period of limitation on criminal prosecutions, the rules of section 6513 shall be applicable."

Thanking you for your consideration of the above, and with esteem, I am

Respectfully yours,

MILLS KITCHIN.

NATIONAL ASSOCIATION OF RETIRED CIVIL EMPLOYEES,
Washington 9, D. C., April 1, 1954.

Hon. EUGENE D. MILLIKIN,
Senate Office Building, Washington 25, D. C.

MY DEAR SENATOR: While Mrs. Edmonds and I now reside in Washington, D. C., we still retain our voting prerogative in the grand old State of Missouri at Kansas City, where we both have lived for more than 60 years.

Our organization, the National Association of Retired Civil Employees, consisting of more than 70,000 members and 400 chapters in the United States of America, is deeply interested in tax revision bill, H. R. 8300, which recently passed the House. Section 38 of this bill provided for exemption of annuities from income tax of retired civil employees, for which this association has been striving for many years.

The exemption allowed is extended only to retirees who are 65 years of age and over, thus eliminating those under 65. Of the 190,000 civil service annuitants on the rolls as of June 30, 1953, one-third were under 65 years of age. We think this discrimination unfair, and are urging all members of the Senate Finance Committee to include those under 65.

In the Mason bill, H. R. 5180, an exemption of $1,500 was provided for retirees on income from pensions and annuities, interest, rents and dividends. In tax revision bill H. R. 8300, this exemption has been reduced to $1,200; we think it only just and fair that the $1,500 exemption be restored, as originally provided by Congressman Mason's bill, H. R. 5180.

Further, the tax revision bill H. R. 8300 contains a provision that a retiree, in order to qualify for the exemption, must have earned income in excess of $600 in each of any preceding 10 calendar years before the taxable year. Such provision bars a retiree on disability having less than 10 years of earned income. It is believed to be unreasonable and difficult of enforcement. We hope an amendment to the bill will be made, so as to take care of disabled retirees who, before retirement, had less than 10 years of earned income to their credit.

Your earnest and careful consideration of this information will be appreciated by both Mrs. Edmonds and myself, as well as by hundreds of our retired civil service employees, school teachers, firemen, policemen, etc.

Respectfully submitted.

WALTON R. EDMONDS.

HOGAN & HARTSON,
Washington 5, D. C., April 2, 1954.

Re Section 311 of H. R. 8300.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: Section 311 of the proposed Internal Revenue Code of 1954 provides, for the purposes of certain other provisions of subchapter C of chapter 1, that a person shall be considered the owner of stock owned, directly or indirectly, by or for certain family members, corporations, trusts or partnerships. The provision has its antecedents in old section 24 (b) (new section 267) and old section 503 (new section 544). However, it differs from each of those provisions, and it operates in areas heretofore not specifically covered by any constructive ownership provision.

I respectfully submit that, for reasons stated below, section 311 causes results clearly at variance with the purpose of the statute, so far as it operates on sections 302 (b) (4) (relating to substantially disproportionate redemption of stock) and 382 (relating to denial of carryovers where there is a substantial change of ownership). I believe it also produces unwarranted results in its application to section 359 (a) (defining publicly held corporations).

The problem arises from the fact that section 311 (b) attributes to the holder of more than 50 percent of the stock of a corporation the ownership of all of the stock of another which is held by such corporation. Section 311 (c), similarly, attributes to a 50 percent beneficiary of a trust or estate the ownership of all the stock held by such trust or estate. A holder of 50 percent or less of the stock of a corporation, or of less than 50 percent of the interest in a trust or estate, is considered to own none of the stock held by such corporation, trust or estate. This is in contrast to sections 267 (c) (1) and 544 (a) (1), which look through the corporation or trust and deem the shareholder or beneficiary to hold his exact proportional interest in the stock held by the corporation or trust. In the American Law Institute's February 1954 draft of its Federal Income Tax Statute, section X 533 takes a middle position, attributing to a shareholder or beneficiary the ownership of his proportional share of the holdings of a corporation or trust, but only if he owns at least a 50 percent interest therein.

Let us examine the working of each of those three alternatives on section 302 (b) (4), where the distortion caused by section 311 is most marked. In the examples which follow, corporate ownership of stock will be referred to, but the effects would follow equally where a trust or estate is involved (except that, for a trust or estate, sec. 311 applies where "at least 50 percent" is owned, rather than "more than 50 percent").

The theory of section 302 (b) (4) is that, if stock is redeemed in proportion to stockholdings, leaving beneficial interests substantially unchanged, the amount paid out should be taxed as a dividend. Yet, by application of section 311(b) or (c), a truly proportionate distribution is distorted into one that is deemed to be disproportionate and is taxed as capital gain. Suppose that three individuals, A, B, and C, each own 20 percent of the stock of M Corporation. A, B, and C also own, in equal thirds, the stock of X Corporation, which owns the remaining 40 percent of M Corporation's stock. Suppose M Corporation redeems half the stock held by A, B, and C. Under the bill, none of the stock held by X is attributed to them, so it is considered that A, B, and C each reduces his interest from 20/100 (20 percent) to 10/70 (14 2/7 percent). Since the latter is less than 80 percent of the former, the transaction produces capital gain. The same is true under the American Law Institute draft. Yet, if the stock held by X corporation were attributed to its stockholders proportionately (as is done by sections 267 and 544), it would be readily seen that each individual owns a one-third interest in M both before and after the redemption, and it should be treated as a dividend.

The same result would follow, under the bill, if there were only two individual stockholders, plus a corporation owned equally by them, since the bill requires "more than 50 percent" ownership before attribution will be applied.

If there is one owner of X corporation with more than 50 percent, and the facts are otherwise similar to the above, that individual may have a dividend but any holders of less than 50 percent will not, even though in reality the redemption is proportionate.

However, it is unnecessary to labor the examples. It is clear that, by placing part of the stock of one corporation in a corporation controlled by them, individual stockholders will be able to carry on a program of equal redemptions of their individually held stock, without fear of dividend treatment, because of the distortions produced by section 311(b).

The distortion can work just as well the other way. Suppose A owns 50 shares of the stock of M Corporation, and B owns 20 shares. The remaining 30 shares are owned by X Corporation, which is owned 45 percent by A and 55 percent by B. The bill would attribute all of X's holdings to B, making A and B each 50 percent owners. Suppose 20 shares were redeemed from A and 20 from B. The bill would deem them each still to be 50 percent owners of M Corporation and would tax them on a dividend. Yet, if true proportions were considered, A has increased his direct and indirect interest from 63½ percent to 72½ percent (so is properly taxed on a dividend), and B has reduced his interest from 36½ percent to 27½ percent (the latter being about 75 percent of the former). If section 302 (b) (4) were applied without the distortions of section 311, B would have capital gain.

The principle of "disproportionate redemption" can be applied successfully only if there is provided a true measure of proportionate interests. That can be done by adopting in sections 311(b) and (c) (as has already been done in subsections (d) and (e)) the test found in sections 267 (c)(1) and 544(a)(1), by which stock owned by a corporation or trust is attributed proportionately to the stockholders or beneficiaries, regardless of whether their interest is more or less than 50 percent.

It is interesting to note that, in dealing with a special situation in section 304, the tests of section 311 were adopted with the proviso that, in determining whether a redemption was substantially disproportionate, the seller should be considered to own the purchasing corporation's holdings of stock in proportion to the percentage of that corporation's stock which he owns. That principle (sec. 304(c)) should be applied equally to section 302(b)(4), where the problem is substantially the same.

The same failure to look through the corporation or trust to determine true proportionate interests causes unwarranted results in the application of section 382, the provision which denies or limits carryovers to the extent that there has been a substantial change in the ownership of stock of a loss corporation. Suppose that A owns 50 percent of the stock of X Corporation, which in turn owns all the stock of M Corporation, which has incurred net operating losses. If A, for cash, buys half of X's holdings of M stock, it would be considered that A had increased his holdings in M from zero to 50 percent, and half of M's carryovers would be taken away. Yet, in true beneficial ownership, A has increased his interest from 50 percent to 75 percent, not enough to make section 382 applicable. If A were to buy all of X's holdings of M stock, it would be considered that a 100 percent change of ownership occurred (losing all the carryovers), though the true increase was only 50 percent (which should cause loss of half the carryovers). If A had held 51 percent of the stock of X, however, all of X's holdings at the beginning of the year would have been attributed to him, so his purchase of all or any part of X's holdings would cause no loss of carryovers.

Similarly, a 40 percent beneficiary of a trust, which owns all the stock of a corporation, may buy half such stock from the trust and cause loss of half the carryovers, or may buy all of it and cause loss of the entire carryovers, since he is not deemed to have had any interest prior to the purchase. But a 50 percent beneficiary may buy all the stock from the trust and no change in ownership will be deemed to have occurred.

The failure to apply the rules of section 311 (corrected as here urged) in connection with section 382(c), coupled with the narrow reference to "such stock" in section 382(a)(2), creates a loophole by which any well-advised person may avoid section 382 (so that it will actually catch only those changes in ownership that occur without tax advice or motivation). The intervention of a holding company will prevent application of section 382. Suppose X Corporation owns all the stock of M Corporation, which has suffered heavy losses. A new group, who are in a position to put a profitable operation into M Corporation, buy all the stock of X Corporation. They are not among the persons whose stockholdings are taken into account under section 382(c), and in any event their increase in indirect ownership under section 382(a) did not result from purchase of "such stock" (i. e., purchase of the loss corporation's stock). Therefore, the new group get the advantage of M's carryovers.

Nor is that loophole available only where there is an existing parent-subsidiary relationship. The individual stockholders of a loss corporation can create a marketable carryover by contributing their stock to a new holding company. Since that is not a purchase by the holding company but a tax-free acquisition under section 351, that transfer will not affect the carryovers. Then a new group may purchase the holding company's stock, and will escape section 382 for the same reasons stated in the preceding paragraph.

To make section 382 work properly, section 311 (b) and (c) should be put on a true-proportion basis, and section 382 (c) should be made subject to section 311 (except that provision should be made for not counting more than once the persons to whom the same stock is attributed). In addition, the words "such stock" in section 382 (a) (2) would have to be changed to include purchases of, or reductions in the amount of, a parent corporation's stock.

Section 311 also controls in the determination of what is a "publicly held corporation" under section 359 (a). The anomalous result is that a corporation with as few as 20 equal (unrelated) owners may be deemed publicly held (enabling trading in carryovers, and merging tax-free with another corporation without regard to the restrictions of section 359 (c)); yet, if the American Telephone & Telegraph Co. were to acquire 51 percent control of another widely held corporation (while 49 percent remained in the hands of many owners), the latter would be deemed not publicly held, and it would be impossible to effect a tax-free merger of the two. The concept of "publicly held corporation" appears in three places in the new code (secs. 304, 354, and 382), in each instance to exempt such corporations from provisions designed to prevent tax avoidance, the theory being that "publicly held corporations usually have a corporate existence separate from that of their shareholders and as a rule do not merge or consolidate with a view to the tax advantages which may result therefrom at the shareholder level" (H. Rept., p. 39). If that is the philosophy, surely the 51 percent subsidiary of a publicly held corporation is more truly "publicly held" than the 20-owner corporation.

The effect of the failure of section 311 (b) to apply true proportions, as applied to section 359 (a), is to make impossible a tax-free merger of one corporation with another in which it owns more than a 50 percent interest, except by first taking the cumbersome preliminary step of inducing enough minority shareholders to exchange their stock for stock of the parent, in order to bring the latter's holdings (in a "single transaction") to 80 percent or more (to qualify under sec. 359 (b)), after which a liquidation could follow. (The latter step presumably might take the form of a merger, but its tax effects would be those of a liquidation.) Any reasons of policy which would permit the simplicity of the statutory merger or consolidation where publicly held corporations are involved would seem to apply equally where one party is a publicly held corporation and the other is itself owned (to the extent of 51 percent or more) by a publicly held corporation. Section 544, which is very similar in purpose to section 359 (a), in that it seeks to determine how widely a corporation is held, affords a precedent for disregarding corporate ownership of stock and viewing the parent's stockholders as proportionate owners.

If section 311 (b) were to apply the principle of looking through the corporation to the actual proportionate beneficial owners, such truly public corporations would not be impeded in accomplishing legitimate business adjustments.

Very truly yours,

SEYMOUR S. MINTZ.

UNITED CREDIT CORP.,
New York 18, N. Y., March 31, 1954.

Re Section 6323, H. R. 8300
Revenue Code of 1954.

Senator EUGENE D. MILLIKIN,
Chairman, Finance Committee, United States Senate,
Washington, D. C.

HONORABLE SENATOR: As a native American citizen, and associated with the financing industry, I very much believe that the proposed section 6323, H. R. 8300, Revenue Code of 1954, is very detrimental to our industry; an industry which does in excess of 5 billions of dollars business per annum.

We feel that the financing and factoring industry are entitled to a certain amount of protection. The writer knows of no other banking or financing facility which has been as helpful over the years to the small-business man as the commercial financing industry.

May I suggest the following changes:

SEC. 6323 (a). Classes of persons to be protected under this section, should be amended to read as follows:

"Invalidity of lien without notice. Except as otherwise provided in subsections (c) and (d) the lien imposed by section 6321 shall not be valid as against any mortgagee, pledgee, purchaser, judgment creditor, or holder of a perfected lien or security interest until notice thereof has been filed by the Secretary or his delegate."

(b) Substitution of notice charged to secured creditor in lieu of a filing.

We feel that we cannot be a policeman and any protective lien or security interest in existence prior to the filing of a tax lien should be prior to such tax lien. In order to keep the proposed Revenue Code of 1954, the same as our present law, may we suggest that section 6323 (c) be changed to read as follows:

"Lien valid without notice in certain cases. The lien imposed by section 6321 shall be valid without the filing of notice thereof as against any judgment creditor, if—

"(1) the judgment creditor has not obtained a valid judgment in a court of record or of competent jurisdiction for the recovery of specifically disignated property or for a certain sum of money; or

"(2) the judgment creditor has a valid judgment of a court of record and of competent jurisdiction for the recovery of a certain sum of money but has not perfected a lien under such judgment with respect to the property involved."

The proposed changes in the code at present puts the onus of policing a debtor's tax status on the secured lender, which will be most burdensome in any revolving credit transaction because there will be no public record to which one may look to determine when an assessment is made.

Any assistance in making the above proposed changes would be very much appreciated by the banking, financing, and factoring industry as a whole and by the writer in particular.

Very truly yours,

PAUL R. BERNSTEIN, *President.*

LAW OFFICE OF HAROLD F. BIRNBAUM,
Los Angeles 14, Calif., March 30, 1954.

Re H. R. 8300, Revenue Code of 1954.

SENATOR EUGENE D. MILLIKIN,
United States Senate,
Washington, D. C.

DEAR SENATOR MILLIKIN: I believe that you will receive letters from a number of lawyers requesting a technical change in section 6323 of the proposed Revenue Code of 1954 and I should like to join with them in this request.

The reference in section 6323 to "mortgagee, pledgee", should be expanded to include "holder of a perfected lien or security interest."

The reason for this technical change is the terminology of the proposed Uniform Commercial Code which was drafted by the American Law Institute and the Conference of Commissioners on Uniform State Laws. The code has been enacted in Pennsylvania and is under consideration by the legislatures of a number of other States, including California.

In the Uniform Commercial Code the name applied to all types of liens and other secured transactions involving personal property is "security interest", or "lien" in some cases. The same rules are made applicable without regard to the technical distinctions which have existed under the different laws of any jurisdiction which adopts the code.

The purpose of section 6323 is to regulate conflicting priorities between a lien on a taxpayer's property for delinquent taxes and liens on the same property in favor of third parties. Since the name of some of these liens in favor of the third parties under State law will be changed as a result of the adoption of the Uniform Commercial Code, it is appropriate for the Revenue Code of 1954 to recognize the new terminology.

The writer is chairman of the Committee on the Uniform Commercial Code appointed by the State Bar of California. The State bar has not as yet taken a position with regard to the adoption of the code. However, I believe that the point referred to in this letter is noncontroversial.

Very truly yours,

H. F. BIRNBAUM.

BINGHAM, DANA & GOULD,
Boston, Mass., March 27, 1954.

Re H. R. 8300, Section 6323

Senator EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building,
Washington, D. C.

DEAR SENATOR MILLIKIN: This office does an extensive practice in the commercial field. It likewise represents a large commercial bank which is continuously dealing with problems relating to secured loan transactions. Day-to-day operations are affected by the impact of Federal tax liens and it is our belief that certain problems will arise under section 6323 of H. R. 8300, which ought to be called to your attention for appropriate action.

The most serious problem raised by the language proposed in section 6323 relates to definition of the class of persons who are protected against the Federal tax lien unless notice thereof has been recorded. As presently written the section gives such protection only to mortgagees, pledgees, purchasers and judgment creditors. We believe that protection is necessary for all persons taking a security interest in property and that those who purchase or loan on assignments of accounts receivable, security interests by way of trust receipts, factors lien or any of the other devices for obtaining security commonly used in the commercial world should have the same protection as mortgagees and pledgees. These problems are very real for we understand the Commissioner in the past has raised the question as to whether some of the above-mentioned types of transactions are presently protected under the language of Internal Revenue Code, section 3672.

The language of section 6323 should be revised in order to make it clear that those persons granted protection are not only those who fit the narrow technical definition of mortgagee and pledgee.

This problem is now of paramount importance by reason of the fact that the Uniform Commercial Code has been adopted by Pennsylvania and its adoption is imminent, we believe, in many other States, including Massachusetts. Under the commercial code, broadly speaking, all the previously existing security devices are merged into a single lien concept, known as a "security interest" and persons holding a security interest are known as "secured parties." Thus in Pennsylvania after July 1, 1954 (the effective date of the Uniform Commercial Code) there will be (under a possible construction of the code) no mortgagees or pledgees at all. There will only be secured parties.

We submit that all of the various security devices encompassed in article 9 of the Uniform Commercial Code clearly merit the protection afforded under Internal Revenue Code 3672 and proposed section 6323. If such protection is not extended it can have very serious and far-reaching results. Valid types of security interests now protected against Federal tax liens may lose that protection; other types equally deserving will not have protection and much confusion and litigation is likely to result.

Accordingly we earnestly recommend that section 6323 (a) of H. R. 8300 be amended by inserting after the words "judgment creditor" the following: "or holder of a perfected lien or security interest * * *."

Another serious problem arises, we think, resulting from the efforts of the House to avoid extreme cases such as *U. S.* v. *Beaver Run Coal Co.* (99 Fed. (2d) 610 (CCA 3d 1938)). The new bill proposes to accomplish this by providing that, even though a notice of lien may not have been recorded as provided in subsection (a), the protection extended under subsection (a) shall not extend to a person who has notice or knowledge of the existence of the lien at the time his interest arises. The aim of the House in attempting to avoid the Beaver Run Coal Co. rule is meritorious. However, as a practical matter, very serious problems can arise in substituting for the old objective rule, which was simple to administer, a new subjective rule dependent upon a fact—that the person had no notice or knowledge of the lien—the final determination of which may have to rest upon the uncertainty of a court verdict.

Much more serious, however, would be the situation of any large institution, such as a bank or insurance company, which makes loans in the regular course of its business. Such institutions must necessarily departmentalize their operations and many of them are in the habit of maintaining operations at various branches. For example, the loan department of a large bank or insurance company makes a loan and the loaning officer has had no notice or knowledge of the existence of a tax lien on the borrower's property. Nevertheless, some officer of another department of the loaning institution that has nothing to do with the loaning department may have happened to have had notice or knowledge of such a lien. If because of the latter officer's notice or knowledge the loaning institution might possibly be charged therewith it is a serious matter, for the loaning institution would have no practical way of protecting itself.

We submit, therefore, that section 6323(c)(1) should be eliminated entirely, or, if the rule in Beaver Run Coal Co. seriously prejudices the revenues, that said subsection be revised to make it clear that loaning institutions or persons are not to be charged with notice or knowledge of an existing tax lien unless it is clear that the loaning department or person actually making the loan had such notice or knowledge.

Very truly yours,

BINGHAM, DANA & GOULD.

BUTLER, BINION, RICE & COOK,
Houston 2, Tex., March 29, 1954.

HON. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SIR: Section 309 of H. R. 8300 (Internal Revenue Code of 1954), recently enacted by the House of Representatives, which imposes a transfer tax of 85 percent on certain corporate distributions in redemption of preferred stock, is disastrous when applied to the fact situation set out in some detail below. Since its ruinous consequences are utterly inconsistent with the fairness which characterizes the bill as a whole, it was unquestionably enacted without knowledge of the inequity which it can and will produce. The injustice of it is all the more glaring in view of the fact that the situation with which we are concerned is the outgrowth of a corporate reorganization in 1952 which, as will appear below, was not motivated by tax considerations and was done only after the Treasury Department had ruled favorably on it.

Names of persons and corporations involved will not be disclosed in this letter but will be furnished at your request.

The corporation involved is engaged in retail business in Houston, Tex. All its products are sold under license from a national organization. In the latter part of 1951, all its stock (common only) was owned as community property by X, a resident of Houston, Tex., and his wife. The corporation was organized in 1946, prior to which time X, as a sole proprietor, had carried on the same business under a license from the national organization for approximately 25 years. The license was cancellable on the death of X, who understood that the licensor would not look with favor on renewing the license with any members of X's family expect males, who must have absolute authority to manage the business. Moreover, the licensor would require that any continuing financial interest in the business of X's estate or his widow be liquidated within a reasonably short period. X, who was in extremely bad health in 1951, had only one child, a daughter. Her husband had, for some time, actually been running the business since X's state of health did not permit him to do so.

In anticipation of X's death, which appeared inevitable within a comparatively short time, it was decided to recapitalize the corporation by having X and his wife surrender most of the common stock in exchange for preferred stock having an aggregate par value almost as great as the net worth of the corporation. X and his wife were then to sell the remaining stock to X's son-in-law for its fair market value. X insisted that the common stock be acquired by his son-in-law by purchase, so that his wife (X's only child) would have a community one-half interest in it. Her ownership of it under this arrangement was not objectionable to the licensor, since her husband could, under the laws of the State of Texas, exercise complete control of it. X's son-in-law was not financially able to purchase and pay for the common stock of the corporation unless its value was reduced, through an issue of preferred stock, to an amount within his financial means. The preferred stock was to be nonvoting so that ownership of it would not carry with it any right to participate in management of the corporate affairs.

It was thus hoped that the licensor could be persuaded to renew the license in the name of the son-in-law, and that the death of X would raise no immediate question of cancellation of the license. A ruling of the Treasury Department was sought and obtained to the effect that no gain or loss would be occasioned by the issue of the preferred stock and that redemption of the preferred stock in accordance with the charter provisions of the corporation would "not be considered as a distribution essentially equivalent to the distribution of a taxable dividend" as long as the preferred stock was owned by X and his wife and the common stock was owned by X's son-in-law. The proposed charter provision of the corporation required that, with certain exceptions, it must apply at least 15 percent of its net profits annually to the redemption of its preferred stock. It was hoped that this would enable the corporation to redeem its preferred stock within a short enough period to be satisfactory to the licensor.

Notwithstanding Treasury Department approval, the licensor withheld its approval of the proposed reorganization. X died in June 1952, but prior to his death he executed a codicil to his will authorizing the executrix of his estate to participate in such a reorganization.

After the death of X, the matter was again taken up with the licensor which then agreed that the corporation might be so reorganized and that the license would not be immediately canceled. However, X's son-in-law was unofficially informed by representatives of the licensor that it would probably be necessary that the corporation redeem, within a shorter period than that contemplated by the above-mentioned charter provision, at least the part of the preferred stock owned by X's widow and his minor grandchildren. The reorganization was accomplished in November of 1952. The estate of X sold to X's son-in-law all the common stock of the corporation for approximately $25,000 and continues to own all the oustanding preferred stock. Upon distribution of the estate, not less than three-fourths of the preferred stock will be owned by X's widow and by trusts for his minor grandchildren.

Federal estate tax was paid on X's community one-half interest in the stock of the corporation at its book value. The corporation's assets were not the type which enhance in value and the license from the national organization could have no value assigned to it for estate-tax purposes, being virtually identical with one or more such licensing arrangements which have been before appropriate courts in estate-tax cases and found to have no value for estate-tax purposes. Upon the reorganization, the preferred stock acquired a basis for tax purposes substantially equal to its par value, which is at least as great as its fair market value.

If we read it correctly, section 309 of H. R. 8300 will impose on the corporation a transfer tax of 85 percent on any property or money which it distributes in redeeming its outstanding preferred stock. This, of course, makes it impossible that any of it be redeemed. It must be assumed that the licensor will not permit the license to remain in effect unless substantial reduction can be made in the outstanding preferred stock. Inevitably, the fruit of X's life work will be in large measure destroyed, for liquidation of the corporation following termination of the license could almost certainly be accomplished only at large financial sacrifice.

Section 309 of H. R. 8300 is intended, of course, to prevent so-called bail-outs of corporate earnings. Obviously, motives which are served by bail-out arrangements are totally lacking in the situation which we have outlined. We are sure you are aware that, in 1951 and for several prior years, the Treasury Department was very conscious of the bail-out method of attempting to realize corporate income without paying tax on it as dividends and we think it goes without saying that approval of the reorganization would not have been given if the facts, necessarily disclosed to the Treasury Department in much greater detail than has been done in this letter, had left even a shadow of a doubt that there was any bail-out motive involved.

It would unduly lengthen this letter to point them out, but you are unquestionably aware of provisions in H. R. 8300 which drastically change existing law but which are so worded as not to penalize taxpayers who entered upon transactions before they could have had any reason to believe that any change in applicable law could be expected. Usually it appears that "cutoff" dates in H. R. 8300 which are intended to prevent such results are related to the earliest date on which the Ways and Means Committee made public announcement of its favorable consideration of the proposed change (see, for example, the last paragraph of section I, part IX of the general explanation of the bill as set out in the Ways and Means Committee report). By contrast, there appears to be nothing in the bill to prevent the disastrous application of section 309 to the situation outlined above, which was entered upon, in good faith and with Treasury Department approval, nearly 18 months prior to House approval of H. R. 8300 and was first conceived about a year earlier than that.

The obvious solution is to revise the language of section 309 so as to make it inapplicable, in its present form, to the redemption of preferred stock which was issued prior to the earliest date on which the Ways and Means Committee publicly announced its consideration of the matter. As to such stock issued prior to that date, the new code should provide only that its redemption will be deemed to be a sale of the stock by the owner or will be treated as a dividend, as the facts warrant, which will amount in substance to a continuation of the law as it was when the stock was issued.

It is regretted that this matter could not have been presented in shorter form, but the confiscatory result of section 309, when applied to the situation we have outlined, and the dire injustice of its application, are obvious only in the light of a rather complete statement of the underlying facts.

We invite your inquiry from appropriate sources of information as to whether the plight of our clients may not be a fairly common one. Your favorable consideration of the proposed revision of section 309 will be greatly appreciated.

Yours very truly,

WILLIAM O. TAYLOR.

JAMES G. SCHILLIN,
ATTORNEY AND COUNSELOR AT LAW,
New Orleans, March 26, 1954.

In re Amendment proposed by Canal Bank & Trust Co., in liquidation, to section 391, Internal Revenue Code of 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee, Washington, D. C.

DEAR SENATOR MILLIKIN: I am addressing you at the suggestion of Senator Long, of Louisiana, on behalf of Canal Bank & Trust Co., in liquidation, which corporation has received from the Treasury Department a tax ruling, which may be nullified because of the provisions of section 391 of the new Revenue bill which makes March 1, 1954 the effective date of subchapter C (Corporate distributions and adjustments).

Our dilemma is that, although our plan, which involves a partial liquidation and tax free reorganization, was submitted to the court long before March 1, 1954, the decree of the court approving and ratifying the plan was not entered until March 5, 1954.

Unless the proposed amendment[1] is enacted into law a grave injustice will be done to the shareholders of Canal Bank & Trust Co., in liquidation. This bank has been in liquidation and receivership under court supervision since 1933. It has over 2,900 stockholders, most of whom are located in and around Louisiana. The bank was ultimately able to pay off its creditors in full, and, for the past several years, the receivers have been working actively towards liquidating and winding up the bank's affairs. After detailed study of the many difficult problems involved, and innumerable conferences with the Internal Revenue Service and others, the receivers determined that the bank's affairs could be best terminated by a plan involving a partial liquidation and reorganization.

On November 26, 1953, this plan in its final form was submitted to the Commissioner of Internal Revenue for an advance ruling. On January 6, 1954, a ruling favorable in all respects was issued by the Internal Revenue Service. On January 11, 1954, the receivers filed a petition in the local court with respect to said course of procedure, and the necessary notices were thereupon published in the New Orleans newspapers. On February 18, 1954, the court held open hearing at which no objections of any kind were interposed. On March 5, 1954, the court's final order was signed, approving and accepting in every respect the receiver's petition.

The proposed revenue bill, if enacted in its present form, would apply to distributions under a plan of complete or partial liquidation unless the plan was adopted prior to March 1, 1954 (sec. 391 (a) (1)), and might adversely affect the tax consequences of the bank's plan which, as indicated, the Internal Revenue Service has already approved under presently existing law. Although Canal Bank's plan was adopted, in the real sense of the word, long before March 1, 1954, and in fact possibly as early as May 30, 1950, the technical objection might be raised that the plan was not adopted within the meaning of the new law until the signing of the court's order on March 5, 1954.

We understand that March 1, was inserted in the revenue bill as the cutoff date because committee press releases were issued on that date, and we take it that neither the Treasury nor the Congress intend, or want to, disturb the tax consequences, under presently existing law, of plans of liquidation adopted

[1] Amendment proposed by me is annexed hereto.

prior to the time that a taxpayer could have had public knowledge of the provisions of the proposed revenue bill.

It is apparent from section 336 (c), p. 81, of the new bill that a plan under that section is to be considered adopted when a resolution is adopted by the shareholders or a board of directors. We feel that some language should be used to make it certain that under section 391 (a) (2) a plan should be considered as adopted when receivers, liquidators, or other representatives of a corporation or its shareholders have made application to the Internal Revenue Bureau, obtained a favorable ruling, long before March 1, 1954, although the court may not have approved the plan, as in our case, until March 5, 1954.

The plan approved by the local court on March 5, 1954, is the result of many years of study and effort on the part of the receivers and its attorneys, and was accomplished at considerable expense, and the receivers are under court order to complete the program described above. Wide publicity has been given to the formulation and adoption of the plan, and the shareholders have acted in reliance thereon.

Senator Long has agreed to offer our amendment, and I understand you will have his hearty cooperation in having it enacted.

We trust that Congress will appreciate the fairness of our position, and that you will do whatever is necessary to see that the bill, when it leaves the Senate Finance Committee, will not have the effect of destroying this plan of partial liquidation and reorganization.

With esteem, and thanking you for your cooperation, believe me,

Very respectfully yours,

James G. Schillin,
Attorney for Canal Bank & Trust Co., in Liquidation

Amendment Proposed by Canal Bank & Trust Co., in Liquidation, New Orleans, La., to Section 391 of Internal Revenue Code of 1954 (H. R. 8300, Union Calender No. 498)

Amend "section 391. Effective date of subchapter C," by adding subsection (c), so that said section 391, as amended, shall read in its entirety as follows:

"SEC. 391. EFFECTIVE DATE OF SUBSHAPTER C.

"(a) This subchapter shall be effective with respect to distributions or transfers occurring after March 1, 1954, except that—

"(1) part II of this subschapter shall be effective only with respect to distributions made in pursuance of a plan of partial or complete liquidation adopted after March 1, 1954, and

"(2) the tax imposed by section 309 shall be applicable only with respect to amounts distributed after the date of enactment of this Act.

"(b) Certain Net Operating Loss Carryovers.—For purposes of applying the special limitation on net operating loss carryovers in section 382, the beginning of the taxable years specified in subsections (a) (1) and (b) (1) and (2) of such section shall be considered to be the beginning of such taxable years or March 1, 1954, whichever occurs later.

"(c) PLAN.—For the purpose of subsection (a) (1) a plan shall be considered as having been adopted prior to March 1, 1954 if, in any receivership, liquidation, or similar proceeding, pending in any court of competent jurisdiction, the plan is submitted by the shareholders or their legal representative to the court for approval prior to March 1, 1954, although the decree approving said plan is not rendered until after that date."

The Goodyear Tire & Rubber Co.,
Akron, Ohio, March 29, 1954.

Hon. Eugene D. Millikin,
Chairman, Senate Finance Committee,
Washington, D. C.

Dear Senator: We have noted section 923 of H. R. 8300 which provides for a credit against tax equal to 14 percent of certain types of income earned abroad. Our company through wholly owned subsidiaries owns and operates rubber plantations in Sumatra, in the Philippines, and in Costa Rica. Natural rubber and latex are produced which for the most part is imported into the United States.

We are anxious to make sure that the tax credit in section 923 will be available to these rubber plantations subsidiaries. We would like to have the record clearly show that this is intended or to have the language in the bill amended to bring this about.

Our reading of H. R. 8300 and House Report 1337 of the Ways and Means Committee leads us to believe that these enterprises come within the scope and meaning of the language "factory, mine, oil or gas well, public utility facility, retail establishment or other like place of business" appearing in section 923 (a) (3) (A) (ii).

This understanding we believe is supported by the explanatory matter found on page A–255 of House Report 1337, which seems to indicate that these plantations would come within the meaning of "other like place of business" as used in the act. Here the following language is found:

"The recital in section 923 of 'factory, mine, oil or gas well, public utility facility, or retail establishment' is not meant to be exhaustive. 'Other like place of business' may include, for example, the operation of a bank or an air transportation business."

If our understanding is not correct, we would wish to urge that this type of business activity is deserving of the same treatment as the enumerated types of enterprise mentioned. Rubber plantations of American companies in the Far East and in Africa were of very great value and important to this country during World War II. Natural rubber in large amounts is still an important necessary raw material needed by our economy. There are very many uses of it to which synthetic rubber is not adaptable.

If in your opinion it is necessary to more specifically cover these rubber plantations under section 923 we ask that suitable language be inserted in the bill to accomplish this. Perhaps the words "agricultural enterprise" might be inserted after the words "oil or gas well" in the subsection of 923 above indicated.

There is another point upon which we would like to be definite and certain. Section 923 (a) (3) (A) (iii) excludes from the benefits of the section subsidiaries where more than 25 percent of the gross income is derived from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States.

Our understanding is that this exclusion would not apply in the case of a subsidiary company owning and operating rubber plantations for the reason that its products are not "manufactured." The products of these plantations are essentially raw materials comprising liquid latex taken directly from the rubber tree and sheets of rubber derived by evaporating the liquid content from rubber latex.

We understand this interpretation to be substantiated by the explanations found on page A–255 of House Report 1337. Here it is said that the requirement with respect to the 25 percent limitation "is confined to manufacturing. Thus the requirement would not apply, for example, to the mining or processing of metals or the extraction or refining of oil," etc.

To summarize we would very much like to have the record show that it is the intent of the Congress that rubber plantations are enterprises to which the benefits of section 923 accrue and that the production of rubber and latex on these enterprises is not subject to the 25 percent limitation.

Very truly yours,

R. H. MINER, *Assistant Secretary.*

ARNO HERZBERG,
CERTIFIED PUBLIC ACCOUNTANT,
Newark, N. J., April 1, 1954.

SENATE FINANCE COMMITTEE,
Senate Office Building,
Washington, D. C.

(Attention: Elizabeth B. Springer, Clerk.)

GENTLEMEN: In connection with the proposed hearings on the 1954 tax-revision bill, I would like to draw the attention of the committee to the problems involving taxing so-called finance reserves.

In view of the record high of outstanding installment loans, dealers of automobiles, appliances, etc., are faced with the following problem: They are credited by the finance companies with an amount that is called reserves and actually constitutes a split of the final charge included in the customer's note. This amount credited is not paid out to the dealer. He has no right to claim it until such time when it exceeds a certain percentage of the total outstanding notes.

The court decisions are not clear in this respect. Some of them want to tax these amounts as soon as they are credited to the dealer although they might disappear completely in time of a slowdown of the economy without the dealer receiving anything of this in cash. It could be shown that, in case the dealer paid taxes on these amounts as soon as they are credited, his working capital would be completely depleted.

I have aired these problems as far back as 1950 in the October issue of the Journal of Accountancy. An article discussing similar problems is scheduled to appear in the May issue of Taxes, the tax magazine. Legislation similar to section 607 (h) of the Merchant Marine Act, 1936, quoted in paragraph 39.22 (b)-1 of Income Tax Regulations 118, is recommended.

Respectfully yours,

ARNO HERSBERG,
Certified Public Accountant.

BRUCE D. CROOK,
CERTIFIED PUBLIC ACCOUNTANT,
Ukiah, Calif., April 6, 1954.

SENATE FINANCE COMMITTEE,
Elizabeth B. Springer, Clerk,
Senator Office Building, Washington, D. C.

GENTLEMEN: After reviewing the proposed 1954 Revenue Code, we suggest consideration of the following items:

1. The due date of the final payment of an individual's declaration of estimated tax be changed from January 15 to January 31. Under the present law of January 15, the small businessman who does not keep a formal set of books, does not have sufficient time between December 31 and January 15 to take and price his inventory, receive his bills for the previous month, determine his income for the year, and then have an estimate prepared. Further, it does not seem reasonable to have the small merchant put to the additional time and expense of having a formal set of books maintained monthly.

2. That where an individual's tax for 1 year is zero, and he files a timely estimate for the succeeding year in the amount of zero, he will not be subject to any penalty for underestimating. The present law states he will not be subject to penalty if he files a timely estimate March 15, based on the previous year's income, and pays the installments thereof. What if the estimate is zero and there are no installments to pay?

3. The law be clarified to either require or not require the filing of a partnership return where a partner sells part of his interest to another partner during the partnership's taxable year. To determine the individual partner's portion of taxable income prior to and subsequent to the sale, it is necessary to compute the profit up to the date of sale.

4. When a partnership initially commences it should have the option of choosing a taxable fiscal year the same as any other business entity. Fiscal years are chosen for several reasons. One of which is the natural business year. Partnerships should have the choice of such year without seeking the commissioner's approval.

Sincerely,

BRUCE D. CROOK.

PROPOSALS RELATING TO REVISION OF THE INTERNAL REVENUE CODE

Harold A. Kuhn, Certified Public Accountant, San Francisco, Calif.

AMOUNT OF WITHHOLDING TAX

Statistics reported in the daily newspapers are as follows:

	1952 returns	1953 returns
Returns filed by Mar. 11 on which taxpayers claimed to have paid more than owing	16,300,000	15,600,000
Refunds ordered by Mar. 11:		
Number	13,895,000	11,200,000
Amount	$987,161,000	$874,258,000
Average	$71	$77

Who are the immense group getting refunds? Those partly unemployed during the year, those with more dependents, medical expense, etc. The government should not operate on their money.

What is needed is *a 10% discount in the withholding tables for the lower brackets.* An employee with a steady job can be depended on to pay his tax, or to claim fewer dependents to have it withheld.

DEFINITION OF DIVIDEND

The law says that the source of taxable dividends is earnings and profits, and even if no earnings and profits are available in the aggregate, then the source is the most recently accumulated earnings.

The purpose of this was to permit the payment by the corporation under the undistributed earnings tax, for the allowance of a credit to the corporation. There can be no logical defense of the theory from the viewpoint of the shareholder, where all prior years resulted in deficits and the current year happens to have profit.

The proposed law closely identifies the shareholder and his corporation by providing a new measure of basis upon liquidation. With that as a general purpose, the definition of dividend must be revised so that the source is only accumulated earnings and profits.

SALE OF A RESIDENCE

Old law and the proposed section 1034 are rules of mandatory nonrecognition of gain.

This is utterly unfair to the taxpayer who has unused capital loss carryovers which he cannot exhaust because of the unfair limitation on the amount available annually. No reason exists why the nonrecognition cannot be at the election of the taxpayer.

INCOME FROM ANNUITIES

The 3 percent rule is a remnant of the stone age. At least two things are wrong with it:

(1) The rate of 3 percent. My own superficial information is that the insurance companies pay about 1 to 1½ percent.

(2) The rate is applied to the original cost. It is obvious that no debtor pays his creditor on anything other than the remaining balance.

The code should be amended without reference to life expectancy, which change (presently suggested) will cause endless trouble as to whose mortality table is to be used. Every succeeding census shows a change in expectancy, and the figures are always 10 to 15 years behind the times. Dividing by a smaller number of years than is scientifically sound gives a larger recovery than necessary. It is not good taxing policy to permit more deduction than is fair, any more than permitting less deduction (as has been the case in the past).

All that must be done to the present rule is—

(a) Determine what the companies are paying, from time to time, and write that rate into the code.

(b) In each year, apply the rate to the balance of cost after previous nontaxable recoveries.

(c) Specifically provide that if the excess recovery is taxable, that the deficiency of recovery by a person who dies too soon is deductible in his final return with carryback privileges up to 2, 3, or 4 years.

ALTERNATIVE TAX ON CAPITAL GAINS

Present law is manifestly unfair, as between taxpayers. Consider the following:

	Taxpayer	Taxpayer
Long-term capital gains	$267,000	$267,000
Ordinary losses and deductions		167,000
Taxable	267,000	100,000
Amount of tax	67,000	67,000

The law should provide that the alternative tax can be computed on any part (but of course not more than the amount thereof) of the net long-term capital gains).

LIMITATION ON CAPITAL LOSSES

Taxpayers are now limited to $1,000 per year each. This does not take into account their occupations, their other income, the kind of risks they take, etc.

The allowable loss should be a percentage of income (adjusted gross income, net income, or whatever) to take into account the kind of risk that the taxpayer is subjecting himself to.

The carryforward privileges should be some sincere effort to exhaust the whole amount of the capital losses, and the above proposal will be a step in that direction.

THE THEORY THAT DEDUCTIONS ARE "A MATTER OF LEGISLATIVE GRACE"

The trouble with us is that we don't seem to learn from experience. Prohibition failed not because it was better to drink than not to, but because it could not be enforced. The byproducts of general disregard for all law should be a lesson to us in tax matters.

People think that a tax on income should be on net, not gross. The fact that that may be legal does not make it moral nor prove it to the satisfaction of the taxpaying citizen. The courts have said the reverse and the legislators have not corrected this. Occasionally the Treasury tries another disallowance of "deductions opposed to public policy" (such as cost of goods sold, in excess of OPA ceiling prices) and the courts must admit that they cannot stomach this. The place for OPA violators is not a tax forum.

A general survey of what to the businessman is a cost, expense, deduction (what matters the name?), but to the inhuman Treasury fiends is not deductible, is long overdue. The enumeration of these items is too long to be attempted here, and would be worthless without the congressional willingness to create a new atmosphere in the field of deductions. The gradual but reluctant allowance of research and development expenses, costs of organizing, etc., is too slow to create an impression among all taxpayers that they are being treated fairly, and instead creates the impression that special interests are getting all the gravy.

COMMUTERS' EXPENSES

That the courts have unaminously denied this expense is a national disgrace.

It is now proposed to allow working mothers the cost of babysitters, and to allow salesmen all expenses as deductions in arriving at adjusted gross income.

Left to its own devices, the Treasury Department will never voluntarily concede the validity of commuters' expenses as a deduction. Its record on this type of items is too sordid to warrant inclusion in any analysis of tax policy.

To the extent that any limitation is required to prevent abuse, the proposed law could provide that the deductible amount shall not exceed the amount which would be spent on ordinary public transportation. Those who prefer limousines with chauffeurs would ride on a par with ordinary citizens.

BLOOD DONATIONS

In the most wrong ruling of all time, the Treasury has recently restated its position that the value of blood is not a charitable contribution (when given to a proper organization) because blood is not property.

It can be touched, weighed, shipped, refrigerated, dehydrated, bought and sold. Too bad some of those Treasury leeches were not in need of a transfusion at some time in their lives, so that they could think like Americans.

The only cure for the kind of administration we have been having is legislation. The number of proposals now in the Congress is testimony to that.

NET OPERATING LOSS DEDUCTION

Again the man with the fluctuating income is the forgotten man. Of course no recognition ought to be given to the risks he takes, and the jobs provided by that.

New code section 172 (d) (3) denies the personal exemption to be carried forward or back. There can be no logical reason for this denial.

Also the man with unearned income is treated better than the one without it, as follows:

	Taxpayer	Taxpayer
Losses of trade or business	$10,000	$10,000
Other income	1,000	0
Other deductions	1,000	1,000

Both have a carryback of $10,000. But the first-column taxpayer is $1,000 better off. This is indefensible, and some day must give way to a better rule; now would be as good a time as any.

DEFINITION OF "CONTRIBUTION"

Most of the effort of many years of taxation relates to the nature of the recipient organization. The question of what is a contribution still seems to elude attention.

Mr. John Doe taxpayer belongs to the church. He pays his annual dues, which permits him to oust anybody from the seat specially allocated to his comfort and his vanity, and to send his children for their Sunday morning education.

He deducts such dues from his income tax returns. But he has not contributed one penny.

The meaning of the word "contribution" must have some root in the donative intent, that is, without consideration. If he in addition, volunteers to pay part of the cost of some new books or a new building, or whatever, it is logical to call that a "contribution."

New code section 170 (c) does not come to grips with the problem, even though it is labeled "definition."

DEDUCTION FOR TAXES

No taxpayer has the opportunity of the proverbial snowball in hell of avoiding a tax payment to a State or municipal government.

Taxpayers on the cash basis must now attempt to file State income-tax returns on the last day of the taxable year, and pay the tax, in order to avail themselves of a deduction. Then amended returns are filed later. How silly can we get, in what we call civilization?

The statute should provide, that regardless of the method of accounting, the taxpayer may elect (without consistency between years) to accrue taxes, meaning property taxes, income taxes, licenses, and other exactions which if not paid will result in we all know what.

The limitation against abuse would be that the payment must be made within the succeeding period (say 1 year).

An income tax on this year's income (which is called a franchise tax for the privilege of doing business next year) would be deductible under the proposed statute, provided Congress did not overlook writing that into the law.

DEDUCTIONS FOR PROFESSIONAL EDUCATION

Everybody gets on the new bandwagon but the specially educated. The owner of inventory gets lifo, the equipment gets declining balance, minerals get depletion, and research is allowable under new code section 174.

Subject to any reasonable definition (which might exclude food, lodging, etc.) there should be a "capital account" for university and postgraduate tuition leading to specified kinds of degrees or endeavors, and which can—

(a) Be depreciated at the option of the taxpayer (in any year in which he can find enough income to warrant it).

(b) Be depreciated in accordance with some statutory binding rule over a given number of years.

(c) Written off to expense upon death, disability, etc., to the extent not previously depreciated, with carryback privileges up to 2, 3, or 4 years.

DEDUCTION FOR PURCHASED "GOODWILL"

The reasoning behind new code section 248 (organization expenditures) could be applied to goodwill with spectacular results, on the basis of amortization or depreciation within defined limits (say 10 percent declining balance method, or some other rule where the amount is limited to a percentage of the income).

Such a provision would no more to stimulate business deals and economic activity than any other 10 provisions ever enacted into tax law. A full memorandum on this subject could be written by any experienced tax accountant or attorney or business adviser, without any hesitancy.

PARTNERSHIP FISCAL YEAR

Too little and too late. The filing date of March 15 should have been changed years ago, and finally is extended a miserable 30 days.

With this small concession to taxpayers, the long-term trend to natural fiscal years, and the spreading of tax work throughout the whole 12 months, is proposed to be abruptly stopped by 1954 code section 706 (b) (1) (B), so that partnerships will report only on the calendar year. It will soon be necessary to extend the filing date on this account.

But what is the motive and purpose of the proposed section? End tax avoidance? At the most, there might be some minimizing for a first year, and if this helps a partnership with working capital problems, is there no one else being helped?—such as owners of inventory (LIFO method), owners of fixed assets (declining balance depreciation), operators of natural resources (depletion)?

Why is it so evil to start a new partnership business; to employ people; to create jobs and payroll taxes; and to make it convenient for the partnership to file its return at some time other than the partner's returns?

"PRESCRIBED BY THE SECRETARY OR HIS DELEGATE"

This is similar to what we have always had. It is silly. The courts read a law that says the Commissioner can prescribe a regulation, and interpret it to mean that the regulation is valid if it meets the approval of the judges.

The inclusion of the phrase leads one to believe that if the phrase is missing, that the Treasury cannot prescribe rules, although everybody knows that is not so either.

Let us eliminate the phrase wherever it appears, and add to subtitle F, Procedure and Administration, some rules describing just what the Treasury can do and all the limitations that apply to the regulatory function.

So many regulations have been declared invalid that there is long overdue some recognition within the Department that they are taking money from people, and people resent the way it is done.

POSTAGE ON TAX RETURNS AND OTHER REPORTS

Government now requires reports and documents involving millions of man-hours all paid for by the taxpayer.

I propose that any tax return, payment of tax, questionnaire, census, report, etc., which is required, be postage free. The word "required" could be written on the envelope and the receiving Government agency would police the compliance.

The proposal would not extend to general correspondence or permit nonrequired reports to be enclosed in the same envelope as required reports.

I doubt that the Post Office will welcome this proposal. But let's stop adding insult to injury on the cost of compliance with so much unnecessary paperwork.

CLEVELAND, OHIO, *March 26, 1954.*

Re H. R. 8300, sections 352–359, respecting statutory mergers and consolidations

Hon. EUGENE D. MILLIKIN,

Chairman, Committee on Finance,

United States Senate, Washington, D. C.

DEAR SIR: We represent seven vessel companies; namely the Consolidated Steamship Co., the Continental Steamship Co., the Duluth Steamship Co., the Globe Steamship Corp., the Inter Ocean Steamship Co., the Sumatra Steamship

Co., and the Triton Steamship Co. These companies are relatively small, each owning 1 Great Lakes bulk vessel with the single exception of Globe, which owns 3 such vessels. As of December 31, 1953, the net worth of the companies, stated in round figures, varied from $216,500 as to Triton to $1,300,000 as to Globe.

These companies were all founded by the late G. A. Tomlinson. Since their organization, which as to some dates back to 1901, these companies have never operated as competitors but have been under common management as a fleet under the name and style of the Tomlinson Fleet. The sole business of each of the companies is the transportation of bulk commodities between ports on the Great Lakes, such as iron ore, coal, limestone, and grain.

The high cost of operation, of modernizing existing vessels, and of the construction of new vessels, necessary to maintain the competitive position of the fleet in Great Lakes commerce, requires a strengthening of the capital structure. It is felt that such strengthening may best be accomplished through a merger of all the companies. Such a measure has been under consideration for some time.

On January 8, 1954, a ruling was obtained from the Reorganization and Dividend Branch of the Office of the Commissioner of Internal Revenue to the effect that no gain or loss would be recognized under existing law either to any of the corporations or to any of the shareholders. That ruling, a copy of which is attached hereto, also sets forth much pertinent information regarding the companies.

In reliance upon the above ruling, the directors of the several companies on March 2, 1954, adopted an agreement of merger whereby shareholders of the existing companies would exchange their stock for stock in the Consolidated Steamship Co., the surviving company, to be known thereafter as Tomlinson Fleet Corp. The exchange would be carried out on the basis of the book value of assets as of December 31, 1953. Notices were promptly sent to the stockholders of all of the companies of meetings called for the purpose of acting upon the merger agreement. The meetings are scheduled for April 13 and 14. Among other things, the stockholders were apprised of the above-mentioned ruling of the Office of the Commissioner of Internal Revenue.

It now appears that the statutory merger of these companies, well underway at this time, would be seriously affected by H. R. 8300. The merger would not qualify under section 359 of H. R. 8300 as a merger of publicly held corporations for the reasons that less than 10 persons own more than 50 percent of the stock of 1 company. Nor would the merger qualify as a corporate acquisition of property inasmuch as on the basis of book values the shareholders of Globe would receive more than four times as much stock in the surviving corporation as would the shareholders of Triton. We are not aware of any other provision in H. R. 8300 under which this merger could be carried out without exposing the stockholders and the participating companies to tax liability.

The merger of these companies has been undertaken in good faith and for sound business reasons. The effect of H. R. 8300 upon the tax liability of the stockholders and the companies would seem to merit the attention of you and the members of your committee. While we would not presume to suggest language, the situation could be taken care of by insertion of a provision that any statutory merger or consolidation approved by the shareholders of participating companies in accordance with applicable law before the date of enactment of H. R. 8300 should be governed by existing provisions of the Internal Revenue Code. Should you and your committee require additional information, we will be glad to furnish it or, if necessary, to appear before you.

Very truly yours,

JOHNSON, BRANAND & JAEGER.

UNITED STATES TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
WASHINGTON, 25, D. C., *January 8, 1954.*

THE CONSOLIDATED STEAMSHIP CO.,
2900 Terminal Tower,
Cleveland, Ohio

GENTLEMEN: We are in receipt of a letter dated November 18, 1953, prepared by the firm of Johnson, Branand & Jaeger, of Cleveland, Ohio, requesting a ruling as to the effect for Federal income-tax purposes of a proposed merger of the Consolidated Steamship Co., the Continental Steamship Co., the Duluth Steamship Co., the Inter Ocean Steamship Co., the Globe Steamship Corp., the Sumatra Steamship Co., and the Triton Steamship Co. Such letter was forwarded to this office by the district director of internal revenue, Cleveland, Ohio for consideration and reply.

Our records disclose that a power of attorney has not been filed authorizing the above-mentioned law firm to represent any of the foregoing corporations in Federal income-tax matters. For that reason, our reply is directed to you.

For the sake of brevity, the corporations mentioned above will hereinafter be referred to, respectively, as Consolidated, Continental, Duluth, Inter-Ocean, Globe, Sumatra and Triton.

The latter states that these coroprations are all engaged in the transportation of commodities in bulk such as iron ore, limestone, coal, and grain, between ports on the Great Lakes. They share business and transportation contracts, and have never actually operated as competitors. In addition, the corporations have had common directors and officers; the majority of the directors of one has always constituted a majority of the directors of all. All of the corporations have been operated under common management as a fleet under the name and style of the Tomlinson Fleet.

It is proposed that the corporations adopt a plan of merger which will be carried out in accordance with the provisions of the applicable laws of the States under which the corporations were organized, with Consolidated being the surviving and continuing corporation.

Continental, Duluth and Inter-Ocean are Minnesota corporations; Globe is an Indiana corporation, and Consolidated, Sumatra, and Triton are Delaware corporations. The proposed agreement of merger provides that the name of Consolidated, the surviving corporation, will become Tomlinson Fleet Corp. The stockholders of each of the corporations will surrender their shares in such corporations, and in exchange will receive common stock of the Tomlinson Fleet Corp.

The exchange will be based on the book value of assets with one exception, which relates to the value of the steamer Morton E. Farr, owned by Consolidated. For the purpose of the exchange of stock only, the book value of the steamer will be increased in the amount of $221,106.85, in order to be commensurate in value to two sister ships owned by Continental and Globe.

The present outstanding capital stock of Consolidated is owned 1,800 shares by Duluth, 1,800 by Globe, 1,800 by Inter-Ocean and 100 shares by Mr. Edward C. Davidson. Based on the higher value for the steamer Morton E. Farr, Mr. Davidson will be entitled to receive approximately 1.716 shares of common stock of Tomlinson Fleet Corp. for each share of Consolidated owned by him. The stockholders of the other corporations will receive common stock of Tomlinson Fleet Corporation according to the approximate ratio, based on the 1952 balance sheets, shown as follows:

Holders of shares of:	*Ratio of shares of Tomlinson Fleet Corp. to shares of merging corporations*
Continental	1.076
Duluth	1.100
Inter-Ocean	1.802
Globe	1.585
Sumatra	1.685
Triton	1.245

Fractional shares of stock will not be issued by Tomlinson Fleet Corp., but provision will be made for the issuance of scrip representing fractional shares. Any stockholder or other person acquiring scrip constituting a full share, and presenting it within 5 years after the effective date of the merger, will be entitled to receive a full share of Tomlinson Fleet Corp. Holders of scrip will have no rights as stockholders, and the scrip will be of no effect after the expiration of the 5-year period.

Based solely on the information submitted, it is held as follows:

(1) The proposed statutory merger of Continental, Duluth, Inter-Ocean, Globe, Sumatra, and Triton into Consolidated, will constitute a reorganization within the meaning of section 112 (g) (1) of the Internal Revenue Code. No gain or loss will be recognized to such corporations as a result of the merger.

(2) No gain or loss will be recognized to the stockholders of Continental, Duluth, Inter-Ocean, Globe, Sumatra and Triton as a result of the exchange of their stock of such corporations solely for common stock, including scrip for fractional shares, of Tomlinson Fleet Corp. (sec. 112 (b) (3) of the code).

(3) The basis to the stockholders of the common stock and/or scrip received pursuant to the merger will be the same as the basis of the stock exchanged therefor (sec. 113 (a) (6) of the code).

(4) No gain or loss will be recognized to Mr. Edward O. Davidson upon the exchange of his common stock of Consolidated for common stock, including scrip for a fractional share, of Tomlinson Fleet Corp. The basis of such new common stock and scrip will be the same as the basis of the Consolidated shares exchanged therefore.

(5) In determining the holding period for which the stockholders have held their new shares and/or scrip, there will be included the period for which they held their old shares (sec. 117 (h) (1) of the code).

(6) The undistributed accumulated earnings and profits of Continental, Duluth, Inter-Ocean, Globe, Sumatra and Triton existing at the date of the merger will retain their character as such in the hands of Tomlinson Fleet Corp. for the purpose of determining the amount of earnings and profits of the latter available for the distribution of dividends within the meaning of section 115 (a) of the code.

Very truly yours,

FRANCES B. RAPP,
Acting Chief, Reorganization and Dividend Branch.

LAW OFFICES OF COOPER, BYRNE, DUNHAM, KEITH & DEARBORN,
New York 7, N. Y., April 5, 1954.

Re H. R. 8300, Section 1235

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: Since writing letters dated April 2 to you and to each member of your Committee, I learn that H. R. 8300 will be open for discussion at hearings of the Senate Finance Committee commencing April 6th.

I therefore am enclosing herewith a recent analysis which I have made of the present law and the proposed law H. R. 8300 in a Memorandum entitled Income and Capital Gains from Patents.

I regard Section 1235 as particularly important to the welfare of the country and urge that the proposed law be modified to encourage inventors who have played and continue to play such a vital part in the industrial progress of this great nation.

Cordially yours,

R. J. DEARBORN.

NEW YORK, *April 2, 1954.*

Memorandum Re Income and Capital Gains From Patents

A leading case under the present law prior to 1950 was that of Edward C. Myers (6 T. C. 258 (1946)).

This case involved an exclusive license to manufacture, use and sell a patented article—which exclusive license is regarded as tantamount to an assignment under the doctrine of *Waterman* v. *Mackenzie* (138 U. S. 252 (1891)) providing for annual payments, referred to in the agreement as "royalties" equal to 5 percent of the selling price of the articles manufactured and sold for the specified minimum annual payment. The court found that the patent was a capital asset and that the exclusive license was a "sale." The payments were held to be properly taxed as capital gains disregarding the fact that such payments were called "royalties."

The law had thus been regarded as settled, that modes of payment were irrelevant to a determination of the tax status of proceeds received from the sale or exclusive license of a patent. One question remained for determination on the facts, namely, was the inventor in the business of inventing and selling patents and if so, the proceeds from the sale of any patent would be taxable income regardless of the method of payment.

The above was at first acquiesced in by the Commissioner of Internal Revenue (C. B. 1946-1 (3), as published in Internal Revenue Bulletin number 12, dated June 17, 1946.

This position was reversed by the Commissioner by Minutes 6490 March 20, 1950, 1950-1, Cumulative Bulletin P 9, from which the following is quoted:

"4. The Bureau has reached the conclusion that where the owner of a patent enters into an agreement whereby, in consideration of the assignment of the patent, or the license of the exclusive right to make, use, and sell a patented article, the assignee or licensee agrees to pay to the assignor or licensor an amount measured by a fixed percentage of the selling price of the article so manufactured and sold, or amounts per unit based upon units manufactured or sold, or any other method measured by production, sale, or use either by assignee or licensee, or amounts payable periodically over a period generally coterminous with the transferee's use of the patent, such agreement, for income tax purposes, is to be regarded as providing for the payment of royalties taxable as ordinary income.

"5. Acquiescence in the decision of The Tax Court of the United States in *Edward C. Myers* v. *Commissioner* (6 T. C. 258), as it relates to the issue whether the payments involved therein were taxable as gain from the sale of property, is hereby withdrawn and non-acquiescence substituted."

The danger that the patentee may be held to have made the invention in the "ordinary course of his trade or business" is illustrated in the case of *Goldsmith* v. *Commissioner* (143 F. (2d) 466 (2d Cir. 1944)) where it was held that the sale of the only play that Goldsmith had written was nevertheless not a capital asset since Goldsmith was in the business of play writing.

Where an inventor has been employed by a corporation primarily to do research work or engineering work and all inventions made by him were assigned to the corporation without special compensation, it has been held in some cases that he was nevertheless not a professional inventor and if he made one invention on his own time and sold that he would be entitled to claim the proceeds as a capital gain. See *Briggs* (178 F. (2d) 748 (4th Cir. 1949)).

If the inventor has licensed his patent and collected royalties and thereafter makes a sale or exclusive license agreement whereby he loses complete control of the invention, the proceeds from the sale or exclusive license are properly classified as capital gain.

All of the capital gains provisions are of course dependent upon the the inventor having held the patent for more than the statutory period of 6 months formerly one year). However, the courts have held that the time from which the 6 months begins to run is the time when the invention is reduced to practice. See *Dieschner* (36 B. T. A. 782 (1937) Aff'd 110 F. (2d) 90, 3d Cir. 1940).

The Commissioner of Internal Revenue should be overruled by the court in view of the decisions above discussed and also particularly in view of the case of *Lamar* v. *Granger* (99 F. Supp. 17, United States District Court for the Western District of Pennsylvania, July 3, 1951), in which the court clearly distinguished between nonexclusive licenses granted by the patentee in one field of use and an exclusive license granted by the patentee in another field of use, holding that the exclusive license on which the patentee received "royalty" of 5 percent of the net selling price of the patented valves, with guaranteed minimum royalties of $1,500 per year involved a "sale or exchange" and that all of the 3 factors which the taxpayer must establish to avail himself of the benefits of section 117 (capital gains) were met as follows:

(1) That the property in question is a capital asset as defined in section 117 (a);

(2) That it has been held for more than 6 months, and

(3) That there has been a sale or exchange of the property.

See *General Aniline & Film Corp.* v. *Commissioner* (2 Cir. 139 F. (2d) 759). The court here reaffirmed that the critical date of ownership of the patent was reduction to practice from the standpoint of establishing the 6 months ownership, that the patentee was not an inventor by trade or in the business of inventing even though he had made a number of inventions.

New bill in Congress

It is particularly important that inventors and patentees should not be forced to litigate the ruling of the Tax Commission and hence the proposed new tax law should be worded so as to fully correct the difficulty and encourage the inventor.

The tax revision bill (H. R. 8300) entitled "Internal Revenue Act of 1954" has been passed by the House and is now in the Senate. Section 1235 pertaining to patents and the statement of the committee reporting the new tax code to the House is well covered by the National Patent Council Bulletin No. 17, dated March 22, 1954, copy of which is attached.

Section 1235 should be amended by the Senate and I am in complete accord with and concur in the recommendations of the National Patent Council for the following reasons:

(1) The value of the invention or patent is seldom known within 5 years and 17 years representing the life of the patent is fully justified.

(2) By a sale or exclusive license the inventor parts with his control just as fully whether the payments are received in 5 or 17 years and the transaction is properly classified as a sale.

(3) The inventor is seldom in position to finance the reduction to practice of his invention and hence the financial backer who takes the risk and may have acquired a part or the entire interest in the patent by assignment should be encouraged the same as the inventor by being allowed to make a sale or exclusive license subject to capital gains.

R. J. DEARBORN.

NOTES.—For more detailed discussion of the above subject see Practicing Law Institute pamphlet entitled Current Problems in Federal Taxation, Tax Aspects of Patents, Copyrights and Trade-Marks by Paul Gitlin and Wm. Redin Woodward, Copyright 1950.

Photostat copy of mimeograph 6490 dated March 20, 1950, is attached hereto.

N. P. C. DIGEST OF PATENT PROBLEMS,
NATIONAL PATENT COUNCIL,
Gary, Ind., March 22, 1954.

TAXES ON PATENT REVENUE

The tax revision bill, H. R. 8300, entitled "Internal Revenue Code of 1954" has finally been reported to the House of Representatives by the Ways and Means Committee. This code now contains a section devoted specifically to taxes on revenue from the sale or exchange of patent rights. The new section reads as follows:

"SEC. 1235. SALE OR EXCHANGE OF PATENTS *BY THE INVENTOR*.

"(a) GENERAL.—Gain from the sale or exchange of property consisting of a patent or application therefor, or an undivided interest therein which includes a part of all rights in such patent or application, BY ANY PERSON WHOSE EFFORTS CREATED SUCH PROPERTY shall be deemed gain from the sale or exchange of a capital asset if and only if—

"(1) the seller retains no interest whatsoever in the patent, application, or undivided interest therein so transferred, except to the extent that the purchase price may be related to the productivity, use, or disposition of the property transferred within a period of 5 years from the date of such sale or exchange; and

"(2) THE ENTIRE PROCEEDS OF SUCH SALE OR EXCHANGE ARE RECEIVED BY THE SELLER WITHIN A PERIOD OF 5 YEARS FROM THE DATE OF SUCH SALE OR EXCHANGE. For purposes of this paragraph, any proceeds due and payable within such period which are received thereafter solely by reason of failure of the purchaser (or any successor in interest of such purchaser) to fulfill a contractual obligation shall be deemed to have been received within such period." [Emphasis ours.]

The provisions of this new section are to be effective with respect to sales or exchanges of patent right occurring after the date of enacting of the 1954 code.

In reporting this new code to the House, the committee made the following statement:

"A. SALE OF PATENTS BY AN INVENTOR (SEC. 1235)

"Under present law an amateur inventor may receive capital gains treatment on the outright sale of his patent but a professional may not. However, if a sale arrangement results in royalty income, rather than installment payments, even an amateur inventor receives ordinary income tax treatment.

"The present distinction between amateur and professional inventors and between royalty income and installment payments is both arbitrary and confusing. MOREOVER, THE PRESENT TREATMENT TENDS TO DISCOURAGE SCIENTIFIC WORK.

"The bill makes no distinction between amateur and professional inventors or between royalty income and installment sales. Capital gains treatment is to be available in all such cases if the contract does not make the sales price dependent, for a period of MORE than 5 years, upon the productivity, use, or disposition of the patent in the hands of the buyer, and if the payments must be completed in 5 years (except for late payments resulting from the failure of the buyer to meet the contract terms). The statute of limitations is extended for this purpose." [Emphasis ours.]

It is regrettable that the committee, while appearing to recognize the necessity for encouraging the development of new inventions, imposed major restrictions upon the tax treatment of patent revenue that will surely defeat the very purpose for which this new section was added to our present tax laws.

It will be observed that section 1235 is limited specifically to transactions involving the inventor, and completely disregards the individual or individuals whose capital investment may have been largely responsible for the development and production of the invention. Also, this new section overlooks the investor whose capital is absolutely necessary in most instances for the commercial exploitation and marketing of the invention. The inventor's financial backer and the invention's promoter will most certainly be reluctant under this section of the proposed new tax code to invest the capital necessary for the production, development, and marketing of new inventions.

It is evident that this new section should be amended to apply to any patent owner and not solely to the inventor. Also, the restriction as to the time (5 years) within which capital-gains treatment is to be given to patent revenue should also be canceled, so that capital gains will apply on all patent revenue throughout the life (17 years) of the patent.

As a suggestion for changing section 1235 to eliminate the foregoing restrictions, attention is directed to the following:

"SEC. 1235. SALE OR EXCHANGE OF PATENTS

"(a) GENERAL.—Gain from the sale or exchange of property consisting of a patent or application therefor, or an undivided interest therein which includes a part of all rights in such patent or application, shall be deemed gain from the sale or exchange of a capital asset if, and only if—

"(1) THE ENTIRE PROCEEDS OF SUCH SALE OR EXCHANGE ARE RECEIVED BY THE SELLER DURING THE LIFE OF THE APPLICATION AND/OR PATENT. For purposes of this paragraph, any proceeds due and payable within such period which are received thereafter solely by reason of failure of the purchaser (or any successor in interest of such purchaser) to fulfill a contractual obligation shall be deemed to have been received within such period."

Because of the special rule under which the House of Representatives is considering this new tax bill, it is virtually impossible to seek any change or amendment in section 1235 before the House. It is possible, however, to have this section changed by bringing the matter to the attention of the Senate Finance Committee to whom this bill will be referred from the House of Representatives.

The House Ways and Means Committee also omitted, in their deliberations, to give favorable consideration to a percentage depletion allowance for patents as provided in H. R. 7040, copy of which was sent you on February 8. The Senate Finance Committee should also be advised promptly of this meritorious proposal and urged to incorporate it in the new tax bill.

All readers of this digest and their friends are urged to write, wire or personally contact promptly the following members of the Senate Finance Committee to express their views on this section of the proposed Internal Revenue Code of 1954.

Eugene D. Millikin, of Colorado, *Chairman*

Clyde R. Hoey (North Carolina)	Edwin C. Johnson (Colorado)
J. Allen Frear, Jr. (Delaware)	Walter F. George (Georgia)
Edward Martin (Pennsylvania)	George W. Malone (Nevada)
Harry Flood Byrd (Virginia)	Wallace F. Bennett (Utah)
John J. Williams (Delaware)	Robert S. Kerr (Oklahoma)
Ralph E. Flanders (Vermont)	Hugh Butler (Nebraska)
Russell B. Long (Louisiana)	Frank Carlson (Kansas)

SECTION 29.22(a)-1: What included in gross income. 1950-7-13328 Mim. 6490

Edward C. Myers v. *Commissioner* (6 T. C. 258)

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington 25, D. C., March 20, 1950.

Collectors of Internal Revenue, Internal Revenue Agents in Charge, and Others Concerned:

1. The Tax Court of the United States held in *Edward C. Myers* v. *Commissioner* (6 T. C. 258) that under the terms of the exclusive license agreement between the petitioner and the B. F. Goodrich Rubber Co. the petitioner sold his invention to Goodrich. The Commissioner's acquiescence [C. B. 1946-1, 3] in the Myers decision was published in Internal Revenue Bulletin No. 12 dated June 17, 1946.

2. Further consideration has been given to the question as to whether the decision in the Myers case should be accepted as a precedent in the determination of income tax liabilities of other taxpayers with respect to contracts containing essentially the same provisions.

3. The exclusive license agreement considered in the Myers case provided, among other things, that the licensor is to receive from the licensee, in return for the exclusive right to manufacture, use, and sell the patented article, annual payments equal to 5 percent of the selling price of the articles manufactured and sold, such annual payments, however, not to be less than a specified minimum annual amount.

4. The Bureau has reached the conclusion that where the owner of a patent enters into an agreement whereby, in consideration of the assignment of the patent, or the license of the exclusive right to make, use, and sell a patented article, the assignee or licensee agrees to pay to the assignor or licensor an amount measured by a fixed percentage of the selling price of the article so manufactured and sold, or amounts per unit based upon units manufactured or sold, or any other method measured by production, sale, or use either by assignee or licensee, or amounts payable periodically over a period generally coterminous with the transferee's use of the patent, such agreement, for income tax purposes, is to be regarded as providing for the payment of royalties taxable as ordinary income.

5. Acquiescence in the decision of the Tax Court of the United States in *Edward C. Myers* v. *Commissioner* (6 T. C. 258), as it relates to the issue whether the payments involved therein were taxable as gain from the sale of property, is hereby withdrawn and non-acquiescence substituted.

6. It is held, under authority contained in section 3791(b) of the Internal Revenue Code, that this ruling shall not be applied with respect to royalties received from such exclusive license agreements for taxable years beginning prior to June 1, 1950.

7. Inquiries regarding this mimeograph should refer to its number and the symbols IT:E1M.

GEO. J. SCHOENEMAN,
Commissioner.

Approved March 20, 1950.

THOMAS J. LYNCH,
Acting Secretary of the Treasury.

BELL, BOYD, MARSHALL & LLOYD,
Chicago, Ill., April 5, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR MILLIKIN: I am enclosing three memoranda containing suggested technical changes in the proposed new Internal Revenue Code. I am not asking to be heard personally because of the pressure of time upon the committee, but would appreciate it if these memoranda could be considered. They are as follows:

1. A memorandum concerning the income-tax provisions for the taxation of estates and trusts. *This memorandum was prepared for use by a subcommittee of the Chicago Bar Association of which I am chairman.* I have stricken out certain paragraphs which do not represent my own views. Those which remain are entirely technical in nature and for the most part deal with apparent defects in draftsmanship.

2. A memorandum concerning the estate and gift tax provisions, prepared for the estate and gift tax committee of the American Bar Association.

3. A memorandum of minor miscellaneous suggestions.

Very truly yours,

JAMES P. JOHNSON.

SUGGESTED REVISIONS OF INCOME-TAX PROVISIONS OF H. R. 8300 RELATING TO ESTATES, TRUSTS, BENEFICIARIES, AND DECEDENTS

(Subch. J of chapter 1, secs. 641-692)

SPECIFIC COMMENTS

1. *Section 642—Special rules for credits and deductions.*—In section 642(b), a simple trust, that is one which distributes all current income, is allowed a deduction of $300, and other trusts are allowed a deduction of $100. *It is believed this distinction creates more complications than it is worth, and that all trusts should be allowed a deduction of $100.* If any $300 deduction is to be allowed, it should be allowed to all trusts which have in fact distributed all ordinary income during the year, rather than only to trusts required to distribute all income.

2. *Section 663—Special rules applicable to sections 661 and 662.*—It should be made clear that the exception in subsection (b) (1) of section 663 includes two or more installments in final distribution. Many trusts provide that, for instance, the trust property should be distributed one-third at age 25, one-third at age 30, and one-third at age 35.

The subsection could be changed to read as follows:

"(1) Final distribution.—Any amount paid or credited as a final distribution, including any amount paid or credited as one of the series of not more than three final distributions at times and in amounts directed in the trust instrument, except to the extent the amount so paid or credited consists of gross income of the taxable year of the estate or trust."

3. *Subpart D—Treatment of excess distribution by trusts (secs. 665-8)—In general.*—Subpart D as proposed excludes up to $2,000 in excess of the income of any year from the throwback treatment. Exception may be necessitated in order to avoid an endless amount of reexamining of prior years' returns by reason of small, unintentional discrepancies between net income and distributed income. However, it may encourage tax avoidance. This amount could be reduced to $500, or perhaps eliminated, without occasioning undue complications.

4. *Section 665—Definitions applicable to subpart D.*—The age at which persons attain majority varies from State to State. In order to make the statute uniform as between States, the exception contained in subsection (b) (1) of section 665 should refer to a specific age rather than to minority. It is suggested that the subsection be changed to read as follows:

"(1) Amounts paid, credited, or required to be distributed to a beneficiary as income accumulated before the beneficiary reaches the age of 21 years or before his birth; and"

5. *Subpart E—Grantors and others treated as substantial owners (secs. 671-8).*—

A. *Section 673(b): Revisionary interests—Exception where income is payable to charitable beneficiaries.*—Subsection 673(b) should be eliminated. It permits the avoidance of the 20 percent (and in some cases 30 percent) limitation on deductions for charitable contributions if the taxpayer, by way of a trust, commits himself to make excess contributions for the taxable year and the following year. There is no more reason why this should be permitted with respect to a commitment by way of a trust than a simple pledge. And it is at least doubtful whether a taxpayer should be permitted to avoid the 20 percent limitation in any year simply by committing himself to do the same thing in the following year.

B. *Section 674 (b) (5): Power to control beneficial enjoyment—Power to distribute corpus.*—The last sentence of this section is defective. It provides that a power does not fall within the excepted powers described in the subsection if any person is enabled to add to the designated class of beneficiaries. A trustee may be given power to distribute corpus to specified beneficiaries. One of the beneficiaries may in turn be given a power to appoint his interest to others. By the language of the sentence referred to, the existence of the totally irrelevant power in the beneficiary would affect the nature of the power in the trustee. The sentence should be changed to read as follows:

"A power does not fall within the powers described in this paragraph if any nonadverse party has a power to add to the class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children"

The foregoing is equally applicable to the last sentence of subsections 674(b) (7) and 674(c).

C. *Section 674(b) (6): Power to withhold income.*—This subsection is correlative with the preceding one concerning powers to distribute corpus, but the standards vary. It is believed that the standards set forth in the preceding subsection are satisfactory and should be likewise applied in this subsection. It is absurd, for instance, to make the taxability of income to the grantor depend upon whether a power of appointment, exercisable 50 years hence, is a general or a special power. It is suggested that this subsection be changed to read as follows:

"(6) POWER TO WITHHOLD INCOME.—A power to distribute or apply income to or for any current income beneficiary, or to accumulate the income, provided that—

"(A) the power is limited by a reasonably definite standard which is set forth in the trust instrument; or

"(B) any accumulated income must be added to the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust."

D. *Section 674 (b) (8): Power to allocate between corpus and income.*—The words "and disbursements" should be inserted after "receipt."

E. *Section 675 (1): Administrative powers—Power to deal, etc.*—By the terms of this subsection, a power exercisable by a person other than the grantor, which enables the grantor *or any person* to purchase the trust preperty for less than full consideration makes the income of the trust taxable to the grantor. This would presumably apply to an option granted to a third person to purchase specific property for a predetermined price or a price determined by a formula. Such a person is in effect a beneficiary of the trust and should be so treated. The words "or any person" should be deleted.

F. *Section 675 (4): Administrative powers—General powers of Administration.*—Third: It is very common to give a beneficiary of a trust a power to direct or veto investments. The interests of a beneficiary are certainly adverse to any selfish motives on the grantor's part. The words "other than a beneficiary," should be added before "without the approval" in the first sentence of the subsection.

Fourth: It is believed that the next to the last clause of the second sentence of the subsection goes further than is intended. It makes taxable to a grantor the income of a trust in which a person in a nonfiduciary capacity has a power to direct investments, *except as to stocks or securities of widely held corporations.* However, the grantor should be taxable only if the power relates to stocks or securities of closed corporations and other investments closely indentified with the grantor. There is no reason why investments in bonds, real estate, mineral interests and commodities, for instance, should not be treated in the same manner as investments in widely held corporations.

G. *Section 678 (a): Person other than grantor treated as substantial owner—General rule.*—1. Subsection 678 (a) (1) provides in part that if any person has a power to vest the income of a trust in himself, he will be treated as the grantor of the trust. Capital gains, for instance will then be taxable to him, even though he has no power to receive them. He will therefore be in a worse position than a beneficiary to whom the trustee is *directed* to distribute income. The reference to income in this subsection should be eliminated, and it should be provided in section 662 (a) (1) that to the extent that any person has a power to have income distributed to himself, such income shall be treated as income required to be distributed currently, if such income is not otherwise taxable to the grantor or another person treated as such.

2. Under subsection 678 (a) (1), the beneficiary of a typical testamentary trust, who is given a limited or unlimited power to draw out corpus, would presumably be subject to tax on capital gains on the trust by reason of this

provision. This would cause considerable practical inconvenience. It is suggested that it at least be made clear that this section would not apply to a limited right of withdrawal. In this connection it should be noted that limited rights of withdrawal are excluded from the definition of taxable powers of appointment under the estate tax portion. (See sec. 2041 (b) (2).) This could be accomplished by changing subsection 678 (a) (1) to read as follows:

"(1) Such person has a power exercisable solely by himself to vest in himself in the taxable year out of the corpus the greater of $5,000 or 5 percent of the aggregate value of such portion."

II. *Application to preexisting trusts.*—It is believed that the changes suggested above should be applicable to all trusts. However, to the extent that they are not adopted with respect to trusts created in the future, it is strongly urged that they be adopted at least with respect to preexisting trusts.

MISCELLANEOUS SUGGESTED REVISIONS TO H. R. 8300

1. *Section 152 (b) (3)—Dependent defined.*—Section 152 (b) (3) of the proposed new code excludes from the definition of a dependent "any individual who is a citizen or subject of a foreign country" unless a resident of the United States or of a contiguous country. This language was introduced by section 10 of the Revenue Act of 1944, and the report of the House Ways and Means Committee states that the language "does not include any nonresident alien individual".

However, the phraseology actually in the statute discriminates against dual citizens, such as an American woman who marries a British subject, and the children of their marriage. It should be noted that the effect is not limited to the credit for a dependent, but extends as well to the parent's privilege of filing a return as head-of-a-family.

The purpose of the provision was obviously to exclude nonresident dependents of resident taxpayers because of the difficulties of proof. The policy, however, should not apply in the case of persons who by reason of citizenship must pay taxes regardless of residence, and whose children are actually living with them. The exclusion should be changed to read "any individual who is a nonresident alien unless such an individual is a resident of a country contiguous to the United States".

2. *Section 212—Expenses for production of income.*—A deduction should be allowed for legal expenses incurred in connection with the disposition of property by will or gift. Such expenses are, from the point of view of the taxpayer's family as a whole, an integral part of "the management, conservation, and maintenance of property held for production of income". There is, however, considerable doubt whether the expenses of drawing a will, for instance, is deductible under present law.

3. *Chapter 34—Documentary stamp taxes.*—

A. The differential in rate between par-value and no-par-value stock is unreasonable and should be eliminated. It makes the amount of tax depend on an entirely irrelevant set of circumstances. A compromise rate of perhaps 1 cent per share for transfers and 2 cents a share for issuance should be adopted.

B. A transfer by a grantor to a completely revocable trust, and a retransfer by the trustee to the grantor, should be exempt from the stock transfer tax. Such trusts are increasingly being used as agency accounts, and no real transfer of equitable ownership is involved.

JAMES P. JOHNSON.

APRIL 5, 1954.

SUGGESTED REVISIONS TO THE ESTATE AND GIFT TAX PROVISIONS OF H. R. 8300

SECTION 2032. ALTERNATE VALUATION

The limitation on the use of the optional valuation to estates in which the value of assets has declined to 66⅔ percent or less of the date of death value is absurd and inequitable. The only reasons stated in the committee report for its adoption are that "this optional valuation date tends to retard the distribution of assets included in the gross estate. Moreover, it frequently requires a determination of property values as of two dates, whether or not an estate tax was paid." The proposed change does nothing to remedy this situation. An executor will still not be willing to risk distribution of an estate before the optional valuation date, lest the value decline to 66⅔ percent or less, and he will still have to make two determinations of value to make sure that it has not so declined. The provision is obviously inequitable to the estate whose assets have declined to, for instance, 70 percent of date of death value.

SECTION 2039. ANNUITIES

The exemption in subparagraph (c) for annuities and other payments received from qualified pension plans and the like is discriminatory in favor of employed persons and against the self-employed, and should be removed.

SECTION 2040. JOINT INTERESTS

The tax advisory group of the American Law Institute recently approved, almost unanimously, the following proposal for taxing joint property:

1. That no gift tax be imposed upon any transfer by the taxpayer of property into joint tenancy or any similar tenancy with his spouse. Proposed section 2515 of the gift-tax law proposes that this treatment for tenancies by the entirety of real property, for the reason that persons who take title in this manner generally have no intention of making a gift and no knowledge that they are doing so. The same considerations are equally applicable to personal property. Since the property will be subject to tax in the donor's estate (except to the extent that he did not furnish contribution) no portion of the property transferred will escape taxation, and in fact an inequitable double tax will be eliminated. Moreover, since the spouses can report income on a joint basis regardless of the manner in which the title is held, no opportunity would be presented for avoidance of income tax without the payment of a gift tax. Substantial correlation between income tax and gift tax would therefore be preserved.
2. That the present estate tax rule for taxing jointly held property be retained with respect to property held jointly by spouses.
3. That the present gift tax rule be retained with respect to the creation of joint tenancies between persons other than spouses. A distinction between the creation of a joint tenancy with a spouse, and with a third person, has merit because in the latter case the transferor is usually conscious that he is making a gift.
4. That the estate tax rule with respect to joint tenancies between persons other than spouses be changed to subject to tax in the estate of each tenant a pro rata fraction of the value of the property regardless of the source of the consideration. This is the rule adopted in many State inheritance tax statutes and would avoid the tracing problem in cases in which a gift tax had been paid.

It is submitted that the foregoing is a fair and practical proposal and should be adopted.

SECTION 2041. POWERS OF APPOINTMENT

Doubt exists in certain cases as to what constitutes a pre-1942 power of appointment. For instance, if a trust was created before 1942 with a life estate in A, a subsequent life estate in B and a power of appointment in B, and if A dies after 1942, it could be argued that B's power was "created" after 1942. Similarly, if a trust was created prior to 1942 giving discretionary powers to the trustees, and if a successor trustee is appointed after 1942, it is uncertain whether his powers should be considered to have been "created" before or after 1942. In these instances, it is within the spirit of the Powers of Appointment Act of 1951 that these powers should be considered to be pre-1942 powers, since they are situations in which no remedial action can be taken. The statute should so state. This could be accomplished by adding to section 2041 (a) (1) a statement that, in the case of a power arising under an instrument executed prior to October 22, 1942, which power was not revocable or amendable by the grantor after that date, the power shall be considered to have been created before that date even though the identity of the donee of the power is not determined and the power does not become exercisable until after that date.

SECTION 2042. PROCEEDS OF LIFE INSURANCE

The complete elimination of the "payment of premiums" test of the taxability of life insurance proceeds is defensible only if the provisions of section 2037, relating to transfers taking effect at death, remain as set forth in the proposed bill. If the provisions of present section 811 (c) (3) are restored, the payment of premiums test should be applicable with respect to the excess of the proceeds received over the cash surrender value of a policy immediately prior to the decedent's death.

SECTION 2056. BEQUESTS, ETC. TO SURVIVING SPOUSE

Substantial doubt exists under the present law as to whether the common-disaster and 6-month-survivorship provision extends to trusts and insurance settlements which otherwise qualify for the marital deduction. The Commissioner originally took the position that it did not. After a considerable time he reversed his position. However, in view of the structure of the statute, the doubt is a real one, and it is carried over into the new bill. A new law will produce an additional period of uncertainty. It is suggested that the statute be made clear. This could be done by changing the first part of section 2056 (b) (3) along the following lines:

"For purposes of paragraphs (1), (4), and (6), an interest passing to the surviving spouse shall not be considered as an interest which will terminate or fail on the death of such spouse, and a power shall not be considered as not-exercisable in all events, if—

"(a) The death of the spouse will cause a termination or failure of such interest, or will cause such power to be unexercisable, only if * * *."

SECTION 2206. LIABILITY OF LIFE INSURANCE BENEFICIARIES

The provisions of both the present law and the proposed statute are unsatisfactory in situations in which insurance is settled under an option providing for installment payments or interest payments, and there is no provision in the local law or the decedent's will providing for the apportionment of estate taxes. Under the Internal Revenue Code the beneficiary is presumably liable for a pro rata portion of the taxes. But the tax is on funds which he has not received. In practice, we have on occasion worked out an arrangement between the insurance beneficiary and the executor permitting the beneficiary to pay over a portion of each installment as he receives it. However, this involves some risk on the executor's part and is certainly not feasible if there is not a continuing trust under the decedent's will. It is suggested that the following be added to section 2206:

"If an insurance company retains the proceeds of any policy after the death of the decedent pursuant to an optional mode of settlement elected by the decedent or a beneficiary, the company shall for the purpose of this paragraph be considered to be the beneficiary thereof to the extent of the proceeds so retained, and any contributions made on account of estate taxes with respect to such policy shall be paid out of the proceeds so held."

SECTION 2502. RATE OF TAX

It is ridiculous for the tax laws to contain rates such as 26¼ percent. While it was the original intention in enacting the gift-tax law to maintain a fixed ratio between gift-tax and estate-tax rates, the ratio need only be approximate. Tax rates should be expressed only in integers, and when possible in numbers divisible by 5. A readjustment of the rates should be undertaken for the benefit of all concerned, and need not affect the revenue.

Similarly, taxable brackets should be expressed in as round numbers as possible. There is some justification for brackets of $5,000 and $10,000 in the very lowest ranges, but, for instance, the bracket from $50,000 to $60,000 should be eliminated.

SECTION 2503 (B). TAXABLE GIFTS—EXCLUSIONS FROM GIFTS

1. The provision of the code concerning the $3,000 annual exclusion has given rise to controversy and litigation entirely out of proportion to its importance. The amendment proposed in section 2503 (c) meets only a small portion of the problem. It is suggested that instead of the donee exclusions, there be substituted a single annual donor exclusion in a compromise amount of perhaps $10,000. This would eliminate all questions concerning future interests.

2. If the foregoing suggestion is not adopted, one highly arbitrary and unreasonable rule which the Bureau has developed and managed to sell to the courts should be overruled. If a trust is created with all the income payable to a beneficiary for his life, it is conceded that the actuarial value of a beneficiary's life estate is a present interest. If in addition the trust agreement

provides that when the beneficiary reaches a given age he shall receive all of the trust property, or provides that the trustee may in his discretion distribute principal to the beneficiary (and to no one else), the beneficiary has received more economic benefit than in the case in a straight life estate. The Commissioner, however, has taken the position that because the technical life estate is subject to termination, the interest of the beneficiary cannot be valued and is therefore a future interest. This position was repeated as recently as March 1954 in revenue ruling 54-92. It is an example of abuse of administrative discretion involving an entirely artificial construction of law. The statute should be amended to provide that in determining the value of a present interest, the value of an income beneficiary's interest shall not be reduced by reason of the fact that his interest may be terminated by a distribution of principal to him.

SECTION 2514. POWERS OF APPOINTMENT

See comments under section 2041 above.

SECTION 2515. TENANCIES BY THE ENTIRETY

1. See comments under section 2040 above.
2. The draftsman of this bill appears to be under a misapprehension as to the common law and State statutory law concerning tenancies by the entirety and joint tenancies. The proposed section relates only to tenancies by the entirety. The committee report states that the section will apply "to any tenancy in real property having all the characteristics of a common law tenancy by the entirety, regardless of the term by which such tenancy is described under local property law." Tenancy by the entirety has been abolished by statute in a number of States, and joint tenancy substituted. This is more than a matter of terminology. One of the characteristics of a common law tenancy by the entirety is that neither tenant can sever his interest without the consent of the other. A joint tenant, on the other hand, can convert the tenancy into a tenancy in common at any time simply by conveying his interest to a third person. The proposed section is therefore discriminatory as between States and its application should be extended to joint tenancies.

SECTION 2523. GIFT TO SPOUSE

See comments under section 2056.

SECTION 6019. GIFT TAX RETURNS

1. A great deal of unnecessary paper work is required of both the Commissioner and taxpayers by the necessity of filing a return if a taxpayer makes a gift to a third person of a present interest in $6,000 and he and his spouse elect to have the gift considered as made one-half by each of them, or if one spouse makes a gift of $6,000 to the other. Section 6019 (a) should be amended to provide that no return shall be required with respect to any transfer which, solely by reason of section 2513 or section 2523, is, under section 2503 (b) not to be included in the total amount of gifts for such year. Section 2513 (a) (2) should in addition be amended to provide that, in case of any gift which is such that, if both spouses had signified their consent to the application of paragraph (1), no amount would be included on account of such gift in the total amount of gifts made during the year by either spouse, both spouses shall be presumed to have signified their consent.
2. Even more unnecessary paper work is required by the Commissioner's insistence that donees make returns even though a donors' return has been filed. His insistence is particularly aggravating in the situations referred to in the preceding paragraph. The sole purpose of donees' returns is to insure the filing of a return by the donor. Nevertheless, if a taxpayer makes a gift of $6,000 to each of his children, and he and his spouse elect to have the gift treated as having been made one-half by each and he duly files a return, each child will receive a letter demanding a donees' return. The statute should be amended to provide that, notwithstanding any other provision of law, no return shall be required from any donnee with respect to a gift in fact reported by the donor in his return. It should be pointed out that there is no express provision in the statute requiring donees' returns, and that they are presumably required under the general authority of section 6011 on the theory that the donee is contingently liable for the tax.

SECTION 6075 (B). TIME FOR FILING GIFT TAX RETURNS

If the date for filing final individual income tax returns is extended to April 15, the same date should be used for gift tax returns. Taxpayers should be required to remember as few dates as possible.

SECTION 6324. SPECIAL LIENS FOR ESTATE AND GIFT TAXES

1. Subsection (c) of 6324 divests the estate or gift tax lien with respect to a security in the hands of a purchaser for full consideration without knowledge of the existence of the lien. This probably is no extension of existing law. Subsection (a) (2), in addition to the subject matter disclosed in the title, operates to divest the estate tax lien on property sold to a bona fide purchaser by any person in possession of the property at the time of the decedent's death except his executor. Subsection (a) (3) operates to discharge the lien on a sale by the executor after receipt of a discharge from personal liability. Subsection (b) operates to discharge the gift tax lien on a transfer to a bona fide purchaser. The only thing left for the new subsection (c) to operate on is apparently a transfer by an executor before discharge from personal liability. In such a case, subsection (c) presumably only operates with respect to a sale of bearer or street-name securities in a transaction in which the purchaser does not know he is dealing with a decedent's estate, since if he did have such knowledge he would presumably be charged with notice of the lien. So far as I know, there is no indication in present case law that courts would not reach this result under the present statute.

There is no sound reason why the lien should not be divested with respect to any property, whether a security or other real or personal property, if a purchaser pays full value to the transferor of the property—at least if the transferor is an executor or other fiduciary. The revenue will be adequately protected by the resulting lien on the consideration in the hands of the fiduciary. However, as indicated above, if a purchaser knows he is dealing with a decedent's property, he is presumably charged with notice of the lien and is not a bona fide purchaser. To facilitate the marketing of a decedent's property, the following should be substituted for subsection (c):

"(c) For the purposes of this section, a bona fide purchaser from an executor or other fiduciary shall be considered to be such regardless of his knowledge of the existence of a lien for estate or gift taxes upon the property purchased."

2. The lien and transferee liability sections of the code with respect to estate and gift taxes, as well as these provisions in general, are in need of overhauling. Section 6324 contains considerable overlapping and is illogical in its arrangement. Section 6901, which appears to be the successor to Revised Statutes section 3467, is so vague in its language that courts are still uncertain as to its meaning.

SECTION 6501 (E) (2). LIMITATIONS—OMISSIONS

Section 6501 (e) (2) provides for an extension of the estate and gift taxes statute of limitations to 6 years if the taxpayer omits from the return "so much of such gross estate or such total gifts as the case may be as exceeds in amount 25 percent of the gross estate stated in the return. * * *" This proposed new subsection should be deleted.

An executor may in good faith omit from a tax return gifts of which he has no knowledge. If an executor distributes an estate before the expiration of the limitation period, he remains personally liable to the extent of the value of the property distributed. This problem is recognized in section 2204, which discharges an executor from liability within 1 year if he makes a request for prompt determination of the tax. However, the courts have construed the corresponding income tax provision in section 6501 (d) not to be applicable in the case of omission of more than 25 percent of the income from the return, in which event the 6-year limitation under section 6501 (e) (1) is applicable. Presumably this same construction would be applicable to section 6501 (e) (2). The result would be that instead of being able to distribute an estate 1 year after the return is filed, an executor must wait 6 years.

Further, an executor may in good faith understate the finally determined value of nonmarketable property by more than 25 percent. Since the proposed new subsection refers to the "amount" of an estate or gift, such an understatement would in itself presumably bring the 6-year period into operation.

Estates are hard enough to close now, without this additional complication.

JAMES P. JOHNSON.

APRIL 5, 1954.

CENTRAL STATE BANK,
Oklahoma City 2, Okla., March 31, 1954.

Re Suggested Revision of Section 353 of the Proposed Internal Revenue Code of 1954 (H. R. 8300).

The Honorable EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington 25, D. C.

MY DEAR SENATOR: First, we wish to compliment you and the members of your committee, as well as the members of the House Ways and Means Committee, for the excellent work you are doing in the comprehensive revision of our internal revenue laws. We are particularly impressed with your efforts to eliminate, insofar as possible, the uncertainties and inequities existing under our present internal revenue laws, thereby permitting taxpayers to ascertain in advance the treatment of their actions for tax purposes. This revision has been needed for many years.

We are particularly interested in section 353 of H. R. 8300, which, in general, provides that stock of a controlled corporation may be distributed to the shareholders of the parent corporation without such shareholders incurring prohibitive tax liabilities which might otherwise be assessed on "unrealized" profits. We agree with the House Ways and Means Committee that such section should contain provisions which will insure that tax avoidance will not result from such distributions. However, *we believe that through inadvertence banks, insurance companies, and similar "active" corporations will be classified as "inactive corporations," unless such concerns are specifically excluded from the definition of an "inactive corporation" under section 353 (c) of the bill, as they are excluded from personal holding company surtax under section 542 (c).* It is doubted that Congress would intentionally classify banks, insurance companies, and similar corporations subject to governmental regulation, with ordinary corporations deriving more than 10 percent of their gross income from interest, dividends, rent, royalties, etc.

Accordingly, we urge your committee to amend subparagraph (3) of section 353 (c) of the proposed Internal Revenue Code of 1954, to provide, in substance, as follows:

"(3) Either the corporation, the stock of which was distributed, was a corporation included in the exceptions set forth in section 542 (c), or 90 percent or more of the gross income of such business for each year of such 5-year period, was other than personal holding company income as defined in section 543."

For your consideration, we are enclosing herewith a more detailed discussion of the need of the suggested amendment by banks, insurance companies and similar organizations which Congress has never seen fit to classify as personal holding companies. This discussion also sets forth the specific problem now confronting one corporation, which, for sound business reasons, desires to distribute to its stockholders its holdings in certain banks now controlled by it.

We respectfully request that you and your committee correct this inadvertent inequity now contained in H. R. 8300, as it passed the House of Representatives

Very truly yours,

CENTRAL STATE BANK
(A Subsidiary of Midcontinent Bancshares, Inc.),
By: L. D. LACY, *President.*

INEQUITIES UNDER SECTION 353 OF THE PROPOSED INTERNAL REVENUE CODE OF 1954

GENERAL COMMENTS

Section 353 in general provides that stock of a controlled corporation may be distributed to the shareholders of the parent corporation without immediate tax consequences. In the case of the distribution of the stock of "inactive corporations" certain restrictions are imposed on the stock so received. For a period of 10 years any amounts received as distributions on the stock or in disposition of the stock are to be taxed as ordinary income to the full extent of the proceeds of such sale. The report of the Committee on Ways and Means clearly indicates in its detailed discussion an intention to permit freedom in the distribution of stock of controlled corporations and at the same time to insure that tax avoidance will not result.

By the proposed statutory definition an "inactive corporation" is one which does not meet three tests. The third test requires that not more than 10 percent of the gross income be personal holding company income as defined in section 543.

Section 543 defines personal holding company income as dividends, interest, rents, etc. However, section 542 (c), in the definition of a personal holding company, makes specific exceptions of certain active corporations such as banks, life-insurance companies, various types of lending, finance, and operating loan and investment companies whose principal operations result in the receipt of substantial amounts of interest in relation to other types of gross income.

It is not believed that active corporations such as banks, insurance companies, loan and investment companies, and finance companies were intended to be included as "inactive corporations." Corporations of this type derive personal holding company income from an active conduct and operation of the business which by the very nature of the businesses produce this type of income. It is believed that the same exceptions should apply in the definition of an "inactive corporation" as are exceptions under section 542 (c) which defines a personal holding company.

SPECIFIC PROBLEM

Mid-Continent Bancshares, Inc., is a bank holding company owning directly or indirectly 100 percent of the stock of 4 banks and 2 Morris plan companies. Mid-Continent Bancshares, Inc. has no assets other than the stocks of these controlled corporations except of a very nominal nature. It is engaged in no business other than as a holding company of the stocks of these subsidiaries.

Each of these subsidiary companies is an active operating company and has been held by Mid-Continent Bancshares, Inc., for a period in excess of 5 years and has maintained separate books and records. However, because of the nature of the business conducted by each subsidiary, a sizable portion of the income of each is classified as personal holding company income which, by the proposed statutory definition would classify each of these subsidiaries as "inactive corporations," even though they are exceptions in the personal holding company definition in section 542 (c) (2) and (8). It is believed that these exceptions were inadvertently omitted in section 353, and that it was not the intent to classify banks and other active operating corporations arbitrarily as "inactive corporations" with the resulting restrictions and penalties.

Certain circumstances will probably require the distribution of all the stock of one or more of the subsidiaries of Mid-Continent Bancshares, Inc. Among these are:

1. Compliance with proposed Federal bank holding company legislation.
2. Two of the banks are Texas banks and the constitutional prohibition against branch banking in Texas has recently caused certain interpretations and rulings which quite possibly will result in the necessity for the separation of the two Texas banks.
3. The need to raise additional capital in the subsidiary banks to provide satisfactory capital ratios. (The Federal Deposit Insurance Corporation reports a national average of approximately 7 percent and strongly recommends that banks below this figure make every effort to attain this ratio.) Each of the subsidiary banks is substantially below the national average. Retention of earnings has not kept pace with growth. Such additional capital cannot be attracted because of ownership of control through a holding company.

It is therefore respectfully requested that the apparent inadvertent inequity which would affect actively operating banks and loan and finance companies in the definition of an "inactive corporation" should be remedied by exemption from the definition of "inactive corporations" those corporations which are specifically exempted from the personal holding company definition under section 542 (c) of the proposed Internal Revenue Code of 1954, provided that they satisfy the requirements of section 353 (c) (1) and (2) as to ownership for a period of 5 years and separate books and records having been maintained for a period of 5 years.

NATIONAL BANK OF COMMERCE,
Memphis, Tenn., March 30, 1954.

Senator JOHN C. STENNIS,
Senate Office Building,
Washington, D. C.

DEAR SENATOR STENNIS: As suggested by you in our telephone conversation of today with reference to the proposed Internal Revenue Code for 1954 (H. R. 8300), this letter is being written to give you our thoughts on the matters discussed. Section 505 of the proposed code deals with investments which are approved for exempt pension and profit-sharing plans. Section 505 (a) (3) reads as follows:

"(3) annuity contracts, or retirement income contracts in which the face amount does not exceed 100 times the monthly annuity payable at normal retirement age under the plan."

Further on in section 505, there is a provision to the effect that this section applies to investments made after March 1, 1954. Our pension plan is what is known as a combination plan, that is to say, one which combines a group life-insurance contract having a conversion feature with a self-administered trust fund. Our contract provides for annual premiums and as additional employees become eligible for entry into the plan they are added to our master contract as additional insureds.

We are fearful that if the pending bill is enacted in its present form that the subsequent payment of premiums not only for the present members of the plan, but for new employees becoming eligible as members would destroy the tax-exempt status of our pension plan. It would, therefore, mean that we would either have to change our plan, to the detriment and unrest of our employees, and the form of the insurance contract or discontinue the life-insurance feature of our plan which is a material part thereof.

At the present time, this institution has 266 employees of which 76 have met the entrance requirements and are members of the plan. The covered members of the plan now enjoy very cheap life insurance which is payable to their beneficiaries and in many instances they would be unable to privately own an equal amount of life-insurance coverage. Furthermore, our policy has a nonmedical provision to the extent of $12,500 of coverage and there are several members of the plan who by reason of their physical condition could not purchase life insurance on an individual basis. We, therefore, respectfully suggest that section 505 (a) (3) be amended so as to read as follows:

"Annuity contracts, retirement-income policies, or life-insurance policies containing provisions for conversion to annuity contracts or retirement-income policies; the face amount of which does not exceed 100 times the monthly annuity payable at normal retirement age under the plan."

Our plan was designed to encourage stability in our employees, provide cheap life-insurance protection and retirement income for them upon their retirement. All employees of our bank are eligible to participate in the plan and will participate as soon as they have met the entrance requirements. We wish to emphasize the point that the insurance and the retirement plan is for the sole benefit of the employees and their beneficiaries.

We will appreciate your consideration of this problem which confronts us as well as many other employers over the country who have established pension or profit-sharing plans embracing life-insurance features for the benefit of their employees.

Sincerely yours,

R. G. BROWN,
Vice President and Trust Officer.

LOWE PAPER CO.,
Ridgefield, N. J., March 22, 1954.

HON. H. ALEXANDER SMITH,
Senate Office Building,
Washington, D. C.

DEAR ALEX: My attention has just been called to a provision in the new tax bill which would, apparently, discriminate very sharply to the disfavor of small corporations, like my own, which have or may have a profit-sharing trust and pension plan.

Naturally in a concern of this sort there is a predominating number of large stockholders among the officers and a good many of these are bound to be related by family ties. To legislate against the approval of a pension trust plan wherever more than 30 percent of the funds of such a plan might be used for stockholder benefits would, it seems to me, injure the health of the corporation rather seriously.

For instance, in my own case, if it is impossible for the corporation to set up a reasonable pension retirement plan for me, I shall be tempted to retain my position as chief officer as long as I live. The ambition as well as the ability of younger men in the organization would doubtless be thereby adversely affected.

Since there are so many small concerns like our own in the country, I think the economic health of the Nation is threatened by this type of legislation.

I urge that you look into the matter and discuss with Dan Reed the advisability of eliminating this particular part of the act.

Very truly yours,

DONALD V. LOWE, *President.*

MARCH 22, 1954.

Hon. DANIEL A. REED,
House Office Building,
Washington, D. C.

MY DEAR CONGRESSMAN: I am the head of a relatively small, but successful, family owned and managed corporation. My attention has been called to a sentence in the new tax bill which appears to discriminate against stockholders and officers of a company such as this. In the hope that you may have overlooked the possible damage that would flow from such legislation, may I call your attention to certain consequences that I think would be unfavorable?

In this particular company, and I think there are many others throughout the Nation similarly constituted, the predominant ownership and various important management positions are held by individuals closely related through family ties. To deprive these officers of the advantages of a profit-sharing pension trust would, in my opinion, adversely affect the growth and economic strength of the company with consequent injury to the interest of employees and customers as well. Present officers, even though they are stockholders and related familywise, must be moved on to make way for the younger generation. Dividend returns, particularly after stock distribution has been effected in the normal ways, remain so low as to arouse the temptation on the part of the older officers to remain in office beyond the period of maximum productivity, thereby discouraging the younger members of the group. The resulting damage to the virility of small companies such as this, it seems to me, would more than offset any tax gains that might result from restrictive legislation of the kind we are discussing.

If opportunity occurs for reconsideration of this proposal, which I quote below, please give serious consideration to its elimination:

"A plan is considered to discriminate in favor of stockholders if more than 30 percent of the funds are used for stockholder benefits. For this purpose an employee is considered to be a stockholder if he owns 10 percent or more of the company's stock (including stock held by close relatives)."

Very truly yours,

LOWE PAPER CO.,
DONALD V. LOWE,
President.

LOURIE & CUTLER,
BOSTON, MASS., *March 26, 1954.*

HON. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: I recently wrote to you urging that you support a change in the changeover provisions of section 461 (c) (2) of the Internal Revenue Code of 1954 accompanying the switch in the method of accruing the deduction for local real estate taxes. May I amplify that letter by two examples showing how the present provisions work and how my proposed substitute solution would work.

Case 1. Corporation with a fiscal year ending January 31 in a State like Massachusetts which assesses local real-estate taxes as of January 1 of each year. Purchase price of real estate, $200,000. Annual real-estate tax $12,000. Corporation purchases real estate on February 1, 1948.

How was this transaction treated when property was purchased?

1. By adjustment between the seller and purchaser, the seller paid the purchaser $1,000 on account of the taxes for January 1948.

2. The purchaser took into account the fact that there was a lien of $12,000 on the property due to the taxes assessed on January 1, 1948.

3. The purchaser therefore established as its cost basis for the property which it bought the amount of $211,000.

4. On its first return for its fiscal year ending January 31, 1949, the purchaser took a deduction for $12,000 the amount of the taxes assessed on January 1, 1949.

5. The purchaser continued to take a deduction for 1 year's taxes in its return for each following full year.

6. On its return for January 31, 1954, the last year it can operate under the 1939 Code, it deducted the amount of taxes assessed on January 1, 1954.

We now change over to the new system of deducting for a ratable period. In my previous letter, I recommend that this be accomplished by requiring an adjustment of the basis of the property equal to what otherwise might constitute a double deduction. How would such a solution work out?

1. In its return for the year ending January 31, 1955, the taxpayer would take a $12,000 deduction, $11,000 for 11 months of the 1954 taxes, and $1,000 for 1 month of the 1955 taxes. This reflects its normal business operations just as have its previous returns. Each year it has paid a full year's taxes and should have a full year's deduction.

2. As this results in a duplication of tax deduction, the taxpayer should be required to deduct $11,000 from the cost basis of the property. Disregarding depreciation, this means that the cost basis of the property is now reduced to $200,000.

3. The effect of this solution is thus to put our taxpayer back into the same position it would have been in if the proposed new method of deducting real-estate taxes had been in effect at the time the property was purchased. It has had a full year's tax deduction for each year of its operation. The purchase price of the property is now readjusted to just what it should have been in the first place.

Now let us see how the provisions presently contained in section 461 (c) (2) of the Internal Revenue Code of 1954 would work out.

1. In its return for the year ending January 31, 1955, the taxpayer will be permitted to deduct only $1,000 on account of real-estate taxes.

2. The taxpayer will be required to pay an income tax on $11,000 of purely fictitious paper income.

3. Its cost basis for the property in question will remain at $211,000 which is obviously an artificial unreal basis due to the peculiar technical results of proceeding under the 1939 Code provisions.

Which is the fairer method of making the necessary changeover from the old to the new system? The change of basis solution that I have proposed which restores the original purchase transaction to reality and imposes no new unreal penalty tax on nonexistent income, or the presently proposed changeover provisions which continues the unreality of the original purchase transaction and in addition imposes an unfair new tax on the taxpayer?

Case 2: Assume the same facts as in case 1 except that the original purchase took place in a State which assesses local real-estate taxes (allocable to a calendar year) on April 1.

How was this transaction treated when the property was purchased?

1. By adjustment between the seller and purchaser, the seller paid the purchaser $1,000 on account of the taxes for January, 1948.

2. The taxes for 1947 having been paid and those for 1948 not having been assessed, there was no lien on the property to be taken into account.

3. The purchaser therefore established as its cost basis for the property it bought the amount of $199,000.

4. On its first return for the fiscal year ending January 31, 1949, the purchaser took a deduction for $12,000, the amount of taxes assessed on April 1, 1948. This is the same as our taxpayer in case 1.

5. The purchaser continued to take a deduction for 1 year's taxes in its return for each following full year. This is the same as our taxpayer in case 1.

6. On its return for January 31, 1954, the last year it can operate under the 1939 Code, it deducted the amount of taxes assessed on April 1, 1953.

We now change over to the new system of deducting for a ratable period. If the recommended changeover solution by readjusting the cost basis of the property is substituted for the present provisions, the changeover would work out as follows:

1. In its return for the year ending January 31, 1955, the taxpayer would take a $12,000 deduction, $11,000 for 11 months of 1954 taxes, and $1,000 for one month of 1955 taxes. This is the same as the taxpayer in case 1

2. As this results in the loss of a part of a tax deduction, the taxpayer should be permitted to add $1,000 to the cost basis of the property. Disregarding depreciation, this means that the cost basis of the property is now increased to $200,000.

3. Here again, the effect of this solution is thus to put our taxpayer back into the same position he would have been in if the proposed new method of deducting real-estate taxes had been in effect at the time the property was purchased. It has had a full year's tax deduction for each year of its operation. The purchase price is now readjusted to just what it should have been in the first place.

Now let us see how the provisions presently contained in section 461 (c) (2) of the Internal Revenue Code of 1954 would work out.

1. In its return for the year ending January 31, 1955, this taxpaper will be permitted to deduct $13,000 on account of real-estate taxes even though it has only paid out $12,000.

2. This taxpayer will get a purely fictitious paper deduction of $1,000, thus saving income tax on this amount.

3. Its cost basis for the property in question will remain at $199,000 which is obviously an artificial unreal basis due to the peculiar technical results of proceeding under the 1939 Code provisions.

Which is the fairer method of making the necessary changeover from the old to the new system? The change of basis solution that I have proposed which restores the original purchase transaction to reality and grants no unreal bonus for a nonexistent expense, or the presently proposed changeover provisions which continues the unreality of the original purchase transaction and in addition grants an undeserved bonus to the taxpayer?

Finally why should the 2 taxpayers in the 2 examples given above be treated differently? Why should a taxpayer in Massachusetts be penalized by a fictitious tax while a taxpayer in another State under exactly similar circumstances is awarded a fictitious bonus? The only difference in these two cases is the difference in the date on which real estate taxes have by law been assessed.

Very truly yours,

GEORGE B. LOURIE.

HOOSIER CARDINAL GIFT & CARD SHOP,
Economy, Ind., March 25, 1954.

Senator WILLIAM JENNER,
Senate Office Building, Washington, D. C.

DEAR SIR: I have been interested in the proposed revisions of the present income tax laws, particularly as it affects the little fellow, the severely handicapped, and those who have the care of invalids.

The thing I know the most about, naturally, is my own condition, and I seem to be in a peculiar category. I am severely handicapped, from 37 years of paralysis caused by polio and now arthritis, but still able to earn a meager living for myself and helper, in my home. For struggling so hard to maintain my freedom and independence, when many others would have given up and let someone support them, I am penalized each year, since I can claim only one exemption. That, in this case, I maintain, is unfair.

I am head of my household with one dependent which I am not allowed to claim as an exemption. She is child minded, entirely dependent upon me and not claimed as an exemption by anyone, as she has no near relatives. I cannot afford to hire domestic help at the prevailing wage, so I took this woman out of the county infirmary and therefore off the taxpayers, but because she is not in the right category of relationship, I cannot claim her as a dependent as far as income tax is concerned. I ask you—Is this fair? My friends who know the situation, think not. My helper is a second cousin to me but even if she were no relation, I ought to be able to claim her as an exemption under the circumstances, for no child was ever more truly dependent upon their parents, than she is upon me, and I would gladly furnish the proof.

I earn approximately $100 a month and even living economically, it costs the two of us all of that to live. Fortunately I have no rent to pay or could not make ends meet on that, but I do have the repairs and upkeep of the property, which is very old with no water or modern conveniences, except oil heat which I put in this winter. I cannot pay out much for medical bills; last year I was hospitalized 53 days, necessarily paid for by the department of public welfare.

When any big expense comes along, such as a special type wheelchair, I have to have help. Fortunately I have many friends, and they have been grand to me, or I could never have made the grade thus far.

If a person is not able to earn his or her entire living, should they be required to pay income tax? Circumstances alter cases, of course, but in my case when I have a true dependent, which in all ways but that of relationship meets the requirements for an exemption, should there not be some provision made in the law for such exceptional cases?

I am also much interested in seeing the handicapped given an extra $600 exemption, just as the blind and those over 65 now have. There are many individuals over 65 much more able to pay income tax than I am. Also, those noble souls who have the care of helpless individuals need the same extra exemption. True, there are a few handicapped who earn as much as normal people (the same with the blind) but they are very much in the minority, as most of us are in the low-income bracket.

I recently paid my income tax of $24, plus self-employment tax totaling $41.68, money which I needed for necessities, though I do not begrudge the self-employment tax so much, since I may live long enough to secure social-security benefits. In 1953 I paid $11.86 income tax, plus $16.10 self-employment tax; in 1952, $30.85 income tax and $25.31 self-employment tax. These are not large sums of money, and I do not wish to appear selfish, for I do appreciate living in this great and wonderful country of ours, but right is right, and I do not believe it is right for the severely handicapped to be penalized for the privilege of earning the little that the majority are able to.

I do hope you lawmakers will see fit to make some changes beneficial to those of us, who, because of physical disabilities, have a harder struggle than most to earn their living and come up smiling. Thank you.

Sincerely yours,

LOIS B. LENNOX.

THE WOMAN'S COLLEGE OF THE UNIVERSITY OF NORTH CAROLINA,
Greensboro, March 23, 1954.

Hon. ALTON LENNON,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR LENNON: May I comment on the tax bill which is currently before the Senate? I should enjoy, as any normal taxpayer would, the relief that would come from the proposed raising of the exemption from $600 to $700 or $800; but I believe that the risk in respect to further unbalancing of the budget is great and that this should be weighed against the larger purchasing power it would release. I do of course favor relief for the small payer before the large, as the bill at present seems to favor, and I see the political implications of each proposal; but I do not believe that political advantage should be the deciding factor when public welfare is at stake.

Now I should like to presume to suggest two amendments to the bill now before you. They grow from my own experience as an unmarried head of a household, but I believe that they are logical and reasonable and that they would help others than the few in my own group. And I do not think that either would cost the Government much.

1. Cost of care of dependents of working taxpayers

(a) The application of the same provision which applies to the married to the unmarried head of a household, i. e., $600 deduction for care of a child.

(b) The same provisions made applicable for elderly, ill dependents as for children. This to be granted both to the married and to the unmarried head of a household.

2. Relief for the taxpayer, both married and unmarried, whose dependent is blind

(My mother is 90, has been blind for years, and if I were only (1) married and (2) 65, she would get a double exemption. Her care is very expensive.)

Thank you very much for your consideration of this request.

Sincerely,

VERA LARGENT.

TWIN CITY-MINNESOTA EDUCATION ASSOCIATION,
LEGISLATIVE COMMITTEE,
March 19, 1954.

SENATOR EDWARD J. THYE,
Senate Office Building, Washington, D. C.

DEAR SENATOR THYE: Now that the tax revision bill has passed the House, including as it does, the exclusion of $1,200 income tax for all retired peoples, both I and the groups which I represent will very greatly appreciate it if you will make every effort to secure the passage of this particular part of the tax revision bill.

The retired teachers throughout the country, and the rather large organization here in Minnesota, and the organization of police and municipal employees already retired, are very active in support of this exclusion measure, and we hope very much that the Senate will pass it with a good vote.

We regretted the limitation which was put on at the February 25 meeting of the Ways and Means Committee in the House, following approval of the proposal as we had hoped it would pass at the previous meeting held on February 17 of this year.

This proposal, H. R. 8300, will of course go directly to the Senate Finance Committee. We are extremely anxious to have the exemption apply to persons retired prior to age 65 under a public or private retirement plan. Of course, we should like to have the exclusion figure raised to $1,500 which was in the original Mason bill, H. R. 5180, and was changed at the February 17 meeting of the House Ways and Means Committee.

I shall greatly appreciate it if you will speak to your friends on the Senate Finance Committee, and if you will give your utmost efforts in securing the passage of this part of the proposed measure which directly affects so many people, all of whom have given much to their country.

Hoping to hear from you, and counting on your unfailing support, I am

Sincerely yours,

LOUISE GREGORY LADD
Mrs. Albee Ladd,
Legislative Representative.

LAW OFFICES OF MARTIN ATLAS,
WASHINGTON, D. C., *March 17, 1954.*

SENATOR EUGENE D. MILLIKIN,
Chairman, Finance Committee,
United States Senate, Washington, D. C.

MY DEAR SENATOR: Section 117 (n) of the Internal Revenue Code provides that a security dealer may obtain long-term capital gains treatment for securities which he holds as investments provided that such securities are so identified in his records within 30 days after acquisition and the securities are held for more than 6 months. Prior to the enactment of this provision, a security dealer could obtain capital gains treatment on such investment only if he could demonstrate that the securities were in fact held as investments. In order to clarify the situation and to avoid much controversy and litigation involving factual situations, section 117 (n) was introduced into the code in 1951.

The position of real-estate dealers who invest in real estate is now the same as was the position of security dealers investing in securities prior to the 1951 amendment. Real-estate dealers may now obtain capital gains treatment for property if the facts clearly demonstrate that such property was in fact held for investment. As in the case of security dealers, real-estate dealers and the Treasury have been embroiled in much controversy over the facts in each case.

Section 1237 of the Internal Revenue Code of 1954 (H. R. 8300) purports to do for real-estate dealers what section 117 (n) of the code has done for security dealers. Section 1237 of the bill, however, contains one provision which is particularly discriminatory, namely, that in order to get capital gains treatment for investment in real estate, property must not only be promptly identified as investment property but must be held for at least 5 years.

The selection of one class of property for a 5-year holding period before it may qualify for capital asset treatment is, I think you will agree, discriminatory and burdensome to those affected. While there is merit in requiring that property acquired for investment be promptly identified, it would seem that once it is so identified, such property should be treated as any other property held for investment purposes.

I trust that you will give this matter your attention so that a provision which is ostensibly designed to clarify and simplify tax administration will not bring with it burdensome discriminations.

Respectfully yours,

MARVIN ATLAS.

MORRISON BROS.,
ACCOUNTANTS AND AUDITORS,
Lovell, Wyo., February 25, 1954.

HON. LESTER C. HUNT,
United States Senator,
Senate Office Building,
Washington, D. C.

DEAR SENATOR HUNT: I note from my tax reporting service and also from the reports recently published in the newspapers that the filing date for filing income-tax returns, beginning with 1955, has been changed to April 15, instead of March 15, for individuals, under the Revenue Act of 1954, now in process of enactment. We in the accounting profession feel that this is a much needed change and a very good thing; however, we feel, at the same time, that in this new revenue bill they should also allow farmers and ranchers an additional month in which to file their final income-tax return, or until March 1, following the close of any taxable year, instead of January 31, as it now is.

Here in Wyoming, I believe the clientele of most of the accountants includes a majority of farmers and ranchers, which is the case with us. We do not feel that January 31, as a filing date for farmers and ranchers to file their final returns, gives enough time after the close of any taxable year to handle the farmers and ranchers. Therefore, we would like to recommend that the filing date of farmers and ranchers for filing their final returns be set up to March 1, of each year in the revenue bill for 1954.

We will appreciate anything you can do in regard to this matter.

Wishing you continued success in your work.

Sincerely,

FRANCIS E. MORRISON.

CHAMBERS, CLARE & GIBSON,
New York, N. Y., March 22, 1954.

Hon. EUGENE D. MILLIKIN,
United States Senator,
Senate Office Building,
Washington, D. C.

DEAR SENATOR MILLIKIN: As attorneys for the following stock fire insurance companies: United States Fire Insurance Co., the North River Insurance Co., and Westchester Fire Insurance Co., we invite your attention to certain sections of the tax revision bill recently passed by the House of Representatives (H. R. 8300) which seriously prejudice the rights and interests of stock fire insurance companies in the position of our clients.

SECTION 34 (H. R. 8300)—DIVIDENDS RECEIVED BY INDIVIDUALS

This is the well-publicized amendment designed to allow individual taxpayers, as a credit against their Federal income taxes, an amount equal to a certain percentage of dividends received by them from domestic corporations.

However, under subsection (c) (1) no credit is allowed for dividends which the taxpayer may receive from "an insurance company subject to a tax imposed by subchapter L (sec. 801 and following)."

Whether or not so intended this subsection apparently withdraws the benefits of the dividend credit section from individual taxpayers who own the stock of stock fire insurance companies. Since stock fire insurance companies (unlike life insurance companies and mutual fire insurance companies) pay the same corporation tax, viz, 52 percent as do all other business corporations, it is clear that this subsection, as drawn, is discriminatory. It is very possible that this language has crept in inadvertently but in any event we wish to bring to your attention its discriminatory nature and earnestly to urge that same be deleted. Clearly stockholders in stock fire insurance companies should receive the same benefits as stockholders in other business corporations. From the tax standpoint they should be treated the same.

SECTION 246 (H. R. 8300)—RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED

For many years a domestic business corporation holding stock in another domestic business corporation has received a credit amounting to 85 percent of dividends received from the second corporation in which it holds stock.

Subsection (a) of section 246 provides that the dividend credit described above shall be allowed in the form of a deduction, but under subsection (a) (1) "an insurance company subject to a tax imposed by subchapter L (sec. 801 and following)" shall not be entitled to this deduction.

It may well be that the draftsman of this section merely intended to make it crystal clear that the 85 percent credit or deduction should not apply to dividends received from life insurance companies or mutual fire insurance companies or other types of mutual insurance companies. However, we bring to your attention that this subsection, as drawn, very materially changes the existing tax law and would operate to withdraw the 85 percent dividend credit or deduction from a domestic business corporation with stock in a domestic stock fire insurance company. As already mentioned domestic stock fire insurance companies (unlike life insurance companies and mutual fire insurance companies) pay the regular 52 percent corporation income tax and there can be no reason for withdrawing the 85 percent dividend credit or deduction from other domestic corporations owning their stock, thereby depriving such other corporations of the dividend credit in an unnecessary and discriminatory manner.

We understand that in all probability there will be one or more public hearings before the Senate Finance Committee in which event we respectfully ask on behalf of our clients above-named an opportunity to present evidence before your committee.

Respectfully yours,

WALTER E. WARNER, Jr.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D. C., April 5, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: Mr. Hugh M. Hadley, Columbus, Ohio, has sent me two suggested amendments to H. R. 8300, which I enclose herewith. He has also described how his company operates in selling and servicing of profit-sharing retirement plans, as follows:

"We suggest that an employer set aside a certain percentage of gross profits each year to be placed in a tax-free retirement trust. We then suggest that a certain percentage of this money (usually not more than 25 percent or 33⅓ percent) be invested in ordinary life insurance policies purchased on the lives of those employees who are eligible for the program. The balance of the money is invested in various securities in accordance with the rules of the Internal Revenue Code.

"When an employee retires, the money held in his trust account invested in securities is used to convert the ordinary life insurance policy to an annuity type of policy. Section 505 of this bill lists the 'allowable investments for employee trusts.' Such trusts will be tax-exempt only if all of its assets are represented by the 'allowable investments' listed.

"This list makes no reference to an ordinary life or similar type of insurance policy. Included in this list of investments are annuity contracts, retirement income policies, which are high premium type of life insurance policies and are not adaptable to the type of program we sell.

"We have devoted a great deal of time and effort to working out such plans for a number of small businesses in the central Ohio area. We feel that the type of plan we sell is the soundest retirement plan for small business, due to the fact that the employer is not saddled with a large fixed pension commitment because the payments are geared to a percentage of profits of the business. We feel that the adoption of our type of program will make available substantial amounts of money for new investment. This is a matter that has been urged by President Eisenhower in his recent major speech on taxation.

"I am enclosing a suggested amendment to section 505 (a) (3) which was prepared by the Connecticut Mutual Life Insurance Co. We consider this amendment to be satisfactory in every respect because it would eliminate the discrimination against our type of plan."

I hope that your committee will give consideration to Mr. Hadley's suggestions during the hearings which will be held on H. R. 8300.

Sincerely,

JOHN M. VORYS.

SUGGESTED AMENDMENT

Amend section 505 (a) (3) to read as follows:

"(3) annuity contracts, retirement income policies, or life insurance policies containing provisions for conversion to annuity contracts or retirement income policies;"

Amend section 505 (b) (1) by inserting after the letter "(a)," and before the words "the terms" the following clause:

"In the case of a pension trust but not of a profit-sharing trust, the terms "retirement income policies" and "life insurance policies" include only policies in which the face amount does not exceed 100 times the monthly annuity payable at normal retirement age under the plan;".

ASSOCIATED PENSION TRUSTS, INC.,
Newark 2, N. J., March 6, 1954.

Subject: Written Objections, With Accompanying Exhibits in Opposition to a phrase in Section 501 (e) (3) of H. R. 8300

To the Members of the Senate Finance Committee, Hon. Eugene D. Millikin, Chairman, Senate Office Building, Washington, D. C.

I want to thank the committee for the opportunity to register my objections in writing, to certain phraseology of section 501 (e) (3) of H. R. 8300. These objections, I understand, will be included in the records of the hearings of your committee on the tax revision bill.

I wish to place before your committee my qualifications to make such objections:

For the last 25 years, I have been engaged exclusively as a tax consultant at the same location in the city of Newark, N. J. All of my clients are small, closed corporations, or individual shareholders of small corporations.

Sixteen years ago, I formed the Associated Pension Trusts, Inc., of which I am the president. This corporation is chartered under the laws of the State of New Jersey for the exclusive purpose of creating, designing, installing and securing Treasury Department approval of qualified pension and profit-sharing plans under section 165 (a); and charitable and educational foundations or trusts, under section 23 (o) of the Internal Revenue Code.

In addition, the Associated Pension Trusts, Inc., acts in the capacity of administrator of such plans for, and with the consent of, the trustees.

All the clients of the Associated Pension Trusts, Inc., may be classified as small, closed corporations.

I now wish to place before your committee, my strenuous objections to a phrase in section 501 (e) (3) of H. R. 8300, the entire sentence of which reads as follows:

"A classification shall be considered discriminatory only if more than 30 percent of the contributions under the plan are used to provide benefits for shareholders or more than 10 percent of the participants in the plan are key employees, except that a classification shall not be considered discriminatory in any case if, in the case of an employer having not more than 20 regular employees, 50 percent or more of all of such regular employees are participants in the plan, and in the case of an employer having more than 20 regular employees, 10 of such regular employees or 25 percent or more of all of such regular employees, whichever is greater, are participants in the plan."

"Shareholders" are defined in the next paragraph, under (B) (i) as follows:

"(i) the term 'shareholders' means any employee who owns (under the rules prescribed in section 421 (d) (1) (C) (i) and (ii)) stock possessing 10 percent or more of the total combined voting power of all classes of stock of the employer, or its parent, as defined in section 421 (d) (2)."

The following phrase in the above-quoted sentence should be deleted:

"more than 30 percent of the contributions under the plan are used to provide benefits for shareholders or";

and this sentence in section 501 (e) (3) should read as follows:

"A classification shall be considered discriminatory only if more than 10 percent of the participants in the plan are key employees, except that a classification shall not be considered discriminatory in any case if, in the case of an employer having not more than 20 regular employees, 50 percent or more of all of such regular employees are participants in the plan, and in the case of an employer having more than 20 regular employees, 10 or such regular employees or 25 percent or more of all of such regular employees, whichever is greater, are participants in the plan."

This quoted phrase—the 30 percent limitation—should be eliminated from the bill because it discriminates against small, closed corporations and their employee-stockholders.

This part of the sentence which I wish deleted is discriminatory in favor of big corporations and their employee-stockholders; against small, closed corporations and their employee-stockholders; and if you will bear with me, I will prove this statement to you beyond any doubt whatsoever.

The prohibition of limiting the company's allowable contribution to shareholders who own 10 percent or more of the stock of the employer corporation to not more than 30 percent of the total allowable contributions to the plan, is discriminatory for the following reasons:

This prohibition (30 percent rule) can never affect the giant corporations of America and their employee-stockholders—and unless this fact is thoroughly and completely understood, the members of your committee will miss this clear-cut case of discrimination.

The reasons that this prohibition can never affect the giant corporations of America and their employee-stockholders are two-fold:

(*a*) Practically no employee of such corporation is rich enough to own 10 percent or more of the stock of his employer; and

(*b*) Even if there were an occasional case where an employee did own 10 percent or more of the stock of a large corporation, and was also a beneficiary under such corporation's 165 (a) plan, the benefits allocated to such employee could never exceed or even equal, 30 percent of the corporation's total allowable contribution to the plan, by reason of the fact of the large number of other employees who would also be participants and beneficiaries in such plan, owing to the enormous size of the corporation.

Therefore it is as definite and as certain as anything can be that the 30 percent limitation could never affect the stockholder-employees of a giant corporation, so as to reduce the allocated benefits to such employee-stockholders, or to reduce such giant corporations total allowable contribution to a 165 (a) plan.

Now, if this be true, what class of corporation and what class of employee-stockholders would this 30-percent limitation affect?

The answer is very clear—it would and could affect only employee-stockholders of small, closed corporations.

The manner in which this 30-percent limitation would affect small, closed corporations is explained in exhibit A, which is attached hereto and is a part of this written objection.

Upon examining exhibit A this discrimination will appear as clear-cut and as simple as words and illustrations can make it.

Prior to submitting this written statement regarding this discrimination, I have previously written to the Hon. T. Coleman Andrews, Commissioner of Internal Revenue, calling his attention to this discrimination in H. R. 8300.

On the date of March 29, 1954, I received an answer to my letter to Hon. T. Coleman Andrews, from William A. Wells, Assistant Director of the Technical Planning Division of the Office of the Commissioner of Internal Revenue—a copy of which letter is attached to, and is a part of, this written statement and is marked exhibit B.

I would like to quote from Mr. Wells' letter to me (exhibit B), because he inadvertently admits this discrimination—he says in his letter and I quote:

"the 'except' clause quoted above modifies in a large measure the result that would otherwise obtain if it were omitted * * *" (meaning the "except" clause).

Now here is a technician from the Commissioner of Internal Revenue's office admitting that the "except" clause "modifies the result that would otherwise obtain," meaning—and there can be no other meaning—that it modifies the very discrimination which I claim exists.

Attached hereto and as a part of this written objection, is my answer to William A. Wells, Assistant Director of the Technical Planning Division of the Office of the Commissioner of Internal Revenue, in the form of a letter dated March 30, 1954, and marked "Exhibit C"—to which I have never received a reply.

There is something else of great importance in the discussion of this particular subject—this particular offending phrase—the 30-percent rule—which is as follows:

The last time the United States Senate and the House of Representatives amended section 165 (a) of the Internal Revenue Code was in 1939. After the President signed the 1939 Revenue Act the then Commissioner of Internal Revenue wrote his regulations governing such changes in 165 (a).

One of his regulations was known as I. T. 3674, which read exactly the same, word for word, as the quoted phrase which I am asking to be deleted from section 501 (e) (3) of H. R. 8300 (the 30-percent rule); and which I claim is discriminatory against small, closed corporations and their employee-stockholders.

While this I. T. 3674 was in force the Associated Pension Trusts, Inc., designed, installed, and secured Treasury Department approval of a number of pension and profit-sharing plans for small, closed corporations—all of which had employee-stockholders owning 10 percent or more of the stock of their employer.

When these companies took their deduction for income-tax purposes on their income-tax returns the examining agent called their attention to I. T. 3674; and these companies had to reduce their allowable contribution because of this regulation, and were therefore denied the full deduction to which they would otherwise have been entitled, and their employee-stockholders who were participants in such plans were also denied their full share of the benefits to which they were entitled—while at the same time large corporations and their employee-stockholders, with many other employees, were never affected by I. T. 3674 for the reasons already stated on page 3 of this statement and as explained in exhibit A, attached hereto.

Now, this I. T. 3674—the 30-percent rule—had the effect of law until the famous Volkening decision by the United States Supreme Court in July 1950, when the Court ruled that such regulation was invalid.

From July 1950, when this discriminatory regulation—I. T. 3674—was declared invalid, up to March 31, 1954, there were more 160 (a) pension and profit-sharing plans created, installed, and approved for small corporations than in the entire previous history of the Treasury Department.

Now this is not a mere statement—your committee can easily verify this, because the records of the Treasury Department will show the great number of small business corporations who secured approval of 165 (a) trusts from July 1950 to March 31, 1954.

I know from experience that most of these corporations wanted to take advantage of 165 (a) long before 1950—but because of the Commissioner's I. T. 3674 (the 30 percent rule) they were prohibited from doing so, by reason of the fact that the allowable contributions and the benefits derived from such contributions for their employee-stockholders, became negligible.

The House Ways and Means Committee on the whole did a good job on this tax revision bill—a very good job—and H. R. 8300 represents a year or two of hard work and labor; and it is certainly not my intention to wreck or disturb the result of this long overdue revision of our tax laws.

But of one thing I am morally certain—and that is, that neither the Honorable T. Coleman Andrews nor the Honorable Daniel A. Reed of their own volition and thought ever devised the discriminatory sentence in this tax revision bill which I refer to in this statement—namely, the 30 percent rule contained in section 501 (e) (3).

I would like your committee to do one thing which I think is only fair, and which will help your committee to come to a conclusion on this matter. Call in the technical assistants loaned by the Treasury Department to the House Ways and Means Committee. Then ask these technicians how this sentence—the 30 percent rule—came to get in the bill in the first place. Ask these Treasury technicians the direct question—

Did Daniel A. Reed suggest this phrase—the 30 percent rule?

Did T. Coleman Andrews suggest this phrase—the 30 percent rule?

When these technicians tell you "No"—then ask them:

Who did place this 30 percent rule in section 501 (e) (3)?

In closing, I once again request your committee to remove this 30 percent rule from the quoted sentence of section 501 (e) (3) of H. R. 8300 and have this sentence read in the final bill, as follows:

"A classification shall be considered discriminatory only if more than 10 percent of the participants in the plan are key employees, except that a classification shall not be considered discriminatory in any case if, in the case of an employer having not more than 20 regular employees, 50 percent or more of all of such regular employees are participants in the plan, and in the case of an employer having more than 20 regular employees, 10 of such regular employees or 25 percent or more of all of such regular employees, whichever is greater, are participants in the plan."

Respectfully yours,

ROBERT E. BURNS, *President.*

EXHIBIT A

HERE IS PROOF OF DISCRIMINATION AGAINST THE SMALL-BUSINESS MAN IN H. R. 8300—SECTION 501 (e)

A part of H. R. 8300, 501 (e) reads: "A plan is considered to discriminate in favor of stockholders if more than 30 percent of the funds are used for stockholder benefits. For this purpose, an employee is considered to be a stockholder if he owns 10 percent of the company's stock (including stock held by close relatives)."

Section 501 (e) provides for numerous code changes in section 165 (a) affecting pension and profit-sharing trusts. Most of these changes are good, but the sentence quoted above in section 501 (e) discriminates violently against the small-business man in the actual operation of 165 (a) trusts.

So that this discrimination becomes perfectly clear, we herewith submit the following actual example of how this sentence in section 501 (e) would affect the pension and profit-sharing plans of small-business corporations.

Under present law, section 165 (a): "Little Co., Inc.," has a qualified profit-sharing trust plan. Little Co., Inc., contributes tax free, out of its profits to this trust annually, 15 percent of the compensation of its employee-participants who are beneficiaries in the trust, as follows:

Employee participants in the trust	Percent of stock owned	Annual compensation	Allowable contribution, 15 percent of the compensation of the participants	Amount allocated for benefits to all participants on basis of compensation
Little Co.:				
President	15	$20,000		$3,000
Vice president	10	20,000		3,000
Treasurer	10	18,000		2,700
All other participants	None	40,000		6,000
Total	35	98,000	$14,700	14,700

"Big Co., Inc.," has the identical qualified profit-sharing trust as "Little Co., Inc.," and contributes tax free on the identical basis as "Little Co., Inc.," as follows:

Employee participants in the trust	Percent of stock owned	Annual compensation	Allowable contribution, 15 percent of the compensation of the participants	Amount allocated for benefits to all participants on basis of compensation
Big Co.:				
President	50	$100,000		$15,000
Treasurer	45	100,000		15,000
All other participants	None	1,000,000		150,000
Total	95	1,200,000	$180,000	180,000

Under present law there is no discrimination regarding benefits for stockholder-employees who are participants in 165 (a) trusts.

But look how the picture changes when the sentence quoted above remains in H. R. 8300—501 (e); "Little Co., Inc.," has made no change in their qualified profit-sharing trust, but under proposed law not more than 30 percent of the funds (deductible contribution) can be used for (allocated to) stockholder-employees, if the stockholder-employee owns 10 percent or more of the stock.

Employee participants in the trust	Percent of stock owned	Annual compensation	Allowable contribution, 15 percent of the compensation of the participants	Amount allocated for benefits to all participants on basis of compensation
Little Co.:				
President	15	$20,000		$887, only 0.0443 percent.
Vice president	10	20,000		$887, only 0.0443 percent.
Treasurer	10	18,000		$797, only 0.0443 percent.
All other participants	None	40,000		$6,000, 15 percent.
Total	35	98,000	$8,571	$8,571.

Thirty percent of $8,571.17 (allowable contribution) is $2,571—the maximum that can be allocated to stockholder-employees owning more than 10 percent of the stock.

"Big Co., Inc.," has made no changes in their qualified profit-sharing trust, but the 30 percent rule does not affect them:

Employee participants in the trust	Percent of stock owned	Annual compensation	Allowable contribution, 15 percent of the compensation of the participants	Amount allocated for benefits to all participants on basis of compensation
Big Co.:				
President	50	$100,000		$15,000, 15 percent
Treasurer	45	100,000		$15,000, 15 percent.
All other participants	None	1,000,000		$150,000, 15 percent.
Total	95	1,200,000	$180,000	$180,000.

Thirty percent of $180,000 (allowable contribution) is $36,000—the maximum that can be allocated to stockholder-employees owning more than 10 percent of the stock, but because of the large size of the company and the large allowable contribution, Big Co., Inc., stockholder-employees are not affected, because 30 percent of the total annual contribution is less than the maximum amount allocated to them, and so the employee-stockholders of Big Co., Inc., continue to enjoy the maximum benefits of 165 (a); while the stockholder-employees of Little Co., Inc., are denied more than 66 percent of their benefits which they presently enjoy under the present law.

EXHIBIT B

UNITED STATES TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C., March 29, 1954.

Mr. ROBERT E. BURNS,
President, Associated Pension Trusts, Inc.,
Newark, N. J.

DEAR MR. BURNS: Commissioner Andrews has asked me to reply to your letters dated March 11 and March 23, 1954, in which you register your opposition to a provision included in the proposed revenue-revision bill of 1954, H. R. 8300.

You refer to a provision in section 501 (e) stated to read as follows:

"A plan is considered to discriminate in favor of stockholders if more than 30 percent of the funds are used for stockholder benefits. For this purpose an employee is considered to be a stockholder if he owns 10 percent or more of the company's stock (including stock held by close relatives)."

You indicate that this provision is a violent and unjust discriminaiton against stockholder-employees of small closed corporations.

We find no sentence in section 501 (e) such as the one you have quoted; however, we believe you have in mind that sentence which reads as follows:

"A classification shall be considered discriminatory only if more than 30 percent of the contributions under the plan are used to provide benefits for shareholders or more than 10 percent of the participants in the plan are key employees, except that a classification shall not be considered discriminatory in any case if, in the case of an employer having not more than 20 regular employees, 50 percent or more of all of such regular employees are participants in the plan, and in the case of an employer having more than 20 regular employees, 10 of such regular employees or 25 percent or more of all such regular employees, whichever is greater, are participants in the plan."

The "except" clause, quoted above, modifies in a large measure the result that would otherwise obtain if it were omitted, and may suggest to you that the provision would not discriminate against stockholder-employees of small closed corporations as your letter states it would on the basis of the sentence you quote.

In the division of responsibilities of the Treasury Department, the Secretary has assigned matters of tax policy, including views on legislative matters, to the Under Secretary. Accordingly, we are bringing your letters to the attention of the Office of the Under Secretary. If you still feel that the subject provision, as quoted above, should be amended, I suggest you communicate with the Under Secretary of the Treasury, Mr. Marion B. Folsom.

We regret the delay in replying to your first letter.

Very truly yours,

WILLIAM A. WELLS,
Assistant Director, Technical Planning Division.

EXHIBIT C

ASSOCIATED PENSION TRUSTS, INC.,
Newark, N. J., March 30, 1954.

Mr. WILLIAM A. WELLS,
Assistant Director, Technical Planning Division, Office of Commissioner of Internal Revenue, Treasury Department,
Washington, D. C.

DEAR MR. WELLS: First, I want to thank you for your kind letter of March 29, regarding certain wording in H. R. 8300, section 501 (e).

True, in my two previous letters to the Commissioner of Internal Revenue, Hon. T. Coleman Andrews, I did not correctly quote H. R. 8300 for the simple reason that up to a few days ago it was impossible to obtain a printed copy of the bill, owing to its size—all I had were committee reports.

However, the sentence I quoted is contained in section 501 (e) with a little different language. In your letter to me, you quote the sentence containing this wording as it actually appears in section 501 (e), which is as follows:

"A classification shall be considered discriminatory only if more than 30 percent of the contributions under the plan are used to provide benefits for shareholders or more than 10 percent of the participants in the plan are key employees, except that a classification shall not be considered discriminatory in any case if, in the case of an employer having not more than 20 regular employees, 50 percent or more of all of such regular employees are participants in the plan, and in the case of an employer having more than 20 regular employees, 10 of such regular employees or 25 percent or more of all of such regular employees, whichever is greater, are participants in the plan."

Now, you go on to say—and I quote from your letter:

"The 'except' clause, quoted above, modifies in a large measure the result that would otherwise obtain if it were omitted, and may suggest to you that the provision would not discriminate against stockholder-employees of small closed corporations. * * *"

Assuming that what you say is true, because your Department will write the regulations after H. R. 8300 is passed—why is the 30 percent clause plus the 10 percent stock ownership in there at all if it is not going to affect small corporations?

You and I know from a technical standpoint, that this provision can never affect a large corporation, and if it can never affect a large corporation, and if the "except clause," as mentioned in your letter modifies any possible discrimination against small closed corporations, why shouldn't this section read as follows:

"A classification shall be considered discriminatory only if more than 10 percent of the participants in the plan are key employees, except that a classification shall not be considered discriminatory in any case if, in the case of an employer having not more than 20 regular employees, 50 percent or more of all of such regular employees are participants in the plan, and in the case of an employer having more than 20 regular employees, 10 of such regular employees or 25 percent or more of all of such regular employees, whichever is greater, are participants in the plan."

Now—compare the two sentences—the one which is actually in the bill as quoted in your letter of March 29—and the one which I quote above—bearing in mind that the 30 percent limitation against stockholder-employees owning 10 percent of the stock can never affect large corporations; and if what you say is true, that the "except clause" would exempt small corporations from this part of the statute, why is the provision there in the first place?

If what you say is true—it is purely surplus language.

I intend to make every effort to eliminate the 30 percent clause—even going to Washington and requesting of the Senate Finance Committee that I be permitted to testify when they hold hearings on this particular subject.

I cannot forget I. T. 3674 because for years, I have been trying to install pension and profit-sharing plans in small business corporations, and I ran into hundreds of small corporations who were actually anxious to install qualified 165 (a) trusts, but because of former I. T. 3674 it was not profitable for them to do so.

After July 1950, when the court threw out I. T. 3674, look into your own records in the Treasury Department—see how many small closed corporations created and installed qualified 165 (a) plans—your own records in Washington will prove that there were more plans qualified under 165 (a) for small closed corporations from July 1950 up to the present time, than in all the previous years since the income-tax law became effective in 1913.

I again insist that if what you say is true about the "except clause" which would modify this discrimination against small corporations or eliminate it as you claim, why is it in there in the first place?

Why, a discrimination that can only affect small business concerns?

I would like to say this—that the majority—the great majority of the provisions of H. R. 8300 are good, were necessary, and were long overdue. As a tax man and as a pension-trust man, I have examined over 800 pages of tax changes, and I find only one joker, (the 30 percent provision), which I am sure was never put in by Hon. Daniel A. Reed, or Hon. T. Coleman Andrews.

I am following your suggestion—I am writing to the Under Secretary of the Treasury, Mr. Marion B. Folsom, and I am sending him a copy of your letter, and of my answer to you; and I am going to explain to Mr. Folsom that if the "except clause" modifies or eliminates the discrimination against small, closed corporations, then it doesn't belong in the statute at all, and whether it modifies it or not, what right has the United States Treasury Department, to discriminate and deny to the stockholder-employee of a small corporation, the tax benefits which accrue to the stockholder-employee of a big corporation—simply because the small, closed corporation is small?

If this isn't discrimination, then I don't know the meaning of the word, and the phrase: "more than 30 percent of the contributions under the plan are used to provide benefits for shareholders * * *" is absolutely discriminatory and must be removed from the statute.

In closing, I want to thank you for your answer, but I shall be heard, and I shall not be deflected from putting forth every effort to remove this discriminatory phrase from section 501 (e) because it doesn't belong there—and if there is no intended discrimination against small business firms, why is it there at all?

Cordially yours,

ASSOCIATED PENSION TRUSTS, INC.,
ROBERT E. BURNS, *President.*

AMERICAN FARM BUREAU FEDERATION,
Washington 1, D. C.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR MILLIKIN: The American Farm Bureau Federation has long believed that a sound national tax policy is one of the primary essentials to the maintenance of the private-enterprise system, which is the foundation of our democracy. Consequently, we have given considerable attention to tax problems in our annual policy development process and have developed a number of recommendations which are pertinent to the pending tax bill, H. R. 8300.

Before making specific recommendations for changes in the present tax code we want to make it clear that we favor the announced purposes of the pending legislation. We recognize the need for a thorough revision of existing tax laws. The primary objectives of such a revision should be to clarify existing law, iron out inequities, and make changes which will contribute to the maintenance of a prosperous economy by stimulating economic development. While many such changes will result in some loss of revenue to the Government, at least in the near future, there are other possible changes in the tax laws which would improve the equity of our tax system and, at the same time, increase Government revenues. The real test in either case should be "what is equitable in view of the needs of the Federal Government for revenue and the tax treatment accorded other individuals and groups"?

Our specific recommendations with reference to the provisions that should be included in the final version of H. R. 8300 are as follows:

Personal exemptions

The proposal to increase personal income-tax exemptions is not feasible at this time, in view of other tax reductions effective this year and the continuation of Government expenditures at a high level. The Farm Bureau believes that the personal income tax should be the major source of revenue for the Federal Government. The income-tax base should be kept broad through retention of the present $600 exemption. All self-supporting persons should make a direct contribution to the support of the Federal Government. We do not believe that it is sound to create a large class of tax-exempt citizens. There is a grave danger that such a group might become a strong political force in favor of constantly increasing Government benefits to themselves. When the budgetary situation permits further reduction in income taxes we would prefer a reduction in rates, particularly in the lower brackets.

Excise taxes

Most of our current policies on excise taxes relate to questions of the items to be taxed and the priority to be followed in reducing excise tax rates, as the budgetary situation permits—questions which are not at issue in the bill.

We do recommend, however, that H. R. 8300 be amended to require that all sellers of items subject to excise taxes must inform the purchasers of the amount of the exice taxes that have been paid on the item in question.

One of the valid criticisms of many of our present excise taxes arises out of the fact that they are hidden taxes. We believe that all purchasers of items on which an excise has been paid should be informed of the amount of such taxes.

Taxation of cooperatives

We support the provisions of existing law which (1) make it clear that cooperative savings allocated to member patrons are taxable in the hands of such patrons, and (2) provide that savings held by cooperatives in the form of unassigned surpluses shall be taxed in the same manner as the profits of other corporations.

It is in the best interests of our entire economy for the savings of cooperatives distributed as patronage refunds to be taxed only in the hands of individual patrons. There is no sound basis for imposing on cooperatives an income tax on patronage earnings refunded in the form of cash, certificates of stock, certificates of indebtedness, or revolving fund certificates where the obligation to the patron is certain.

Corporation dividends

For a number of years, the resolutions of the American Farm Bureau Federation have favored the exemption from Federal income taxes of that portion of the annual earnings of corporations that is distributed to the stockholders as dividends, when such dividends are taxable in the hands of stockholders.

Our currently effective resolution on this subject reads as follows:

"All corporations should be exempted from Federal income taxes on the portion of their earnings that is distributed to the stockholders as dividends and taxable in the hands of the stockholder. Pending the time when this can be done without seriously unbalancing the Federal budget, we recommend that partial relief from the existing double taxation of dividends be given priority over the reduction of present corporation tax rates."

We have heard it argued that Congress should not grant relief from the double taxation of dividends because relatively few people own stock and many stockholders are well-to-do. This does not seem to us to be a very meritorious argument. We do not excuse a thief because he steals only from a few or only from the rich, and we should not condone an unjust Federal tax because it has a limited application. And, it does seem to us to be unjust to tax a corporation 52 percent of its net income, and then apply the full personal income-tax rates against any of the remaining 48 percent of its income that is paid out to the stockholders. Furthermore, the number of people who have an interest in corporation dividends is much greater than is commonly believed. Many people who do not hold a single share of stock in their own names have a substantial indirect interest in corporation stocks through investments in life-insurance policies or pension funds. In addition, all of us have an interest in the establishment of a tax program which will encourage the continuing investment that is necessary for economic development and prosperity. We believe that partial relief from the double taxation of dividends will encourage savings and investments.

Dividend withholding

We oppose the application of a dividend withholding tax to cooperatives or other corporations.

The withholding of taxes against wages and salaries rests on a fundamentally different premise than the withholding of taxes applicable to dividends. A major reason is the fact that dividends are much less likely to be the major source of a taxpayer's income. In many cases, the amount involved in dividends is small, and there is not a practical way for the paying cooperative or corporation to determine the dividend receiver's exemptions.

The withholding of taxes against dividends is unnecessary in view of the fact that other forms of reporting are available for checking against failure to report such income. The heavy and unnecessary administrative burden that would be involved in checking returns and making the inevitable refunds further emphasizes the impracticability of dividend withholding.

These reasons apply equally whether the dividends are paid by cooperative associations or corporations.

Capital gains

The treatment of capital gains under the tax code must avoid undue discouragement of the investment of risk capital and also should avoid creating a tax loophole.

We recommend the continuation of the minimum holding period provided by present law for capital gains treatment. We also recommend that the rate of tax on capital gains be reduced as the length of the holding period is increased, provided adequate safeguards can be developed to prevent the abuse of such a provision.

The adoption of the above recommendation for a gradual reduction in the rate of a capital-gains tax as the length of the holding period increases would greatly reduce the injustice that now results when increases in dollar values due to inflation are taxed as though they were real gains. For example, our price level has roughly doubled since 1940. Consequently, a man who sells a piece of property for exactly twice what he paid for it in 1940 may actualy have no real gain, yet he is subject to a capital gains tax on 50 percent of the sale price. We are told, for example, that the reluctance of farmers to pay a capital-gains tax on what is really nothing more than an adjustment of many values to inflation is a factor limiting the availability of farms to young men who want to start farming. Our recommendation for a declining capital-gains rate would help to solve this type of problem without exempting from tax those who make a quick profit even though such a profit is partly a result of inflation. On the other hand, proposals to reduce the present minimum holding period would primarily benefit persons engaged in short-time speculative operations.

Accelerated amortization

A resolution adopted at our 1952 annual convention and reaffirmed at our last annual meeting reads as follows:

"The accelerated amortization program, under which the Government has allowed industry a rapid tax writeoff on part or all of the cost of new facilities, appears largely to have served its purpose of encouraging a rapid expansion of our productive capacity. We, therefore, urge that the program be terminated as soon as possible. As a longtime policy, any encouragement that may be found to be necessary to bring about the construction of new facilities should be provided through generally applicable provisions of law rather than by programs which require that the Government pass o: individual projects."

The accelerated amortization program, no doubt, has served a very useful purpose in encouraging the expansion of industrial facilities which were required by our national-defense program. We would have no objection to the continuation of such a program if it could be restricted to facilities that are to be used solely for defense purposes, however, most industrial facilities have peacetime uses. Any program which requires Government officials to pass on individual projects with normal peacetime uses, and to decide which are to receive favored tax treatment is open to abuse. It gives such officials a lever, which can be used to influence the location of plants and the competitive position of various companies within an industry. For this reason, we believe that the committee would be wise to recommend termination of the present emergency authority for accelerated amortization and to approach the problem of plant amortization through legislation to establish general rules which will remove the necessity of specific Government approval of the amortization provisions applicable to individual projects.

The special provision of law enacted last year to permit the rapid amortization of grain-storage facilities illustrates how a special amortization rule can be made available to stimulate a desired type of construction without requiring Government approval of individual projects. We urge that similar treatment be extended to facilities constructed for the storage of fruits and vegetables.

Depreciation

As a result of the trend toward the mechanization of farm production, farmers are very much affected by depreciation rules. We favor the provisions of H. R. 8300 which set up a new alternative method of calculating depreciation. We believe that the so-called declining balance method of depreciation which permits larger deductions in the earlier years of the life of a depreciable item will encourage many businessmen and farmers to modernize their equipment and that this will be beneficial to the economy.

We also favor the provisions of H. R. 8300 which are designed to allow farmers to elect, within limits, whether certain types of expenditures for soil and water conservation are to be treated as current expenses or capital investments. The treatment of such expenditures has been a matter of controversy between farmers and the Bureau of Internal Revenue for a number of years. The fact that the law and the Bureau's regulations have been interpreted differently in different internal revenue districts indicates that there is a need for Congress to clarify the situation.

Depletion allowances

With taxes at their present high level, it is imperative that we make every effort to assess taxes on a basis which will not only avoid the penalizing of individuals or groups, but will also avoid giving one group of taxpayers an unfair advantage over other groups.

The depletion allowances now authorized for certain extractive industries are widely believed to constitute substantial tax loopholes.

We urge a thorough review of the provisions of the tax code authorizing such allowances.

We are in accord with the principle that extractive industries should be allowed to recover their invested capital through reasonable depletion allowances. When allowances equal to capital invested have been taken, however, we recommend termination of such tax-free allowances.

Taxation of bond interest

For a number of years, it has been the position of the American Farm Bureau Federation that "income from all future issues of Federal, State, and local government bonds should be taxed as other income is taxed."

There are two reasons why we believe that this recommendation is sound:

(1) The existence of tax-exempt bonds provides a very substantial tax loophole for upper bracket taxpayers. With corporation and personal incomes taxes at present levels and with the present double taxation of corporation dividends, money invested in an ordinary business must earn a very high rate of return if the investor is to realize as much from it as he can obtain from a 2-percent tax-free bond. From an economic standpoint, this is bad because it encourages wealthy people to buy tax-exempt bonds instead of making "risk capital" investments, which would further economic development. Removal of the income-tax exemption now applicable to State and local Government bonds, no doubt, would lead to somewhat higher interest rates on such bonds; however, this would make this form of investment more attractive to small savers who ordinarily are not direct sources of risk capital.

(2) The ability to float tax-exempt bonds at a low rate of interest encourages governmental units to go into various business activities that otherwise would be left to taxpaying private enterprise.

Fluctuating incomes

The problem of fluctuating income is particularly difficult in agriculture, due to weather hazards and the relative instability of agricultural prices. In areas that are subject to drought, for example, a farmer may have a relatively good income in some years, and little or no income in others. The present provisions of law which authorize taxpayers to carry losses forward or backward appear to be designed primarily for industrial operations and do not fully meet the problems of agriculture. We recommend that additional methods be provided for equalizing tax burdens on widely fluctuating individual incomes where the problem arises from causes beyond the control of those affected.

Pension plans

We favor an amendment of the Federal income-tax law so that self-employed persons and others in a similar situation may have tax treatment similar to that now available to the several million employees who are participants in pension plans established by their employers. To accomplish this, the law should permit a deduction for premiums paid into a properly safeguarded pension fund.

American business is, at an increasing rate, providing retirement plans for its employees including pension plans, negotiated between management and labor unions as well as plans adopted unilaterally by the employer. Many farm cooperatives are, likewise, providing pension plans for their employees. When approved by the Treasury Department, such pension plans receive special income-tax advantages which accrue to the beneficiaries at retirement age.

Farmers are a substantial part of a large group of self-employed persons who are not now being served by such retirement plans. Our recommendation would remove the inequity that now exists between the self-employed and those who are participating in pension plans established by their employers. The opportunity to deduct limited premiums paid into a properly safeguarded private pension plan should also be made available to employees who are not covered by a Treasury-approved pension plan established by their employers so long as they continue in that situation.

Hospital and medical insurance premiums

The American Farm Bureau Federation is opposed to compulsory health insurance and in favor of voluntary plans of medical, dental, and hospital insurance. In order to encourage the further development of such voluntary programs we favor an amendment to the tax law to permit the deduction of premiums paid for hospital, medical, and dental insurance on the same basis as business expenses.

Insurance

Due to the fact that many of our member State Farm Bureaus have established insurance services for their members we have a very real interest in the provisions of H. R. 8300 which change the tax rules applicable to insurance companies. Our views on this subject will be forwarded to you in a separate communication.

Conclusion

We urge that H. R. 8300 be amended to conform to the above recommendations, and that this letter be made a part of the hearing record.

Sincerely yours,

ALLAN B. KLINE, *President.*

(The following letter was subsequently supplied for the record:)

AMERICAN FARM BUREAU FEDERATION,
Washington, D. C., April 20, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: The American Farm Bureau Federation wishes to submit the following statement for inclusion in the record of hearings on H. R. 8300 concerning the proposed revision in the internal-revenue laws relative to deductions for corporations for dividends received.

Under existing law a corporation, in general, is entitled to a credit against net income of 85 percent of the amount received as dividends from other domestic corporations which are subject to Federal income tax. Section 243 (a) of H. R. 8300 continues this treatment but as a deduction instead of a credit. However, section 246 (a) of the bill provides for a major change in the existing law by not allowing such deductions to corporate shareholders on dividends received from insurance companies which are subject to the tax imposed by subchapter L (sec. 801 and following).

The American Farm Bureau Federation, by action of its board of directors, opposes this proposed change in the treatment accorded dividends received by insurance company shareholders. The American Farm Bureau and its member State farm bureaus have a real interest in the continued success of the insurance industry. Nearly all of our member State farm bureaus have developed some type of insurance program for their members. These programs have proved to be very beneficial and we are confident that they also have been consistent with the best interests of the Nation.

Since the potential volume of business available among farm-bureau members in a single State is sometimes insufficient for a sound life-insurance operation, several life-insurance companies have been organized by State farm bureaus on a multistate basis. For example, the Western Farm Bureau Life Insurance Co. (which was organized in 1952) operates in six States in the western region. It is a legal reserve stock company with its capital stock owned by six service companies affiliated with the respective State farm bureaus. Each State farm Bureau service company has sold its capital stock to farm-bureau members in its State.

The State farm bureau service company looks to the life-insurance company for dividends on its stock in the life company as a legitimate source of income which it needs to meet its own dividend obligations to the farm-bureau members who put up the money which made this service possible. It is quite obvious that the proposed change in the internal-revenue laws which would take away the present 85-percent credit on intercorporate dividends would constitute discriminatory treatment and would present a serious financial problem to State farm bureaus which have organized insurance services in this manner.

Similar problems would be created among numerous fire- and casualty-insurance companies affiliated with member State farm bureaus, most of which operate on a State basis, but which nonetheless have corporate relationships with farm bureau service companies. In fact, the majority of our 1,591,777 members would be adversely affected, one way or another, if section 246 (a) were permitted to become the law of the land.

Since these stock-insurance companies were organized by the respective State farm bureaus to serve farm-bureau members at the lowest possible net cost, and insofar as possible operate on a mutual basis, various safeguards were worked into the articles of incorporation and bylaws of such insurance companies to limit the amount of dividends payable on outstanding capital stock. It would therefore be very difficult to reorganize these insurance operations to overcome the difficulties which would result from the application of the rule set forth in section 246 (a).

We also note that section 34 (a) of H. R. 8300 would provide for a credit against the income tax of an individual of a certain percentage of dividends received from domestic corporations which are included in the gross income. However, section 34 (c) would provide that the credit shall not be allowed with respect to dividends from insurance companies taxed under subchapter L (sec. 801 and following). We feel that this provision also singles out the holder of stock of insurance companies for inequitable treatment.

It does not appear to be in the public interest for Congress to take away from present holders of stock in insurance companies certain rights which they possessed at the time of such stock purchase, thereby adversely affecting their net return on such property, when they had no knowledge that the Federal Government had any intention of changing the rules in question.

In conclusion, we would like respectfully to request that H. R. 8300 be so amended as to eliminate any provisions which discriminate against shareholders of insurance companies, whether such shareholders be individuals or corporations.

Sincerely yours,

ALLAN B. KLINE, *President.*

MEMORANDUM PROPOSING AN AMENDMENT TO SECTION 2055 OF THE INTERNAL REVENUE CODE OF 1954, RELATING TO THE FEDERAL ESTATE TAX DEDUCTION FOR CHARITABLE BEQUESTS

(Submitted by George Craven, Philadelphia, Pa. as attorney for executors of estate of Solomon Allinger, deceased)

PROPOSED AMENDMENT

It is proposed that section 2055 of the Internal Revenue Code of 1954, corresponding to section 812 (d) of the Internal Revenue Code now in force, relating to the estate-tax deduction for "transfers for public, charitable, and religious uses," be amended by inserting at the end of subsection (a) a new sentence reading as follows:

"The complete termination of a power to consume, invade, or appropriate property for the benefit of an individual, by reason of the death of such individual or for any other reason, shall be considered an irrevocable disclaimer."

This amendment should be made effective on the date of the enactment of the Revenue Act of 1942, applicable to estates of all decedents dying after October 21, 1942, or, in any event, to estates of all decedents dying after June 30, 1948.

EXPLANATION

Section 2055 allows an estate-tax deduction for bequests, legacies, devises, or transfers to recognized charitable organizations. If a decedent leaves property in trust to pay the income to an individual for life, with an unconditional remainder to charitable organizations, the actuarial value of the remainder interest, computed as of the date of the decedent's death, is an allowable estate-tax deduction. It was held, however, in *Merchants National Bank of Boston* v. *Commissioner* (320 U. S. 256 (1943)) and *Union Planters National Bank & Trust Co.* v. *Henslee* (335 U. S. 595 (1949)), that where a broad general power is given to an income beneficiary or someone else to apply principal of a trust for the benefit of the income beneficiary or any other person, the value of the charitable remainder is so uncertain that no deduction is allowable. Prior to the Revenue Act of 1942, the charitable deduction was denied in such cases even though the individual for whose benefit the power existed renounced the right to have the power exercised.

The Revenue Act of 1942, by section 408 (a), amended section 812 (d) of the code by adding the following language after the words which allow deductions for charitable bequests, legacies, devises, or transfers "(including the interest which falls into any such bequest, legacy, devise, or transfer as a result of an irrevocable disclaimer of a bequest, devise, transfer, or power, if the disclaimer is made prior to the date prescribed for the filing of the estate tax return)."

A case has arisen recently where a decedent left property in trust with income to his widow for life and with remainder to charitable organizations; where the trustee was given power to invade principal for the benefit of the widow; where the widow was critically ill at the time of her husband's death and was unable to take any action with respect to a disclaimer, and where the widow died within a few weeks after the husband's death without benefiting to any extent by the exercise of the power but without having executed a formal disclaimer. The trust fund was in fact distributed to the charitable organizations, pursuant to a decree of the State court, within 1 year after the decedent's death. The Internal Revenue Service determined that the death of the widow and the distribution of the trust fund to the charitable organizations within 15 months after the decedent's death did not operate as a disclaimer and that in such case no deduction was allowable for the remainder interest which passed irrevocably to the charitable organizations within the 1-year period. An action was brought by the decedent's executors in the United States district court in which it is claimed that a charitable deduction is allowable. A motion to dismiss was made by the Government, and following argument on the motion the district judge rendered an interim opinion in which he indicated that the widow's death was not a disclaimer within the meaning of the statute (opinion of Judge Ganey rendered February 12, 1954, in *Girard Trust Corn Exchange Bank* (*Solomon Allinger estate*) v. *Smith, Collector*).

It is submitted that the case clearly falls within the spirit of the statute, and that in order to avoid any question about its meaning, the statute should be amended to provide that the complete termination of the power within 15 months after the decedent's death shall be sufficient to support the deductions.

FACTS OF CASE

The facts of the case referred to above are as follows:

Solomon Allinger died July 28, 1948, a resident of Philadelphia County, Pa. By his will he left his residuary estate in trust to pay the net income to his wife, Rebecca Wynne Allinger, for life and directed that on her death, after payment of cash sums to named individuals, the remainder be paid to or for the following qualified charitable organizations or purposes:

Mt. Sinai Hospital of Philadelphia, Pa.

Community fund of Philadelphia and vicinity.

Jewish Hospital Association of Philadelphia for the Home for Aged and Infirm Israelites.

Grand Lodge of Free Masons of Pennsylvania for the Masonic Home at Elizabethtown, Pa.

Article fifth (*d*) of the decedent's will contained the following direction to the trustee:

"(*d*) To pay to or for the account of my said wife, Rebecca Wynne Allinger, from time to time, such amount or amounts of principal as my corporate trustee, in its sole discretion, shall deem proper, either for comfortable maintenance and support, for illnesses and operations, or for any reason whatsoever which might seem sufficient to my said corporate trustee."

On the date of Mr. Allinger's death, his wife was 75 years of age, was critically ill, and had no substantial life expectancy. She died September 13, 1948, 47 days after Mr. Allinger's death. The trustee did not make any payment from trust principal to or for the widow and she did not have an opportunity to file a formal disclaimer. Within 1 year after Mr. Allinger's death, the Orphans' Court of Philadelphia County entered a decree directing distribution of the trust fund and the fund, after the payment of cash sums to individuals, was in fact paid to the charitable organizations.

The Commissioner of Internal Revenue in a letter dated June 18, 1951, ruled that the death of Mrs. Allinger, the life beneficiary, within a short time after her husband's death did not operate as a disclaimer because "no affirmative action was taken by the life tenant disclaiming any right to the benefits of an invasion of the trust principal on her behalf." The interim opinion of the United States district court, referred to above, indicates that the Commissioner's ruling will be sustained.

REASONS FOR AMENDMENT

The purpose of Congress in enacting the amendment relating to disclaimers was to avoid the harsh rule resulting from the decisions of the Supreme Court referred to above, which held that no deduction was allowable where there was a power to invade principal during the life of the income beneficiary and thus prevent some or all of the principal of the trust fund from passing to the charitable organizations. The intention of Congress was to permit the deduction where something occurred before the due date for filing the return which made it clear that the power of invasion would not be exercised and that the full amount of the trust fund would go to the charitable organizations, and where the power was ended beyond recall before the running of the statute of limitations for making deficiency assessments. This is shown by the report of the Senate Finance Committee on section 408 of the revenue bill of 1942 where the following statement is made (77 Cong., 2d sess., S. Rept. No. 1631, p. 240):

"Your committee has changed the House draft of this section to provide that the disclaimer, if otherwise proper, need not be irrevocable prior to the date prescribed for the filing of the estate tax return, provided that it becomes irrevocable (for example, in cases in which the disclaimer by a beneficiary not under disability is not irrevocable when made, by a distribution of the bequest from the estate to the charity) before the expiration of the applicable period of limitations for the redetermination of the estate tax."

It is thus shown to be the intention of Congress that the deduction should be allowed if during the 15-month period something happened to show that the power would not be exercised, and before the expiration of the statute of limitations for redetermination of the estate tax (3 years after filing the return) the estate was in fact distributed to the charitable organizations.

It is difficult to think of any situation where there could be more certainty than exists here in connection with the elimination of the power to invade principal. The widow died within 7 weeks after her husband's death, ending the power, and the fund was distributed to the charitable organizations within 1 year after her husband's death. It is inconceivable that Congress could have intended that the deduction be disallowed in such cases. In order to eliminate any question about the right to the deduction in cases such as this, section 2055 should be amended to carry out the intention of Congress by providing that the deduction shall be allowed if the power of invasion terminates during the specified period.

The amendment should in any event be made to apply to estates of decedents dying after June 30, 1948.

Memorandum Submitted on Behalf of Atlantic, Gulf & Pacific Co. of Manila in Connection With the Provisions of H. R. 8300 Relating to Foreign Income

This memorandum is submitted on behalf of Atlantic, Gulf & Pacific Co. of Manila, a West Virginia corporation (herein called the "company") having its principal office and place of business in Manila, Republic of the Philippines, in connection with the consideration of H. R. 8300 by the Senate Finance Committee. The company has no office or place of business in the United States other than its statutory office.

The company, since 1909, has been engaged in business as general contractors. It also operates a structural machine and foundry shop in which it fabricates structural steel for bridges, buildings, and other constructions. It operates a creosoting plant for wooden poles and piles and a plant for wolmanizing lumber. It imports machinery and equipment for resale, acts as agent for United States manufacturers and, under a management contract with Philippine Iron Mines, Inc., a Philippine corporation, renders technical, engineering, and other services in the exploration, development, and operation of the mining properties of Philippine Iron Mines, Inc., and in the marketing of its products.

From 1921 to July 4, 1946, the date at which the Republic of the Philippines became independent, the company was not subject to United States income taxes under the provisions of section 251 of the Internal Revenue Code, exempting from such taxes gross income derived from sources within a possession of the United States. Since July 4, 1946, the company has been subject to United States income taxes. Its competitors, however, have been subject only to the Philippine income tax, which was, and presently is, about 24 percentage points lower. The competitive disadvantage is obvious.

Two points are considered in this memorandum.

I. H. R. 8300 SHOULD BE CLARIFIED TO MAKE CERTAIN THAT A DOMESTIC CORPORATION HAVING NO OFFICE OR PLACE OF BUSINESS IN THE UNITED STATES (OTHER THAN A STATUTORY OFFICE) WILL BE ALLOWED THE TAX CREDIT FOR FOREIGN INCOME

H. R. 8300 proposes to eliminate existing inequities in the tax treatment of foreign income if an enterprise is engaged in the conduct of a business "involving a significant investment abroad." (See report of the Committee on Ways and Means, XXV, p. 74 et seq.)

From the references in sections 923 and 951 of H. R. 8300 to a "branch" the inference might be drawn that a domestic corporation operating exclusively in a foreign country would not qualify for the benefits provided by the bill. Such treatment would not accord with the treatment given to Western Hemisphere trade corporations by sections 921 and 922 and no reason for such discrimination against a corporation operating exclusively in a foreign country suggests itself.

Moreover, the following example given on page A258 of the committee report indicates that the Ways and Means Committee does not consider income from the United States to be significant:

"* * * Thus, assume that the A corporation had in 1956 taxable income eligible for the 14 percent credit of $100,000 from country X, a loss of $40,000 from country Y and no income and no loss from domestic sources. In such case the credit will be 14 percent of $60,000."

Section 923 (a) (1) allows a credit as provided in section 37 with respect to taxable income derived from foreign sources "as branch income includible in gross income under part IV." Section 951 (a) referring to branch income and section 951 (b) (2) defining "home office" and "elected branch" may be open to the interpretation that they presuppose the existence of an office other than a mere statutory office within the United States.

The company has been conducting over a period of 40 years an active trade or business otherwise qualifying for the tax credit under section 923 through its principal office located in Manila, Republic of the Philippines, and has not maintained any office or place of business (other than a statutory office) in the United States. In order to make certain that the company is not deprived of the tax credit, we suggest that section 923 of H. R. 8300 should be clarified to show that it applies to domestic corporations operating exclusively in foreign countries.

II. THE REFERENCE IN SECTION 923 (a) (1) OF H. R. 8300 TO PART IV INTRODUCES AMBIGUITIES AND POSSIBLE INJUSTICES

The bill is unclear because it may deny the benefits of section 923 if the foreign office or branch is engaged in activities covered by both sections 923 (a) (1) and (2).

Section 923 (a) allows a credit with respect to taxable income derived from foreign sources—

"(1) as branch income includible in gross income under part IV;

"(2) as compensation for the rendition of technical, engineering, scientific, or like services;".

Section 923 (a) (1) refers to part IV and therefore incorporates for the purposes of treatment under section 923 the definition in section 951 (a) of income which may be deferred under the latter section. Section 951 (a) allows a domestic corporation "which * * * operates a branch in a foreign country which is engaged in the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business" to elect the treatment provided by part IV if such branch has, during the taxable year, derived "(2) 90 percent or more of its gross income from the active conduct of *such* a trade or business." (Emphasis added.)

If a branch (or in the case of the company the principal office) derived 20 to 50 percent of its gross income from the rendering of technical services to a foreign corporation as contemplated by section 923 (a) (2), and the balance of its income from a business qualifying under section 951, it could be contended that the branch (or the company) does not fall within the definition incorporated by reference in section 923 (a) (1) because its branch income does not meet the 90 percent test. If that be correct, the income from services would still qualify for the tax credit under section 923 (a) (2) but the remaining income would be disqualified. A similar problem may arise if dividends and interest, qualifying for the tax credit under section 923 (a) (3) and (4), are received by a branch. The legislative intent announced in the committee report indicates no basis for such a distinction.

Incidentally, it should be noted that section 923 (a) allows the credit with respect to branch income "includible in gross income under part IV." Literally the allowance of the tax credit would seem applicable only to income which was deferred under part IV and subsequently became includible in gross income and would not be applicable to income with respect to which an election under part IV was not exercised. Such literal construction appears unreasonable and contrary to the evident intention of the committee to grant the tax credit to income of the type referred to in part IV (see page A254 of the report of the Committee on Ways and Means).

We suggest that section 923 (a) be clarified to remove the ambiguities occasioned by the reference to part IV.

Respectfully submitted.

WICKES, RIDDELL, BLOOMER, JACOBI & MCGUIRE.

STATEMENT ON TREATMENT OF BLOCKED FOREIGN INCOME FOR FEDERAL INCOME-TAX PURPOSES BY KURT WEHLE, J. D., FLUSHING 67, N. Y.

Preface

Taxpayers who for one reason or another are recipients of income in blocked foreign currency are confronted with a difficult problem as far as the treatment of such income for Federal income-tax purposes is concerned. It might well be that in the field of income taxation this problem ranks among those on which there reigns the most thorough confusion.

This thesis is intended to present a survey of the problem and its implications. This writer had hoped to be able to get acquainted with the Commissioner's private rulings on the subject issued after the publication of mimeograph 6475 but unfortunately his hopes were disappointed. The thesis is, therefore, based merely on the generally known decisions and rulings as well as on the literature on the subject.

LIST OF CASES

S. E. Boyer v. *Com.* (9 T. C. (1952) 1168; P. H. par. 6033A).
Com. v. *First State Bank* (168 F. 2d 10004, C. C. A. 5th 1949).
Ceska Cooper (15 T. C. 757).
Corliss v. *Bowers* (281 U. S. 376).
Credit and Investment Corporation v. *Com.* (47 B. T. A. (1942) 673).
Richard R. Deupree (1 T. C. 113).
Douglas v. *Com.* (322 U. S. 275; 64 Sup. Ct. (1944) 988).
Phanor J. Eder, Violet L. Eder, James P. Eder v. *Com.* (47 B. T. A. (1942) 235, 138 F. 2d 27, CCA 2d, 1943).
Eisner v. *Macomber* (252 U. S. 189; 40 Sup. Ct. (1920) 189).
Estate of Anthony H. G. Fokker (10 T. C. (1948) 160).
Forstmann v. *Ferguson* (17 F. 2d 659; C. C. H. 1927, par. 7038).
Foundation Company (14 T. C. (1950) 1333).
Freudmann v. *Com.* (10 T. C. (1948) 775).
Estate of Ambrose Fry (9 T. C. (1947) 70).
Gen. Utilities & Operating Co. (296 U. S. 200).
Lewis Eugene Grigsby Trust (5 T. C. 51).
Hedrick v. *Com.* (154 F. 2d 90).
Heiner v. *Gewinner* (114 F. 2d 723, 725).
Helvering v. *Horst* (311 U. S. 112).
Helvering v. *Tex-Penn Oil Co.* (300 U. S. (1937) 481).
International Mortgage & Investment Corporation v. *Com.* (36 B. T. A. (1937) 187).
Iselin v. *U. S.* (270 U. S. 245).
Morris Marks Landau (7 T. C. (1946) 12).
New York Life Insurance Co. (24 B. T. A. 1217; affirmed F. 2d 345, certiorari denied 290 U. S. 682).
North American Mortgage Co. (18 B. T. A. (1929) 418).
Stuart, James & Cooke, Inc. (P. H. 1938, B. T. A. Mem. Service, par. 38095 (II)).
Towne v. *Eisner* (245 U. S. 418; 38 Sup. Ct. (1918) 158).
United Artists Corporation of Japan v. *Com.* (3 T. C. M. 574).
U. S. v. *Pleasants* (305 U. S. 357).
Frederick Victor and Achelis v. *Salt's Textile Manufacturing Co.* (26 F. 2d 249; 1 U. S. 274).
Estate of Frank D. Waterman v. *Com.* (195 F. 2d 244 C. C. A. 2d Mar. 5, 1952).
Edmund Weil, Inc. v. *Com.* (150 F. 2d 950; C. C. A. 2d, 1945).
James A. Wheatley (8 B. T. A. 1246).

Chapter I

Foreign Income and Exchange Control

A. TAXATION OF FOREIGN INCOME

With a few exceptions, income from without the United States (foreign income) earned by a United States citizen or a domestic corporation or a resident alien is subject to Federal income taxation and is treated in the same way as income from within the United States.[1] Thus in principle, there is no difference

[1] I. R. C., sec. 22.

between income from within and from without the United States with respect to the determination of taxability. In other words, foreign income is taxable if and when it is to be considered gross income under statute and/or case law.[2]

Exemptions.—For the purposes of this study it will suffice merely to enumerate the exemptions from Federal income taxation of income derived from sources without the United States. These are: (*a*) A United States citizen who has been a bona fide resident of a foreign country or countries uninterruptedly for an an entire taxable year.[3] (*b*) A United States citizen who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period[4] is exempt in regard to such income if received as compensation for personal services actually rendered. (*c*) A United States citizen or domestic corporation is exempt with respect to such income, if 80 percent of the taxpayer's gross income for the last 3 years—of which one-half or more is from a trade or business—is derived from sources within a possession of the United States.[5] [6] In all these cases the problem of deductions allocable to such exempted income is regulated accordingly.

Foreign income tax

To avoid double taxation the code provides[7] that within certain restrictions a credit for income taxes (also war-profits or excess-profits taxes) paid or accrued to a foreign country or countries or possessions of the United States is granted to United States citizens, alien residents and domestic corporations. The taxpayer, however, has an option of deducting the total foreign tax paid from gross income rather than applying it as credit against its United States tax.

In this connection we find one of the rare regulatory provisions[8] dealing with blocked foreign income which lays down a procedure for the granting of tax credit in those cases. We shall deal with this provision below.[9]

B. FOREIGN EXCHANGE CONTROL

Using the term "restrictions" in its broadest sense, and so as to include the control of gold, one may say that practically all countries apply money or exchange restrictions of one kind or another.[10] When one realizes that exchange control, whatever its original purpose "tends rapidly to be applied to the whole gamut of foreign exchange transactions from tourist traffic to merchandise trade"[11] and means more or less complete governmental control "with respect to any financial intercourse with foreign countries whatever the currency"[12] one may easily reach the conclusion that exchange controls have been a sore trial to international business and social relations. This also applies to United States business and investments abroad.

The various exchange restrictions which make up the different national systems of exchange control are of tremendous complexity, being devised so as to fit the particular economic, financial and political situation of the country concerned and to guarantee the completest possible governmental control of all economic and financial relationship between the country's inhabitants and between its institutions and foreign countries. Thus the restrictive measures are of a great variety within one country and also differ from country to country. It is not possible, within the framework of this paper, to give a detailed account of the many different forms exchange controls may take, nor of the principles underlying them, nor of the changes they undergo from time to time. But the following points should be mentioned:

One of the most common features of exchange control is the prohibition of payment(s) to a foreign or to a nonresident[13] creditor, amounts owed to such

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[2] Infra, p. 16 et seq.
[3] I. R. C. sec. 116 (a) (1).
[4] I. R. C. sec. 116 (a) (2).
[5] I. R. C. sec. 251.
[6] Cf. also I. R. C. sec. 109 (Western Hemisphere Trade Corps.) and I. R. C. sec. 454 f (Exemptions from Excess Profits Tax).
[7] I. R. C. sec. 131.
[8] Reg. 111, sec. 29.131–136.
[9] See p. 12.
[10] The city of Tangier can be considered as the sole exception. See Nussbaum, Money in the Law, p. 488, n. 9 (1950); cf. also Summary of Exchange and Foreign Trade Regulations as of January 1, 1953, issued by the National City Bank of New York. The United States and Switzerland do not have any foreign exchange control but control gold.
[11] Report on Exchange Control: Economic and Financial Committee, League of Nations, Geneva, July 9, 1938, p. 27.
[12] Nussbaum, op. cit., p. 362.
[13] Emphasis is usually given to residence rather than to citizenship.

persons not being transferable abroad. If the creditor insists on being paid and refuses to wait he can receive payment only in local currency into a so-called blocked account to be established in his name with a domestic bank having been licensed to keep such accounts. Yet the debtor may be allowed to free himself from his obligation by such payment even to a creditor who would otherwise prefer to wait. This implies that payment in foreign currency is forbidden.

The most significant consequence of exchange control is that the currencies cease to be mutually convertible. The only currencies interchangeable without limitation are the United States dollar and the Swiss franc whereas all other currencies are not.[14] As will be seen in the course of this study, convertibility of controlled (blocked, restricted, frozen) foreign currency into United States currency is the key principle governing the treatment of such currency for tax purposes.

Blocked accounts

To a foreigner or rather a nonresident the blocked account symbolizes all the impediments of the exchange and money restrictions imposed by the government of the country against which he has matured claims or where he has deposits or securities which he as the owner is not permitted to transfer into his own country or to exchange against his country's or another foreign country's currency.[15]

In principle, a blocked account, always expressed in local currency, cannot be used by its owner either within the issuing country or abroad. Today, however, we no longer find this principle applied in such rigid forms anywhere. What we do find is a variety of exceptions which usually permit a limited use of blocked currency within the country either by the owner himself or by a third person and which also grant a limited transfer possibility. Different provisions govern the use of different kinds of income (interest, dividends, salaries, etc.) and capital gains; in some instances the use is free, in others it is subject to general or individual permits. In general, it may be said, there is a more liberal approach to the defreezing of blocked accounts for use within the country than for transfer abroad. The degree to which the use of blocked currency within the issuing country or its transfer (convertibility) is allowed is of utmost importance for our considerations as is the time element, for it clearly makes a big difference as far as the taxation of such income is concerned, whether the blocking of the income, the imposition of restrictions upon it, happens before or after its realization.[16]

C. VALUE OF BLOCKED CURRENCY

For tax purposes in the United States foreign currency is not money; it is a commodity. Therefore, the question of the value of foreign currency is to be considered. As a matter of principle such currency should be included in gross income at its fair market value as is the case with other taxable income received in other values than United States currency.[17] [18]

In a free economy the value of a freely convertible currency is measured by the current rate of exchange which represents its fair market price. Thus, no difficulty is encountered when quotations of exchange rates are available which have been arrived at under truly free economic conditions. These may be relied upon as reflecting the genuine fair market value varying from quotation date to quotation date as a true result of the interplay of supply and demand.

In the case of blocked currency, however, the question of establishing the true economic value or the fair market price becomes very difficult. First of all, one has to realize that in principle, the official rate of exchange in these cases is governmental fiat and not the result of free economic competition. These rates are unilateral, but are in the absence "of free markets generally quoted and employed in other countries though they are often greatly overvalued."[19]

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[14] It may be mentioned, however, that there are today several systems of limited convertibility as for instance the European payments union, the sterling block (scheduled territories), and others. There is a trend on the part of Great Britain and West Germany toward free exchangeability of their respective currencies into United States dollars. On the other hand, there is an awareness of the undesired complications bilateral arrangements of this kind would bring about in regard to the contemplated integration of the west European economy.

[15] Cf. definition of blocked exchange by F. A. Southard quoted in Klarman, Taxation of Income in Blocked Currency, 28 Taxes 477 (1950).

[16] See p. 53.

[17] O. D. 419, 2 Cum. Bul. 60.

[18] I. R. C. sec. 115 (j), I. R. C. sec. 111 (b). Cf. Klarman, op. cit.

[19] Nussbaum, op. cit., passim.

These official rates have been used as the sole existing basis in a number of decisions other than in tax matters.[20][21][22] Instead of using such unilateral rates of exchange it might be considered feasible to apply the last quoted freely established rate of exchange. But this rate would not reflect a true market value either, owing to the lapse of time and to political and economic changes that may have occurred since that quotation. In some instances the so called free rate of exchange will be available. As outlined above, blocked currency may be used in some countries for various purposes by the owner or a third person upon general or individual permission. In such cases a market will usually be found for dealing with such blocked currency where a rate of exchange substantially lower than the flat rate will develop. This market is called free market and the rate free-market rate. It seems obvious that this market, though restricted to generally or individually licensed buyers and sellers and to certain kinds of deals, represents a medium through which a value of the currency can be established which is nearer to the fair market value than the official rate of exchange. It is generally accepted that the free-market value wherever it is established should be used [23] as representative of the fair-market value, one of the reasons being that it results from the functioning (although within a limited field) of a basic economic law.[24] In countries, however, where in addition to a free market there are other markets, black or gray markets, developing additional rates of exchange or where a multitude of official rates of exchange are in use, it is often thought that even the free-market rate of exchange does not reflect exactly the fair-market value or, in other words, that it is not "realistic."

Professor Nussbaum [25] points out that the official rate of exchange if used for taxation purposes would place an excessive burden upon the taxpayer and goes on to say: "Unless the tax law itself prescribes rates for foreign exchange, the Government has power and is even obligated to adjust its tax claims to the real exchange situation without being hampered by the particular considerations by which courts feel fettered in the evaluation of foreign currencies." This means, in other words, that some "realistic" method should be found to establish the currency's fair market value.

Thus, a rate of exchange more realistic than the free-market rate--which is generally to be taken into account—is sought, whenever this rate is not the only one available or where it does not furnish a "realistic" basis for the establishment of a fair-market value in a given situation.

Thus, in *Edm. Weil* v. *Commissioner* [26] a "commercial" rate was used and in *Eder* v. *Commissioner* [27] the Tax Court accepted as a basis for establishing the value of blocked currency the variable between the prices at which the same or similar commodities commonly used by citizens of the country living in Colombia sold in the United States and Colombia throughout the taxable year. In this latter case the opinion of an expert was requested.[28] The valuation in the Eder case comes near (though does not present a clear-cut example of) the application of the theory of the purchasing power parity for the establishment of relative values.[29] In this study we have to deal not only with the problem of how to establish the value of taxable income but also, as will be shown, with the question of what time or date should be decisive for the valuation. Should the value of the income be established at the actual time of receipt or at the moment of unblocking, etc?

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[20] Nussbaum, op cit., p. 483 and decisions quoted there under footnote 29.

[21] In *Eder* v. *Commissioner* the official rate has been used unsuccessfully by the lower instance only.

[22] Cf. Mertens, Law of Federal Taxation, 1952, pocket supplement, p. 22, "It seems to be established that the official rate of exchange does not apply to 'blocked' currency."

[23] The Foundation Co., 14 T. C. 1333; Morris Marks Landau, 7 T. C. 12 (1946); Estate of Ambrose Fry, 9 T. C. 70 (1947); Ceska Cooper, 15 T. C. 757 (1950).

[24] In one case blocked guilders could not be converted into dollars but into free Swiss francs and the latter into dollars. Taxed on bases on ⅓ of official value. Estate of Anthony H. G. Fokker, 10 T. C. 160 (1948).

[25] Nussbaum, op. cit., p. 483.

[26] 150 F. 2d 950, C. C. A. 2d (1945).

[27] 138 F. 2d 27, C. C. A. 2d (1943).

[28] Expert testimony on value may also be required where restrictions in various countries change and also where free market possibilities vary. Cf. Charles C. Parlin, Block Income, tax form No. 127.

[29] A very interesting study by Norman Alexander, Realistic Exchange Rates, points out that the purchasing power parity theory of exchange rates in spite of certain shortcomings has a certain applicability as a basis for judging "realistic" rates, whereas free (or black) market rates cannot be accepted as "realistic" as these markets are dominated by local conditions.

CHAPTER II

TAXABILITY OF BLOCKED FOREIGN INCOME

Having shown in brief outline that foreign income is, in principle, subject to Federal income tax and, on the other hand, that foreign income is subject to restrictions as a result of exchange controls which most foreign countries impose, we are ready to consider the problem of taxability of blocked foreign income.

The complexity of the problems involved becomes apparent if one reads the following statement made by the Deputy Commissioner of Revenue in a letter to Prentice Hall on December 17, 1940: "The restrictions respecting the transfer of moneys and/or the transmission of funds to the United States by foreign corporations located without the United States are not the same in the cases of all foreign countries which have issued orders or decrees prohibiting the transmission of cash to United States investors. It is therefore the opinion of this office that as the existent facts and circumstances in each particular case are controlling no general ruling may be rendered which could be applicable to all cases." [30] This sounds in fact like an act of resignation on the part of the official spokesman for the United States tax authority, and it seems that this is still or at least was the basic attitude toward the matter in Washington. For, as will be seen, even the latest attempt to solve the problem (made in 1950), Mimeograph 6475, did not offer a solution in principle but rather one in method.

A. STATUTORY AND REGULATORY PROVISIONS

We find in the Regulation 111, section 29.43-1 (a) implementing IRC section 43 ("Period for which deductions and credits taken") a provision which reads as follows: "In any case in which, owing to monetary exchange, or other restrictions imposed by a foreign country, an amount otherwise constituting gross income for the taxable year from sources without the United States is not includible in gross income of the taxpayer for that year the deductions and credits charges against the amount so restricted shall be deemed to have been 'paid or accrued' or 'paid or incurred' proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income. See section 29.131-6 for the treatment of foreign income tax imposed with respect to such amount as a basis of credit for foreign income tax in such cases."

It has been pointed out [31] that this provision does not clarify at what time blocked income is not includible in gross income, or that it simply says that "when earned income is not includible in gross income, it is not includible in the gross income." Though this is true it might be doubtful whether section 29.43-1 is the right place to give the definition. It seems that the provision is significant in that it implies that there definitely exists income which, owing to monetary exchange or other restrictions is excluded from gross income in the taxable year. This too is a clear indication that the Treasurer agrees to such income becoming includible in gross income if and when and to the extent to which it ceases to be restricted. This expressly refers only to the proper time for the application of such deductions and credits; but in the absence of a direct and proper definition of the income excluded in consequence of exchange, money or other restrictions, the provision of section 29.43-1 (a) second paragraph must be given adequate attention. Exactly the same applies to Regulation 111, section 29.131-6 (second paragraph) which provides for the treatment of taxes paid to a foreign country on restricted income not includible in gross income and the credit to be taken for it.[32]

Another provision dealing with blocked foreign income is IRC, section 433 (a) (1) (M) concerning the excess-profits tax.[33] Obviously this is the first instance where the matter is handled by statute. It provides for the exclusion—from computation of excess-profits tax net income—of income from sources in

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[30] See 1940 Prentice-Hall Federal Tax Service, par. 66.452.

[31] Cf. Steefel, unpublished study on Income Taxation of Blocked Foreign Currency; also Charles C. Parlin, op. cit.

[32] Regulation 111, sec. 29.131-6 (2d paragraph) reads as follows: "If, however, under the provisions of sec. 29.43-1 an amount otherwise constituting gross income for the taxable year from sources without the United States is, owing to monetary, exchange, or other restrictions imposed by a foreign country, not includible in gross income of the taxpayer for such year, the credit for income taxes imposed by such foreign country with respect to such amount shall be taken proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income."

[33] See also Regulation 130, sec. 40.433 (a)-2 (M).

a foreign country to the extent that such income would, except for foreign restrictions, have been includible in gross income. There is no clarification offered in this provision either as to which income is excluded from gross income.[34] Other provisions dealing with the subject are Mimeographs 5297, 6475, 6494, 6584; J. T. 4037 which will be dealt with later.[35] They do not give any definite answer to our basic question either.[36] Where then can we look for an answer?

Applicable basic tax principles

It seems that there are two basic problems involved:

(1) What is income?

(2) When is income realized and which is the period in which such income is taxable?

It is a commonplace that the definition of income is not static; income is a changing term developed by courts and legislators.[37] Yet, since the famous definition given in *Eisner* v. *Macomber*[38] a pretty clear line has been followed in defining income. The difficulty particularly in regard to our subject lies in the question as to when income is realized and, consequently, for which period it should be reported. Thus, the time element is of importance, which follows from the fact that taxation is based on income accumulated during a certain taxable period.[39] However, the fundamental question of when items become income and when items are deductible despite years of extensive litigation remains today not only as troublesome as ever, but even more so.[40] This throws light on the difficulties involved. Generally, income is to be included in the gross income for the taxable year in which it is received by the taxpayer.[41] The question is, of course: When is an income considered to have been received? The law is, for instance, that convertibility into cash is not an absolute requisite to taxability,[42] and this applies also in the case of a taxpayer using the cash-receipts method of computation. A taxpayer has been held to be in the receipt of income if he has the power to obtain the item in cash if he wishes it; if some of his obligations, by agreement, are discharged by a payment which does not come to him at all; or if he receives some form of communal obligation regarded as the equivalent of cash.[43] This has, of course, a bearing on our situation. On the other hand, there is a well-established principle that for Federal tax purposes income must be expressed in terms of United States dollars.[44] The principle is very well expressed in *Fred. Victor and Achelis* v. *Salt's Textile Manufacturing Co.*,[45] viz: "* * * [our tax law] does not measure assets in terms of marks, francs, or kronen, any more than in terms of wheat or pig iron. Nor can it be of any relevancy or importance to us whether or not in terms of francs or marks there has or has not been addition to the capital, whether the capital is located in Chicago or Paris. Regardless of the situs of its capital, it is the income of an American corporation which is the subject of measurement and income accrues to it only in terms of dollars." There is not necessarily a conflict[46] between these two principles when applied to blocked foreign income: The first principle deals with income which can be easily measured in the medium of cash, i. e., in United States dollars, the second principle underlines the fact that income to be taxable has to be measurable in United States dollars, or in other words, income, though taxable under the first principle, is not taxable if it cannot be expressed in United States dollars and from this it follows that it is not received (realized) at the time of its actual taking into possession.

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[34] There has been some speculation as to whether or not this provision has any relation to Mimeograph 6475. Cf., Mertens, op cit.; par. 42.41c, Herman Stuetzer, Jr., Tax Problems Raised by Foreign Currency Devaluation and Blocked Foreign Income.

[35] See infra, pp. 32 et seq.; 36 et seq.

[36] "We do not have a well-planned overall system of taxing income derived from foreign business. We have a patchwork of special provisions that has grown up over the years * * *." Paul D. Seghers, Lecture on Tax Advantages in Doing Business Abroad, the Export Manager Club, report, December 16, 1952.

[37] Cf. Justice Holmes' characterization in *Towne* v. *Eisner* (245 U. S. 418).

[38] 252 U. S. 189, 40 Supreme Court 189 (1920) 35; cf. Martens, op. cit., pars. 5.02, 5.21, etc.

[39] I. R. C. See p. 34 et seq.

[40] Martens, op. cit., par. 12.01.

[41] Reg. 111, sec. 29.42–1 (a).

[42] Reg. 111, sec. 29–111–1; Magill, Taxable Income, pp. 177–186; *Heiner* v. *Gwinner* (114 Fed. (2d) 723, 725; C. C. A. (3d) 1940, cert. den. 311 U. S. 714 (1940)).

[43] Magill, op. cit., pp. 177–186, and decisions there quoted.

[44] North American Mortgage Co., 1929, 18 B. T. A. 418. Cf. Shepherd, Foreign Exchange—Tax Consequences, Tax Law Review, 1946, 228.

[45] 26 F. (2d) 249 (1 U. S. T. C. 274); cf. also James A. Wheatley, 8 B. T. A. 1246 (C. C. H. Dec. 3040).

[46] See, however, Steefel, op. cit.

Our starting point in this subchapter was the question when income is to be considered realized and taxable. The principle outlined above that income is realized in some instances already at the time when it is not yet expressed in cash leads to what is called constructive receipt. Income not actually reduced to possession but credited or set apart to the taxpayer without any substantial limitation or restricion as to the time or manner of payment or condition upon which payment is to be made and which must be made available to him so that it may be drawn at any time and its receipt brought within his own control and disposition, is subject to tax for the year during which so credited or set apart.[47] Or, in other words, income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income whether he sees fit to enjoy it or not.[48]

To complete the short survey on taxing principles, a word should be added as to when income is realized on the accrual basis. On that basis all income accrued or earned is being reported whether received or not; the decisive factor being the right to receive rather than the actual receipt. Income on the accrual basis is realized "* * * upon (1) the completion of those operations on the part of the prospective recipient for which the money or money equivalent is to be paid, plus (2) the happening of a sufficient number of events to make it reasonably probable that a determinable amount of money or its equivalent will in fact be paid in due course of business." [49] On the other hand, "a likelihood of payment in some indefinite year in the future is hardly enough to justify a present accrual." [49]

Having shortly surveyed the basic tax principles or elements which are decisive in determining the taxability of foreign blocked income, one could try to develop from these principles the rules which should govern the taxation of such income. It seems more appropriate, however, to refrain from such a theoretical undertaking and rather to explore the law as it has been developed by the courts.

B. DEVELOPMENT OF CASE LAW

"The case law on taxation of blocked profits, standing alone, is unsatisfactory and it is difficult with confidence to deduce any clear line of principle from the existing decisions." [50] The decisions "present no coherent body of doctrine on the subject" and rather equity than any specific rule of tax law has been decisive.[50]

This and similar criticisms have been voiced by the writers on the subject. This critical attitude is largely based on the fact that the line of decisions established by *International Mortgage and Investment Corporation* v. *Commissioner* [51] and followed by *Credit and Investment Corporation v. Commissioner* [52] and *United Artists Corporation of Japan* v. *Commissioner* [53] has been abandoned and "has unfortunately been blurred by an overlapping line of cases" [54], viz: *Eder* v. *Commissioner* [55] *Edmund Weil, Inc.* v. *Commissioner*,[56] *Freudmann* v. *Commissioner*.[57]

International mortgage

International Mortgage & Investment Corporation v. *Commissioner* [51] is the basic case on taxation of blocked foreign income. [58] The opinion expressed in the decision says:

"Measured in marks, the petitioner had income from its business in Germany, but income for our Federal income-tax purposes is measured only in terms of dollars. * * * [59] The excess of amount realized over cost of the mortgages during that period was not measurable in terms of dollars. The dollar equivalent

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[47] Reg. 111, sec. 29.42–2.

[48] *Corliss* v. *Bowers*, 281 U. S. 376; *Hedrick* v. *Commissioner*, 154 F. (2d) 90; *Richard B. Denpree*, 1 T. C. 113; *Lewis Eugene Grigsby Trust*, 5 T. C. 51. Cf. Magill, op. cit., p. 447.

[49] Magill, op cit., p. 208.

[50] James, Taxation of Blocked Foreign Income.

[51] 36 B. T. A. (1937) 187.

[52] 47 B. T. A. (1942) 673.

[53] 3 T. C. M. 574.

[54] Cf. James, op. cit.

[55] 47 B. T. A. (1942) 235, 138 Fed. (2d) 27, C. C. A. 2, 1943.

[56] 150 Fed. (2d) 950, C. C. A. 2, 1945.

[57] 10 T. C. (1948) 775.

[58] Based on *Helvering* v. *Tex-Penn Oil*, 300 U. S. 481, 1937.

[59] Reference is made to: *James A. Wheatley*, 8 B. T. A. 1246; *North American Mortgage Co.*, 18 B. T. A. 418; *Frederick Victor* and *Achelis* v. *Salt's Textile Manufacturing Co.*, 26 Fed. (2d) 240; *New York Life Insurance Co.*, 24 B. T. A. 1217; affirmed Fed. (2d) 345, cert. den. 290 U. S. 682.

of those marks could not be obtained. The petitioner did not have unrestricted use and enjoyment of the marks. It had a claim against its agents for the amounts of the marks but it could not remove the credit or the marks from Germany. * * * Thus it appears that these particular marks during 1931 were subject to a very serious restriction and were in no sense the equivalent of free marks. It was, therefore, improper to compute a gain * * * by translating the excess marks received into dollars at the rate of exchange applicable to free marks."

The facts underlying the decision are these:

"The petitioner in years prior to 1931 took dollars into Germany * * * and used the money to purchase German mortgages at less than face value. Some of the mortgages were paid off during the taxable year between July 12 and December 31, and the petitioner's agent received from the mortgagors more marks than the mortgages had cost the petitioner. The marks so received were blocked.".

On July 13, 1931, the German banks were closed, and before they reopened on August 1, 1931, the German "Devisen-Ordnung" prohibited the transfer of marks out of Germany without the permission of the German Foreign Exhange Office.

"The agents of the petitioner in Germany, after July 12, 1931, were unable to pay over or credit to the petitioner any of the amounts received in payment of mortgages in such a way that the petitioner could obtain or use the money outside of Germany. No exceptions to the general rule applied to the petitioner, and it did not get permission at any time during 1931 to transfer out of Germany any of the marks representing repayments of mortgages received after July 12. The petitioner could not obtain permission and was unable to transfer out of Germany any of the marks on deposit with German banks on July 13, 1931. A regulation was adopted in Germany on December 30, 1931, providing that the owner of restricted marks, after obtaining written consent of the Foreign Exchange Office, might reinvest the blocked marks in Germany on a long-term basis, provided that repayments would be turned into a blocked account. * * * There was no market in 1931 for the restricted marks, and no one could form an opinion as to their value at that time. * * *"

International mortgage doctrine

From the above quotation it can easily be seen that the decision is built on a number of facts which in the opinion of the Court constitute the nontaxability of the gain in this particular case, and likewise, it is evident that no particular emphasis has been put on any of these facts enumerated in one line, one after the other, viz:

(*a*) Income was not measurable in dollars;

(*b*) Dollar equivalent could not be obtained;

(*c*) There was no unrestricted use and enjoyment of the marks;

(*d*) None of the marks could be removed from Germany either physically or by way of credit;

(*e*) Marks were subject to a very serious restriction;

(*f*) Marks were in no sense the equivalent of free marks, and further (from the factual findings of the Court);

(*g*) The marks received could not be paid over or credited in such a way that that the owner could obtain or use them outside of Germany;

(*h*) No permission for a transfer of the marks could be received;

(*i*) There was no free market for these marks;

(*j*) There was no way to form an opinion on their value.

Thus it appears to be difficult to find the correct answer to the question: What is the international mortgage doctrine? Is the emphasis, in addition to the requirement that the income must be measurable in United States dollars, upon—

(1) The convertibility into dollars, or is it considered a sufficient basis for its subjection to Federal income tax if the income is—

(2) available for unrestricted use and enjoyment—

(*a*) in the foreign country or

(*b*) in the United States or

(*c*) elsewhere?

The answer cannot be found in the decision itself not even in that part which deals with the petitioners mark income before the restrictions were enacted.[*] There,

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[*] It reads as follows: "The agents of the petitioner received similar payments during the first part of 1931 and at the time of receipt the marks were not restricted but were freely negotiable, convertible, and transferable. Held, that the gain on these transactions measured in dollars at the current rate of exchange was income, and, held further, that such income was not reduced and no loss was sustained due to the fact that some of those marks may have been allowed to remain in German banks until they became blocked on July 13."

that income is deemed realized[61] and therefore taxable because at the time of receipt it was freely negotiable, convertible and transferable or, in other words, earned in free currency. This is no indication of the court's opinion on the question as to which is the attribute on the absence of which they would deem an income not taxable nor as to what degree of deficiency would warrant the recognition of nontaxability.[62] Therefore, it is necessary to look for another source to assist interpretation; in this context nothing else is available except a few subsequent decisions in which reference has been made to the International Mortgage case. The first case in point is *Credit & Investment Corporation* v. *Commissioner*.[63]

Here, emphasis is placed on—

(1) the fact that a free market for blocked marks existed in New York and that, therefore,

(2) the blocked marks had a fair market value and that

(3) the money and exchange restrictions did not prevent the sale of blocked marks and

(4) did not make it impossible for the petitioner to have the marks taken out from Germany.

The petitioner did not prove, however, as, according to the decision, he is obliged to do "that the particular marks could not have been transferred out of Germany and sold." On the other hand, the Court also said: "The fact that the marks could be used for certain purposes within Germany without permission of the German Government did not, in our opinion, make them free marks."

Thus, it is evident that the income in blocked foreign currency in this case has been found taxable—

(*a*) because it was measurable in United States dollars (i. e., had a fair market value) and

(*b*) because the taxpayer was entitled to convert the income into United States dollars.[64]

Now, in what relation does this case stand to the International Mortgage case? The taxpayer based his defense on the statement that "the blocked marks were subject to such serious restrictions that it was impossible to realize dollars upon them." The Court deals with this objection in the following terms:

"Such a finding, in effect, was made by this Board in International Mortgage. * * * In that proceeding the petitioner could not obtain permission and was unable to transfer out of Germany any of the marks on deposit in German banks on July 13, 1931. There was no market in 1931 for the restricted marks. * * * But no such fact has been stipulated or shown in the evidence in the instant proceeding."

The Court concludes that "the authorities relied upon [International Mortgage] are therefore inapplicable."

The next case to be considered here is *United Artists of Japan* v. *Commissioner*.[65]

The Court said:

"* * * We are of the opinion that the decision in this case is governed by this Court's opinion in International Mortgage * * * wherein this Court held that the petitioner therein realized no gain for Federal income tax purposes as a result of the receipt by the petitioner of marks which could not be removed from Germany either physically or by way of credit during the taxable year. * * *"

The court, however, did not limit the reference to the International Mortgage case to this quotation but, in addition, gave a complete excerpt from the decision without emphasizing any particular point. Yet, in a third quotation, concerning the taxpayer's blocked currency which had been exported to the United States but remained blocked (or earmarked for a special use by the foreign

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[61] Principle of constructive receipt.

[62] Under the International Mortgage rule no loss has been recognized with respect to the blocking of foreign currency after it has been realized. The explanation, however, makes it clear that to be recognized as a loss an amount must first have been reported as income. "* * * the owner of the deposit cannot go back and claim that income deposited in the account was not income in the first place because it was subsequently lost. The blocking of the marks on deposit on July 13 might have resulted in a loss to the taxpayer. But the evidence before the Board does not show that there was any loss to the taxpayer in 1931 from the blocking. * * *" In other words, though the blocking alone does not cause a loss, a loss will be recognized when and if the blocking is severe enough to render the amount worthless.

[63] 47 B. T. A. 678 (1942), promulgated September 15, 1942.

[64] As assumed by the Court.

[65] 3 T. C. Memo 574 (June 13, 1944).

government), the court put stress on the fact that "'the petitioner' as in the International Mortgage * * * case 'did not have the unrestricted use and enjoyment * * *'" thereof.[66] Pointing out that neither the Credit and Investment case nor the Eder[67] cases are applicable, the court held "that the income received by the petitioner in Japan in 1938 and 1939 in Japanese yen is not to be included in petitioner's gross income for those taxable years."[68]

Stuart, James & Cooke, Inc.[69]—In this case, taxpayer received rubles for personal services performed in Russia which could be used in Russia for payroll expenses only and which could not be converted into dollars. It has not been established whether there was a free market for those rubles or not. The court's decision is substantially the same as the decision in the International Mortgage case.

International mortgage ruling

Considering the International Mortgage decision in conjunction with the above decisions, it should be possible to formulate the rule which is called the International Mortgage doctrine. One may be justified in assuming that this rule should read as follows:

"Income in blocked foreign currency is subject to Federal income tax upon receipt if it is measurable in United States dollars, i. e., its fair market value in terms of United States dollars can be established and if it can be converted into United States dollars."

It appears also to be clear from these decisions that the international mortgage rule did not consider taxable such restricted income as could be used in the foreign country only.[70][71]

A relatively recent decision: Ceska Cooper[72] upheld the international mortgage rule and, at the same time, limits its use in that it considers as taxable blocked pounds sterling—though they could not have been brought to the United States in cash—because they were freely expendable anywhere in the sterling area,[73] and because their value could be established with reference to the prices at which the British blocked pounds were freely selling in the New York free market. This case is distinguished from the International Mortgage case because in the latter case there was no market available and the value of the marks could not be established.[74][75]

This line of decisions is followed by cases decided under the so-called specific legislation and economic satisfaction rules respectively.

Specific legislation rule

The idea governing this rule is that income which is subject to taxation under specific provisions of the Internal Revenue Code is treated under these provisions even if the income is earned in blocked foreign currency and even if the currency is not convertible into dollars. In other words, the specific provisions of the code supersede the international mortgage rule. In the case *Eder* v. *Com-*

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[66] Taxpayer had blocked yen, part of which had been transferred to a bank in San Francisco, where it "was in no appreciable way less blocked from petitioner's use than if it had been in Japan itself, and was subject to be returned to Japan, if restrictions upon it were evaded."

[67] See infra, p. 25, et seq.

[68] Part of the blocked yen in the counter value of $67,000 has been paid upon permission of the Japanese Government to taxpayer's creditors in the United States. Such payment equals unblocking and would constitute realization and taxability. This question, however, was not before the court.

[69] 7 P–H (1939), B. T. A. memorandum, par. 38095 (December 1938).

[70] According to Roberts, Taxation, the International Mortgage and the Credit and Investment cases "appear to enunciate this rule: In order to be subject to tax on the receipt of blocked currencies the taxpayer must have the legal power to convert the foreign currency into dollars."

[71] Stream, Earned Income, states, however, that a "more appropriate statement of the rule * * * would seem to be that blocked currency is taxable on receipt where it has an ascertainable equivalent dollar value and where the taxpayer has the legal power to convert it into American dollars or to derive economic satisfaction from its use within the country of its origin."

[72] 15 T. C. 757 (promulgated Nov. 30, 1950).

[73] In this connection reference is made by the court to the Eder and Freudmann cases (infra, pp. 25 et seq.).

[74] The free market rate and not the official rate of exchange has been used with reference to Morris Marks-Landau (see footnote 20b); Estate of Ambrose Frey (see footnote 20b).

[75] See also *S. E. Boyer* v. *Commissioner* (9 T. C. 1168, 1952, P. H., par. 603 3A). (Part of compensation received by an overseas Army officer in British pounds and French francs was convertible into United States dollars in accordance with the official or controlled rates of exchange, but no loss was sustained because of the difference between such rates and those in the free or open market; the evidence was that upon leaving Britain or France the officer could redeem his pounds and francs at the official rates.)

missioner (*Phanor J. Eder, Violet L. Eder, James P. Eder* v. *Commissioner*)[76] the specific provision applied is I. R. C., section 337 (b).

In this case the Circuit Court of Appeals (2d) held that undistributed supplement P income of a foreign personal holding company was taxable income to its shareholders though earned in blocked Colombian pesos not transmittable to the United States even if it were distributed in the form of dividends.

In *Max Freudmann, et al.*, v. *Commissioner*[77] the specific rule was that of I. R. C., section 182, concerning the computation of net income from partnership. Here, too, the court held that the particular provision should be followed in preference to the section containing the general provision (I. R. C., sec. 42), and impliedly to the case law (International Mortgage). The court held that the distributive share of the income of a Canadian partnership was, under I. R. C., section 182, taxable to a United States resident partner, though the income could not be transferred to the United States due to Canada's currency restrictions.

The specific legislation rule has been severely criticized by commentators for several reasons, the most important being that income which is not includible in gross income when received (I. R. C., secs. 21, 22, 23) does not become taxable when its distribution is assumed.[78]

Another reason is given by Roberts,[79] who points out that supplement P gross income is computed in the same way as in the case of a domestic corporation and, as the International Mortgage rule applies to a domestic corporation, it should apply equally in this case. The same is true in the case of partnerships where income is computed as in the case of an individual. Moreover, "the obvious purpose of the statute was to treat similarly the distributed and undistributed income of a foreign personal holding company."[80]

The rule is found unsound also on the following grounds: If the income in the Eder case had been distributed it would have been credited to blocked accounts and the International Mortgage case would have been followed. "Statute does not require that the doctrine of that case [International Mortgage] should be ignored when there is no distribution."[81]

If, for instance, the foreign personal holding company earns 2 units in blocked currency 1 of which distributed, while the other is retained the application of the Eder rule would result in the nondistributed share being subject to tax whereas the distributed share would not be taxed under the International Mortgage rule.[82]

When dealing with taxation problems, the ultimate effects, the payment of taxes, should always be kept in mind. If income in foreign blocked currency is taxed which is convertible into dollars no problem arises as dollars are available. Under the specific legislation and economic satisfaction rules,[83] however, the tax must be paid from United States income or capital. "The resulting burden is tantamount to an additional income tax or a tax on capital which has not been contemplated by Congress."[84] The court, however, pointed out in the Eder case that "Congress, in enacting section 337 of the Revenue Act of 1938 and supplement P in which that section is included, did not make the legal transfer to the United States of the distributed earnings of a foreign personal holding company a condition precedent to the levying of the tax. Distribution was assumed by the statute. * * *" The reasoning in the Freudmann case follows a similar line.

If, what has been described in this subchapter as the specific legislation rule stood alone it might be held that the International Mortgage rule is replaced by the specific legislation rule as the rule controlling these cases, and this would afford a firm basis for examining the question as to whether or not (and if, to what extent) the International Mortgage rule is still law. Such a clear basis, however, is not available because in no case did the court base its decisions solely

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[76] 47 B. T. A. (1942) ; 235, 138 Fed. (2d) 27; C. C. A. 2, 1943.
[77] 10 T. C. (1948) 775.
[78] Cf. Klarmann, op. cit.
[79] Roberts, Effect of Blocking of Currency on Gain or Loss, N. Y. U., 7th Annual Institute on Federal Taxation, p. 1224, 1949.
[80] Roberts, Taxation of Transactions in Foreign Currencies, New York C. P. A., vol. 18, p. 101, 1948.
[81] Roberts, Effect.
[82] Cf. Parlin, op. cit.
[83] Infra, pp. 27, 28.
[84] Carroll, The Need for a Practical Rule for Taxing Foreign Income in Blocked Currencies; cf. Gelfand, the Freudmann case.

on the specific legislation doctrine; all the decisions also take into account the economic satisfaction doctrine.[85]

Economic satisfaction doctrine

In the Eder case the court stated the following: "There can be no denying that the taxpayers could have invested, or spent, the 'blocked' pesos in Colombia and, as a result, could there have received economic satisfaction." In the Freudmann case, taxpayer could use the blocked funds in Canada and, therefore, economic satisfaction doctrine was applied, too.

A case decided after the Eder and before the Freudmann cases, *Edmond Weil, Inc.* v. *Commissioner*[86] contained a dictum which warrants the conclusion that also in the absence of special legislation income in blocked foreign currency—which is not convertible into dollars—but which can be used by the taxpayer in the foreign country, is taxable. The following quotation from the decision may clarify the situation:

"The taxpayer objects to the decision of the Tax Court principally on the ground that there was no taxable capital gain since it 'could not export the gain to the United States.' Even if this were so, the taxpayer could not succeed and we ought to do no more than remand so that evidence might be presented to show some other basis for measuring an evident gain than current rates of exchange—just, as we did in *Eder* v. *Commissioner*, (138 Fed. (2d) 27). But we think inability to export capital from Brazil to the United States was not so established as to justify our disregarding a decision of the Tax Court to that effect * * *"

From the above, it appears that it is difficult to define the field of application of these two doctrines. It must, however, be stressed that the court, in distinguishing the Eder case, declared in the *United Artists of Japan* case:[87] "In that [Eder] case, the taxpayer urged the applicability of the International Mortgage * * * case, but this court held that that case was not in point so it was not premised upon any specific legislation as was the deficiency in the Eder case, to wit, section 337 (b) of the Revenue Act of 1938." This enunciation limits the Eder doctrine to specific legislation cases, whereas—as noted—the Edmond Weil case does not.[88]

In the circumstances, there is an uncertainty on this point so that some state that the Eder doctrine is generally applicable and must not be premised on specific legislation,[89] while others are of the opposite opinion.[90] Of course, if the general application of the economic satisfaction doctrine, not limited to specific legislation cases, be accepted, it must be borne in mind that it is not at all clear—

(*a*) whether any conceivable use of the blocked foreign currency is considered a realization of income,

(*b*) whether the actual use or the availability for use is decisive, and

(*c*) how the equivalent in United States dollars—due to the absence of a free market—should be established.

It appears that the cases decided do not supply any clear answer to these questions: Therefore, we find different interpretations advanced by the commentators.[91]

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[85] The specific legislation doctrine as such—whether correct or not—should be applicable to the case of beneficiaries under I. R. C., sec. 162 (b). Cf. Roberts, Effect.

[86] 150 F. 2d 950, 951 (C. C. A. 2d, 1945).

[87] Supra, p. 22.

[88] A recent decision, *Estate of Frank D. Waterman* v. *Commissioner* (195 F. 2d 244 (C. C. A.) 2d, Mar. 5, 1952), giving the reference to the Eder case as the sole reason, says: "When a note was paid in blocked pounds, the taxpayers realized the value in dollars of such foreign currency in that taxable year notwithstanding the fact that because the pounds were 'blocked,' the recipient was then unable to convert them into American money." Here no specific legislation is involved. This was also the case in Coska Cooper, supra, p. 24.

[89] Cf. Roberts, Effect; Stream, op. cit.; Shepard, op. cit.

[90] E. g., Montgomery, Federal Taxes, Corporations and Partnerships (1949–50), 26.

[91] See in general to this point: Roberts, Taxation; Roberts, Effect; Klarmann, op. cit.; Roberts, Blocked Currency, Acc. and Non-Acc., 28 Taxes 514 (1950). Roberts, Effect, is of the opinion that economic satisfaction doctrine is applicable possibly only if volume of investment is important. That opinion based also on regulation 111, sec. 29.43–1, 29.181–6, and Mim. 5397. He considers potential rather than actual use decisive. However, in Taxation he says that the doctrine may not be applicable in cases where persons are not interested in economic satisfaction abroad or do not have any possibility to obtain it.

Klarmann, Taxation, on the other hand, says: "Although the decisions are based upon special provisions of the law, their real meaning * * * is in the fact that the income received had been realized by leaving or reinvesting it in the business from which it was derived. It can be shown that this reasoning applies not only to the special cases decided by the Tax Court—income from foreign personal holding companies and from partnerships—but to all business income."

There is reason to assume that the answer to (*a*) should be that income in blocked foreign currency is taxable under the economic satisfaction rule if the taxpayer, under the foreign country's legislation, is free to use and enjoy it in any way, viz, to the extent to which he actually uses and enjoys it. Only this approach will result in the taxation of realized income on the ground of economic satisfaction. It seems difficult to assume economic satisfaction on the basis of a constructive receipt only; to assume constructive realization of income[92] in blocked foreign currency, usable in the foreign country only, would probably lead to absurd results,[93] because in the circumstances—income not convertible into United States dollars—the possibility of use and enjoyment exists only if and when the taxpayer is attracted by such possibility and actually makes use of it.[94] This answers our question (*b*). As far as (*c*) (valuation) is concerned, it must be stated[95] that, as no free market exists, the only valuation available is the one used in the Eder case, or if possible, an improved form of the purchasing power parity theory.[96]

In my view, the question whether the economic satisfaction rule is generally applicable law cannot be answered under the existing decisions. Whether applicable alone or only in conjunction with the specific legislation rule, in either case it violates a generally established rule that income for Federal income-tax purposes must be measurable in dollars.[97]

On the other hand—following the system of the IRC according to which income should be taxed whether derived from sources within or without the United States—we must bear in mind the possibility of tax evasion in cases where blocked foreign currency, not convertible into United States dollars, is used by the taxpayer within the foreign country in a manner and for purposes for which he necessarily would have to spend United States dollars if no blocked local currency were available or, if available, it were not usable. Furthermore, such dollars would have to be converted into local currency at the official rate of exchange—in the absence of a market. This consideration may lead to the view that, though the International Mortgage doctrine has not been overruled by any of the subsequent decisions, the fairness of its applicability has been rendered doubtful in cases where the blocked foreign currency cannot be measured in, and not be converted into United States dollars but where economic satisfaction, which otherwise would have to be procured by spending United States dollars, actually is derived from such income in the foreign country.

Summary of case law

It is obvious that the cases do not present a unique, clear, and generally applicable doctrine and, that therefore in the view of everybody concerned with the matter, the situation is rather confused. On the other hand, there is the International Mortgage doctrine, as we understand it[98] and as it is laid down in the cases including the Ceska Cooper case:[99] on the other hand, there are cases based on the specific legislation and economic satisfaction rules, which disregard the International Mortgage doctrine but are not general enough to overrule it. In practice, there will probably be less opportunity in future for the two doctrines to clash, since for most of the blocked foreign currencies there exist free markets developing rates of exchange which enable the assessment of their value in United States dollars and will eventually make possible their conversion into United States dollars, if not by transfer, at least by sale. In spite of this, the situation as developed under case law remains too ambiguous to permit the taxpayer or his adviser to make a safe decision pro or contra the inclusion of

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[92] Supra, p. 15.

[93] In an unpublished ruling, blocked Brazilian cruzeiros were held taxable if taxpayer could convert them officially or unofficially, or if he could buy merchandise and export and sell it for dollars, or if he could buy real property, the title to which could be exported and sold for dollars (referred to in Carroll, op. cit.).

[94] James op. cit.: "Can a corporation be supposed to squander only because there is a possibility in the foreign country to use the blocked currency in some way?" See, however, Roberts, Effect.

[95] Supra, pp. 7 et seq.

[96] In the Freudmann case, the question did not appear because the rate of exchange had been stipulated.

[97] Cf. Lassen, Blocked Accounts, who points out that, e. g., I. R. C., sec. 337, did not establish any exemption from that rule.

[98] Supra, p. 28.

[99] Supra, pp. 17 et seq.

income in gross income in cases not obviously covered by the International Mortgage rule.[1]

C. ATTEMPTS TO RESOLVE THE PROBLEM

Mimeograph 5297

This ruling[2] refers to two problems presented by "the existing system of so-called blocked accounts and related accounts maintained by the United Kingdom incident to the control by that Government of foreign exchange and foreign trade transactions * * * from the standpoint of Federal income taxation," viz:

> (*a*) the amount of gross income from sources wihin the United Kingdom to be reported on Federal income and excess-profits-tax returns; and
>
> (*b*) the foreign exchange rates to be applied under the present methods of British governmental exchange control in the conversion to United States dollars of income from such sources receivable in British pound sterling and includible in such returns.

In other words, the problem is, whether and to what extent, as well as on the basis of what rate of exchange income in restricted British pounds sterling should be included in gross income for Federal tax purposes.

The mimeograph enumerates those items[3] which may be credited only to blocked accounts in Great Britain covering payments to a nonresident of that country, pointing out that the only way in which a nonresident of the United Kingdom may realize on the blocked account, except by special permission, is "by conversion with permission into specified governmental securities from which such nonresident may receive interest in sterling which as income is available to him through registered account at the official exchange rate established by the British Treasury." Only such realized income will be reported for United States Federal tax purposes, whereas otherwise "any income * * * paid into the blocked account is not realizable in any amount and, therefore, not includible in gross income for Federal income-tax purposes." On the other hand, income from British sources or various kinds (exclusive of capital gains) such as e. g. salaries, pensions, commissions, professional fees, dividends, profits on commercial transactions and others, received by a taxpayer (whether residing in Great Britain or elsewhere), if payable in sterling are convertible to dollars at the official rate of exchange only. This is the only rate available for Federal income-tax purposes.[4] Where, however, actually different rates of exchange have been applied to realize British income (or to pay British taxes) those rates will be controlling.

Thus, Mimeograph upholds the rule expressed in the International Mortgage and Credit Investment cases that income in foreign blocked currency is not taxable if not convertible in any amount into United States dollars, and is considered taxable if realized (by transfer or sale) in United States dollars.[5] It is also in line with the principle laid down in regulation 111, 29.43-1 and regulation 111, 29.131-8[6] that completely blocked foreign income is not gross income and not taxable.[7]

Magill report

The reports of the Special Tax Study Committee to the Committee on Ways and Means, House of Representatives, of November 4, 1947, Revenue Revision 1947–48, contain the following suggestion: "Any amount of foreign income subject to United States income tax should only be included at the time it can be transmitted to the United States in dollars. This is generally believed true un-

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[1] An alarming remark about the relationship between the International Mortgage and the Ceska Cooper cases and the possible consequences are to be found in Comments, Taxation of Foreign Currency Transactions, 61 Yale Law Journal (1952) 7, viz: "* * * no logical justification for retaining a distinction between the Ceska Cooper and International Mortgage situations; when the use of inconvertible currency is severely restricted, those restrictions should be reflected in lower market rates. Courts might therefore establish a uniform rule that all gains in foreign currency are immediately taxable."

[2] 1 C. B. 1942–84, dated December 16, 1941.

[3] (*a*) Sterling proceeds of certain securities; (*b*) amounts to be distributed following the sale or winding up of companies or the dissolution of partnerships; (*c*) legacies or similar payments; (*d*) capital payments arising out of settlements; (*e*) proceeds of the sale of real estate, furniture, pictures, jewelry, or other movable assets situated in the United Kingdom, other than goods imported for sale in the ordinary course of trade.

[4] See, however, I. T. 3568, 1942–2 C. B., 112, providing for the use of rates "clearly reflecting the proper amounts of the items to which they relate as affected by the conditions and available means and rates of conversion * * *."

[5] As to the modification of Mim. 5297 by Mim. 6475, see infra, p. 54.

[6] Supra, pp. 11 et. seq.

[7] Cf. Stuetzer, op. cit.

der present regulations, but any clarification needed in the statute should be provided."

This statement of present law and the suggestions for statutory treatment of the problem is obviously intended to incorporate the international mortgage doctrine into the statute and to eliminate the use of the rules expressed in the Eder case. However, by using the phrase "transmitted to the United States in dollars," the principle of the international mortgage doctrine is not stated broadly enough to include the rule which deems the blocked foreign income taxable if and to the extent that it can be converted into dollars.[8] It may be assumed, however, that during the legislative processing of the report's suggestion an adequate wording would probably have been substituted for the original terms and would have resulted in a very urgently needed clarification.[9] Actually, the report has never been transformed in a statutory act.[10]

CHAPTER III

MIMEOGRAPH 6475

It was only natural that in these circumstances the taxpayers should feel the need for greater legal security, and considerable pressure was brought to bear on the Bureau of Internal Revenue to bring about a clarification.

After some preparation, the Bureau issued mimeograph No. 6475, dated March 1, 1950, on the Treatment of Blocked Foreign Income for Federal Income Tax Purposes.[11] The reaction to this ruling has been somewhat critical in view of the fact that it did not offer any interpretation of the statute and the conflicting Case law,[12] but, instead, introduced an electional method of accounting under which the reporting of foreign blocked income can be deferred; it thus left many problems unanswered.[13] The mimeograph, however, has been praised as "an imaginative attempt to resolve the problem of taxing income received, credited, or accrued in foreign currency which is subject to monetary or exchange restrictions,"[14] and its advantage has been found in the fact that it gives security to the taxpayer.[15] Another characterization of the mimeograph calls it "a bold and ingenious attempt to help solve a very troublesome subject."[16] Still another laudatory comment reads: "Mimeograph 6475 represents a praiseworthy attempt of the Treasury to find a workable solution to a vexatious problems."[17]

It would be of interest to know to what extent the taxpayers have been and are making use of the election offered by the mimeograph, but no data are available.[18] Judging by the customary attitude of the taxpayers, we may safely assume that the number of elections made under the mimeograph is considerable.

A. GENERAL CHARACTERIZATION OF MIMEOGRAPH

The mimeograph is based on Internal Revenue Code, sections 41–43, giving the Commissioner direct authority with respect to accounting methods. The Commissioner, however, does not present a "method as in the opinion of the Commissioner does clearly reflect the income"[19] but, instead, offers the election of such an accounting method. The question has been raised, as to whether such an election is a statutory one and, if not, what possible consequences for the taxpayer and the Treasury the exercise of such an election may have.[20] Therefore, and for a couple of other reasons, it is not easy to classify the mimeograph simply as a regulation on accounting methods, derived from direct statutory authority. What kind of regulation is it?

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[8] Supra, p. 23; cf. however Carroll, op. cit.: Foreign Income Should Not Be Taxable in the United States Until It Is Available in United States Dollars.
[9] Cf. Carroll, op. cit.
[10] For a thorough critical discussion of the Magill report see Roberts, Taxability of Income Received in Blocked Currency, Journal of Accountancy, September 1948, p. 231.
[11] 1950–51 C. B. 50.
[12] The mimeograph "* * * stands quite independent of the previous Case law." James, op. cit.
[13] In fact, the time of reporting of income—the question in which the Treasury is interested—is an accounting problem.
[14] Roberts, New Developments in Foreign Exchange, N. Y. U., Eighth Annual Institute on Federal Taxation, p. 24, 1950.
[15] Cf. Otto L. Walter, Amerikanizche Steuerpflicht.
[16] Parlin, op. cit.
[17] Montgomery, op. cit., 1950–51, p. 22.
[18] Letter received from Office of Internal Revenue of October 24, 1952.
[19] Internal Revenue Code, sec. 41.
[20] Infra, p. 55.

There are generally recognized three kinds of Commissioner's regulations. There are first those which are based on statutory authority such as, for instance, on Internal Revenue Code, section 41. There is a second group intended to clarify provisions of the Internal Revenue Code which are unclear or too broad and too general; and there are finally those by which the tax administration tries to impose its policy when it does not agree with the effect of some provisions and does not want to wait until the law is changed (an activity which, in fact, should be up to the courts on the ground of bilateral contest). Though these latter regulations are referred to as the "least justifiable" by Peairs,[31] he welcomes mimeograph 6475 as an example of a regulation "designed particularly for the elimination of taxpayer inconvenience or disadvantage."

The mimeograph, it seems, is therefore only partly covered by statutory authority and, to the extent to which it is so covered, insofar as it establishes a procedure for the deferment of foreign blocked income (accounting method) it is authoritative and not reviewable; on the other hand, it is also a regulation without special authority and reviewable.

The situation is characterized by the fact that it gives rise to such questions as: Does not the Commissioner use these rules to attempt to transform into taxable income what in the cases is not gross income?[32]

Is the Bureau legally correct in treating the problem of deferment of income as an "election" expressed through a method of accounting?[33] These questions and others can, however, be answered only after a very close study of the mimeograph. It may be useful to begin with a—

B. SHORT SURVEY OF CONTENTS

The mimeograph creates a new term "Deferable income" and establishes a reporting procedure by which the taxpayer who elects to use it[34] is allowed to defer the reporting of "deferable income" until the income ceases to be "deferable income," at which time it is includible in gross income. The mimeograph lists the reasons for which income ceases to be "deferable income" and deals with the deferment of expenses and costs in United States and foreign currency and their allocation when two or more foreign countries are involved (mimeograph 6494).[35] It illustrates these provisions by means of an example. There are also provisions relating to losses and rules for a change in accounting method. Mimeograph 5297[36] is modified. Finally the applicability of mimeograph 6475 as to taxable years is adapted by mimeograph 6584.[37]

C. DETAILED DISCUSSION OF PROVISIONS

1. "Deferable income"

For its purposes, the mimeograph creates the term "deferable income" which it defines as "income received by, credited to the account of, or accrued to a taxpayer which owing to monetary exchange or other restrictions imposed by a foreign country, is not readily convertible into United States dollars or into other money or property which is readily convertible into United States dollars." In other words, deferable income is blocked foreign income not readily convertible, either directly or indirectly, into United States dollars. To fully understand the definition, one must be clear about the meaning of the term "readily convertible" or rather about the difference between "readily convertible" and (plain) "convertible". The mimeograph itself does not offer any explanation of these terms. According to Webster[38] the word convertible, as applied to our case, means "to be capable of being converted by being exchanged for property value or obligation of another kind." The meaning of readily is given as being: "with promptness, quickly, at once, easily * * *." Thus, we are offered a choice between a considerable number of explanations. If we examine them more closely to discover those that have a bearing on the interpretation of the mimeograph, there is reason to believe that the emphasis lies on the following con-

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[31] Peairs, General Principles of Taxation, An Initial Survey, second installment, Tax Law Review, vol. 6, p. 471.

[32] Parlin, op. cit.

[33] Angel and Kramer, Some Questions on Taxability of Foreign Income Left Unanswered by Mimeograph 6475, Journal of Accountancy, December 1949.

[34] Whether individual, corporate, or other (mimeograph, point 8).

[35] 1950–51 C. B. 54.

[36] Supra, p. 82.

[37] 1952–52 C. B. 19.

[38] Webster's New International Dictionary, 2d edition.

siderations. The starting point of the mimeograph is, if only by implication, the recognition of the existence of blocked income which is convertible (and therefore taxable).[29]

As outlined above, there exists a large variety of currency restrictions and there is also considerable variation in the possibilities allowed for the use and enjoyment of the restricted currency. It follows that, to allow a deferment of blocked foreign income which is "not convertible" at all would not mean very much by way of relief to the taxpayer: Any possibility of exchange whatsoever of the blocked foreign currency against any kind of property, value or obligation measurable in United States dollars would exclude a deferment and render the regulation meaningless. Therefore, the use of the term "readily convertible," appears to qualify the term "convertible" in such a way as to limit its use; hence, for our purposes, "readily convertible" can only mean such convertibility as can be effected easily, i. e., without any particular effort or sacrifice on the part of the taxpayer and as is not contrary to his wishes and does not run counter to his private or business intentions and interests. Though probably the term must not be interpreted in so broad a sense as to denote a convertibility which is available to the owner of blocked currency only by virtue of a general permission, it would seem reasonable to carry the interpretation nearly to that point.[30] Another approach to define "deferable income" would be simply to say that income not readily convertible may be equal to income not taxable under statutes and case law, to hold, in other words that "deferable income" is income the restrictions of which make it nontaxable.[31] The difficulty, however, lies in the fact that no clear-cut rule exists as to what kind of restrictions are required from the point of view of Federal income taxation to render an income nontaxable,[32] and none is offered in the mimeograph.[33] Finally, it should be noted that the preamble to the mimeograph contains the statement that the monetary or exchange restrictions often make "it difficult for taxpayers to ascertain the value, in terms of United States dollars of the blocked income * * *." One might therefore be allowed to look upon the terms "deferable income" and "readily convertible" income from this angle, which would lead to an interpretation of these terms to the effect that not readily convertible, and therefore deferable, income is income the value of which in terms of United States dollars cannot be readily ascertained. It seems, however, that such reasoning provides too narrow a basis for the application of the mimeograph.

Consequently, the first interpretation, given here, is probably the only safe basis for the application of the mimeograph. In fact, following our outline about the present status of the Case law[34] it is obvious that "deferable income" is not a synonym for "nontaxable income"; there is definitely income which is to be included in gross income if no election is made under the mimeograph, but which is deferable if election is made.[35]

2. Ending of deferment

In the words of the mimeograph, income ceases to be deferable income when, to the extent thereof—

(*a*) money or property in such foreign country is readily convertible into United States dollars or into other money or property which is readily convertible into United States dollars;

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[29] Cf. Roberts, New Developments.

[30] The blocked (West) deutschemark (Sperrmark) may serve as an example: This currency is—

(*a*) usable in Germany for various purposes;

(*b*) salable to other nonresident blocked account holders at a discount of about 50 percent;

(*c*) transferable and convertible to a certain extent if it qualifies as a pension (and in some instances).

According to our interpretation, one may be justified in assuming that income in Sperrmark is deferable as long as no use of conversion possibilities is made under (*a*) or (*b*) and with the exception of Sperrmark under (*c*). These latter marks are not deferable and, in fact, taxable in the year when received (credited, accrued), as if they were "free" marks, regardless of whether they are transferred or not.

[31] A similar consideration might have caused the remark in Angel and Kramer, op. cit.: "* * * [The Commissioner's] method of giving the taxpayer an 'election' rather than of recognizing taxpayer's absolute right to defer blocked income, does violence to some well-recognized tax law and his own regulations (111, sec. 29, 48-1)."

[32] Supra p. 81.

[33] This is what makes it so difficult to answer the question put by Stuetzer, op. cit., whether under the term foreign currency not readily convertible into dollars only such income is meant which under prior law was considered as tax free. He is of the opinion that such a narrow concept would be meaningless.

[34] Supra, p. 16, et seq.

[35] E. g., in the case of income in Sperrmark; see footnote 115.

(b) notwithstanding the existence of any laws or regulations forbidding the exchange of money or property into United States dollars, conversion is actually made into United States dollars or other money or property which is readily convertible into United States dollars; or

(c) such income is used for nondeductible personal expenses, is disposed of by way of gift, bequest, devise or inheritance, or by dividend or other distribution, or, in the case of a resident alien, a taxpayer terminates his residence in the United States.

The mimeograph does not mention one additional reason for the ending of deferment, viz, the unblocking of the income which causes it to become an income in free currency, and is, as a matter of course, a taxable event, because it automatically constitutes the realization of that income whether or not actually converted, transferred or used.[36] The reasons for the ending of deferment can be divided into two groups, i. e., the reasons given under (a) and (b) are such under which the income is readily convertible or actually converted into United States dollars, whereas the reasons given under (c) provide for taxability without any reference to ready convertibility, or, for that matter, any convertibility at all, direct or indirect, into United States dollars.

Note on (a): The provision hardly calls for interpretation. It simply points out that not readily convertible income ceases to be deferable when it becomes readily convertible. Whether this is the case depends on the acts of the government of the foreign country concerned and on the interpretation adopted by the taxpayer or eventually by the United States tax authorities.[37]

Note on (b): The reason given under (b) takes into account the fact that there are instances of actual conversion of blocked foreign income into United States dollars, directly or indirectly, where under the existing foreign law this very income is not readily convertible. There are conversions effected in the black market and other transactions which, from the point of view of the foreign government, constitute acts of varying degrees of lawfulness. It goes without saying that the reason under (b) is a necessary complement to (a).

Note on (c):

(i) *Nondeductible personal expenses.*—When blocked foreign income is used for nondeductible personal expenses it equals a realization of the income in line with the economic satisfaction rule. There is no doubt, however, that deferment is ended only by the actual use for these expenses of the blocked income, not by the availability for use.[38] The reason why nondeductible personal expenses only receive separate treatment must clearly be sought in the fact that the mimeograph in subsequent paragraphs deals with cost and other expenses as a correlate to deferred income.

(ii) *Gifts.*—The disposal of blocked foreign income by way of gift is construed as realization of income, which interpretation is equally in line with the economic satisfaction rule: economic satisfaction may result from a gift.[39] Parlin, however, asks whether what is not translatable into dollars can be converted into a taxable dollar income because it has been donated to somebody else.[40] It would seem that a gift should be considered a taxable event only if and when the conditions as outlined above in the subchapter on the economic-satisfaction rule, are fulfilled.[41]

(iii) *Bequest, devise, or inheritance.*—The provision that income ceases to be deferable if disposed of causa mortis is highly controversial. It seems illogical to hold that the death of a person should effect any change in the convertibility

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[36] Cf. Roberts, New Developments.

[37] There does not exist any periodical or nonperiodical list, published by the Treasurer or the Commissioner of countries and restrictions which they recognize under the mimeograph. Cf. Stuetzer, op. cit.

[38] Supra, pp. 26, et seq.

[39] Cf. Roberts, New Developments; cf. I. T. 3932, 1948, 2 C. B. 7 cf. I. T. 3910, 1948, 1 C. B. 15; cf. *Helvering v. Horst*, 311 U S. 112.

[40] Parlin, op. cit.

[41] Supra, p. 81.

[42] Internal Revenue Code, sec. 126, provides in substance that the amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or of a prior period shall be included in the gross income, for the taxable year when received, of the estate, of a beneficiary or a third person entitled.

[43] Internal Revenue Code, sec. 42 (a), provides: "In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts * * * accrued only by reason of the death of the taxpayer shall not be included in computing net income for the period in which falls the date of the taxpayer's death."

[44] *Cf. Parlin*, op. cit.

[45] Regulation 111, sec. 29.44-5, provides a method of deferred reporting in the case of a decedent who dies possessed of installment obligations.

or readiness for convertibility of deferred income. One can hardly see any justification for this provision, and the less so as there exists a statutory provision to the contrary, viz, Internal Revenue Code, section 126.[43] The provision also conflicts with Internal Revenue Code, section 42.[44] "The Commissioner's own regulations would offer a proper way of handling the matter by analogous application of regulation 111, section 29.44-5.[45] There is reason to believe that this provision of the mimeograph would probably not be upheld by the courts should a taxpayer's estate refuse to recognize it as providing for the end of the deferment. Many a taxpayer may hesitate to elect deferment of income, being afraid that in the year of death the total income might suddenly reach a very high amount, while the equivalent in dollars would not be available.

(*iv*) *Dividend or other distribution.*—The rule that deferred income becomes taxable if disposed of by dividend or other distribution is equally controversial. Though this provision may find a justification in *Commissioner* v. *First State Bank*,[46] grounds for opposing it may be found in another case.[47] As far as applicability to partnerships is concerned, it is obvious that a partner who accepts the distributive share is allowed to defer the income as an individual, and, further, since the partnership as such is not taxable, it would seem that the partnership cannot be deemed to have realized any income as a result of such distribution.

Another feature of the provision is that it refers to distribution; thus nondistributed income of a partnership or foreign personal holding company remains deferred if election has been made. Considering the mimeograph alone, one might say that such election should be made by the partnership or corporation; however, taking into account Internal Revenue Code, sections 182 and 337 (b), election by the partner or shareholder might prove sufficient. This, at least is the interpretation that might be given a private ruling of the Bureau, dated April 18, 1950.[48]

(*v*) *Resident alien.*—Income ceases to be deferable when the taxpayer is a resident alien and terminates his residence in the United States. This is obviously an expediency rule and we should not examine too closely from the angle of its legal justification. Certainly, the change of residence of a taxpayer is not a taxable event and does not bring about any change in the convertibility of the deferred income.[49] On the other hand, the rule seems to be necessary for fiscal reasons.[50] The question remains, however, whether, in the interest of a more appropriate legal construction, the taxpayer should not be rather under the obligation (*a*) to attach to his return of income on forms 1040 C and/or 1040 D a declaration with respect to the deferred income and (*b*) to deposit an appropriate security for possible future tax on such income.

3. *Deferment of costs and expenses*

Expenses in foreign currency.—The mimeograph, logically and pursuant to regulation 111, section 29.43-1 (a), provides that expenses "paid or accrued" or "paid or incurred" in the currency of the country in which there is deferable income "will be deductible in any subsequent taxable year in the same proportion as the deferable income is includible in taxable income." The same applies to depreciation,[51] obsolescence and depletion, measured in terms of such foreign currency. Foreign tax credit for taxes paid or accrued with respect to deferable income may be taken only as provided for in regulation 111, section 29.131-6.[52]

Costs and direct expenses in United States dollars.—The general principle to be applied is that United States dollar income is not to be burdened by costs and direct expenses in United States dollars to the extent involved in the production of deferable income.[53] The mimeograph contains detailed provisions which cannot be reproduced here but may be illustrated by the example given in the mimeograph of a United States manufacturer who sold merchandise for 2,000 units of the

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[46] 108 F. 2d 1004, C. C. A. 5th, 1940: "Ordinarily no gain or loss is realized from the mere distribution of its assets in kind in partial or complete liquidation, * * * but the rule is deemed to be otherwise where the dividend in kind is not in liquidation. * * * It is the realization of income rather than the acquisition of the right to receive it, that is the taxable event and there is no reason why the rule that income tax is not to be avoided by an anticipatory assignment of income shall not apply to dividends."

[47] General Utilities and Operating Co. (296 U. S. 200).

[48] 28 Taxes (1950) 514; infra, p. 58.

[49] Cf. Parlin, op. cit.

[50] Roberts, New Developments.

[51] Cf. Parlin, op. cit., for an interesting discussion on depreciation during time of deferment of income in case of sale of real property.

[52] Mimeograph, point 6.

[53] Mimeograph, point 7.

money of a foreign country.[54][55] There is, however, always the possibility to fully deduct such expenses from the realized gross income with the Commissioner's consent. Special rules are stated (and adapted by Mimeograph 6494) for the allocation of costs and direct expenses if they are applied in foreign operations in more than one country.

Indirect expenses.—By giving rules for direct expenses without making any provision for the treatment of indirect expenses the mimeograph obviously leaves the deductibility of indirect expenses untouched. Therefore, it appears that expenses under Internal Revenue Code section 23 (a) (2) are deductible though they are paid or incurred for the production or maintenance of property held for the production of income which at the time is "deferred" only.[56]

4. *Substantial worthlessness of foreign holdings*

Mimeograph under point 7c provides: "If and when it becomes apparent that any foreign holdings which reflect the receipt of deferable income are substantially worthless, the taking into account for tax purposes of costs and direct expenses pertaining thereto and described in this paragraph shall no longer be deferred."

In this connection it might be of interest to examine first of all, what is meant by the term "substantially" worthless. The term "worthlessness" itself is controversial. According to Webster it means "having no value," "having no worth"; it is not easy to determine when a right, a security, or any other item has decreased in worth or value to such a degree that no worth or value is left. Now, does the attribute "substantially" mean more or less worthless? It would appear that the expression "substantially" should be understood to mean[57] "considerably" or "solidly based"; we thus get a "considerable worthlessness" or a "solidly based worthlessness," for which, it would seem, less rigid evidence is required than for worthlessness without any qualification, for complete worthlessness. This is undertandable under the circumstances.

The correlative to this provision can be found in point 8 of the mimeograph which deals with deferable losses.

5. *Deferable losses*

The provision reads: "Where the taxpayer adopts the method of accounting provided for by this mimeograph, losses shall also be taken into account under the rules for deferment stated herein." It has been pointed out that the meaning of the provision is not quite clear.[58] In fact, it seems to rule that losses in foreign blocked currency have to be deferred if—

(*a*) the taxpayer defers income using the election method, and

(*b*) if the losses are sustained in currency which is not readily convertible into United States dollars.

In other words, the same treatment applies to income as to losses.

6. *Procedure*

A taxpayer[59] who elects to use the method of accounting offered in the mimeograph is required to file with his Federal income-tax return a return headed "Report of Deferable Foreign Income, Pursuant to Mimeograph No. 6475," using for this purpose a separate income-tax form of the same type as that with which it is filed.[60] In such return the taxpayer shall declare that the "deferable income" will be included in taxable income in the year in which such income, to the extent thereof, ceases to be "deferable income." In such return, the taxpayer has also to declare that he waives any right to claim that the "deferable income," or any part thereof, was includible in his gross income for any earlier year.[61]

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[54] "The cost of goods sold was $700, and direct expenses attributable to the sale were $100. The manufacturer was able to convert into United States dollars in the taxable year of the sale only 1,560 units of the foreign money at the rate of $0.50 per unit ($780). In such case only $80 is required to be included in gross income in such year on account of the transaction (the excess of $780 over the cost of $700) and 1/6 of the direct expenses of $100 is deductible in such year (being the ratio of the 100 units of the foreign money which is reflected in the $50 gross income to the 600 units of such money in excess of the 1,400 units applied against cost)."

[55] It is questionable whether this is a good example, as the expenses referred to therein seem to be rather selling, and therefore indirect, expenses. Cf. Parlin, op. cit.

[56] According to James, op. cit., the same conclusion may be arrived at by inference from certain unofficial interpretations of the mimeograph.

[57] Cf. Webster's New International Dictionary, 2d edition.

[58] Cf. Parlin, op. cit.

[59] Mimeograph, point 4.

[60] A separate return is required for each country where deferable income is produced.

[61] See next subchapter.

There is no direct provision in the mimeograph concerning the currency in which such income should be presented in the report of deferable foreign income, whether in United States or foreign currency but it seems logical to assume that the income can be expressed in foreign currency only because of valuation difficulties. This must also be concluded from the mimeograph's provision[59] that "All information required by the return of 'deferable income' shall be furnished with such adaptation to the currency involved as may be necessary," which in itself is nothing but a piece of technical advice to the taxpayer who has to use forms adapted for United States dollar income and deductions only. Moreover, the reporting of the income in terms of foreign currency is beyond any doubt provided for by a subsequent ruling.[60]

The above-mentioned reporting rule is complemented by another providing for the method of reporting deferred income when it ceases to be deferable, viz: "On his income-tax return for the taxable year in which any 'deferable income' is includible in taxable income under the method of accounting provided for herein, the taxpayer shall include such income in gross income and claim the deductions allocable thereto * * *." There is further provision for an accurate control of the disposal of deferred income in that the taxpayer is requested to verify the income (deductions) reported, against the returns of deferable income previously filed.

D. TAXATION OF UNBLOCKED FOREIGN INCOME

In the preceding subchapter we have described the technical procedure to be followed in reporting blocked foreign income if and when it becomes includible in the taxpayer's gross income as a consequence of the realization of one of the reasons for which income ceases to be deferable. A number of problems arise in connection with this final phase, taxation.[61]

Valuation.—The mimeograph does not deal at all with the question of how to establish the value in United States dollars of the "unblocked" income; it says nothing about the rate of exchange to be applied or about the time element.

As far as the rate of exchange is concerned[62] it appears that different rates will have to be applied according to the particular manner in which deferment of the blocked foreign income has ended. The different ways in which this can happen have been outlined above.[63] In such cases where taxability is caused by a conversion of the income into United States dollars, the amount actually received or credited in United States dollars is decisive, and the rate used here must also be applied to the allocable expenses to arrive at a net figure. In these cases the free market price will, as a rule, be the rate applied; in some instances, the official rate will be used, particularly in the case of general unblocking, i. e., in the case of restricted currency being generally changed into free currency.

In all other cases the free market rate will be the only one that can be applied provided it is available; if it is not, a valuation on the lines of the Eder case or a more realistic method[64] will have to be applied.

Time element.—Deferable income is includible in gross income at the time when it ceases to be deferable. Hence, the salient point is the determination of the time of cessation and the ascertaining of the value of the income at that time. In other words, blocked foreign income is deemed realized at the moment it ceases to be deferable and at that very moment it is taxable. Therefore, this moment is the time deemed to be the date of receipt of that income, though the income may actually have devolved upon the taxpayer at an earlier date, and the former, not the latter, date is decisive for the choice of the rate of exchange to be applied. This is in line with other rulings of the treasurer.[65] The computation of the dollar equivalent of foreign currency income also does justice to the concept of foreign currency as a commodity that should be valued at its fair

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[59] Mimeograph, point 5.

[60] I. T. 4037, 1950-52, C. B. 81.

[61] As to the question in which sequence income shall be deemed to be realized, see discussion in James, op. cit. There are three possibilities: (1) Identification, (2) per analogiam FIFO, (3) per analogiam LIFO. It seems that the question is of importance only either in cases where some repartition is allowed in accordance with the periods in which the income has been earned or in cases where the taxpayer's earned income in one country consists in a number of units of foreign blocked currency each of which is (or groups of which are) restricted in a different way.

[62] Supra, pp. 5 et seq.

[63] Supra, pp. 42 et seq.

[64] Supra, pp. 8, et seq.

[65] O. D. 410, C. B. 2, 60, O. D. 459, C. B. 2, 60; O. D. 1060, C. B. 5, 66.

[66] Cf. Klarmann, Gains and Losses, p. 720.

market value when received as income.[69] The same principle of establishing the value of the income under consideration is laid down in a ruling complementing Mimeograph 6475, viz: "When such income ceases to be 'deferable income', the amount thereof, translated into terms of United States currency, at the rate of exchange prevailing at that time, would be included in the taxpayer's gross income * * *."[70]

Finally the Magill report seems to point to the same principle. The above applies to the valuation and taxation of blocked foreign income realized at the time of unblocking. Where, however, the blocking itself did not result in a postponement of the realization and the unblocking results in an increment of value, such an increment is not taxable until the currency received is disposed of by a taxable transaction.[71]

Tax due.—In the absence of any provision to the contrary, in the mimeograph or in the statute, the taxation of deferred and now reported income hits the total of such income as if it were earned in its entirety during the taxable year in which it is included in gross income, although part of such income has been earned during preceding taxable periods. The situation which results therefrom has been described as a hardship to the taxpayer in "pyramiding income spread in receipt over many years into 'income' received in a single entirely different one. And in a day when the tax rate mounts more often than yearly the skyrocketing effect on the taxpayer who, it will be noted, has no control over the contingency which brings it into play."[72] A remedy could be found possibly by adopting 1 of these 2 procedures: either by including the income, when unblocked, in the gross income of the taxable year of original receipt,[73] or by devising some kind of averaging method to distribute the income, e. g., per analogism Internal Revenue Code, section 107.[74] Whereas it appears to be within the Treasury's regulatory power to adopt the first possibility, statutory provision would be required to enact a procedure on the line of Internal Revenue Code, section 107.[75]

E. MODIFICATION OF MIMEOGRAPH 5297

It is not too clear what the effect of mimeograph 6475 on mimeograph 5297 is, to wit, whether deferment is allowed only in the case of currency considered as nontaxable in mimeograph 5297 or also in the case of other income convertible at the official rate of exchange into United States dollars. It would have been helpful if mimeograph 6475 (point 12) had given an explanation.[76]

F. ELECTION

As outlined in the subchapter dealing with the general characterization of the mimeograph, the accounting method of deferring the reporting of "deferable income" is not made obligatory, but offered to the taxpayer as an optional method. This is probably the first time that an election has been offered by a mimeographed ruling to solve a difficult problem, though elections have been introduced by Treasury regulations,[77] in addition, of course, to those included in the Internal Revenue Code. The election under mimeograph 6475 is backed by a waiver. Whereas normally an election should be definitely binding on the taxpayer and the Treasury, in this case the mimeograph provides: "In such return, the taxpayer shall also declare that he waives any right to claim that the 'deferable income', or any part thereof, was includible in his gross income for any earlier year."[78] The power of this waiver is questionable as it is based on a mimeograph ruling only, and not on a ruling or regulation approved by the Secretary in accordance with Internal Revenue Code, section 3791.[79][80] Thus, it

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[70] I. T. 4037, 1950–52, C. B. 31.

[71] Cf. Roberts, Effect.

[72] Dissenting judge in *Douglas* v. *Commissioner* (322 U. S. 275, 64 S. Ct. 988 (1944)).

[73] Cf. *Forstman* v. *Ferguson* (17 F. 2d 659); cf. Lassen, op. cit., who is for this solution.

[74] Cf. Roberts, Effect; Roberts, Taxability; Steefel, op. cit.

[75] Steefel, op. cit., refers to an opinion privately expressed by the Bureau, according to which the Commissioner could not include in his regulations a method similar to the one in sec. 107, because the "ratability of compensation in personal service, pension, copyright, and back-pay cases existed only by virtue of statutory enactment, and if the same were to apply to this situation specific legislation by Congress is required to cover this point."

[76] In the Ceska Cooper case, mimeograph 6475 has not been applied. Mertens, op. cit., notes without explaining that the mimeograph was obviously inapplicable. Nothing is known, in this direction, with reference to the Waterman case.

[77] Cf. I. T. 3369, 1940–1, C. B. 46; I. T. 3956, 1949–1, C. B. 78.

[78] Mimeograph, point 4.

[79] As in the case of e. g. I. T. 3795, 1946–1, C. B. 15, 17.

[80] Cf. Roberts, New Developments, who refers to I. R. C., sec. 3760, as the basis on which waiver and consent of the taxpayer should be agreed upon under the circumstances.

is quite possible that the courts would permit a taxpayer who had made the election, subsequently to challange some of the accounting rules.[81] This might be the case particularly with respect to some of the rules relating to the cessation of the deferment of income, e. g., causa mortis.[82]

It is significant that the waiver does not include deferred costs and expenses in United States dollars. Whereas the treatment of expenses in foreign currency is based on regulation 111, section 29.43-1, the provision concerning the deferment of United States dollar costs and expenses has no statutory basis. The reason for the different treatment of income on the one hand and related dollar costs and expenses on the other, is not clear; there is probably no reason to assume that the taxpayer could be bound more strongly by his election in respect of costs and expenses than of income in regard to which his voluntary election is fortified by his consent and waiver.[83]

Seeing what the development of the case law has been in this field of taxation, one feels some reluctance to predict future jurisdiction; but it must always be borne in mind that a determination by the Commissioner represents his interpretation of the law, not the law itself.[84]

G. TAXABLE YEAR FOR WHICH MIMEOGRAPH APPLICABLE

Under mimeograph 6475 the election can be made for all open taxable years.[85] An election for a prior taxable year is effective only when all intervening taxable years are open at the time of making the election.[86] The election for a given year does not preclude subsequent additional elections for prior open years under the condition just mentioned.[86] This rule has been amended by mimeograph 6584 of December 28, 1950, viz: Election with respect to open taxable years can be made—under certain conditions—not later than at the time of the return for the taxable year 1950. Otherwise, the election is to be made not later than at the time for filing the income-tax return for the first taxable year for which the election is applicable; the first taxable year for which the method of deferment shall be used shall be designated as such, and the election will be binding for that first designated year and all subsequent years.[87] This means, of course, that it is binding also for years of loss. The rule also means that the taxpayer is not free to elect to defer income earned in one country while not making the election with respect to another country, i. e., not to report the income from the second country on the ground that it is not includible in gross income (without reference to the mimeograph). Thus, in the case of election, there can be only two kinds of income in blocked foreign currency: One reported in the tax return, one deferred and reported in the "report."

A taxpayer who adopts the optional method of accounting under mimeograph 6475 cannot make any change or variation therein without first securing the Commissioner's consent.[88]

CHAPTER IV

CONCLUSIONS

A. RELATIONSHIP OF MIMEOGRAPH TO PRIOR LAW

The mimeograph does not explain the Case law, nor does it attempt to reconcile the decisions as developed prior to its issuance. However, the reasons advanced for the termination of the deferment indicate that the Commissioner follows the International Mortgage rule combined with the Economic Satisfaction rule as outlined above.[89] Still, it was of significance that the subsequent ruling, I. T. 4037, threw more light on these questions; it provided that deferable income which was actually deferred remains deferred if used for the purchase of investment or business property. This clearly indicates the Commissioner's position on the question of reinvestment of deferred income, but

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[81] Cf. Parlin, op. cit.

[82] Supra, pp. 45, 46.

[83] Cf. the highly interesting discussion of this point in Janes, op. cit. The treatment of dollar costs and expenses is said to be the reason why the Bureau did not issue a regulation interpreting the I. R. C., but instead one offering an optional accounting method.

[84] *U. S. v. Pleasants* (305 U. S. 357); *Iselin v. U. S.* (270 U. S. 245).

[85] Mimeograph, point 9.

[86] Cf. letter of Department of Commerce to P.-H., dated April 24, 1950 (par. 76283).

[87] As to criticism of the changes by mimeograph 6584, cf. Stuetzer, op. cit.

[88] Mimeograph, point 10.

[89] Supra, pp. 23 et seq.

does not add anything to our understanding of his attitude toward the Economic Satisfaction rule in cases where no use is being made of the mimeograph. A private ruling, dated April 13, 1950,[90] refers to the Freudmann case and provides that a partner of a partnership using the optional accounting method may defer his distributive though nondistributed share like other gains and losses.[91]

Position of taxpayer.—Whether mimeograph 6475 and the prior law will mutually influence each other remains to be seen. For the time being it is safe to say that the mimeograph governs cases where the election has been made, and that the Case law controls all other cases, subject, of course, to new development in the courts. In view of this situation and because the mimeograph is pretty much in line with the decisions, "some taxpayers may prefer to take their chances on the development of the law on the subject, rather than to commit themselves as required in the report." [92] It is hard to decide in any one particular case whether it is preferable to use the electional accounting method or to defer blocked income ipso jure (as nongross income) or to report it annually. The deferment has the undisputable advantage of insuring that, if accepted, the deferred income will not become taxable until the event terminating the deferment, hereby giving the taxpayer security and temporary financial relief. There might also be instances in which the income when includible in gross income will ultimately be taxable as capital gain. In general the character of the income will be determined by reference to the original transaction out of which it arose.[93] On the other hand, the fear of a pyramiding of income, the possibility of higher taxes may induce the taxpayer to report the blocked income currently at a lower rate of exchange due to the restrictions than to report it after deblocking, at a higher rate of exchange and possibly at a higher tax rate.[94]

It is a consequence of the failure of the mimeograph to take a position on the Case law that there is also no indication about the Commissioner's position with respect to the taxpayer who does not elect the accounting method. This, however, cannot have any effect on the taxpayer's position in regard to income other than "not readily convertible foreign blocked income." But in this respect, the Commissioner's failure to consider the matter does not mean much either. It seems that the taxpayer has a choice between three possibilities:

(1) He can elect to defer;

(2) He can defer ipso jure;

(3) He can currently report not readily convertible blocked foreign income (and losses).

Normally, it would make no difference whether he defers ipso jure or whether he elects to defer; election, however, would be preferable because of the greater degree of security it offers him. On the other hand, where there is an absolute right to defer, such deferment has its advantages, in that the taxpayer will be free of the ties imposed by the mimeograph, particularly as to the termination of the deferment. A taxpayer who defers such income makes his own decision about when to include it in gross income; under the mimeograph, however, he is obliged to include it, as soon as it ceases to be deferrable under the mimeograph. The termination of deferment mortis causa may serve as an example: If income was deferred as a non-gross-income item death cannot change anything in this situation. But if it was deferred on the basis of an election it is subject to the conditions of the mimeograph [95] (unless rejected by the court).

There is still another approach to the matter:

"If income is deferrable, the taxpayer will have to decide whether to exercise his option. Assuming the income to be presently taxable (Ceska Cooper), the taxpayer will base his decision primarily on whether he would rather pay annually or in a lump sum later. Assuming the income to be nontaxable under the International Mortgage rule, taxpayers might decline the deferment option in the hope that, when the currency was later exchanged either for dollars or for other goods, the income would be taxed at capital gains rates." [96]

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[90] 28 Taxes 514 (1950).

[91] Mimeograph is silent on problem of loans in blocked currency repaid by earned blocked currency. Cf. Roberts, New Developments; also Klarman, Taxation.

[92] Montgomery, op. cit., 1950–1, 28.

[93] Cf. I. T. 3795, 1946–1, C. B. 15. As to when foreign currency is a capital asset, is governed by I. R. C., sec. 117.

[94] Cf. Kramer, op cit.

[95] Cf. Angel and Kramer, op. cit.

[96] Comments, Yale Law Journal, loc. cit.

B. CONCLUSION

It is evident that the problem of the treatment of blocked foreign income for Federal income tax purposes, despite the issuance of mimeograph 6475, is still awaiting a solution more satisfactory to the taxpayer. In fact, there is no clear rule today on which the taxpayer and his adviser could safely rely when dealing with such income; it is true that in many cases the election offered by the mimeograph would bring such certainty, but, as has been mentioned above, this temporary relief could eventually turn out to be very costly. On the other hand, it might prove not less costly, currently to report as income what actually is not gross income, speculating on future losses to bring relief. And to defer ipso jure would no doubt meet with resistance from the Bureau.

Of course, many suggestions are being advanced to remedy the situation. These suggestions mostly arise from the desire to induce American capital to invest abroad and from the difficulty in achieving the goal, as long as there is no relief of the domestic tax burden. One such suggestion reads:

"The basic principle of United States Federal income taxation rests on citizenship. Taxation on the basis of source of income rather than on the citizenship of the taxpayer would be much more in keeping with our role as an international investor and trader * * * We should subject to domestic taxation only income from domestic sources." [97]

The view has also been expressed that even changes effected in the mimeograph would work toward the objective of lessening the deterrent effect of blocking on investment, that, however, a stronger incentive would be achieved by the reduction or elimination, at least in part, of taxes on foreign income that becomes reportable.[98] "The growing significance of American business operations in foreign countries makes increasingly important a tax policy that deals realistically and equitably with these variables (viz. fluctuations of exchange rates and currency restrictions)." [98]

These suggestions like many others are not concerned with the legal aspect of the matter: They approach the problem from the angle of tax policies that will best serve the economic (and political) aims of the United States.

In his state of the Union message, the President of the United States, on February 2, 1953, stressing the peaceful aims of the United States and her dedication to the task of making the free world secure, outlined the importance of profitable and equitable world trade, saying that, to this end, the United States Government will encourage the flow of private American investment abroad. The President also referred to the task of charting a fiscal policy directed toward a reduction of the tax burden. He also pointed out that, as a matter of tax policy, a review would be made of the tax structure and that readjustments of existing taxes and the clarification and simplification in the tax laws and regulations would be necessary.

In fact, if this program in the field of tax policy and tax laws and regulations is pursued, it is highly probable that the problem which has been discussed in this study will eventually be solved satisfactorily.

This is not an easy undertaking and it might be difficult to find models which it would be safe to follow.[99] One may be justified in suggesting that the best course would be one that is closest to the statute and the international mortgage rule, at the same time adopting, up to a point, the economic satisfaction rule (limited as suggested above) [1] and granting a deferment of reporting until the realization of the income as understood under the mentioned rules and also devising a method of apportioning the income. The tax should not be due until United States dollars originating in the transactions in blocked foreign currency were available. Appropriate administrative help should be given to the taxpayer through publications by the Bureau of Internal Revenue on exchange and currency restrictions in force in the most important countries and on the Bu-

[97] Russel Baker, International Trade and Investment—An Imperfect Alliance of Taxation and Policy, Taxes—The Tax Magazine, vol. 31, February 1953.

[98] Cf. Comments, Yale Law Journal, loc. cit.

[99] In the frame of this study, the parallel provisions of other countries cannot be discussed. It should, however, be mentioned that, e. g., in Canada, in principle, a rule similar to the International Mortgage rule plus Economic Satisfaction rule is being applied, but in a different way, namely that the income is to be reported but the tax, allocable to the blocked foreign income or part thereof, can be postponed, or rather its payment can be postponed, until a portion of the blocked foreign income was released or otherwise disposed of, under the condition that the Minister of National Revenue is satisfied that to require payment of the whole of the Canadian tax upon such foreign income would impose extreme hardship upon the taxpayer. Cf. Arthur Gilmour, Income Tax Handbook, pp. 426–427.

[1] Supra, pp. 80, 81.

reau's policy in classifying them. In addition, there might be a number of relief provisions which would be found necessary to promote private investment abroad.

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(Whereupon, at 1:25 p. m., the committee recessed, to reconvene at 10:05 a. m., Thursday, April 8, 1954.)

THE INTERNAL REVENUE CODE OF 1954

THURSDAY, APRIL 8, 1954

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met, pursuant to recess, in room 312, Senate Office Building, at 10:05 a. m., Senator Eugene D. Millikin (chairman) presiding.

Present: Senators Millikin, Martin, Williams, Carlson, Bennett, Byrd, Hoey, and Frear.

The CHAIRMAN. The meeting will come to order.

Mr. Tarleau, chairman of the American Bar Association. Mr. Tarleau, be seated and make yourself comfortable, and identify yourself for the record.

STATEMENT OF THOMAS N. TARLEAU, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. TARLEAU. My name is Thomas N. Tarleau, 15 Broad Street, New York City.

The CHAIRMAN. The bill before us covers 875 pages. Undoubtedly, in a bill of this magnitude there will be technical defects, including printing or clerical errors. In order to conserve the time of the committee and enable it to concentrate on changes in tax policy, witnesses who have discovered technical, printing, or clerical errors should bring such matters to the attention of Mr. Colin F. Stam, chief of staff of the Joint Committee on Internal Revenue Taxation, our technical adviser, room 1011, New House Office Building, and Mr. Kenneth Gemmill, Assistant Secretary of the Treasury, room 3804, Treasury Department.

I am submitting for the record a statement released by Hon. Daniel A. Reed, chairman of the Committee on Ways and Means, calling attention to certain defects in the effective date of some of the provisions of the bill.

(The statement referred to follows:)

STATEMENT OF HON. DANIEL A. REED, CHAIRMAN, COMMITTEE ON WAYS AND MEANS

Some questions have been raised concerning the effective date of certain provisions in subchapter C of chapter 1 of subtitle A of H. R. 8300, relating to corporate distributions and adjustments.

It was not our intention in H. R. 8300 to prevent transactions which qualify as reorganizations within the definition in section 112 (g) (1) of the Internal Revenue Code of 1939 from being carried out tax-free where a distribution or transfer occurs pursuant to a resolution adopted by the shareholders or board of directors on or before March 9, 1954. Similarly, it was not our intention to alter the tax results of corporate liquidations made pursuant to a resolution adopted by the shareholders or board of directors on or before March 9, 1954. In such cases, the resulting tax consequences at both the corporate and shareholder level will be determined under the Internal Revenue Code of 1939.

Appropriate steps will be taken to notify Hon. Eugene D. Millikin, chairman of the Senate Finance Committee, of this intent.

I am advised that the Treasury Department is in accord with this statement.

Senator CARLSON. Mr. Chairman, I would like to state it is a pleasure to have Mr. Tarleau here, because I personally remember his work years ago on the House Ways and Means Committee, of which I was a member, and I would say that the American Bar Association is well represented by having him.

The CHAIRMAN. We are very happy to have you here, Mr. Tarleau.

Mr. TARLEAU. Thank you.

Mr. Chairman, I appear before you as chairman of the section of taxation of the American Bar Association, and I appear on behalf of the association.

The Ways and Means Committee of the House, during June, July, and August 1953 held extensive public hearings on the subject of tax revision. The deliberations of the committee, after these hearings, resulted in H. R. 8300. The bill represents a gigantic effort on the part of the Treasury and the congressional staffs to give the American taxpayer a new and better revenue code. The Congress is to be commended for undertaking this comprehensive revision of the internal revenue laws, the first since before the turn of the century and the enactment of the income tax.

Obviously, H. R. 8300 is a measure of the greatest magnitude. Not only has the present code been completely rearranged and, to a large extent, reworded, but extensive substantive changes have been made. No public hearings were held in the House on the bill itself and the text of the bill was not available to the public until several days after its introduction into the House on March 9. In the short space of time since the text of the bill was made public it has been impossible for the association to give it the detailed consideration that the bill merits. A rapid and necessarily cursory examination does, however, give rise to certain conclusions.

It appears that many of the changes that have been advocated for years by the American Bar Association have finally been accorded recognition and for this the association is extremely appreciative. There are many provisions that will be warmly welcomed by taxpayers. Particularly helpful are the amendments designed to allow greater flexibility in determining allowable depreciation; the provision more nearly equating book income and taxable income; and the more liberal provisions for research and development expenditures.

As you perhaps know, the American Bar Association does not feel that it should speak on such matters as rate structures and fiscal policy. We do, however, endeavor to assist the Congress, the public, and the profession by suggesting improvements, clarification in language, and the correction of inequities.

There are large areas in which the changes proposed in H. R. 8300 are drastic and far-reaching and have not had any previous public consideration. For example, in the field of corporate reorganizations and distributions the bill proposes extensive changes in existing law which may have a vital effect on many business transactions. It is the hope of the American Bar Association that, despite the natural desire of all interested in tax revision to secure as quickly as possible the benefits of this bill, due consideration will be given to the many proposals for amendments to the bill submitted by this and other associations and individuals. Viewed as a whole, H. R. 8300 represents a great advance over the existing law. However, to the extent that its deficiencies are not cured, it may be harmful rather than helpful.

On effective dates, questions have arisen with respect to effective dates of various provisions of the bill. Those who will receive benefits naturally desire those provisions to be effective with respect to taxable years beginning in 1954. Those who may be subjected to unexpected and unforeseen taxes honestly believe that the new law should not affect transactions taking place in 1954.

As a general principle, new sections of the law which impose drastic changes imposing a tax on transactions which previously were not taxable should not be effective retroactively.

On the other hand, relief provisions which relieve taxpayers from existing inequities may well be retroactive.

Subchapters C and K of chapter 1: We strongly urge the committee that at least 2 parts of the bill, which vitally affect important segments of the business community—namely, subchapters C and K of chapter 1, subtitle A, dealing with corporate organizations, acquisitions and separations, and with partnerships, respectively, become effective no earlier than for taxable years beginning after December 31, 1954—or, at the least, that these sections be made inapplicable to transactions or transfers which take place prior to the expiration of 90 days after the date of the enactment of the bill.

The bill makes many far-reaching changes in existing law in these fields, which are exceedingly technical and complex.

Sections 391 and 771, relating to the effective dates of the provisions on corporate distributions and adjustments and on partnerships, make these provisions applicable with respect to transfers and distributions occurring after March 1, 1954. Many business organizations had on that date entered into binding agreements or commenced transactions which were nontaxable under the provisions of existing law. Completion of the transactions—by transfers occurring after March 1, 1954—which they may be legally obligated to make, may, under this bill, subject them to large and unforeseen taxes.

Moreover, the very existence of such retroactive provisions in a bill dealing with corporate reorganizations makes the tax results so uncertain and unpredicable that the business community is now of necessity marking time on all such transactions, where possible, until Congress has acted.

As a general rule, such transactions require a period of 60 to 90 days for completion, due to the necessity of holding stockholder meetings, printing proxy statements, and fulfilling SEC and other requirements. To make the effective date retroactive to March 1, or even the date of the enactment of the bill, would only prolong the present uncertainty.

A practicable solution is for your committee promptly to make a public announcement as to the effective date of the provisions relating to subchapters C and K and also to amend the bill so that the provisions of these subchapters will either apply only to taxable years commencing after December 31, 1954, or only to transfers which take place after expiration of 90 days from the date of the enactment of the bill.

The CHAIRMAN. Are you going to submit specific amendments?

Mr. TARLEAU. We will do that. We appreciate that it is very easy sometimes to make a suggestion as to how a thing is to be done, but to implement it is sometimes a matter of considerable difficulty. And our endeavor will be to draft language which we think will be helpful, and to submit it to the staff.

The CHAIRMAN. Will you submit your drafts to Mr. Stam, so that they will be available to the committee in executive session?

Mr. TARLEAU. I will do that, Mr. Chairman.

Senator BENNETT. Mr. Chairman?

The CHAIRMAN. Yes, Senator Bennett.

Senator BENNETT. May I make the observation, Mr. Tarleau, that even if our committee made such an announcement, it would have no effect because the House has already acted in a different manner and we can't guarantee what might come out of conferences. So I think it would only add to the confusion.

Mr. TARLEAU. That is obviously a very sound observation, and we have been puzzled a good deal by it. This is a practical problem.

The CHAIRMAN. Yes.

Mr. TARLEAU. I think the business community as a whole, having a realization that through an utterance by this committee and through an utterance by Mr. Reed, that both branches of the Congress realize this difficulty, and are mindful of it, and will recommend to their respective committees that the date be pushed forward, will be greatly relieved.

At the moment there is a feeling of consternation about this effective date, which is most unfortunate. Obviously, we cannot give them a bill and give them absolute assurance, but I think certainly, Senator, you would have a better climate of opinion about this whole matter if some public utterance of that kind could be made.

The CHAIRMAN. I may say I have refused to make utterances of that kind because I didn't want to prejudge the action of this committee. It is always a practical difficulty that the committee may not sustain that kind of an utterance either by a member or by its chairman. Secondly, it may not be sustained in conference. And, thirdly, it might not be sustained by the Congress. And if you have a statement confronting you, in which business did act, then the confusion would be compounded.

Mr. TARLEAU. Your point is so sound, and the difficulty of being too firm about a suggestion of this kind is so evident, that we just make it as a suggestion. We see the difficulty that confronts you, and we wouldn't be at all astonished if you didn't feel the better part of wisdom would be to disregard it.

The CHAIRMAN. If we called the committee in a special session, to informally dispose of those provisions of the act, as far as the committee is concerned, you have problems with the conference and the two Houses which would still exist.

I may say a recent case has come to my attention, where a corporate transaction was sort of suspended in midair as a result of the action taken in the House. Chairman Reed has made a statement that they did not intend to do that, and that they were sympathetic to a change. And I think the committee will be sympathetic to a change. Still, we have to run the gamut of the conference and final vote by both Houses.

And if something should go wrong, if the committee's preliminary viewpoint were not sustained, you would have a mess, as I said before, compounded many times.

Mr. TARLEAU. I appreciate that.

The CHAIRMAN. Then we would be in the position of not passing law, but of giving deceptive assurances, on top of what might be considered bad law.

Mr. TARLEAU. I don't want to be impertinent, but I do think that, sitting where I am and having the pressure of the business community, sending its wires and telegrams and cornering us as we leave our offices, and so on, that we tend to see this thing in a somewhat different perspective and don't see the difficulties that confront the legislators sitting on the other side.

The CHAIRMAN. That is why we are glad to have your testimony. And we are doing everything we can to expedite these hearings. We are doing some things that we don't like to do. We are putting time limits on testimony; we are taking written statements where we would prefer to have verbal statements, the whole idea being to get through with this as fast as possible so that everyone operating under the statute will know what it is all about.

Mr. TARLEAU. Of course, we can go back to our association with the feeling and the assurance that what can be done within your judgment of what is practical under the circumstances is going to be done.

The CHAIRMAN. Yes. But I don't want a misconception about premature statements. As I say, this situation which appeals to me, that I was referring to, I feel quite confident that others will have a similar viewpoint to that which I have and which Chairman Reed has. And yet, long experience around here has taught me not to count these chickens before they are hatched. A bad statement, a statement that proved erroneous in time, would be a terrible thing.

Senator WILLIAMS. Mr. Tarleau, did I understand you were suggesting to postpone the effective date of all of that section of the bill which revises the code, or only certain sections?

Mr. TARLEAU. No, we suggested it for all of that subchapter—subchapters C and K.

Let me say, just in passing, as my own individual opinion, that to break the subchapter down into different sections to be effective at different dates would probably be technically extremely difficult, and if it were to be accomplished, it would take more time than is really available to us.

The CHAIRMAN. I can give you this assurance, that we are going to give that very, very careful study. It is under review by the staff right now, and this committee will give it very careful study. You must remember that some people benefit by these sections that relate to the dating of the effectiveness, and they also should be considered.

Mr. TARLEAU. Yes, indeed.

I have a short section on some of the transition problems that we see in connection with this bill.

One of the most troublesome problems in connection with a large-scale tax revision of the character contained in H. R. 8300 is that of the transition period during which pending and continuing transactions and arrangements initiated under the old law are affected by the new.

I have just two examples of the sort of problem we are thinking about in that connection. For example, since 1952, a wife who receives payments under an ordinary separation agreement not incident to a court decree has not been taxable on the amounts received, and her husband has not been entitled to a deduction for the amounts paid. Section 71 (a) (2) of the bill reverses the rule with respect to further payments under these agreements.

The effect of this change on payments made under existing separation agreements will be most upsetting, since an important consideration involved in fixing the amount of the payments was that the wife would receive them tax free and the husband could not deduct them in computing his tax.

The CHAIRMAN. May I interrupt to read Congressman Reed's statement. He says:

Some questions have been raised concerning the effective date of certain provisions in subchapter C of chapter 1 of subtitle A of H. R. 8300, relating to corporate distributions and adjustments.

It was not our intention in H. R. 8300 to prevent transactions which qualify as reorganizations within the definition in section 112 (g) (1) of the Internal Revenue Code of 1939 from being carried out tax-free where a distribution or transfer occurs pursuant to a resolution adopted by the shareholders or board of directors on or before March 9, 1954. Similarly, it was not our intention to alter the tax results of corporate liquidations made pursuant to a resolution adopted by the shareholders or board of directors on or before March 9, 1954. In such cases, the resulting tax consequences at both the corporate and shareholder level will be determined under the Internal Revenue Code of 1939.

Appropriate steps will be taken to notify Hon. Eugene D. Millikin, chairman of the Senate Finance Committee, of this intent.

I am advised that the Treasury Department is in accord with this statement.

I have been notified of that.

Mr. TARLEAU. Mr. Chairman, the effect, as I said, of this change on payments made under existing separation agreements will be most upsetting, since an important consideration involved in fixing the amount of payments was that the wife would receive them tax-free and the husband could not deduct them in computing his tax. We have heretofore urged upon the Congress such a change in existing law, but our recommendation has always been coupled with a provision that the new rule should not apply to payments under agreements made before the rule was adopted. And we call this type of transition problem to your attention.

Another example is the accrual of real property taxes in certain of the States. In order to harmonize the tax law with generally accepted accounting principles, the rules for the accrual of real property taxes are changed by section 461 of the bill. For many years, the taxpayers have accrued real property taxes on the date on which the taxes became a lien on the property regardless of the year to which the taxes were applicable. Thus, in States in which taxes for 1954 became a lien on July 1, 1953, they were accrued on that date. Under the bill, taxes for 1955 must be accrued ratably in 1955, with the result that there will be no real property tax accrual in 1954. This new rule may be more workable for future years, but for 1954 it will result in substantial distortion of taxable income for many taxpayers.

These transition problems require study and consideration. We mentioned them as transition problems because in essence, when the bill is in full operation, they may be excellent provisions. The problem during the transition period is that they create certain difficulties.

Taxation of partnerships: Sections 701 through 777 deal with the income-tax liability of partners. They prescribe rules for determining the income of the partnership and the partners' distributive shares of such income. They also provide rules for determining the tax consequences of dealings between the partners and the partnership.

We have previously recommended to the Congress a complete set of proposed provisions dealing with partners and partnerships. While some of the concepts embodied in our proposals have been adopted in H. R. 8300, there are also many differences which we believe to be important. A summary of these differences, together with the reasons why the association prefers its own proposals, will be submitted to the staff. As members of a profession which often functions in partnership form, we are keenly aware of the problems involved in taxation of partnerships. However, the incidence of these problems is far broader than partnerships in the legal profession.

Interest of deceased partner: Section 736 (a) deals with the continuing interest of a retiring partner or the estate of a deceased partner in the income of the partnership. It provides that amounts received from the partnership during the first 5 years after the partner's retirement or death shall be taxable to him or his estate, but that amounts received after 5 years shall be treated as a gift from the remaining partners, who are taxed on all the income of the partnership, including the amounts used to make the so-called gifts.

We think you should consider seriously whether there should be such an artificial distinction between payments made within 5 years and those made after 5 years. Under existing partnership agreements, many partnerships on the cash basis are obligated to pay to retiring and deceased partners their proportionate shares of income subsequently received for services rendered or sales made prior to retirement or death.

It is not unusual for these amounts to be received more than 5 years after retirement or death. In such cases, the income is just as much the income of the recipient after 5 years as it is before, and the proposal appears to impose a tax on one taxpayer with respect to income of another. We think you should consider whether this should be done in any case, and particularly in a case where rights are fixed by presently existing agreements.

Senator CARLSON. Mr. Tarleau, right on that point, I hope Mr. Stam will make a note there, because I am personally familiar with the situation which I think might be quite seriously affected if some provision isn't made to correct the situation that deals with income from partnerships that are established.

Mr. STAM. I might say that problem has been presented to us, and we are going into it.

Mr. TARLEAU. We are also particularly concerned over the sections dealing with the basis of partnership interest, sections 705 and 722; contributed property, with its effect upon distributive shares of gain, loss, depreciation, et cetera, sections 704 (c), 722 and 723; basis of partnership property after transfer of partnership interest, sections 741-743, 751-753; distributions to partners, sections 731-737; sales between partner and partnership, section 707 (b); and computation of partners' distributive shares, section 704 (b).

We believe that these sections create complicated long-term accounting problems, artificial unexpected gains and losses, unnecessary valuation problems, and general uncertainty. They are extremely complicated and technical, and we will discuss these problems in detail in the material to be furnished to the staff.

Corporate distributions and adjustments: One of the most important parts of the new code, from the standpoint of its effect on business, is subchapter C of chapter 1, Corporate Distributions and Adjustments. In this area there has been a practically complete and an extremely drastic rewriting of the provisions of existing law. It is stated in the House committee report that:

> Existing law with respect to corporate distributions, liquidations, mergers, consolidation, separations and other transactions is so confused that taxpayers cannot plan transactions with any degree of certainty.

This, to a very large extent, is a just criticism of existing law. The committee report then goes on to state three basic objectives in the revision of present law:

First, to make the law more certain; second, to postpone recognition of gain or loss in cases which involve merely shifts in the form of the corporate enterprise and do not involve any distribution of assets to shareholders, and, finally, to close a number of tax avoidance possibilities that now exist. With these objectives, the American Bar Association is in complete accord.

We have examined the provisions of subchapter C with these purposes in mind and have grave doubt as to whether they achieve their stated purposes. Our criticism should not be deemed a denial of the necessity for statutory revision in this field. It must be borne in mind, however, that this is one of the most technical and difficult areas in the whole field of Federal taxation and one in which revision must be made with the utmost care, lest more harm be done than good accomplished.

Our examination of the bill leads us to suggest a considerable number of changes which we think necessary before subchapter C should be adopted. A great number of these are technical in nature, and we shall, as Senator Millikin has suggested, present them to the Treasury and congressional staffs for their consideration.

Some of our misgivings about this part of the new code, however, go to what seem to be definite policy decisions which raise considerable question. Without going into technical detail, I should like to discuss some of the more important of these.

In the first place, I should like to point out that the American Bar Association is not an advocate for the small corporation, as against the large, publicly held corporation, or vice versa. It may be that this committee will wish to favor one or the other. Without taking any position as to the policy, we think it should be pointed out that the provisions of subchapter C—probably unintentionally, but nevertheless quite definitely—discriminate against the small, privately held corporation.

For example, a typical situation that confronts a small business corporation is the following: A and B go into a corporate enterprise and own common stock equally. The corporation needs further financing, but it is too small and new to get public financing. B agrees to put the corporation in funds by buying preferred stock.

Under the proposed code, this normal method of financing small corporations is virtually precluded. The reason is that under section 302 of the bill, if the corporation should redeem, in the example given, B's preferred stock, while he still holds his 50 percent of the common stock, the amount he gets in repayment of his preferred stock is treated as a dividend.

In a large corporation that can sell preferred stock to the public, the limitation imposed by section 302 may not be of serious consequence, because the preferred stock can be redeemed without dividend tax consequences. For the small corporation, which looks to its common stockholders for preferred stock financing, this section is a serious roadblock, because of the dividend tax consequences of redemption of the preferred.

Another example of this discrimination against small, privately held corporations appears in the provisions relating to statutory mergers and consolidations and corporate acquisitions of stock and property. Existing law permits statutory mergers and consolidations to be consummated without recognition of tax on either the corporations involved or to their shareholders. Under section 354, the rule of existing law is continued for publicly held corporations. However, if 1 or both of the 2 corporations is not publicly held, these transactions will not be tax free under section 354 unless the conditions of section 359 are met.

These conditions require that, in mergers, consolidations, and corporate acquisitions of stock or property, the shareholders of the acquired corporation must own at least 20 percent of the stock of the acquiring corporation immediately after the transaction. This rule would effectively prevent tax-free amalgamation of 2 corporations in a case where 1 of the corporations is less than one-fourth the size of the other. It would greatly restrict the opportunities now available to owners of small, closely held corporations to merge or consolidate with larger corporations, for business reasons not connected with tax avoidance.

A third example of discrimination against small, privately held corporations appears in section 382, under which the net operating loss carryover of any company which is not publicly held would be curtailed if 50 percent of the stock of that company were transferred during the taxable year. Again, this restriction does not apply in the case of a publicly held corporation.

The term "publicly held" as defined in these provisions should not be confused with the customary layman's view that this means a corporation whose stock is listed on a stock exchange. Actually, under the definition, many corporations whose stock is listed on the stock exchange would not be publicly held corporations. On the other hand, many corporations whose stock is not listed on a stock exchange would be deemed publicly held. A question is raised as to whether the term "publicly held corporation" as used in the bill is adequately descriptive of the type of corporation intended to be so classified under the bill.

The CHAIRMAN. Mr. Stam, what was meant by publicly held corporations?

Mr. STAM. Well, the committee was considering the problem that avoidance generally arises in the case of closely held corporations, and they don't arise in the case of publicly held corporations.

The CHAIRMAN. That is a term in opposition to privately held.

Mr. STAM. That is right.

The CHAIRMAN. Whether they are listed or not listed?

Mr. STAM. That is right.

Mr. TARLEAU. Preferred stock bailouts: Another area of extreme importance in the bill is that dealing with the so-called preferred stock bailout. A typical bailout transaction is the following:

An individual owns all the common stock of a corporation which has large accumulated earnings. He does not wish to pay the surtax rates on a cash dividend. He, therefore, causes the corporation to issue a nontaxable preferred stock dividend for the amount of the corporation's cash. He then sells the preferred to a third party and shortly thereafter, the preferred is redeemed. In effect, he has had ordinary income at the cost of a capital gains tax.

Under section 309 of the proposed code, the transaction would be treated as follows: There would be no income to the shareholder on receipt of the preferred. The shareholder would be taxed at capital gain rates on sale of the preferred. The corporation would pay an excise tax of 85 percent on the amount paid by it to redeem the preferred. This excise tax would apply to any redemption within 10 years after the stock was issued.

There is a serious question whether section 309 would close the loophole. The result might well be to set up a definite, approved pattern of conduct which, if followed by taxpayers, would assure the successful operation of the bailout transaction. It would only be necessary to defer the redemption of the stock for a period of 10 years after its issuance, a small price to pay for the very substantial tax savings to be accomplished. And it is only the redemption which would need to be deferred. The sale at capital gain rates could take place at any time.

Moreover, the 85 percent transfer tax operates without any regard to whether or not a bailout has actually taken place. For example, even if the preferred stock which is being redeemed was issued out of a paid-in surplus account and not out of earnings, the tax would apply. Furthermore, section 309 provides that preferred stock outstanding on January 1, 1954, is deemed issued on that date for the purposes of section 309, however long before that date it may actually have been issued.

Consequently, it is quite possible under section 309 that for the next 10 years excise taxes would be imposed on the redemption of preferred stocks which were not bailouts at all, and which may have even been subject to dividend tax in the hands of shareholders when issued.

It also should be pointed out that section 309 does not, because of certain exceptions to its application, apply even in certain situations when the preferred stock is sold and redeemed within a 10-year period. Because of the apparent exception in section 309 for those redemptions which are treated as dividends, it is easily possible to so arrange transactions that the redemption from the purchaser of the preferred stock is a dividend. When the purchasers are corporations, the intercorporate dividend of 7.6 is the only tax imposed on anyone.

Obviously, section 309 is a tax on the wrong taxpayer and for that reason alone, its results are bound to be irrational. The taxpayer who is benefited by the bailout is never subjected to tax except possibly indirectly through the corporation. The tax penalty on the corporation will be unfair to its minority stockholders and new stockholders.

In our opinion, section 309 is not the proper way of meeting this problem. If a preferred stockholder has, in effect, received ordinary income under the guise of a capital gain, the remedy is to tax him at ordinary income rates and not to impose a penalty tax on the corporation. For that reason, we recommend that the approach of section 309 be abandoned, and that a provision taxing the shareholder at ordinary income rates be substituted.

Pro rata partial liquidations: The problem of pro rata partial liquidations is covered by section 336 of the bill. This is an admittedly difficult problem. Liquidation of stock interests should be given capital gain or loss treatment unless such liquidations are disguised dividends——

The CHAIRMAN. Unless what?

Mr. TARLEAU. Unless such liquidations are disguised dividends, in which case they should be taxed as dividends. The present law in this area is in a state of considerable confusion and the bill commendably attempts to lay down some definite rules.

Section 336 permits capital gain treatment of pro rata distributions in partial liquidation only if the distribution is attributable to the termination of 1 of at least 2 businesses, and if for at least 5 years immediately preceding the distribution, the books and records for the terminated business were maintained separately from the books and records covering the other business or businesses of the corporation, and if such terminated business has been operated separately from the other business or businesses of the corporation.

The question has been raised whether it is equitable to define partial liquidations that are not dividends in such a narrow and restricted manner. For example, let us assume the case of a corporation that has 2 warehouses, 1 in Washington and 1 in Richmond. The Richmond warehouse burns down and the corporation decides that the insurance proceeds are not needed in the business, since it intends to carry on with only one warehouse.

There is considerable doubt whether the distribution of those insurance proceeds in cancellation of part of the stock should be taxed as a dividend any more than the distribution of the proceeds of liquidation of 1 of 2 separately conducted businesses. Both are the result of a business curtailment and a consequent reduction of the capital needs of the corporation.

Would it not be more logical to give the benefits of the pro rata partial liquidation provisions to all cases where there has been an actual business curtailment and a consequent reduction of the capital needs of the business?

We have covered but a few of the problems involved in these new, extensive, and complicated provisions of subchapter C relating to corporate adjustments and distributions. There are a great many other problems which it is impossible for us to cover in a brief oral statement, such as the definition of participating and nonparticipating stock.

From a technical point of view, we have doubts whether these definitions satisfactorily achieve their stated purpose. Many debt instruments issued by corporations may be deemed nonparticipating stock under these definitions, with a resulting loss of the interest deduction, and the possible taxation as a dividend of the amounts paid to redeem them.

We expect to take up with the staff many such technical problems involved in these proposals.

Consolidated returns: The problem of reporting for tax purposes the transactions between a corporation and its subsidiaries is a complicated one. In the past, it has been taken care of by enacting certain standards in the code, and delegating to the Internal Revenue Service the authority to make regulations with respect to the many details which must be covered.

These regulations have now been bodily written into the new code. We have no particular objection to the provisions of the present regulations, nor do we have any changes to suggest at this time.

We do know, however, that experience has shown that inequities and inconsistencies have arisen in the application of these regulations to affiliated groups of corporations, making imperative the immediate amendment of these provisions. The fact that they were contained in regulations made such amendments possible in time to meet the business need.

The inclusion of the regulations in H. R. 8300 will destroy the flexibility of the amending process which now exists and in the past has proved so desirable.

Foreign income, credit for foreign taxes: Present law permits a taxpayer who pays taxes abroad on income arising abroad to credit those taxes against the United States taxes which he has to pay on the same income, with two limitations. The first limitation is the so-called per country limitation, by means of which the credit for taxes paid to any country may not exceed that proportion of the entire United States tax which the income from the country bears to the entire income subject to United States tax.

If the average rate of tax in the foreign country is greater than the average rate in the United States, the excess over the United States rate is not allowed as a credit.

The second limitation is the so-called overall limitation, by means of which the credit for foreign taxes may not exceed that proportion of the entire United States tax which the income from sources outside the United States bears to the entire income subject to United States tax.

If the taxpayer is engaged in business abroad in more than 1 country, and if he suffers a loss in 1 country, this limitation prevents crediting of foreign taxes against United States tax in an amount greater than the United States tax on the net income from foreign sources, after reduction by the amount of the loss.

The second limitation, the overall limitation, has been in our law for many years, and serves a useful purpose in preventing foreign taxes from being credited against income from United States sources. The "per country" limitation was added during the depression primarily as a measure to enhance the revenue by preventing credit of high taxes paid in country A against low-taxed income from country B.

In recent years, our policy has been to foster foreign trade, and the wisdom of the "per country" limitation has been questioned by the American Bar Association, which has recommended its repeal. The arguments in favor of repeal are that there is double taxation of foreign income to the extent that the "per country" limitation applies; that the "per country" limitation creates an unjustifiable discrimination between a taxpayer doing business in more than one country abroad, and a taxpayer doing business in a single foreign country; and that a government policy of fostering foreign trade warrants giving up the small revenue produced by this limitation so long as foreign taxes are not credited against the United States tax on income from the United States sources.

Section 904 of the bill proposes to repeal the overall limitation and to retain the per country limitation. For the reasons already given, we suggest that you consider the advisability of repeal of the per country limitation and, if this is done, retention of the overall limitation.

14-POINT CREDIT AGAINST FOREIGN INCOME

The bill proposes to allow a 14-point credit against the tax with respect to certain types of income from foreign sources. Sections 923 and 951 limit the credit to income from active conduct of a trade or business through a factory, mine, oil or gas well, public-utility facility, retail establishment, or other like place of business, from certain dividends of, and interest from, foreign corporations conducting such businesses and from compensation for technical services. The House committee report (p. 75) indicates that the intention is to exclude enterprises engaged largely in the importation and sale of goods without conducting any other significant economic activity in the country. The bill has the effect, however, of applying different rates of tax to similar economic activities, depending on the form of organization. If a domestic corporation manufactures goods through a foreign subsidiary which sells these goods the reduced rate is applied to the entire income. If it has one foreign subsidiary which manufactures and another which sells, the manufacturing subsidiary obtains the benefit of the credit but the selling subsidiary does not unless it sells at retail. Here the economic activity is the same, but the tax rate is different because the form of organization is different. We suggest that you consider whether this is a logical distinction.

The bill excludes wholesalers and distributors from the benefits of the credit. The business activities and economic investment of wholesalers are generally at least as great as, if not greater than, those of retailers, who are included. International commerce is a complex of trade and investment, which cannot be realistically separated. Investments abroad usually grow out of trade abroad. If we are to encourage investments we must encourage trade. Many American concerns commence their foreign operations by selling products made here and, after their volume has increased sufficiently, begin to manufacture abroad. With this pattern of foreign commerce, you may want to consider whether you wish to discourage the trade which will lead to eventual foreign investment, especially when our Government's policy is to encourage that investment.

The bill also excludes agriculture, which is certainly as important in stimulating the economies of foreign countries as retail trade and often constitutes an important investment abroad. Other activities not included are banking, construction, insurance, and transportation, all of which are essential to commerce and investment abroad.

We believe that the varied application of the proposed bill to the different types of business and of business organization which occur in foreign trade will produce unwarranted discrimination. We therefore suggest that you give consideration to revising the criteria so that one rule can be applied to all types and methods of businesses. Possibly you will feel that the inquiry ought to be limited to consideration of whether the foreign income is derived from business and whether that business is conducted in a foreign country. A simple criterion is whether the income-producing activities are conducted at a permanent establishment abroad. This is not a new concept; it appears in most of our income-tax treaties, and we therefore suggest that you consider whether the criteria appearing in section 923 (a) (3) (A) (ii) can or should be revised to require only that the income shall have been derived to the extent of at least 90 percent from the active conduct of a trade or business through a permanent establishment situated within a foreign country. Section 951 (a) should also be amended so as to be consistent with any such revision.

On page 21, we discuss the accumulated earnings tax. The longstanding inequity of a surtax on the reasonably accumulated portion of the earnings, as well as the unreasonably accumulated portion, has been carried over into sections 531 through 536 of H. R. 8300. To make the punishment fit the crime, we recommend an amendment to exclude from the accumulated earnings tax such portion of the accumulated taxable income as is not accumulated beyond the reasonable needs of the business.

Dealers in real property: Section 1237 was evidently designed to meet complaints that were made in the hearings before the Ways and Means Committee about 2 problems:

1. A dealer in securities or any other type of property may invest in the same type of property with no intention to sell his investment to customers in the ordinary course of his trade or business, and he will get capital-gains treatment on the ultimate sale thereof; whereas, in the case of dealers in real estate, the securing of capital-gains treatment is usually uncertain.

2. Also, the casual investor in real estate who is primarily engaged in some other line of activity frequently may, under present law, find himself branded as a "dealer" and, therefore, the proceeds of any sale of property made by him may be treated as resulting in ordinary income.

The chief complaints in these two areas were that the criteria furnished by the statute were so indefinite that revenue agents are encouraged to assert deficiencies against anybody in either class on any sale of property as being a sale in the ordinary course of his trade or business.

Section 1237 attempts to meet this problem, but it may be deficient in the following respects:

1. It applies a different rule to noncorporate dealers from that applied to corporate dealers, a distinction not made in connection with dealers in any other type of property.

2. It indicates that the making of any "substantial improvements" automatically disqualifies the property as a capital asset.

3. It requires a holding period of 5 years, or 10 times that required in the case of other capital assets.

Because of the very substantial countrywide interest, in real-estate transactions, it is submitted that these provisions of section 1237 should have very careful consideration and probably substantial revision before this provision is adopted.

Section 1235 of the bill, which appears to be intended to give relief to the professional inventor by granting him the same capital-gains treatment as the amateur or occasional inventor received under present law, may, by imposing too harsh restrictions, make the purported relief illusory, and hurt the amateur inventor.

The 2 restrictions imposed by section 1235 are from a practical business point of view impractical: First, the seller must, after the sale of the patent, retain no interest whatsoever in the patent; and second, the entire sales proceeds must be received within 5 years from the date of sale. If the two requirements are not met, the inventor loses the capital-gains treatment which he would enjoy under present law.

The rule of "no retained interest after sale" prevents the inventor from holding any kind of security or lien for performance of the sales agreement. In other words, even though an invention is sold for a fixed amount payable in the future, the inventor cannot retain a protective lien for the selling price, as sellers of other types of property are permitted to do.

The 5-year rule seems unreasonable in the case of applications for patents, to which the section also applies. Patents are finally issued only after many years. The 5-year rule applied to such applications would have the practical effect of dissuading inventors from ever selling their inventions until final issuance of the patent, with consequent financial inconvenience in many instances, and discouragement of prompt development and marketing of inventions.

We suggest that the committee should consider whether there is any reason for applying such restrictive provisions against a seller of patents and patent rights.

On returns we have some suggestions. The bill fails to recognize the hardship in filing amended declarations of tax too soon after the end of the calendar year—except in the case of farmers. All taxpayers except farmers, as all of us are aware, are required to file amended declarations of tax or returns in lieu of such declarations on January 15. Under the bill farmers are to be given until February 15.

Many taxpayers, other than farmers, find it extremely difficult to get their figures together and determine their net income in sufficient time to permit them to file an amended estimate by January 15. Accordingly, the filing date should be changed to February 15, not only for farmers but for all taxpayers.

It may well be that with the adoption of the later date, a substantial number of taxpayers will be able and willing to file a final return in lieu of an amended estimate on February 15, thereby accelerating the flow of tax revenues into the Treasury and spreading more evenly the burden of processing returns and collections. This change would seem to improve the ease of administering the taxing statute.

In the field of pension and profit-sharing trusts, section 505 of the bill presents a number of serious problems. This section undertakes to limit the investments which may be made by these employee trusts.

Thus, an employees trust will no longer be exempt if more than 5 percent of the total value of its assets is invested in one piece of real estate or in securities of any one corporation other than the employer.

We stress the word "value" which is used in the bill because that one word involves us in the many well-known valuation problems which often arise where real estate and closely held stocks are to be appraised. Apparently the actual cost of the assets to the trust, under the bill as written, is of no consequence. The problem is particularly acute since these percentage requirements must be met every 3 months, and if a slip occurs at the end of any quarter, the exemption is disallowed for the year.

It is quite possible that the proposed stringent and arbitrary investment restrictions will discourage the establishment of these employee trusts and the administration of them by qualified independent trustees. We feel this is particularly true in the case of small trusts which cannot afford to follow expensive trust investment procedures.

It should be noticed in this connection that no similar investment limitations are imposed upon charitable and other exempt trusts or organizations. Even regulated investment companies appear to us to have more freedom of action under section 851 of the bill. This problem is particularly important since a corporation may lose its deductions due to the actions of trustees whom it cannot control.

Section 505, it is suggested, may lead to extensive litigation. Many terms used in the section are not defined and have been in the past the subject of much dispute. Such terms as "receivables," "Government securities," "real estate," and "securities" are all terms which have been construed in various ways. Two examples will suffice. Do "Government securities" include securities of a foreign government? Does "real estate" include an overriding royalty in an oil and gas lease?

Aside from these problems, the bill would impose on the Internal Revenue Service a serious burden of policing these trust investments. In view of the usual restrictions of the various trust instruments and the additional restrictions of local law, and in view of the overall requirement that the corpus and income be used for the exclusive benefit of the employees, we suggest that section 505 be given further serious consideration.

KEY EMPLOYEE TEST

Section 501 (e) of the bill deals with the so-called "key employee" test for qualified pension plans. Admittedly, the provisions are complicated. Our examination of the section suggests that it discriminates against small employers and is a restrictive change from existing law. In a plan covering all regular salaried employees, the plan would not qualify if more than 10 percent of the participants are key employees, and the salaried employees number less than 25 percent of all regular employees.

TAFT-HARTLEY TRUSTS

The problems arising from the Taft-Hartley type of employees trust were brought to the attention of the Ways and Means Committee, but do not seem to us to have been covered by the provisions of the bill. Typical of these trusts is the United Mine Workers welfare fund. Many of these trusts have existed for years but do not meet the actuarial tests prescribed in section 23 (p) of the present law and continued by section 403 of the bill.

There is a question whether contributions by employers to these Taft-Hartley funds are deductible for income-tax purposes where the funds do not meet the actuarial requirements relating to conventional pension plans. The deduction of such contributions is doubtful since it will be practically impossible to bring many of these funds within the actuarial requirements of the usual pension trust.

Our proposal is simply to make contributions to such Taft-Hartley funds clearly deductible as ordinary and necessary business expenses. Our suggested statutory language is printed under topic 16 in the hearings before the House Ways and Means Committee.

On estate and gift taxes we are submitting a number of suggested technical changes to the staff. We do, however, want to call to your attention one change in the estate-tax provisions which we believe will result in administrative difficulties and delays.

The present law, section 811 (j), provides that an estate may be valued as of date of death or, at the election of the executor, as of a date 1 year after date of death.

That provision, it will be recalled, was put in the estate-tax law as a result of the tremendous decline in the values from decedents estates that took place in a comparatively short period of time in 1929 and in 1930, and the consequent hardship of very frequently having to pay an estate tax larger than the amount of the estate that was left at the end of 1 year.

The proposed code, section 2032, permits such an alternative valuation only if "the aggregate of all items in the gross estate has declined to 66⅔ percent, or less, of the value of the aggregate of all such items as of the date of decedent's death. * * *"

It appears from the House committee report that this limitation is proposed because of the belief that the present optional date "tends to retard the distribution of assets included in the gross estate" and "frequently requires the determination of property values as of two dates, * * *."

In the first place, even if these represented serious defects in the present law, we do not believe that the proposed change will materially remedy the situation. A responsible executor will still not be willing to risk distribution before the optional valuation date lest the value decline to 66⅔ percent, or less, and, at least in many cases, two valuations will still have to be made in order to make sure that the executor does not overpay the estate tax.

But even if the distribution might, in some cases, be accelerated, and even if the problems of executors might be eased in some cases, this does not seem enough to justify such an arbitrary limitation and the resulting administrative difficulties, confusion, and delays.

Take the case, for example, of a taxable estate valued at $1 million at date of death and $675,000 at the end of a year after death.

That is a decline of 32½ percent. The executor must value the estate at $1 million and sell a large part of the remaining $675,000 in assets to pay the estate tax because the tax—assuming no marital deduction—would be approximately $285,000. In such a case, the net distributable assets of the estate would be approximately $390,000. In contrast, assume the value had declined 35 percent to $650,000. The tax in that case would be based upon that value rather than $1 million and would be approximately $180,000, leaving net distributable assets of approximately $470,000. Thus it is seen that the taxpayer gained $80,000 as a result of a further reduction in value of only $25,000.

In other words, under the situation as it is now provided for in the bill, it is sometimes cheaper for an estate to become less valuable, and there would be more money left to distribute to its beneficiaries.

Such a situation would well result in litigation which would be avoided under the existing provisions. Such litigation might also present the paradoxical spectacle of the Commissioner contending for a low valuation at date of death and the executor contending for a high valuation at date of death. So that they may be sure to show a decline of the required one-third.

We do not believe that such an incongruous result can be justified either on the ground of accelerating the distribution of the estate or on the ground of diminishing the valuation problems of the executor.

A number of changes are made by the provisions of the bill relating to procedure. Some of the provisions will have far-reaching effects on the substantive rights of taxpayers, and they require careful study by this committee.

MISDEMEANOR TO FELONY

It would seem that a distinction might well be made—as it is under existing law—between the taxpayer who wilfully attempts to evade a tax by filing a false return and one whose offense is the failure to file a return. The latter is presently guilty of a misdemeanor, but his offense, which is in the nature of an omission, is made a felony under section 7201 of the new bill, and he is placed in the same position as one who is guilty of an affirmative attempt to defraud and deceive.

OMISSION FROM GROSS INCOME—ESTATE AND GIFT TAX

Section 6501 extends the period of limitations from 5 to 6 years in cases in which the taxpayer omits more than 25 percent of his gross income from his return. It may well be that the experience of the Internal Revenue Service has demonstrated the need for such a provision in the proper administration of the income-tax provisions. The bill proposes, however, to extend the 25-percent rule to gift and estate taxes. It is doubtful whether experience justifies such an extension. Most omissions in gift and estate tax returns result from undervaluations, a matter seldom susceptible of exact determination. Moreover, the prompt closing of estates is socially desirable, and such a provision would tend to prolong administration.

EFFECT OF RETURN MADE BY SECRETARY OF TREASURY

Section 6020 (b) gives the Secretary authority to make a return for any person who fails to make a return or who makes a false or fraudulent return. This return is to be prima facie "good and sufficient for all purposes." This seems too broad. For example, it is open to question whether it is desirable to give the Secretary the authority in a return prepared by him to bind a taxpayer on matters such as rates of depreciation or the right to use the standard deduction.

Because the emphasis of my comments has been largely adverse to certain provisions of the bill, we are fearful that we may have left the impression that there is little in the bill which our association finds praiseworthy. Such an impression would be wholly unwarranted. We feel that the bill represents a landwashing in the effort to make the Internal Revenue laws more certain, more equitable, more flexible, and easy of administration. Many of its provisions parallel recommendations which our association has made to the Congress. It would be most unfortunate if these provisions should be lost because of objections to details which we believe are susceptible of correction.

As I have indicated before, there are technical problems of drafting and wording which we feel could be more appropriately considered by your committee after the staff has had an opportunity to digest and report upon our suggestions. Accordingly, we would like to have the committee's permission to file a written statement containing more detailed comments with respect to this bill. If such permission is granted we plan to make our statement available to the committee staff and to the Treasury in ample time for consideration and report to your committee before the end of these hearings.

The CHAIRMAN. That permission is granted. We would appreciate your view with respect to certain amendments. Please keep in close contact with Mr. Stam. The sooner the better.

Mr. TARLEAU. Thank you, Mr. Chairman, for the privilege of presenting these views.

Senator WILLIAMS. Mr. Tarleau, listening to this report it would appear that some of the suggestions would hurt some taxpayers and help others. And I would like to ask, do these statements, made this morning, represent the views of the American Bar Associations?

Mr. TARLEAU. These suggestions that I have made here this morning represent the view of the American Bar Association; yes, Senator.

The CHAIRMAN. Any further questions?

Thank you very much, Mr. Tarleau.

(The supplemental statement of detailed comments follow:)

AMERICAN BAR ASSOCIATION, SECTION OF TAXATION

SUPPLEMENTAL STATEMENT FILED WITH THE SENATE FINANCE COMMITTEE IN CONNECTION WITH HEARINGS ON H. R. 8300

In an oral statement before the Senate Finance Committee on Thursday, April 8, it was possible in the hour afforded to cover only those features of H. R. 8300 which seemed to be of the most pressing importance and with respect to which the committees of the association had already reported. The Senate Finance Committee was courteous enough to permit an additional statement to be filed by the association.

The work of analyzing the provisions of H. R. 8300 for the American Bar Association has been done by the various committees of the section of taxation. Necessarily, these committees have worked under extreme pressure of time and the reports which they have rendered on the bill have not been reviewed by the section of taxation with the care and attention which, under ordinary circumstances, they would have received. It was believed, however, that these reports would be helpful to the staffs of the joint committee and the Treasury, and that their presentation was therefore appropriate.

The reports which follow express the sentiments of members of these committees and are not to be considered the views of the American Bar Association unless expressly indicated. The substance of these reports has been submitted in conferences between representatives of the section of taxation and the staffs of the Joint Committee and Treasury Department. The many constructive suggestions and criticisms which were submitted received sympathetic attention and consideration by the members of these Staffs.

The areas of H. R. 8300 covered by the reports which are included in this memorandum are those in which some of the more perplexing problems are found. In addition, a considerable amount of very useful material was submitted by committees of the section to the staffs and discussed with them. It is regrettable that because of the physical limitations of time and space it has not been feasible to include in printed form the substance of all the reports.

CORPORATE ADJUSTMENTS AND DISTRIBUTIONS

Subchapter C of Chapter I, Subtitle A, and Related Provisions

Subchapter C of Chapter 1 was considered by members of the Committee on Corporate Stockholder Relationships. The following discussion is largely a synthesis of the comments from many of the members of that Committee and from other sources. It has not been reviewed by the Committee or by its Chairman, and is not to be considered a report of the Committee. Many of the suggestions contained in this report involve matters of technical drafting. So far as members' suggestions on policy matter are included, they are transmitted merely for the consideration of the Congressional Committees and their staffs, without implying an endorsement of such suggestions by the Bar Association.

General Comments

Although the bill certainly recognizes the need for a revision of the structure and a reclassification of the corporate sections of the Internal Revenue Code, greater simplification might be accomplished by the draftsmen. Simplification is not a matter of saving paper, space and print, but of whether the statutory structure facilitates identification by the taxpayer of his obligations and privileges. The bill relies extensively on references, cross-references and re-cross-references to other sections of the Code, many of which are somewhat confusing even to those familiar with the concepts underlying the provisions. Furthermore, interpretation of the sections is actually aided in a number of instances by reading from the end of a Part toward the beginning, the reason being that the basic definitions are at the end of the Part.

Another comment which has been made is that the consequences of transactions, in numerous instances, depend upon lapses of time of five to ten years. Illustrations are in section 302(c), involving the reacquisition of an interest in a corporation after a redemption of stock; the section 309 tax on nonparticipating stock redeemed within ten years after issue; the requirement of separate books, records and operation of a business for five years (sections 336 and 353); the various five and ten year provisions affecting spin-offs (section 353); and the five year provision with respect to reincorporation after liquidation (section 357). It is apparent that such lengthy time limitations will impose a serious burden on both the tax administration and the taxpayers and corporations affected.

In a number of instances, Subchapter C discriminates against the small, privately-held corporation by relieving "publicly held corporations" of certain restrictions imposed upon the former. Instances of that discrimination are mentioned in succeeding parts of this report. The asserted reason for the distinction is that the "public" corporation is not expected to indulge in the tax avoidance which is anticipated from the closely held corporation. A number of our correspondents have seriously questioned the validity of that distinction. If it is to be retained, a redefinition of "publicly held corporation" is desirable, both because it will be impossible for a corporation to ascertain, in many cases, whether it is "publicly held" under the present definition (see discussion below under section 311), and because such definition does not seem to be adequately descriptive of the class of corporation intended to be covered.

A major aim of Subchapter C has been to eliminate the business purpose test, which requires the exercise of judgment and therefore creates uncertainty, in favor of relatively more mechanical safeguards which will supposedly create greater certainty in this field. It has been suggested, however, that the primary accomplishment is telling taxpayers what they *cannot* do, which is perhaps more useful for those who wish to know how far they can go and be safe, but is undesirable for those taxpayers who have unquestionable business purposes for their transactions, and who will be precluded from entering into legitimate transactions because of absolute rules written to prevent tax avoidance by others. There are numerous provisions in the Subchapter which may prove traps for the unwary innocent and which it may be possible for the well-advised to steer around even though they have a tax avoidance purpose.

There are a number of instances in the bill where the mechanical safeguards will operate inequitably on certain taxpayers. In certain of these cases it will be possible to steer around the rules and thus prevent inequity. An illustration is the case where the redemption of a large block of preferred stock (held by one who purchased it for money or property and who happens also to hold 1% or more of the common) would result in a dividend tax on the entire proceeds; yet that result can be avoided by selling the preferred to an outsider and letting it be redeemed from him. What warping of moral standards in tax matters results if ethical taxpayers are required to utilize avoidance devices in order to prevent an unjust tax effect? Since (in the absence of any controlling test of motive or purpose) the same devices may be used to avoid a *just* tax, is each taxpayer to be made the judge of the justice or injustice of the tax effect which mechanical rules impose upon him? These questions apparently go to the root of the philosophy underlying the bill, i.e., the expressed preference for mechanical standards.

Effective date of Subchapter C

Various suggestions have been received as to the effective date of Subchapter C, and to some extent these suggestions have been conflicting.

A number of persons believe that the policy and technical considerations inherent in Subchapter C require that its enactment be deferred *in toto* in order to permit time for adequate study.

Others would give taxpayers an election for 1954 to come under Subchapter C or under the Internal Revenue Code of 1939. There seems to be considerable doubt that such an election would be feasible for Subchapter C as a whole. Hence some have recommended a partial remedy, i.e., that the 1939 Code shall be applicable to distributions or transfers occurring after March 1, 1954, and before the date of enactment of Subchapter C, if "no gain or loss" would be recognized as to such distributions or transfers under the provisions of the 1939 Code, but would be recognized under the provisions of Subchapter C. There are, of course, a number of cases which would not be covered by the "no gain or loss" language.

Still other persons seem to be mainly interested in making immediately available, preferably retroactive to January 1, 1954, the relief provisions of section 333.

In his appearance before the Senate Finance Committee on April 8, 1954, the Chairman of the Tax Section urged that Subchapter C, Title 1, Subtitle A, become effective no earlier than for taxable years beginning after December 31, 1954, or, at the least, that these sections be made inapplicable to transactions or transfers which take place prior to the expiration of 90 days after the date of the enactment of the Bill.

There seems to be virtual unanimity that, in any event, any Subchapter C transactions begun prior to March 9, 1954, in reliance on existing law, should not be adversely affected by the Bill.

Further comments as to effective dates are contained in the detailed discussion of various sections of the bill, below.

Section 301

Section 301 taxes to the stockholder as a dividend, with certain specified exceptions, "a distribution of securities or property by a corporation to its shareholder." Under the literal terms of that section, money received by the shareholder from the corporation as principal or interest on its securities would be treated as a taxable dividend, since it does not come within any of the specified exceptions. It is suggested that section 301(a) be amended so that the opening language provide:

> "A distribution of securities or property by a corporation to a shareholder *with respect to participating or non-participating stock*, other than in partial or complete liquidation," etc.

It is noted that section 301(b)(3)(B) preserves a loophole which the Treasury once tried very hard to close both by regulation and by litigation. See *Ernest R. Blauvelt*, 4 T.C. 10; *Hanna Iron Ore Company*, 6 T.C.M. 873. The problem relates to the complete exemption of distributions to stockholders when the corporation has no current or accumulated earnings and profits and the distribution comes from increase in value of corporate property accrued before March 1, 1913. If the distribution had come from original capital of the corporation, or from pre-1913 earnings, it would be applied first against the stockholder's basis and thereafter would be taxed as capital gain. But when it comes from pre-1913 appreciation, it exhausts the basis and thereafter is wholly exempt. Since the holder has received back his cost (or the March 1, 1913 value of his stock, if that is the applicable basis), there is no reason to exempt him, any more than if the distribution came from original capital or from pre-1913 earnings.

Section 301(a), in the case of a dividend of appreciated property, treats the adjusted basis in the hands of the distributor as the amount of the dividend taxable to the distributee, where the latter is a corporation. The Committee Report (p. A 71) says that such treatment "insures" a carry-over of basis. But no provision therefor is made in the bill itself, and litigation could be avoided by taking the opportunity to spell it out in the statute. See Section X 540(c) of the American Law Institute's February 1954 draft of Federal Income Tax Statute.

Section 302

Under Part I, and particularly under section 302, capital gain or dividend treatment of distributions by corporations depends upon the circumstances of the particular shareholder. Whatever the wisdom of that policy so far as the stockholders are concerned, it is questionable with respect to the effect on the corporation's earnings and profits.

The accumulated earnings and profits of the corporation affect not merely the particular stockholder, but also the other shareholders whose taxability will depend thereafter on the earnings and profits which remain, to the extent that dividends may be in excess of current earnings. In addition, in excess profits tax years, the amount of accumulated earnings affects the corporation's tax. An impossible burden is placed upon the corporation to ascertain what other stock is held by the person from whom it redeemed stock. In view of the holding of stock in brokers' or other nominees' names, and the attribution of ownership rules of section 311, hereafter discussed, a corporation may be completely unable to determine whether it has paid a dividend, subject to a reduction of its earnings and profits under section 310(a), or has made a section 302(a) redemption which will cause a limited reduction of its earnings and profits under section 310(c). It seems safe to predict that within a very short period few widely held corporations will be able to determine accurately the amount of their earnings and profits.

Since under section 312(e), the redemption of stock is defined to include even a purchase on the stock market with no intention of retirement of the stock, a person who sells his stock on the open market runs a risk that the purchaser, unknown to him, will be the corporation and that he will thereby incur a dividend tax. (This risk applies, of course, only to the holder of 1% or more of the participating stock who is unable to qualify under any of the very limited exceptions to section 302(a).)

Section 302(a) seems improperly to include "(2)" in the first parenthetical clause, with respect to inventory assets. Section 302(b) treats any distribution in redemption which falls outside of section 302(a) as a distribution subject to section 301. Since section 302(a) excludes a liquidating distribution of inventory assets, section 302(b) makes such a distribution subject to section 301. Yet section 301 itself excludes a liquidating distribution without regard to the assets composing it. Section 331 treats the receipt of inventory assets in liquidation as in payment for stock (although gain is not recognized). Therefore, the exception for inventory assets distributed in liquidation, as found in section 302(a), is nullified and should be eliminated.

There appears to be an inconsistency between section 302(a)(1) and section 309(a)(4). Since it is stated in the Committee Report that section 302 is intended to be the dominant section in this respect, it is suggested that section 302(a)(1) be stricken.

While section 302(a)(4) may work properly with respect to the redemption of participating stock, it may have quite inequitable effects where non-participating stock alone is redeemed. A person who owns 1% or more of the common stock may hold preferred stock far out of proportion to his holdings of common, and it may have been acquired for full value in a transaction independent of his common stock holding. A typical example is the case of one of several stockholders who, in a period of stress, advances additional capital in exchange for preferred stock. When he receives repayment of that sum, even though the other stockholders receive nothing, he will be deemed to have received a dividend to the full extent of his return of capital. The error in section 302(a)(4) lies in determining proportionality by the effect on one's *continued* holdings of common stock, rather than by whether the *distribution* is substantially in proportion to his holdings of common stock. It is suggested that there be adopted in lieu of the test in section 302(a)(4), the standard specified in section X530(a) of the American Law Institute's February, 1954 draft of Federal Income Tax Statute, modified to the extent desired to bring in an 80% standard.

It has been said in justification of the test adopted under section 302(a)(4) that the American Law Institute test can be avoided by making a transfer of the preferred stock prior to its redemption, and thus escaping ordinary income tax pursuant to the *Hobby* decision. That is equally true, however, under section 302(a)(4). In fact, because of the unjust results which would otherwise occur under the test of the pending bill, a preferred stockholder who also holds common stock would seem to be not only compelled to make a *Hobby* transfer but fully justified in doing so. The result is that a blueprint has been provided by which both the avoiders and the well-advised innocents will be able to escape the effect of section 302(a)(4), and the only persons who will actually be affected by that provision will be those lacking proper advice, who may be the recipients of a distribution not actually equivalent to a dividend. If the provision were framed as above suggested, so that only a true proportional redemption were affected, it would not be necessary to leave an escape mechanism available, and it would then be possible to make a direct attack on the *Hobby* principle and to close that loophole, along the lines of section X531 of the American Law Institute draft.

Section 302(a)(4) also ought to have a provision comparable to the last sentence of section 304(b), to prevent a series of redemptions, each of which changes the proportions "immediately after" but the sum total of which restores the former relationship. See also the second sentence of section X530(a) of the February 1954 draft of the American Law Institute Federal Income Tax Statute.

See, further, the comments with regard to the effect of section 311 in distorting the substantially proportionate interest test, as discussed in connection with section 311, below.

Section 302(a)(5) relieves of dividend treatment a redemption from holders of less than 1% interest, even if the redemption is proportionate. Since there are many large corporations which have no stockholders who own as much as 1% of the common stock, these corporations could effect a substantially proportionate distribution without dividend consequences. Accordingly, one of our members has suggested that section 302(a)(5) be deleted because of that possibility. On the other hand, unless the inequities in section 302(a)(4) are removed, an argument could be made for actually increasing the percentage in paragraph (5) to as much as 5 or 10 percent. If the exemption is retained, it is suggested that there be written into the provision an express proviso preventing the regular practice of redeeming stock from small stockholders in lieu of dividends. While the Committee Report states that it is intended not to permit such a practice, a literal reading of the statute would permit just that. The "step transaction" rule would not prevent it, for if the whole series of redemptions were taken together, they would still be exempt from dividend treatment under section 302(a)(5). Granted that "plain language" may sometimes be controlled by the Committee Reports, it seems better, since the opportunity offers, to express the intention clearly in the statute.

Section 302(b) treats an actual redemption of stock not meeting any of the tests of section 302(a) as a dividend under section 301. However, no provision is made for adding the basis of the redeemed stock to other stock retained by the shareholder. It is suggested that appropriate language avoiding this inequity be added to section 302(b) or to section 307.

Section 302(c)(2) may impose a serious burden on both the taxpayer and the Government in keeping track of the events referred to in that subsection over a period of ten years, and it may be advisable to shorten the period to five years. The provision that the selling stockholder may not become an officer, director or employee during the succeeding 10-year period raises a number of troublesome questions. For example, the law permits that he remain interested in the corporation as a creditor. Upon default, it might become necessary for him to take over and run the business to protect his interests, but this provision would appear to prevent it unless he is willing to incur serious tax consequences. The same would be true if he acquired stock within that period by inheritance (as permitted by the section) and desires to resume an active part in the business in which he thus becomes interested again. There is also a question with respect to the status of a person who retires under a deferred compensation arrangement which requires him to render consulting services if called upon. If he is deemed to be an employee thereafter, he will be unable to avail himself of the benefits of section 302(c)(2), despite his actual ceasing of active participation in the business.

Section 303

Section 303, like its predecessor (section 115(g)(3) of the present Code), fails to take account of the possibility of a substitution of stockholdings after the death of the decedent by way of reorganization of the family corporation, exchanges of new stock for old stock, stock dividends, liquidation of holding companies or even a voting trust. For example, if a reorganization were initiated prior to the decedent's death and consummated after death, the estate would find itself in the position of not holding the exact stock owned by the decedent at his death and included in his gross estate. The same would be true if there was a stock split after death, such as the exchange of a single class of common for new voting and non-voting common. Similarly, if a decedent died owning the stock of a holding company, which in turn owned the stock of an operating company, upon liquidation by the estate of the holding company, as is a frequent practice, the operating company's stock would not qualify for redemption to pay death taxes, since it was not the stock owned by the decedent at his death. In all these cases, the substituted stock received after death represents the value of property included in the decedent's gross estate and in every practical sense is the same stock as that owned at death. It is therefore recommended that section 303 of the proposed Code be revised to include provisions stating that stock received after death in substitution for that owned at death may qualify for redemption without dividend tax.

Under the present Code, section 115(g)(2) (involving redemption of stock through a related corporation) and section 115(g)(3) (involving redemption to pay death taxes) are coordinated, so that stock of a parent corporation sold to a subsidiary of the parent qualifies under the provisions of section 115(g)(3). Such coordination is not provided under sections 303 and 304 of the proposed Code. It is therefore recommended that sections 303 and 304 be appropriately amended to make clear that stock of a parent, otherwise qualifying for redemption to pay death taxes under section 303, may be sold by the estate to the parent's subsidiary (or to a sister corporation) without the proceeds being subjected to tax as a dividend. This procedure, which is protected under present law, is frequently a practical necessity for an estate where the funds for redemption are available only in the subsidiary and not in the parent corporation.

The new bill provides that stock of two or more corporations may be treated as the stock of one corporation if there is included, in determining the value of a decedent's gross estate, more than 75% in value of the outstanding stock of each. Such a standard would be impossible to meet where community property applies, since only one-half of the stock, at the most, would be includible in the decedent's estate. It is suggested that language be added to the effect that in determining the aforesaid 75% ownership, stock owned by a decedent's spouse will be deemed to have been owned by the decedent for the purpose of the percentage requirement. That language would likewise cover any situation in a common law state where stock might, for example, be held jointly or partly by the decedent's spouse.

Section 303(b)(1)(A) permits the redemption at any time within the period of limitation provided by section 6501. The old law restricted it to the period provided by section 874(a), I.R.C., which thus prevented availing of the unlimited fraud period. Reference in the new bill to section 6501 *generally* means that redemption may be effected as long as six years after the return date (if there was a 25% omission) or many years later if no return was filed or if there was fraud (as may be evidenced by the imposition of a fraud penalty)—and that is permitted even though the actual assessment was promptly made and the tax and penalty had been paid from other funds. Reference, therefore, should be to the time limited "by section 6501(*a*), determined without the application of any other *sub*section." The extended period provided in section 303(b)(1)(B) will take care of most cases where there is an *actual* determination of a deficiency after the normal three-year period, but it does not take care of the case where such an assessment is uncontested; to cover such cases, there might be allowed a specified time after actual assessment.

Section 304

Publicly-held corporations are exempted from the provisions of section 304. The stated reason for this is that such corporations as a rule do not engage in the transactions covered by this section. Nevertheless, if a publicly-held corporation should engage in such a transaction, there would be no reason to exempt such a corporation, any more than it is exempted from the provisions of section 302 (which are sought to be avoided by the kind of transaction proscribed under section 304). The exemption seems to be an open invitation to public corporations to engage in such transactions. It should be noted, furthermore, that a corporation with as few as twenty equal (unrelated) stockholders may be classified as a "publicly held corporation" and thus may, under the present provisions of section 304, indulge in the kind of transaction here involved.

Under section 304, the proceeds of the sale of stock in one corporation to another commonly controlled corporation are treated as amounts distributed in redemption of stock of the purchasing corporation and are taxable as a dividend, to the extent of the earnings and profits of the purchasing corporation, unless the distribution is substantially disproportionate within the meaning of section 302(a)(4). The above discussion of section 302(a)(4) is important in this connection, especially since compliance with this test affords the only escape from section 304 as it is presently written. No good reason appears for this unnecessary strictness, however. For example, as pointed out above, stock redemptions within section 303 should be excepted from section 304 as well as from section 301. Similarly, redemptions which completely terminate the shareholder's interest in the commonly controlled corporations should be excepted from section 304, and no reason appears for the more severe treatment of minority shareholders under section 304 than under section 302(a)(5). On the other hand, it has been suggested that using the purchasing corporation's earnings and profits as the measure of dividend taxation may open a wide loophole for avoidance, since a corporation with large earnings and profits might arrange to acquire a subsidiary with no earnings and profits for the sole purpose of redeeming its own stock at capital gain rates. This loophole might be avoided by treating a section 304(a) distribution as a redemption by the corporation which issued the stock.

Section 304(b) provides that, to the extent a section 304(a) distribution is treated as a dividend, the purchased stock shall be considered a capital contribution to the purchasing corporation. This provision probably is intended to permit the selling shareholder to add the undepleted basis of the stock he sold to his basis for the stock he retained. To avoid administrative difficulties, uncertainty, and possible litigation, the manner in which this shall be done should be prescribed by the statute, or by regulations pursuant thereto.

Section 305

In respect of stock rights, section 305(a) treats the distribution of stock rights as tax-free, but makes no provision in respect of the exercise or sale of such rights. In order to correlate the treatment of stock dividends and stock rights, it should be made clear that stock rights distributed with respect to stock may be exercised tax-free.

The provision of section 305(c)(1)(A), taxing a preferred stock distribution in liquidation of dividend arrears, may seriously interfere with the recapitalization of corporations in financial difficulties, since preferred stockholders may be unwilling to accept new preferred stock for their back dividends if it will involve a tax before they have received any cash. If there is a tax avoidance possibility in the deliberate accumulation of preferred dividends, that may be handled by making the taxability of such distributions dependent on the existence of such a purpose, as in section X513(b) of the American Law Institute's February 1954 draft. Alternatively, such avoidance may be dealt with at the corporate level pursuant to sections 531 - 536 (old section 102).

In any event, section 305(c)(1)(A) seems unduly stringent, since tax is incurred even though the amount of accruals is not reflected in the new stock received, and even if the value and liquidating preference of stock received is less than the liquidating preference (without regard to accruals) of the stock surrendered. This is in contrast to the provisions of section 306(e) with respect to accrued interest. It is suggested that a relative value test, such as is used in section 306(e), should be applied to section 305(c)(1)(A), if such provision is retained. If such a test is not supplied, taxpayers will in effect be invited to discharge accrued preference dividends in advance of the exchange of stock in order to avoid an unjust tax. Sanction of this device will, in turn, invite other taxpayers to use it to avoid tax upon the receipt of stock actually reflecting the value of accruals.

Section 305(c)(1)(B) taxes a dividend where an option "is held" to take property instead. The quoted words import an option existing at least to the time of declaration, if not later. This seems narrower than present section 115(f)(2) ("whether exercised before or after declaration") and, unless a change was intended, the old language should be considered for adoption.

The extension of the principles of old section 115(f)(2) into the recapitalization field raises a question where convertible preferred stock is called for redemption while still convertible into common. In such circumstances, the preferred stockholders literally have the option to take common stock or cash, and it could be argued that section 305(c)(1)(B) therefore makes those who take common taxable. Clarification is indicated here.

Another problem which arises under section 305(c)(1)(B) deals with fractional shares resulting from a stock dividend, where the dividend declaration provides that unless scrip is combined into full shares within a certain time, cash will be paid for the fractions. Assuming that a holder of scrip for a fractional share actually uses it with other purchased scrip to receive a full share, it might be argued that the taxpayer held an option to receive stock or cash within section 305(c)(1)(B). The situation is dealt with under present law by having the corporation act as agent for the shareholders to buy and sell fractional shares. Such practice has been approved by ruling. It is suggested that the statute could clarify this situation as well as dealing with the problem in the preceding paragraph, by amending paragraph (B) to read:

> "(B) An option is held by the shareholder whereby, without surrender by him of stock (including rights to acquire stock), a distribution is payable either in stock (including rights to acquire stock) or in property."

It appears that the words "or securities" should be added to the end of section 305(c)(1)(B) as presently drafted. Since section 312(f) defines "property" as excluding securities representing indebtedness of the distributing corporation, section 305(c)(1)(B) in its present form permits a shareholder to be granted an election between stock and bonds (or short term notes) of the distributing corporation, without being taxed if he elects stock. Since no reason is apparent for this distinction, it has been suggested that it be eliminated.

Under sections 312(d) and 312(c)(1), non-participating stock includes a debt obligation subordinated to trade creditors' claims and held by persons who together own 25% or more of the participating stock. Under section 305(a) such debt obligations may be issued tax-free to shareholders. When sold to other than shareholders, these debt obligations apparently will revert to true debt, subject to redemption by the corporation without section 309 transfer tax. No concrete suggestion for closing this loophole has been made.

Section 112(b)(2) of present law permits the exchange of common for common or of preferred for preferred by individual stockholders between themselves, without the intervention of the corporation. Its elimination from the proposed Code is said to be based on the fact that it was rarely used. Advice from our Committee members indicates that it is valuable in some instances, particularly in passing voting control from an older group to a younger group of executives by an exchange of voting common owned by the former for non-voting common owned by the latter, or by an exchange of convertible preferred owned by the former for other preferred owned by the latter. Possibly it was omitted because it did not fit the pattern of Subchapter C. It might appropriately be retained, however, in Part III of Subchapter O.

Section 306

Section 306(b) should be clarified in a number of respects. It is not stated clearly that a person who also holds stock will not be taxable on a distribution of securities in exchange for other securities held by him. Such result is implicit in the parenthetical clause of section 306(b), but it should be made clear. It is suggested that there be added at the end of the third paragraph of section 306(b), prior to the indented paragraph:

> "Except as provided in the next preceding sentence, no gain or loss shall be recognized upon the receipt of securities solely in exchange for other securities in the case of a security holder who held stock in the distributing corporation immediately prior to the distribution."

The phrase "immediately prior to the distribution" is one which may also give rise to controversy. The situation might be more precisely described if, instead of an indefinite time, a specific event were established, such as the date the distribution was declared or the date prescribed by the resolution specifying the stockholders of record.

Section 306(b)(1) applies dividend treatment to boot, excepting only a section 302(a)(4) situation; but section 306(b)(2) treats boot as sale proceeds in situations within both 302(a)(4) and (5). To effect the intent expressed in the Committee Report, an exception for a section 302(a)(5) case should be added in section 306(b)(1).

Sections 306(d)(1) and 305(b), respectively, permit the exchange of securities *solely* for other securities or *solely* for stock, without incurring tax. Presumably, therefore, there is no policy reason for taxing the receipt of part stock and part securities, in exchange for securities. There appears to be no provision for such partial "down grading" in the case of a person who holds only securities.

Section 306(d)(2)(A) and (B) use the language "included in the income" and "gain or loss shall be recognized," respectively, without defining the nature of the income or gain which is referred to. If it is intended that the one be ordinary income and the other capital gain, minor factual differences can produce sweeping tax consequences. The following examples are from a source other than the membership of our Committee:

> Example 1: X (not a stockholder) surrenders a $1,000 ten year 4% debenture of a corporation, and receives in exchange a $1,000 twenty year 4% debenture plus $50 in cash. The cash is income to X. (Section 306(d)(2)(A)).
>
> Example 2: Same as example 1, except that the debenture received had a principal amount of $999. X will realize capital gain or loss measured by the difference between $50 and 1/1000th of his basis for the debenture surrendered. (Section 306(d)(2)(B)).
>
> Example 3: Same as example 1, except that X (or his mother) also owns less than 1% of participating stock. The $50 will be attributed to the stock, apparently representing a gain in respect thereof.
>
> Example 4: Same as example 1, except that X owns more than 1% of participating stock. The $50 is apparently a dividend, to the extent of earnings and profits. If there are no earnings and profits, it represents a tax-free recovery of stock basis to the extent thereof.

Under section 306(d)(2)(B), partial redemptions of securities accomplished through an exchange of securities are treated differently than direct partial redemptions.

> Example 1: A, who owns a $1,000 bond, receives a $400 partial payment of principal without surrendering the bond. Such a payment is tax-free to the extent of A's basis.
>
> Example 2: Same as example 1, except A surrenders his bond and receives $400 plus a $600 bond of like tenor. A realizes gain or loss measured by the difference between $400 and 40% of his basis.

It has been suggested that section 306(e) may interfere with the reorganization of corporations which are in financial difficulties but are not reorganized under sections 371 and following. A person who has held securities with long overdue and unpaid interest thereon will be loath to accept new securities covering both old principal and accrued interest where the result is to cause all such interest to be included in income in one year, and at a time when no money or liquid property is received from which the tax can be paid. That fact may frequently force the ailing corporation into a section 371 reorganization, since the rule of the *Carman* case (which is overruled by section 306(e)) has not been changed in the case of insolvency reorganizations.

Section 306(e) predicates interest treatment upon two factors: One, which is perfectly proper, is that the distribution exceed the principal amount of the surrendered security. The second requirement is that securities, money or property be received. However, if *any* securities, money or property is received, the entire excess of fair market value of proceeds over the principal amount of the surrendered security is treated as interest. This means that stock, in any amount, can be received tax-free; but that if $1 in cash is also received, part of the stock will constitute interest.

In section 306(e), the words "any amount of such excess shall be treated as interest to the extent thereof" are ambiguous. Literally interpreted, they might mean that any such excess shall be treated as interest, although a part of such excess might result, not from interest, but from a call value in excess of stated value. It is suggested that the words "to the extent thereof" be changed to read "to the extent of such interest."

Section 306(f) attributes ownership of securities and stock under the rule of section 311 for purposes of this section. Provisions corresponding with section 302(c)(2) (no attributed ownership on termination of interest) are missing.

Section 307

The principal problem under section 307 relates to the disappearance of the stockholder's basis in cases where redemption of stock is treated as a dividend under section 302, and where certain dispositions or distributions are treated as dividends under section 353. We understand that the practice of the Treasury under present law has been to reallocate such basis among the shares of stock continued to be held. However, certain problems are created in cases where attributed ownership is involved. This matter is discussed more fully in connection with the discussion of section 353, below.

It appears that technical revision of section 307(a)(2) is required. In the phrase "stock or property held immediately prior to the transaction" the word "securities" has been omitted. Evidently this is a typographical error. In addition, as this provision is presently drawn, it requires allocation among the items received of the entire basis for the items held before the distribution, even if the latter are retained. The basis, of course, should be allocated among both the items received and the items held before the distribution.

Section 309

It is the opinion of all members of the Committee who have commented on section 309 that it adopts the wrong approach to the bail-out problem. It appears that section 309 actually would encourage bail-outs by spelling out the exact steps by which its provisions may be avoided. It becomes necessary merely to find an investor who is willing to accept a ten-year maturity on the preferred stock, approximately two years longer than the maturity in the *Chamberlin* case. Furthermore, the section as presently drafted does not apply to the redemption of stock rights, callable participating stock, or subordinated securities, all of which may be distributed tax-free and sold at capital gain rates. Even if these loopholes were unavailable to a taxpayer seeking a bail-out, the combination of capital gain tax on the stockholder and the 85% tax on the corporation is the approximate equivalent of a 60% or lower tax on a dividend in the shareholder's hands, and a high bracket stockholder may come out with much more net proceeds than if he had been taxed on a dividend. Thus, the provision probably will be completely ineffective to check bail-outs by those who have tax avoidance motives.

On the other hand, the burden of the tax may fall upon those who had no part in the distribution or receipt of the dividend in preferred stock or in the bail-out transaction. All or part of the common stock of the corporation may have changed hands in the interval between the preferred stock dividend and the redemption. The burden of the tax falls on those who are common stock holders at the time of the redemption, and said redemption may be required by a contract which they have no power to alter.

Furthermore, since the tax is made to depend on the individual circumstances of the stockholder, by virtue of section 309(a)(2) and (4), and section 302(a)(3), (4) and (5), the corporation may be unable to ascertain whether it is liable to the tax. The difficulties of a corporation in ascertaining the ownership of its stock are discussed more fully in connection with section 311.

It is suggested that the appropriate time for tax on a bail-out is when the stock is sold by or redeemed from the recipient (except in a reorganization, where the stake remains in the business), and that the burden of the tax should fall on the person who benefits from the bail-out. In this connection, it has also been suggested that it might be proper to consider as a personal benefit to such recipient the proceeds of a sale by a family member or by a charity to whom or to which he had transferred the stock by gift, unless it was held by the recipient for a considerable period.

A number of recommendations have been made by our members in the form of substitute provisions. It has been suggested that the most effective provision would be to treat preferred stock which was received as a dividend or in a recapitalization as having no basis and as resulting in ordinary income when disposed of. The effect would be greatly to restrict the use of preferred stock as dividends or in recapitalizations, so that it would be used in such circumstances only in those family situations where there was a strong desire to divide the nature of the equity interest for purposes of gifts or bequests to different members of the stockholder's family. Since such preferred stock would ordinarily be held until death, which would provide a new basis, such a provision would have the effect of permitting recapitalization in this family situation, while making it relatively undesirable generally. An alternative suggestion would be to put a ten-year limit on the treatment of the proceeds of such preferred stock as ordinary income or dividend. The question of the allocation of basis after the ten years expire would have to be given consideration in such a case. In addition, it would have to be considered whether the ordinary income tax on the disposition of preferred stock of this nature should be limited to the earnings and profits, and if so, whether the earnings as of the date of distribution or the date of disposition should be controlling. It would also seem necessary to provide in section 302 (a) an exception for redemption of stock on which a dividend tax had been paid by the original recipient, under the suggested provision, at the time of his sale thereof.

If section 309 is retained and follows its present pattern, a number of suggestions have been made for improving its structure.

In connection with section 309(a)(2), questions have been raised regarding the requirement that redemption be from the "original recipient" in order to make the exemption applicable where there is a concurrent redemption of participating stock. It has been questioned whether that is consistent with the policy of section 302(a)(3), since it would impose the penalty tax in circumstances where one other than the original recipient completely terminates his interest in the business.

Clarification is desirable with respect to the intended treatment of a redemption of preferred stock from a person who had transferred his common stock, where such common stock is redeemed from another as part of the same transaction. Literally, the tax would not apply where preferred is issued to H while he owns the common but is redeemed from H after he has given the common to W, provided the common is redeemed from W in the same transaction. Whatever the intention may be in this respect, it should be more clearly expressed.

It is also suggested that the statute should except from the transfer tax the redemption of nonparticipating stock where, prior to such redemption, the participating stock with respect to which the nonparticipating stock was issued had already been redeemed. A suggested amendment of section 309(a)(2) to effect this suggestion is as follows:

> "(2) Corresponding redemption of participating stock—In case of a redemption of nonparticipating stock from the original recipient of such stock, to the extent that there is redeemed as part of the same transaction or that there has been theretofore redeemed the amount of participating stock with respect to which the nonparticipating stock was issued. If the redemption is one of several redemptions of nonparticipating stock, the amounts of participating and nonparticipating stock then and theretofore redeemed shall be aggregated in determining whether there is or has been redeemed the amount of participating stock with respect to which the nonparticipating stock was issued."

In the event that the foregoing suggestion is not adopted, it is suggested that the phrase "the same transaction" should be precisely defined, particularly if it is intended, as discussed above, that redemption from two different persons may qualify under this subsection.

The suggestion has also been made that the phrase "original recipient" should be defined in terms of the attribution rules of section 311, to take care of cases where a father gives common stock to his son and his dividend of preferred stock to his daughter, and the two are simultaneously redeemed.

Consideration should also be given to permitting an equal redemption of participating and nonparticipating stock not only from the original recipient but also from his heirs and legatees. The same policy consideration would appear to govern in this case as in the case of redemptions from original recipients.

Section 309(a)(3) should be broadened to take care of situations where a tax was paid in connection with the original issuance of the preferred stock. Thus, where the stock was issued for services, the treatment accorded to stock issued for property should be extended to such shares. In addition, there should be no 85% tax on the full amount of the preferred where the stock was originally issued as a taxable dividend, either under the old *Gowran* principle, or under the bill as a distribution in lieu of money. The same would apply where the preferred was issued for accrued interest, as in a case under section 306(e) of the bill. Furthermore, unless amended, the tax will apply in full to stock which is redeemed after an earlier disposition thereof has incurred a dividend tax under section 353(b); and the identical redemption may even incur a dividend tax under section 353(b) and a penalty tax under section 309, where the circumstances of the redemption are within the description of section 302(a), and therefore do not come within the exemption of section 309(a)(4).

It has also been suggested that section 309(a)(3) should extend not merely to nonparticipating stock which takes the place of other nonparticipating stock issued for property, but also to nonparticipating stock which takes the place of participating stock issued for property.

The question is also raised whether 105% is a sufficiently high premium to cover all bona fide cases, particularly when a corporation may find it necessary to issue its preferred on the market at a discount.

The criticism is made that where an issue of preferred stock originates as a dividend but subsequently additional shares are issued for property, and those shares are traded on the market over a period of years, especially in the period before 1954, it may soon become an almost impossible task to trace the particular shares to which the tax will apply to its full extent and those which are exempt to the extent of 105%.

A suggestion has been made for clarification of the phrase "issued for securities or property," as it appears in two places in subsection (3). Although property is defined in section 312 to include money, section 309(a)(3) may appear to the uninitiated to be limited to cases where property other than money was the consideration for the preferred stock. It has therefore been suggested that the somewhat redundant but nevertheless clearer expression used in section 312(e) be adopted, namely, "money, securities or property (other than money)".

There seems to be a technical error in section 309(a)(3), in that the last words thereof should read "such *securities or* property."

However, it is also suggested that the fair market value test is inappropriate with respect to nonparticipating stock which was issued in exchange for securities (i.e., obligations of the corporation issuing the nonparticipating stock). Such nonparticipating stock (preferred stock or income bonds) would ordinarily have been issued in a reorganization, in exchange for senior securities which would usually have been depressed in value at the time, but which nevertheless represented a liability to the full extent of their face value. In such a case, it seems equitable that any payment in redemption of such nonparticipating stock should be exempt from the penalty tax, at least up to 105% of the amount of the indebtedness and accumulated interest, rather than only the amount of the value of the securities when exchanged. It is suggested, therefore, that there be added, at the end of section 309(a)(3), the following:

> "provided, however, that where the nonparticipating stock was issued in satisfaction of true indebtedness, evidenced by bonds, notes or similar obligations plus accumulated interest, the amount of such indebtedness shall constitute the fair market value of such securities or property for the purposes of this section."

Suggestions have been made for certain additional exemptions under section 309. One relates to the situation where a stockholder first exchanges all of his common for preferred stock as in the cases covered by the *Hartzell* and *Dean* decisions. In such a situation, if at the time of the original transaction there had been a complete redemption of the common stock rather than an exchange for preferred, there would have been no dividend tax. And yet, if the stockholder first takes preferred and subsequently that is redeemed within the ten year period, the penalty tax will be incurred. Furthermore, if he had exchanged his common for new common and preferred and then surrendered the common ratably with the preferred at the later date, the redemption of the preferred would be exempt from transfer tax. There seems, therefore, no reason to impose the penalty tax when preferred issued under such circumstances is redeemed, even though no common is redeemed at the same time.

It is also suggested that sections 302(a)(4) and (5) afford capital gain treatment to stock redemptions which are substantially disproportionate or cover less than a 1% interest, respectively. In view of the purpose of section 309, it is suggested that the transfer tax should not apply in cases where section 302(a)(4) and (5) apply. Where the reason for the penalty is gone, the penalty should not apply, since to do so injures third parties deriving no benefit.

One person has also suggested that publicly held corporations should be exempted from the section 309 tax because of the special circumstances said to affect them.

In order to avoid pushing the penalty too far beyond its purpose, some effort might be made to correlate the tax with the earnings and profits, either at the time of the distribution or at the time of the redemption. If no dividend tax would have been incurred on a cash distribution at the time the preferred stock was distributed, there seems no reason to impose the penalty.

Consideration should be given to closing certain loopholes which exist in section 309 as now drafted. It appears that under section 305(a), rights to acquire either participating or nonparticipating stock can be distributed tax-free. Nevertheless, only the redemption of "nonparticipating stock" is subject to transfer tax under section 309, and the definition of "nonparticipating stock" in section 312(d) apparently does not include rights to acquire stock. The same is true of the definition of "participating stock" in section 312(b). Thus, retention of either of such rights for six months before their sale or redemption apparently would satisfy the requirements for long term capital gain and would to that extent result in a bail-out.

As has been suggested in connection with section 302, the bill would also make easy a bail-out by means of the transfer of participating stock to an outsider, followed by its immediate redemption.

In the case of nonparticipating stock, the penalty tax can be avoided by transferring the stock in advance of redemption to a corporation (entitled to the dividends received credit), which owns 1% or more of the participating stock and which therefore can receive a dividend under section 302 at minimum tax cost. Transfers to loss corporations, low-bracket individuals and exempt organizations may possibly also be used in this manner. A provision similar to section X531 of the American Law Institute February 1954 draft seems desirable to overcome the foregoing possibility.

Clarification of section 309(b) is desirable in at least one respect. That subsection permits the distribution of the stock of a controlled corporation under section 353(a) without the imposition of the section 309 transfer tax. This purpose is accomplished by providing that the stock so distributed shall be deemed to be the stock of the corporation "the stock or property of which *was acquired.*" If the stock of a controlled corporation was acquired by the distributing corporation in connection with the section 353(a) distribution, section 309(b) apparently will be effective to prevent imposition of the transfer tax. But it is not made clear what will happen if the controlled corporation's stock was acquired at an earlier date, or if it has been owned by the distributing corporation from its very inception.

Much criticism has been expressed of the effective date provision in section 309(c). That provision has the effect of imposing the transfer tax on the redemption, even pursuant to mandatory sinking-fund provisions, of preferred stock issued many years ago. Thereby, it imposes a longer holding period requirement on stock issued before the law was ever enacted than on stock which was issued after the change in the law and with its provisions in mind. Thus, corporations which may or may not have had tax avoidance in mind when they issued the preferred stock and incurred mandatory sinking-fund requirements, are treated less favorably than corporations which today may be considering tax avoidance devices and can arrange to avoid the impact of the tax. It is suggested that the tax be made inapplicable to stock issued prior to March 1, 1954, or such other date as may be selected. If it is felt necessary to apply the tax to certain previously issued stock because of the avoidance devices which have been practiced in recent years, it seems at least that the holding period requirements should be no more stringent than are imposed with respect to subsequent issues.

Finally, it is noted that there is no provision for a refund of the transfer tax, after many years, if (as may result from the operation of section 302(c)(2)) a transaction which was at the time treated as a redemption is later transformed into a dividend taxable to the stockholder and therefore exempt from section 309.

Section 310

In a corporate separation under section 359(d), a pro rata part of the distributing corporation's earnings and profits should carry over to the recipient corporation. Under section 310(c), provision is made for reduction of the distributing corporation's earnings and profits in this case, but the amount of the earnings and profits to be carried over to the recipient corporation is not specified. Instead, this problem is left to existing law, with the Committee Report admonition (p. A96) that the carry-over to the recipient corporation *shall not exceed* the reduction for the distributing corporation. None of our members have taken a position on what a fair formula should be for allocating earnings and profits between the distributing and recipient corporations. Three formulas which have been used in the past are: (1) the ratio of fair market value of assets distributed to the fair market value of assets held before the distribution; (2) the ratio of adjusted basis of assets distributed to the adjusted basis of assets held before the distribution; and (3) if ascertainable, the earnings history of the assets distributed or retained. It is suggested that one or more alternative formulae be selected and uniformly applied to *both* corporations.

Section 311

Although section 311(a) defines the family of an individual more narrowly than under the comparable provisions of section 267 and section 544, it may still be too inclusive for the broad purposes for which section 311 is applied. The section assumes a unity of action and of interest within the family which is frequently lacking, at least where dependency does not exist. It has been suggested, therefore, that the family should be limited to one's minor children, spouse and other dependents. It is the experience of practicing lawyers that one is consulted far more often with respect to family and partnership squabbles over property than on family plans to avoid income taxes. Section 311, in some of its applications, contains possibilities for persecution and extortion by adverse family members of one another. For example, under section 357, certain members of a family holding the required percentage of the property received in liquidation could re-incorporate, and thereby cause another member of the family (whose interest may be quite adverse to theirs) to incur a dividend tax with respect to the property which he received as a return of his capital and did not place in the new corporation.

One member of the Committee has suggested that an additional category for attribution of ownership be added to cover the case of stock held by a charitable corporation or foundation, completely dominated by a shareholder. It is noted that section 267(b)(9) of the new bill would bar losses on transactions between a charitable foundation and the person in control thereof, but, even in that case, stock owned by such foundation is not attributed to the controlling person.

The most serious problems under section 311 relate to subsections (b) and (c). These subsections cause results clearly at variance with the purpose of the statute, so far as section 311 operates on section 302(b)(4) (relating to substantially disproportionate redemption of stock) and section 382 (relating to denial of carryovers where there is a substantial change of ownership).

The problem arises from the fact that section 311(b) attributes to the holder of more than 50% of the stock of a corporation the ownership of *all* the stock of another corporation which is held by the first corporation. Section 311(c), similarly, attributes to a 50% beneficiary of a trust or estate the ownership of *all* the stock held by such trust or estate. A holder of 50% or less of the stock of a corporation, or of less than 50% of the interest in a trust or estate, is considered to own *none* of the stock held by such corporation, trust or estate. This is in contrast to sections 267(c)(1) and 544(a)(1), which look through the corporation or trust and deem the shareholder or beneficiary to hold his exact proportional interest in the stock held by the corporation or trust. In the American Law Institute's February 1954 draft of its Federal Income Tax Statute, section X533 takes a middle position, attributing to a shareholder or beneficiary the ownership of his proportional share of the holdings of a corporation or trust, but only if he owns at least a 50% interest therein.

Let us examine the working of each of these three alternatives on section 302(b)(4), where the distortion caused by section 311 is most marked. In the examples which follow, corporate ownership of stock will be referred to, but the effects would follow equally where a trust or estate is involved (except that for a trust or estate, section 311 applies where "at least 50%" is owned, rather than "more than 50%").

The theory of section 302(b)(4) is that, if stock is redeemed in proportion to participating stock held, leaving beneficial interests substantially unchanged, the amount paid out should be taxed as a dividend. Yet, by application of section 311(b) or (c), a truly proportionate distribution is distorted into one that is deemed to be disproportionate and is taxed as capital gain. Suppose that three individuals, A, B, and C, each own 20% of the stock of M Corporation. A, B, and C also own, in equal thirds, the stock of X Corporation, which owns the remaining 40% of M Corporation's stock. Suppose M Corporation redeems half the stock held by A, B, and C. Under the bill, none of the stock held by X is attributed to them, so it is considered that A, B, and C each reduces his interest from 20/100 (20%) to 10/70 (14-2/7%). Since the latter is less than 80% of the former, the transaction produces capital gain. The same is true under the American Law Institute draft. Yet, if the stock held by X Corporation were attributed to its stockholders proportionately (as is done by sections 267 and 544), it would be readily seen that each individual owns a one-third interest in M both before and after the redemption, and it should be treated as a dividend.

The same result would follow, under the bill, if there were only two individual stockholders, plus a corporation owned equally by them, since the bill requires "more than 50%" ownership before attribution will be applied.

If there is one owner of X Corporation with more than 50%, and the facts are otherwise similar to the above, that individual may have a dividend but any holders of less than 50% will not, even though in reality the redemption is proportionate.

However, it is unnecessary to labor the examples. It is clear that, by placing part of the stock of one corporation in a corporation controlled by them, individual stockholders will be able to carry on a program of equal redemptions of their individually held stock, without fear of dividend treatment, because of the distortions produced by section 311(b).

The distortion can work just as well the other way. Suppose A owns 50 shares of the stock of M Corporation, and B owns 20 shares. The remaining 30 shares are owned by X Corporation, which is owned 45% by A and 55% by B. The bill would attribute all of X's holdings to B, making A and B each 50% owners. Suppose 20 shares were redeemed from A and 20 from B. The bill would deem them each still to be 50% owners of M Corporation and would tax them on a dividend. Yet, if true proportions were considered, A has increased his direct and indirect interest from 63½% to 72½% (so is properly taxed on a dividend), and B has reduced his interest from 36½% to 27½% (the latter being about 75% of the former). If section 302(b)(4) were applied without the distortions of section 311, B would have capital gain.

The principle of "disproportionate redemption" can be applied successfully only if there is provided a true measure of proportionate interests. That can be done by adopting in sections 311(b) and (c) (as has already been done in subsections (d) and (e)) the test found in sections 267(c)(1) and 544(a)(1), by which stock owned by a corporation or trust is attributed *proportionally* to the stockholders or beneficiaries, regardless of whether their interest is more or less than 50%.

It is interesting to note that, in dealing with a special situation in section 304, the tests of section 311 were adopted with the proviso that, in determining whether a redemption was substantially disproportionate, the seller should be considered to own the purchasing corporation's holdings of stock *in proportion* to the percentage of that corporation's stock which he owns. That principle (section 304(c)) should be applied equally to section 302(b)(4), where the problem is substantially the same.

The same failure to look through the corporation or trust to determine true proportionate interest causes unwarranted results in the application of section 382. Those effects may best be discussed in connection with the general discussion of section 382, below.

If the foregoing suggestion is not adopted, some clarification of section 311(c) is suggested. Whereas section 311(b) deems the 51% stockholder to own "all stock" owned by his corporation, section

311(c) charges the 50% beneficiary with "stock" owned by the trust or estate. Unless a difference is intended, the word "all" should be inserted. With respect to back-attribution from the beneficiary to the trust or estate, the words "same proportions" are used. Is it intended that 100% of the trust or estate's stock be attributed to the 50% beneficiary, but that only a proportion of *his* stock be attributed to the trust or estate; and, if so, is it in proportion to his actuarial interest or his interest in the income?

In connection with section 311, there should be discussed the insurmountable burden which is cast on a widely-held corporation in requiring it to know the individual circumstances of all its shareholders. For certain purposes, the bill will require a corporation to know its stockholders and both their actual and constructive ownership of stock or debt. It would be difficult enough if they were required merely to know the direct owners of their stock, since their shares commonly are traded daily on recognized exchanges and large amounts of stock are held in the names of brokers or other nominees. It seems essential that a provision be included which will permit the corporations to ascertain, either from the brokers themselves or from the forms which the brokers are required to file under section 39.147-8 of the present Regulations, the identity of the actual owners of their stock. Even this provision, however, will not enable such corporations to keep track of the rapid changes in ownership of their stock. When, in addition, section 311 also is applied, the corporation is required to determine the family, corporate, trust, estate and partnership relationships of every one of its stock or debt owners to every one of its other stockholders. It does not appear that any steps short of such complete determination would give the necessary assurance to the corporation. Quite apart from the effect on corporate-stockholder relationships if the corporation pries into the family and trust situation of its shareholders, the mere physical task of doing so is impossible for a widely-held corporation. It is therefore suggested that widely-held corporations be, at the least, exempted from the application of section 311 in those situations where it is necessary for them to know the situations of their stockholders. The problem of defining widely-held corporations, which itself turns on the application of section 311, will be discussed in connection with section 359(a).

There are at least four sections under which a corporation's tax situation is directly affected by the application of section 311 in the case of its stockholders. The first of these is section 247, which permits a deduction for dividends paid on certain preferred stock of public utilities. Generally the deduction is limited to dividends paid on preferred stock issued before October 1, 1942, but under paragraph (b)(2) this treatment also is available to dividends paid on preferred stock issued for certain limited purposes on or after October 1, 1942. One of the defined transactions in this respect is a statutory merger or consolidation under section 354(b) (this section number is printed in error as section 355(b) in the proposed bill). Since section 354(b) relates to a statutory merger or consolidation of only publicly-held corporations (as defined in section 359(a), which in turn incorporates section 311), a public utility corporation must ascertain whether it was qualified thereunder in order to know its right to a deduction.

Under section 275, a deduction for interest is denied in the case of interest on corporate obligations which fail to qualify as securities under section 312(c). To qualify under section 312(c), the security may not be subordinated to trade creditors generally if the holders of the obligation, taken together, own 25% or more of the corporation's participating stock. For this purpose, section 311 applies in determining the ownership of both debt and stock. Thus, each time a corporation pays interest on subordinated securities, it must ascertain the family, corporate, trust, estate and partnership relationship of each of its security holders to its participating stockholders. If the corporation's securities are widely held, this is manifestly impossible.

As has been mentioned in previous connections, a corporation which redeems its stock must determine whether that redemption qualifies under section 302(a) or is a dividend under section 301, in order to ascertain the effects on its earnings and profits. Three of the classes of redemption under section 302(a) require application of section 311 in determining the ownership of stock. These are paragraphs (3), (4), and (5). Even aside from the effects of section 311, those three paragraphs cast an extremely difficult burden upon the corporation when it attempts to ascertain the amount of its earnings and profits. In addition, under paragraph (2) of section 302(c), a corporation must keep track of the status of its former stockholders for a ten year period in order to determine its earnings and profits and the dividend effect of a redemption of stock.

In section 354(b), tax-free statutory mergers or consolidations are permitted, unhampered by the restrictions of sections 359(b) and 359(c), only if the parties are publicly-held corporations. Since the definition of a publicly-held corporation in section 359(a) incorporates the tests of section 311, many widely-held corporations will not be able to ascertain whether they will qualify as "publicly-held" within the meaning of the statute, since they will not know the family, corporate, trust, estate and partnership relationship of each of their shareholders to each of the others (particularly since this must be determined as of the time the statutory merger or consolidation is consummated, and plans must be laid well in advance thereof).

The standard of "publicly-held corporations" applies also for exemption purposes under section 304 and section 382, but occasions perhaps less sympathy for the corporation which is unable to determine whether it is exempt under these provisions, since the policy of these exemptions may be subject to question in any event.

It is suggested, therefore, that a widely-held corporation should be permitted to ignore section 311 for purposes of the cited provisions because of the impossibility of these corporations learning the actual inter-relationships of their stockholders. In order to exempt such corporations from this impossible requirement, it seems desirable to erect a classification into which most such corporations will fit and into which few corporations without these characteristics can be made to fit. It is suggested that a satisfactory test may be a two-fold requirement of: (1) listing on a recognized stock exchange, and (2) a minimum number of shareholders. (In respect of section 312(c), this test should relate to security exchange and security holders.)

Section 312

Section 312(a) substantially restates the present law except for the last sentence of paragraph (1) thereof. That sentence changes the law as expressed in the *Stern Brothers* case, 16 T.C. 295, 322. Under present law, contested income tax liabilities accrue as a reduction of earnings and profits in the year in which the taxpayer earns the income to which such income taxes relate. That presents a truer picture of the earnings and profits of the corporation, since, if the income tax contest results in a greater tax liability, it will normally also result in a greater amount of net earnings, and such additional net earnings will themselves be related back to the year in controversy, so that the offset of income taxes against such contested income avoids a distortion. The provision of the bill which would defer the accrual of the taxes until the termination of the controversy (while still permitting the relation back of the income in question) causes artificial distortion and inflation of the earnings available for dividends during the period of the controversy.

The definition of participating stock in section 312(b) excludes from the class a participating preferred stock and even a class of common stock with full voting power and an interest in the equity, if such stock has any preference over any other class of common stock. It is entirely possible for two classes of stock to be preferred over each other in different respects, with the result that there would be no participating stock in that corporation at all within the meaning of these definitions. Furthermore, by virtue of the fine distinctions which are drawn, there are areas in which either classification which may be desired for tax purposes can be achieved without substantial economic effect. The definitions of participating stock, nonparticipating stock and securities should be drawn in a manner which prevents arbitrary classification by taxpayers, even if this requires some loss of precision in the definition.

It is suggested that consideration be given to the purpose for which the definition is used in each of the various sections where it is applied, and that the definitions be redrafted in the light of such purposes. If, as appears, the factor which ought to be emphasized is the limitations imposed upon preferred or similar stock, rather than its preferences, consideration might be given to substituting the definition found in section X500(c) of the American Law Institute's February 1954 draft, which reads as follows:

> "(c) Participating Stock.—Participating stock means, for the purpose of this part, common stock or preferred stock, the participation of which in the earnings of the issuing corporation is not limited to a stated amount of money for any given period, or the participation of which in the assets of the issuing corporation upon liquidation is not limited to a stated amount of money."

It is not clear whether section 312(c), when coupled with section 312(d), is intended to be the final answer on the thin incorporation problem. So far as the dividend tax on redemption is concerned, section 302 speaks entirely of redemption of stock, and therefore it may be assumed that the redemption of anything falling outside the definition of participating or nonparticipating stock would not be subject to dividend tax, regardless of the "thinness" of the corporation. With respect to the interest deduction, section 275 expressly prohibits a deduction with respect to nonparticipating stock and perhaps impliedly permits the deduction with respect to any indebtedness which does not fall in that category. The bad debt problem perhaps is not solved, since it has been most acute with respect to open account indebtedness, which is excluded entirely from the categories defined in section 312 (b), (c), and (d). A statement in the Committee Report with respect to the intention of Congress in this matter would be helpful.

Consideration should be given to whether two additional requirements should be incorporated in the definitions of "security," such as are found in the American Law Institute's February 1954 draft, section X500(g)(1) and (2); namely, a fixed maturity date (in which may be included a demand obligation), and secondly, a requirement that the debt must have been incurred in return for an adequate consideration in money or money's worth or else received as a dividend distribution.

It is suggested that the considerations of policy which dictate the specific requirements imposed upon "securities" by subsection (c) apply equally to open account indebtedness. Furthermore, they would seem to apply to notes which, under the stamp tax line of cases, may not be "known generally as corporate securities." It is doubtful that Congress intends to draw any such distinction between plain promissory notes and securities. It is suggested that the litigation-producing phrase "known generally as a corporate stock or security" be eliminated in subsection (d), and that nonparticipating stock be re-defined as an instrument, issued by a corporation, representing stock ownership or indebtedness, other than open account indebtedness (if that distinction is to be preserved) and other than an instrument to which subsection (b) or (c) is applicable.

Subsection (c) defines "securities" in a way that excludes a bond on which the interest is *to any extent* contingent upon earnings. The effect of such definition, coupled with the provisions of section 275, is that even the *fixed* minimum interest on bonds will not be deductible if there is a provision for increased interest contingent on earnings. It is suggested that, at least, a deduction should be allowed for interest on obligations, although within the definition of nonparticipating stock, to the extent that such interest is payable regardless of earnings.

Sections 331, 332, and 334

It has been suggested that the emphasis on market value in section 331 and particularly in section 334(c) will cause a great deal of litigation with respect to the fair market value of assets. Such questions, however, were present under prior law in liquidations under section 115(c) and under the *Kimbell-Diamond* principle. The new area where valuation becomes necessary is in parent-subsidiary cases formerly covered by section 112(b)(6). In the latter area, new problems are created with respect to the valuation of good will, trade name and other intangibles.

One technical flaw in section 334(c) is that it may result in the allocation to cash and similar items of a basis which is greater or less than the amount thereof. Consistently with the decisions respecting the allocation of a lump-sum purchase price, it is suggested that provision should be made for deducting from the stock basis the amount of any cash and cash equivalents received and for the allocation of the remaining stock basis among the other assets. See *L. M. Graves,* 11 T.C.M. 467.

The principal criticism which has been directed at this group of sections lies in the treatment of distributions of inventory assets. Such criticism is directed particularly at the disappearance of a portion of the stock basis where the basis of the inventory is less than such stock basis. Since the problem is inter-related with a similar problem under section 333, the questions of liquidating distributions of inventory will be discussed together hereinafter.

Serious complications are envisioned when the various categories of assets are not distributed proportionately among the stockholders, so that some stockholders will realize gain under section 331(b) and others will defer it under section 331(d), some may have a greater proportion of gain treated as ordinary income than others, and some may in fact lose their stock basis entirely if they receive only appreciated inventory. To prevent both anomalous results and the matching of assets distributed against the tax position of particular shareholders, it has been suggested that the corporate asset basis which is taken into account in the determination of gain on liquidation and as the basis for the assets received should be measured by a pro rata share of the aggregate basis of the corporate assets, rather than by the basis of the particular assets each stockholder receives. Such averaging of basis, however, would seem to make difficult, if not impossible, the accomplishment of the intention that all the corporate appreciation on inventory should be taxed as ordinary income upon the disposition thereof. No concrete suggestion for meeting such problem has been made.

Under the present law, no gain or loss is recognized upon the liquidation of a solvent subsidiary by its parent, and the subsidiary's basis for its assets carries over into the parent. Under sections 331 and 332, it is proposed that gain shall not be taxed if there is gain (the parent taking fair market value as its basis for the liquidated assets, if that is less than the subsidiary's basis therefor), but that capital loss shall be recognized if there is loss (the parent taking fair market value as its basis for the liquidated assets). No provision has been inserted to prevent one corporation from purchasing the stock of another, taking down its earnings and profits at intercorporate tax rates, and then liquidating the acquired corporation at a capital loss.

Under the present law, ordinary loss is recognized upon the liquidation of an insolvent subsidiary which is indebted to its parent. This rule has given rise to difficulties. If the parent, in satisfaction of debt, receives from its subsidiary assets worth more than the parent's adjusted basis for its subsidiary's debt to it, gain is taxed to the parent. On the other hand, if the subsidiary transfers appreciated or depreciated property to its parent in satisfaction of its debt, gain or loss is recognized to the subsidiary. The Internal Revenue Service has attempted to solve the administrative difficulties inherent in this latter rule by giving the parent an election to assume the subsidiary's basis for its assets (Rev. Rul. 259). Section 331(e)(1) of the bill seeks to solve the difficulties inherent in both the foregoing rules by treating securities (including short-term and demand notes, but not open account indebtedness) of a subsidiary held by its parent as stock. Liquidation of this type of indebtedness will give rise to no gain or loss to the subsidiary (section 308). As set forth in the immediately preceding paragraph, gain will not be taxed to the parent if there is gain but capital loss will be recognized if there is loss.

Under section 331(e)(1), ordinary loss is not necessarily denied to a parent upon the liquidation of an insolvent subsidiary, since open account indebtedness is not treated as stock. Thus a parent may elect whether or not to come within the ambit of section 331(e)(1) by selecting the form of its subsidiary's debt to it. It is not suggested in either the bill or the Committee Report that this selection must be made at any particular time before liquidation, or that this selection cannot be changed from time to time before liquidation. If any limitations are to be placed upon a parent corporation in this regard, it is suggested that they be spelled out.

In its present form, section 331(e)(1) does not deal with the problems of a corporation which distributes assets in satisfaction of debts to others than a parent corporation. Individual owners of corporate businesses have the same problems as parent corporations in these respects. In addition, the assumption of liabilities to others upon liquidation of a corporation by either individual or corporate shareholders may give rise to gain or loss upon appreciated or depreciated property under present law. It is suggested that the solution provided by section 331(e)(1) should be extended into these areas.

It is questioned whether 332(a) should change existing law in respect of the taxation of gain or loss upon corporate liquidation to dealers or other persons in whose hands corporate stock is not a capital asset. Present law provides ordinary income or loss treatment in this situation, whereas section 332(a) specifies capital gain or loss treatment.

Section 332(b)(1) characterizes as a dividend any gain received upon the liquidation of a subsidiary by its parent corporation, and provides a 100% dividend received credit in respect thereof. However, this provision has not been integrated with other sections affecting dividends. For example, section 246(b) limits the aggregate dividends received credit to 85% of taxable income. It is suggested that all provisions which might otherwise limit the effectiveness of the 100% dividend received credit provided by section 332(b)(1) be appropriately amended.

Upon the sale of property in connection with corporate liquidation, the gain which is not recognized by section 333 is attributed by section 332(c) to holders of participating stock. The definition of "participating stock" (section 312(b)), however, has not been integrated with this provision. For example, a corporation may have no "participating stock", or it may have a class or classes of "nonparticipating stock" entitled to share ratably with the "participating stock". Section 332(c) should contain its own tests for the apportionment of section 333 income among the recipients thereof.

Section 333

The requirement that the liquidation of the corporation be completed within the taxable year of the sale of the property or the next succeeding taxable year seems unduly stringent. It would force 100% liquidation within a period of from one to two years. This could result in the forced sale of some assets in order that the advantages of the section should not be lost with respect to the property first sold. It is suggested that the section be changed to call for the non-recognition of gain to the liquidating corporation if *the proceeds of the sale* are distributed within the next succeeding taxable year. The general requirement of the definition of partial liquidation and complete liquidation would then give adequate protection to the revenues by forcing the liquidation of the balance of the assets of the corporation within a reasonable time. Alternatively, provision should be made for the granting of extensions by the Secretary in meritorious cases, such as is provided for under section 336(b) in the case of complete liquidations.

Section 333(a) excludes from its scope a sale of inventory assets other than in the normal course of business. This is discussed immediately below.

Liquidations involving "inventory assets"

One of the asserted purposes of Part II is to assure that mere formal differences in the method of disposition of corporate assets upon liquidation (whether the corporation sells assets and distributes the proceeds, or it distributes the assets to be sold by the stockholders, or the stockholders sell their stock and the purchaser liquidates the corporation) should not make a difference in the tax consequences. A second purpose is to assure that the appreciation on "inventory assets" will not, through liquidation, escape tax in the same manner and amount that would have been incurred in the absence of such liquidation. In the effort to achieve the second purpose, the former purpose has been defeated, in all cases where a corporation holds "appreciated inventory."

That effect is produced by the facts that

(1) where the portion of the stock basis which is allocated to inventory exceeds the corporation's basis for the inventory, the stockholder, upon liquidation, loses such excess (with a limited exception not material to this discussion) from the basis for his investment; and

(2) a sale of inventory assets by a corporation, in conjunction with a plan of liquidation, is denied the benefits of section 333(a).

It is not clear why either of the foregoing rules were adopted in the bill. It is suggested that the purpose to assure that gain on inventory assets will be once taxed in the manner and to the extent that the corporation would have been taxed may be achieved even though those rules are changed. An example will illustrate the point. Because of the inherent complexities of the problem, the example has been greatly over-simplified, but it is believed that variations in the assumed facts would not invalidate the conclusions.

Let us suppose that A forms a corporation and invests $200.00. The corporation buys inventory assets for $100.00 and other assets for $100.00. The inventory assets and the other assets each appreciate to $150.00, and it is desired to sell out to B, an individual. For simplicity, let us assume that the corporation is in the 50% tax bracket, and let us use 50% and 80%, alternatively, as the tax brackets of the individuals. Capital gains are assumed to be taxed at 25%.

First, if A liquidates the corporation and sells the assets to B for $300.00: A's stock basis is allocated, $100.00 to inventory and

$100.00 to other assets, in proportion to market values. There is no gain or loss on liquidation, and $100.00 becomes the basis of each class of asset. On the sale of inventory to B, A is taxed on $50.00 of ordinary income ($25.00 tax in 50% bracket, $40.00 tax at 80%). On sale of the other assets, A has $50 capital gain ($12.50 tax). The total tax is $37.50 or $52.50, depending on A's assumed tax bracket.

Second, if the corporation sells the assets to B for $300.00 and then distributes the proceeds to A in liquidation: Under section 333(a), as now framed, the corporation would pay ordinary income tax of $25.00 on $50.00 of ordinary income. On the other assets, if section 333(a) is complied with, no gain would be taxed to the corporation, but the $50.00 capital gain would be attributed to A (causing a tax of $12.50 on him); he would increase his stock basis by $50.00, making it $250.00. Upon receiving a liquidating distribution of $275.00 ($300 proceeds less $25.00 tax at the corporate level), he would have a further capital gain of $25.00 and a tax of $6.25. The aggregate tax on A and the corporation would be $43.75.

If section 333(a) were made applicable to sales of inventory (not in the ordinary course of business) by corporations in liquidation, the corporation would incur no tax in that situation, but A would bear ordinary income tax on the corporation's $50.00 gain on inventories ($25.00 if he is in the 50% bracket, $40.00 at 80%) and capital gain tax of $12.50 on the corporation's $50.00 gain on other assets. The basis of his stock would be increased by $100.00, and he would have no gain or loss on his stock. The aggregate tax is $37.50 or $52.50, just as if the corporation had liquidated before the sale. The policies above cited are thereby both satisfied.

It will be noted that, where A is in a bracket materially higher than the 50% corporate bracket, the application of section 333(a) to inventories would be unfavorable to him, since he would be better off with the "double tax" than with a single tax at ordinary individual rates. If the exception for inventories is removed from section 333(a), high bracket taxpayers will seek to keep the tax at the corporate level by having the corporation sell inventories before adoption of a formal plan of liquidation. To that extent, it will be impossible to achieve the purpose of making all methods equivalent in tax effect. Possibly, to avoid inequity resulting from the application of section 333(a) to inventories, it will be desired to amend section 332(c) to limit the tax on the individual to the amount that would have been incurred by the corporation. (To make the alternative methods completely equivalent in effect, it would be necessary to work out a similar solution for the rate inequity that results from the shifting of corporate inventory basis to the individual stockholder upon liquidation in kind, but that probably cannot readily be accomplished.)

Third, if A sells his stock to B for $300.00 and B liquidates the corporation: A has a capital gain of $100.00 (tax of $25.00). Of B's stock cost, $150.00 is allocated to inventory and removed from his stock basis; but he gets an inventory basis of only $100.00, and $50.00 of his investment disappears. When B sells the inventory (disregarding any further profit in his hands), he would have ordinary income of $50.00 (tax of $25.00 in 50% bracket, $40.00 at 80%) and no gain or loss on receipt of the other assets or on their subsequent sale (if values remain unchanged). B bears the tax on inventory even though he merely recovers his investment, while A (during whose ownership the appreciation occurred) gets off with capital gain. That shifting of the burden may not be so important, however, since the parties can take it into account in negotiating the price. (If B, for that reason, paid less than $300 for the stock, it would reduce A's capital gain and, in view of the allocation requirement, would correspondingly increase both capital gain and ordinary income for B. The example would not be invalidated by a change in the price). The more significant fact is that the aggregate tax on A and B would be $50.00 (in the 50% bracket for B) or $65.00 (at 80%), or much in excess of the tax if A had liquidated and sold the assets to B (which method would produce aggregate tax of $37.50 and $52.50, respectively).

On the other hand, if it were provided that stock basis shall be reduced by only the amount of the basis of the inventory, thus preventing disappearance of any stock basis, B would take the $100.00 corporate basis for his inventory and would have a $200.00 basis left for his stock. B would have $50.00 ordinary income when he sells the inventory (disregarding further profit in his hands), and would incur a tax of $25.00 (50% bracket) or $40.00 (80% bracket). He would have a $50.00 capital loss on receipt of the other assets (saving $12.50 in tax if he has offsetting capital gains). When A's $25.00 tax on the gain of $100.00 on his stock is added in, the net tax effect is an aggregate tax of $37.50 or $52.50 on the series of transactions, the same as if A had liquidated the corporation and then sold. (Here again, if B negotiates a lower price, to reflect the tax burden shifted to him by A, that would merely reduce A's capital gain and B's capital loss, without altering the net result.)

Thus, substantially identical tax results can be achieved under all three methods, without sacrifice of the purpose to prevent the escape of tax on inventory assets, if:

1. Section 331(e)(2)(A) is amended to provide that the adjusted basis of the stock be reduced by the amount of the adjusted basis of the appreciated inventory, rather than by the portion of the stock basis allocable to such inventory; and

2. Section 333(a)(2) (making an exception for sales of inventory not in the ordinary course of business) is stricken.

Section 336

It seems imperative that section 336(a) should define in some detail the new concepts of "separate business", "operated separately", and "separate books and records". In the case of "separate business", it should be made clear whether the separate businesses must involve distinct products and services, possibly applying the standards developed in connection with the new product provisions of old section 722. On the other hand, the concept might well include the conducting of the identical business in two different cities or at two different locations in the same city. An example would be a corporation conducting the roofing business in two different cities. Each business maintains a separate working force but has the same executive officers, and the books and records are all maintained in one location. If unprofitable operation caused the closing of one of the branches, is that a partial liquidation? Another point which should be clarified is whether manufacturing and distribution can ever be considered as separate businesses, even when completely separate books are maintained and separate divisions are established. One possible nonexclusive definition which has been suggested for a "business" is as follows:

> "As used in this section a 'business' includes any department or division of the business activities of the corporation which is capable of being operated independently by another person and which if so operated would require a return of income under this Subtitle."

Does the requirement of "separate operation" require a separate management, and if so to what level? Does it require a separate address and name, and an absence of joint employees? These are matters which might well be answered in the statute, and in any event should be covered in detail in the regulations.

Can the requirement of separate books be satisfied if the results of operations are merged with other branches of the business in general books of account? Are partial liquidations to be allowed only to corporations which have maintained expensive cost accounting systems, or is it to be sufficient that the results of the operations of a branch are clearly separable in appropriate accounts, except such general items as may be allocated on some reasonable basis? Is it necessary that the branch have a separate profit and loss statement? Since the apparent purpose of the requirement of separate books, aside from assisting in identifying a separate operation, is to make possible the determination of whether 90% or more of gross income has been non-personal holding company income, it would seem that the purpose of the statute could be satisfied by requiring no more than that the accounts make separable the results of operations. If this is the case, the statute should be clarified to express such intention.

The concept of complete termination of the business ought to be clarified in the statute. Read literally, it would not permit the distribution of a separate business to stockholders who then continue the business individually or in partnership. Since the Committee Report, in dealing with complete liquidations, says that such distribution to stockholders who continue the business is intended to be consistent with a complete liquidation, it is presumed that the intention is the same in the case of partial liquidation. However, the literal language of the statute does not seem clearly to support the Committee Report in either case.

It is suggested that the concept of partial liquidation might be extended, consistently with cases under present law, to permit the contraction of a single business, for *bona fide* business reasons, as in instances where output is reduced or methods are changed so that less capital is required, or in cases where part of a single business is destroyed by fire or subjected to condemnation. In such instances, it would probably be advisable to impose a percentage requirement respecting the degree of contraction of a single business which is necessary in order to constitute a partial liquidation.

Consideration might also be given to expanding the meaning of partial liquidation to cover the case where, for example, a corporation distributes, say, 70 or 80% of its assets in reduction of stock pro rata, under a plan of complete liquidation, and then for some good business reason cannot complete the liquidation or else dumps its residual assets into a new corporation and dissolves. Compare *J. S. Alexander*, 2 T.C. 917.

As in the case of section 333(a), discussed above, it does not seem that section 336(a) ought to create undue pressure for a quick disposition of a business. Section 336(a) is even more stringent than section 333(a), in that it requires the distribution to occur during the taxable year "in which the plan is adopted" or within the succeeding taxable year. Since the adoption of a plan to terminate one of at least two businesses might precede the finding of a purchaser for the assets by a substantial length of time, it is believed that this provision is much too stringent. The distribution of the assets or proceeds of assets of the terminated business should be tied to the time of sale or to the termination of the business rather than to the time of adoption of the plan. It is suggested that paragraph 3 be rewritten to read as follows:

> "(3) The distribution occurs during the taxable year in which the business is terminated, by sale of properties or otherwise, or within the succeeding taxable year."

Under old section 112(b)(6), controlled subsidiaries were frequently liquidated via statutory merger. The use of the merger route, like the liquidation into the parent, was tax-free. It was simply easier to do and had considerable practical advantages, particularly in the avoidance of the drafting, executing and recording of numerous real estate deeds. The regulations under section 112(b)(6) recognized the statutory merger as permissible within the liquidation statute. Presumably, under the authority of section 336(c)(2) (which contains language similar to section 112(b)(6)) similar regulations will be adopted under the proposed law. Possibly, however, this point should be further clarified in the statute itself.

Under section 336(c), a plan is not regarded as being in effect for any distribution until after the shareholders or the board of directors have adopted a formal resolution. This provision seems to exalt form above substance. Thus, preferred stock could be retired before a resolution for complete liquidation is adopted and the corporation might thus be made to qualify as a subsidiary of its parent within the meaning of sections 336(g) and 336(h), even though in actual fact a plan of liquidation was in existence before the redemption of the preferred stock.

In section 336(d)(3), inventory assets are defined to include "rights to income", and the Committee Report (p. A113) states that this term is intended to include all rights to future income. It is questioned whether this term is intended to include, *inter alia,* contract rights to earn income by the performance of future services or contract rights to income for the future use of capital. It is suggested that this definition be refined to exclude items to be earned in the future.

Under section 336(g) the term "parent corporation" is defined by use of the word "stock". The word "stock" is defined in section

7701(a)(7) without reference to the term "nonparticipating stock" defined in section 312(d). Since the latter term includes corporate securities other than stock, it should be made clear whether these securities are to be counted in applying the test of section 336(g), and, if so, how, these securities are to be counted in applying the "total number of shares" test.

Section 351

The cases under the old section 112 had developed, with good reason, a somewhat restrictive meaning for the term "securities". It was not permissible to receive demand notes or short-term notes tax-free in a reorganization or in a section 112(b)(5) transaction. Since the definition of securities in section 312(c) is made applicable throughout Subchapter C, and since that definition includes virtually all indebtedness except open accounts, there has been made *sub silentio* a major change in the scope of section 351 and also, apparently, in section 359(d) (although it may be of little importance in the latter instance since the securities received cannot be distributed tax-free to the stockholders). If it is intended to maintain the former standards with respect to the permissible securities in a section 351 transaction, it will be necessary to incorporate a definition provision, or else at least to exclude specifically the application of the definition in section 312(c).

In the case of stock distributed in exchange for services in a section 351 transaction, a suggestion has been made that the receipt of stock should not be taxable until one's interest is severed from the corporation. In such a case it would be necessary to provide that sales of stock so received should produce short term capital gain or ordinary income, and it might be necessary to condition the exemption on the filing of an agreement such as that under section 353(d).

A question has been raised whether, if such promotional stock is taxable as compensation, provision should not also be made permitting a deduction to the corporation. Presumably, such compensation would be covered by the amortization of an organization expense deduction under proposed section 248, but some clarification might be desirable.

A technical suggestion is made that the parenthetical clause in section 351(a) should except not only transactions under section 359(c) or (d) but also under section 354(b).

Section 352

In the first sentence of section 352(a) the word "securities" has been omitted from the phrase "who receives a distribution of stock or property" immediately after the word "stock", and the words "or securities" have been omitted at the end of the phrase "shareholder or security holder of the corporation issuing the stock." It appears that these omissions were inadvertent and should be corrected.

Section 353

The general rule of subsection (a) is applicable to a "shareholder or security holder". The word "shareholder" is not defined in Subchapter C, although section 312 does define the word "securities". The question is whether a holder of an evidence of corporate indebtedness which comes within the definition of "nonparticipating stock" rather than within the meaning of the term "security" as there defined is a "shareholder" within the meaning of section 353. It is suggested that the term "shareholder" be defined in section 312 so as to make it clear that it includes the holder of anything which constitutes participating or nonparticipating stock.

Although section 353(a) is plainly intended to state the tax consequences to the stockholder in the case of a corporate separation under section 359(d), where the stock received by the transferor corporation is distributed to its stockholders, it is possible that it might not be so applied, because of the "single transaction" rule. Section 353(a) literally covers only distributions of stock of "controlled corporations". It might be held that where, under section 359(d), stock of the transferee corporation is merely passed through the transferor corporation to its shareholders, the momentary holding of such stock does not constitute "control". It is suggested that the section be clarified by inserting after the words "corporation making the distribution" the following:

> "or of stock or securities received by a shareholder or security holder in a transaction described in section 359(d)."

A question has been raised concerning the necessity for permitting divisions which do not involve the transfer of business assets. The stated purpose of permitting insulation of investment assets from the risks of an operating business could as readily be accomplished merely by transferring the operating business to a subsidiary, without a spin-off.

Under section 112(b)(11) of the present Code, there is some doubt whether a corporation can spin off tax-free stock which it acquired in an earlier tax-free spin-off. If it is intended that the conditions stated in section 353(a) be the only limitation on its operation, apparently that doubt is now removed. However, it would be helpful if this point were clarified either in the statute or in the Committee Report.

It is not clear whether the operation of section 353(a) is optional with the taxpayer. There will be circumstances where, because of the lack of sufficient earnings and profits in the distributing corporation, or for other reasons, a taxpayer would rather have an immediate tax on the distribution, to the extent of such earnings and profits, rather than take the consequences imposed by section 353(b), which operates irrespective of earnings and profits either in the distributor corporation or in the corporation whose stock is distributed. Since the filing of an agreement under section 353(d) is made a condition to the exemption by virtue of section 353(a)(2), it is inferable that the taxpayer may have a choice to be taxed or not taxed on the original distribution. On the other hand, it might be construed that the agreement is provided as an administrative convenience for the Commissioner, and that the failure to file an agreement might not be used to the advantage of the taxpayer. An election, therefore, appears to be desirable, but it should be more clearly spelled out than has been done at present.

Section 353(b) freezes the stock received for a period of from five to ten years. This replaces the requirement of present law that there be no intention at the time of the distribution to dispose of the stock received or to liquidate the corporation. Ten years seems unnecessarily long as an objective or mechanical test of the presence of such an intention. The policy of freezing assets for such an extended period is open to question. Suppose a stockholder used the stock as collateral for a loan and the loan was foreclosed. That is but one of many illustrations of the new events which could arise which would make it necessary or desirable to dispose of the stock within less than ten years, even though the spin-off was in complete good faith.

Section 353(b) appears to make the time of receipt of the proceeds of disposition or of a distribution from the spun-off corporation control the tax effects of such receipts, irrespective of the taxpayer's method of accounting. It might more easily prevent avoidance of the provision if the time of disposition rather than the time of receipt of the proceeds were made to control. That could be accomplished by striking the words "within a period of ten years from the date of such distribution" in the first line of paragraph (b)(1), and inserting such language in the next to last line of that paragraph after the words "upon the disposition of such stock."

In so far as the severe tax consequences of owning stock of an "inactive corporation" fail to depend upon the presence of earnings and profits at any time, they appear to be extremely harsh. A formula ought to be devised by which the consequences would be limited to the amount of earnings and profits at the time the stock was distributed by the transferor corporation.

Under section 307 (made applicable by section 353(e)(3)), part of the basis of the original stock is transferred to the stock spun-off. But if anyone sells the stock within five to ten years, as the case may be, the entire receipt is a taxable dividend, and there is no provision for restoring the basis to the original stock, even assuming that such stock is still held by the stockholder at that time. This inequity is aggravated by the fact that section 353 applies to widely-held corporations whose smaller stockholders may be under compulsions to sell, unrelated to any tax motive. Furthermore, where the original corporation had more than ten per cent of its income from "personal holding company" sources (for example, dividends from subsidiaries), it is entirely possible that both corporations would be deemed inactive corporations, and if someone sold both stocks, one hundred per cent of his recovery would be a dividend and his entire basis for his investment would disappear.

Problems are also created by the fact that the attribution of ownership rules apply. Thus it may be necessary to devise a means by which the basis of stock sold by one person will be transferred to the basis of stock in the hands of a member of his family or other related taxpayer. Possibly a solution to the problem of restoring the lost basis may be found in the American Law Institute's February 1954 draft of its Federal Income Tax Statute, section X534 and comment on page 276. Another possible solution would be to allow a capital loss to the extent of the basis attributed to the inactive corporation's stock at the time the dividend tax is imposed upon its disposition. Possibly, in the initial allocation of basis, a zero basis could be allocated to the stock of the inactive corporation, but this might serve to permit the realization of too large a loss or too little gain upon the disposition of the stock of the active corporation; and it would not solve the problem where both corporations are deemed inactive corporations. Similar problems of disappearing basis exist, of course, in the case of redemptions of stock under section 302(b).

A suggestion has been made that it would be equitable to integrate section 353(b) with the policy of section 302; that is, if the disposition of stock of an inactive corporation under section 353 results in the termination of the stockholder's interest in *all* of the corporations involved in the spin-off, the disposing shareholder might, with appropriate safeguards, be afforded the same capital gains treatment as is given by section 302 in the case of a complete redemption, or otherwise in connection with a sale of stock.

Section 353(b)(1)(B) is ambiguous; the words "in such stock" should be added between the words "basis" and "is" so that the phrase reads "by a person whose basis in such stock is determined . . ."

Section 353(b)(1)(B)(ii) covers a person whose basis is determined by reference to the value of such stock on the date of death of such shareholder or security holder. Technically, therefore, the rule of subsection (b) would not apply to a person whose basis was determined by reference to fair market value on an alternative valuation date elected by an executor pursuant to section 2032. That section provides in subsection 2032(b) that wherever "in any other section or subsection of this chapter [that is, chapter 11] reference is made to the value of property at the time of decedent's death, such reference shall be deemed to refer to the value of such property used in determining the value of the gross estate." It is suggested that there be added at the end of section 353(b) the following:

> "Wherever reference is made in this subsection to the value of stock on the date of death of any person, such reference shall be deemed to refer to the value of such stock used in determining the value of his gross estate for purposes of chapter 11."

Possibly that language should be qualified to take care of the situation where no estate tax return is filed or is due.

It is not particularly clear whether a stock dividend received upon stock of an inactive corporation within the five or ten year period is such a distribution as to make the dividend tax apply at that time. If a tax is intended upon the receipt of a stock dividend from an inactive corporation, that should be spelled out in the Committee Report. If it is not intended to impose a tax upon such a stock dividend, it becomes possible to receive such stock tax-free and then sell it at capital gains rates, because of the phrase "upon the disposition of *such stock*". In that event it would be advisable to change "such stock" to "any stock of such corporation." If such change were made, however, it might be necessary to insert an exception for stock which the stockholder held in the inactive corporation prior to distribution in the spin-off (i.e., minority stock in a pre-existing subsidiary).

It is not made clear to whom paragraph (2) of subsection (b) applies. Literally, this paragraph would apply ordinary tax rates (except as provided in section 303) to any amounts received by any person without regard to how he acquired the stock and to all distributions whether made as dividends or as redemption of all or part of his stock in complete or partial liquidation or otherwise. It is suggested that there be inserted in paragraph (2) after the words "within such period" the following: "by any person described in subparagraph (a) or (b) of paragraph (1) of this subsection."

Two suggestions have been made with regard to the last five lines of section 353(b). As written, it would appear to permit without ordinary income taxation the immediate sale of retained stock in an inactive corporation with five years' existence before separation, so long as in none of the preceding five years was over 10% of that corporation's income personal holding company income (even though in the spin-off it disposed of its active business). It would also appear to permit the retention of a newly acquired business in the old corporation and the immediate sale of the retained stock at capital gain rates without qualifying as an active corporation. If that result was not intended, then the words "gross income of the corporation" should be changed to use "gross income of the business". It is also noted that, since this provision contains no requirement that the corporation's business have been held in the family for five years, it would apparently permit the distributing corporation to purchase all the stock of a wholly unrelated operating corporation and distribute it to stockholders. Since the corporation, the stock of which was distributed, might never have had any personal holding company income, the holders of the distributing corporation could sell the stock distributed immediately upon its receipt and receive capital gains tax treatment. Since it is doubted that this result was contemplated, it is recommended that the requirements of this provision be changed so that it will operate only after the business of the inactive corporation has become active within the meaning of section 353(c). This would mean, in addition to the income and records requirements, that the shareholder must have had an indirect interest in the corporation's business for at least five years prior to the disposition or distribution in question. It is suggested, therefore, that the words from "90 per cent " to the end of the sentence be stricken from section 353(b) and that there be substituted "the corporation shall have ceased to be an inactive corporation."

In determining whether a corporation is "inactive", what is the intended solution of the following problem: Assume three lines of business, each requiring assets of substantially equal value. Two of these lines of business have been conducted by a corporation for six years and the third has been conducted for two years. If the corporation spins off into a single corporation both one of the six-year businesses and the two-year business, is the spun-off corporation active or inactive? Some clarification of this matter ought to be provided in the statute.

The tax imposed by section 353(b) is levied upon amounts received in respect of stock acquired in a distribution to which section 353(a) is applicable. Similar distributions may be made under section 112(b)(11) of present law. By section 7807(b)(1) of the bill, any provision of the bill which depends upon the application to a prior period of any portion of the bill is deemed to refer (when appropriate and consistent with the purpose of the provision) to the corresponding provision of the 1939 Internal Revenue Code. To prevent any possible doubt that the section 353(b) tax might be imposed with respect to stock distributed under section 112(b)(11), it is suggested that section 353(b) specifically be made applicable only with respect to stock distributed after the effective date of Subchapter C.

The comments which have been made on the partial liquidation requirements with respect to separate business and separate books and records are equally applicable to section 353(c).

Under paragraph (1) of subsection (c), it is not clear whether anything less than ownership through one or more wholly owned subsidiaries would meet the requirement that the business had been held "directly or indirectly" by the distributing corporation. Unless there is a policy reason to the contrary, it is suggested that the test of parent and subsidiary laid down in section 336(g) and (h) might be made applicable here. That might be accomplished by putting a comma after "directly" and then adding after "indirectly" the words "through one or more controlled corporations".

With regard to the requirements in subsections (b) and (c) that at least ninety per cent of gross income be other than personal holding company income, it would seem desirable to make it clear that the corporation or business must have had gross income in each year, ninety per cent of which was other than personal holding company income. Otherwise, it is not clear that a corporation or business would be deemed inactive if it simply held cash or other property and had no gross income. It is suggested that there be substituted for the ninety per cent clause the following:

> "Such business had gross income for each year of such five year period, 90 per cent or more of which was other than persona. holding company income as defined in section 543."

That would apply in both places where the ninety per cent clause appears in subsection (c), and in subsection (b) if the change suggested above is not made.

On the other hand, the gross income requirement may work hardship in the case of a manufacturing subsidiary where a big drop in inventory could reduce gross income to the point where a normally insignificant amount of personal holding company income would cause the company to be classified as inactive. A test based on gross receipts would not be wholly satisfactory, however, for the same reasons that apply in the case of personal holding companies. Perhaps the law could be amended to give relief where ninety per cent of the corporation's assets have been used in its business for the five-year period, even though it fails to meet the income test.

Consideration should be given to the different purposes of section 543 and the present section, particularly in view of the fact that a mere ten per cent of personal holding company income will disqualify a corporation as "active". It may be that the definition of personal holding company income should not be applied indiscriminately for purposes of section 353. In particular, an exception ought to be made for dividends or interest received from a controlled corporation which is not, at the time of payment, itself an inactive corporation. It should also be considered whether such things as income from personal service contracts or from the use of property by shareholders, especially when in the relatively small amounts here under consideration, are such that classification as an active corporation should be denied.

The inactive corporation concept seems complex, ill-defined and cumbersome, and will mean long periods of time during which tax liabilities may remain uncertain. It is suggested that active study should continue to provide an alternative safeguard in this area.

It has been suggested that the requirement that the stockholder agree to notify the Commissioner of dispositions of the stock is a needless complication. The taxpayer can be adequately bound to notify the Commissioner (on pain of having no benefit from the statute of limitations) by his simply taking the benefit of section 353(a). It may be that the Commissioner can be alerted by an appropriate notation on the individual income tax return together with a single return of information by the distributing corporation.

It is noted that no requirement is made that the Commissioner be notified of distributions received from a corporation when the stock is not disposed of, although such distributions would be taxable under subsection (b) regardless of the amount of the corporation's earnings and profits. It is suggested that requirement be made of notice of any distribution from an inactive corporation in excess of amounts included in the taxpayer's return in the year of receipt. This would prevent the statute of limitations from running where a stockholder excludes from his income a portion of a dividend received from an inactive corporation during the ten-year period on the theory that it is a return of capital.

It has also been suggested that the obligation to notify the Secretary of any disposition of the stock, or of a distribution, be imposed upon the corporation itself, unless the corporation has received a ruling that it has become "active". Presumably, the corporation would be able to give such notice on the basis of its stock transfer records, although that might be difficult where nominee holdings are involved.

If, as appears to be the case, taxpayers may elect whether to be taxed on a dividend at the time of the initial spin-off or to take the consequences of section 353(b), a corporation faces additional difficulties in keeping its earnings and profits accounts straight. It must not only ascertain when a taxable disposition is made by any stockholder, but it must also know what taxpayers elected to be taxed on a dividend at the time of the initial distribution. It has been suggested that it be required by regulation or otherwise that a duplicate of the agreement filed with the Treasury be sent to the distributing corporation.

It is also suggested that section 353(d) should provide that a notification pursuant thereto should not bar the notifying taxpayer from taking the position that the reported disposition did not result in ordinary income within the meaning of section 353(b). In other words, it should have no evidentiary value as an admission by the taxpayer that the conditions for a dividend tax under section 353(b) existed.

It is noted that page A122 of the Committee Report refers to a pledge as a taxable disposition of stock, where there is no personal liability. A similar statement is made on page A109, in conjunction with section 333(c), with respect to a pledge of property, without the qualifying phrase "without personal liability". On the other hand, the Government itself has successfully argued that a pledge without personal liability is not a final disposition of property or stock on which gain or loss is realized. *Woodsam Associates* v. *Comm'r*, 198 F. (2d) 357. No doubt there is a tax avoidance potential opened up by that decision in cases where there is no personal liability, see 6 Tax Law Review 219 and New York University 10th Annual Institute on Federal Taxation 71. But, in view of the outstanding decision and the fact that the Government took the view sustained therein, some positive statutory declaration, perhaps of general application, seems necessary to change the law. The two statements in the Committee Report serve merely to confuse the situation, in the absence of some such amendment of the statute.

Section 354

Numerous correspondents have raised serious objections to the discrimination against the family corporation found in section 354(b), which prevents a statutory merger or consolidation, on a tax-free basis, where one of the corporations involved is not a publicly-held corporation, and where the corporate parties are unable to comply with the relative size test and the requirement of section 359(b) and (c) that solely or largely participating stock of the transferee corporation be given in the exchange. The new restriction seems to be contrary to the basic purpose of the reorganization sections to defer recognition of gain where an exchange results in leaving one's investment at the risk of the corporate business.

As a practical matter, the provision would prevent many mergers or consolidations where good economic justifications exist, in the case of small businesses. Most such mergers and consolidations of small businesses are bottomed upon two facts: (1) the shareholders of the transferor cannot afford to take stock of the transferee on a taxable exchange and both pay the tax and keep their stock; (2) the transferee cannot afford to pay cash for the stock of the transferor. In many cases, the stock of the surviving corporation will not be salable, even if it technically classifies as a "publicly-held" corporation, and it will be impossible for the stockholders to obtain funds to pay the tax. Furthermore, it is understood that upon a merger the Securities and Exchange Commission, in the absence of a registration, requires that the stockholders certify that the stock which they are receiving is intended to be held for investment and not for resale. If it is necessary for them to resell the stock in order to pay the tax, they will also have to go through an expensive registration procedure.

The stated reason for the new restriction is that some small corporations may abuse the tax-free provisions as a means of getting out earnings without paying dividend tax. Since stockholders can realize earnings at capital gain rates without going through a merger, merely by selling their interests, it is not clear what advantage the merger provision affords in such a case. If it appears that abuses are likely to occur, it seems more reasonable to curb the abuses rather than to prevent the transaction entirely. Much loop-hole plugging has been done in sections 302, 305, 306 and elsewhere, and it does not appear what further opportunities may exist for abusing the merger provisions as a device for getting out earnings. In any event, the effect of the provision is to impose tax liability on transactions regardless of whether there is any disguised distribution of earnings involved. It does not appear that normal *bona fide* business reorganizations involving small corporations should be proscribed merely because the stockholders of some other small corporations may abuse the privilege.

It is noted, furthermore, that the definition of publicly-held corporations is such that, as has been discussed in connection with section 311, many corporations may actually be unable to find out whether or not they are publicly-held corporations and may thus be unable to determine the appropriate procedure to follow in merging with another corporation.

It is suggested, therefore, that the words "publicly-held" be stricken from section 354(b) wherever they appear.

If that solution is not acceptable, it is suggested that the abuses which seem to be anticipated would not exist in a case where there is at least one publicly-held corporation involved in the transaction, and that it should not be required that all corporate participants be publicly-held.

A further alternative suggestion, if the foregoing are unacceptable, would be to require all corporations to comply with section 359(c) in a merger transaction, with the right in corporations of any size to adopt the section 354(b) method upon first showing the Commissioner that a principal purpose of the transaction is not tax avoidance. If it is believed that publicly-held corporations are more likely to be free of such motives, the law might give such corporations the benefit of a presumption in making such a showing of their motives.

In any event, provision should be made to permit mergers in cases where one widely-held corporation holds 50% or more of the stock of another but the balance of the latter's stock is widely held. In such a case, it is not possible to satisfy section 359(c), yet section 354(b) is unavailable because the subsidiary, technically, is not "publicly-held". It is suggested that it be provided that stock owned by a publicly-held corporation should be disregarded in determining whether the subsidiary is a publicly-held corporation.

Objection has also been raised to the last five lines of section 354(b). That requirement would prevent mergers in which old preferred stock is redeemed or converted to debentures. Such a transaction would not merely be taxable to the preferred stockholders; the failure of the preferred holders to continue as such would make the common stockholders taxable too. Continuity is provided if the required percentage of common stockholders continue as such. It is suggested that the requirement referred to be limited to the participating stock.

Two technical comments may be made in respect of section 354 (b)(1):

The cited paragraph permits receipt of stock and property by a corporation in a merger but makes no mention of securities. No like restriction is imposed on a consolidation. Since the securities, like the property, will be boot when distributed to the stockholders in the merger, it does not appear that there is any reason for taxing the corporation upon the receipt of securities. Presumably, the omission of "securities" was an oversight.

The Committee Report (page A126) expressly, and the subsection itself at least by one possible interpretation, seems to confine tax-free mergers to those of *two* corporations. The language of the subsection, while not very clear, is not inconsistent with the tax-free treatment of a multiparty merger, since there is, with respect to any particular property, only one transferor and one transferee in the merger. But clarity would be aided if the Committee Report were made to read "in the case of a merger of two or more publicly held corporations", and much could be said for clarifying the statutory language as well.

Section 355

The effective date of the basis provision should be coordinated with sections 391(a) and 1052(c), since there are now both overlaps and gaps. Section 391(a) makes the taxability of corporate adjustments turn on whether they occurred after March 1, 1954, thus intending to leave the old Code effective as to transfers in January and February (although there is a gap here of which the draftsmen already are aware). Section 1052(c), however, applies the old basis rule to transfers in taxable years beginning before January 1, 1954 (thus creating both an overlap, in fiscal year cases where transfers may occur as late as November 30, 1954, and be subject to the old basis rules as well as the new, and a gap, with respect to calendar years and January 31 fiscal years, where transfers before March 1, will be subject to the old rule on taxability but not to the old basis rule). Section 355(a) and section 355(b), in turn, relate the new basis rules back to January 1, 1954, regardless of the taxable years in which a transfer occurred (thus overlapping with fiscal year cases under section 1052(c)), and starting the new basis rules two months before the taxability rules change. Since those subsections refer to acquisitions in connection with transactions "described in" or "defined in" various new sections, it does not appear that section 355 can be read as confined to such transactions occurring after section 351, and so forth, become effective, especially in view of the date stated expressly in sections 355(a) and (b). In any event, clarification and coordination are needed.

The attempt (in section 355(a) and (b)) to integrate the basis effects of acquisitions under section 359(b) and (c) raises a number of questions. Section 355(b) declares that the basis of stock acquired pursuant to section 359(b) shall be the amount which would be equal to the aggregate basis of the *assets* "if a similar part of the assets of such other corporation had been acquired in a corporate acquisition of property, as defined in section 359(c)". Suppose Corporation A acquires all of the stock of Corporation B from the latter's stockholders, in exchange for $50,000 in cash and $50,000 (market value) of A's participating stock. Apparently (since the word "solely" is omitted in section 359(b)) that would qualify under section 359(b). But if "a similar part" of the assets had been acquired for a like consideration, there would be no carry-over of corporate basis at all, because section 359(c) would not fit. Read literally, section 355(b) would therefore not attach any part of the corporate asset basis to the stock. It is inferable, however, that it was intended that a pro rata part of the corporate asset basis should carry over. If that is the intention, it should be clarified. And, in that event, it should also be made clear that a cost basis attaches to the proportionate part of the property acquired for other than participating stock (i.e., if a carry-over basis is denied to that extent, a cost basis should be allowed, to reflect the additional investment).

A pro rata carry-over of asset basis to stock, if that is what section 355(b) is intended to provide, raises an additional problem when the amount of stock acquired in exchange for participating stock reaches 80%, for at that point, if "similar part of the assets" had been so acquired under section 359(c), the carry-over of asset basis would have been complete, and not pro rata. If it is intended that the pro rata rule apply below 80%, but that the asset basis carry over *in toto* if 80% participating stock is given in exchange for stock, some peculiar results will follow. If Corporation A acquires all of Corporation B's stock for $79,000 (market value) in stock and $21,000 in cash, and B's assets have a basis of $10,000 the above rule (which is suggested as a possible interpretation of section 355(b)) would give the stock a basis of $7,900 (79% of B's asset basis) plus $21,000, or $28,900. But if A gave $80,000 in stock and $20,000 in cash, the suggested interpretation would result in a stock basis of $10,000, or even less than the actual cash investment (which is also the result which would follow upon an acquisition of property under section 359(c)).

The above example does not take into account the fact that gain would be recognized to the stockholders of B, to the extent of the cash received. In this respect, too, the effect of section 355(b) is unclear. In an acquisition of property under section 359(c), basis would be increased by gain recognized to the transferor (section 355(a)); but no gain would be recognized to the transferor corporation, even with respect to the cash received (section 354(a)(1)), so no increase in basis would result therefrom. When section 355(b) says the stock basis shall be the same as if a similar part of the assets had been acquired under section 359(c), that might be considered to incorporate the clause of section 359(a) respecting increasing basis by "gain recognized to the transferor"; but, to achieve a result comparable to that under section 359(c), the gain of "the transferor" would have to refer to corporation B (which is not even a party to the section 359(b) exchange, and has no gain), rather than to B's stockholders.

Further study and clarification of section 355(b), therefore, is urged.

Some criticism has been expressed of the policy of section 355(c) in overturning the philosophy of the *Brown Shoe Co.* case and giving a zero basis to property contributed to capital by non-stockholders. The saving provision of section 355(d) adds to the confusion and will create controversy over whether the nonstockholders intended a capital contribution or a gift.

The general policy of the bill is to provide only one definition which describes a particular corporate organization, acquisition or separation. For example, section 359(c) or (d) and not section 351 describe corporate acquisitions of property by one corporation from another corporation. Nevertheless, both section 351 and section 359(b) would apply in the case of a corporate acquisition of a controlling interest in another corporation from a person who is thereafter in control of the acquiring corporation. In respect of this transaction, subsections (a) and (b) apparently prescribe two conflicting rules for determining basis. It is suggested that the rule intended to be applied in this situation be specified.

Under section 359(d) the transferor corporation in a tax-free corporate separation may retain the stock or securities received from the transferee corporation. Since the transferor's basis for the stock or securities it receives is not prescribed by section 355, it appears that the transferor will have a cost basis under section 1012. If, as it is believed, the transferor's cost is intended to be its adjusted basis for the assets transferred to the transferee corporation, this should be specified in section 355.

Section 357

The wording of the statute is slightly ambiguous in that it leaves the possibility of a contention that if one of the persons who is needed to make up the group of controlling stockholders were to sell to another his share received in the liquidation and therefore did not participate in the "transfer" to the new corporation, the statute might not be applicable because its application seems to depend upon its "transfer" by those individuals. In this respect it reads:

> "In any case in which one or more individuals receive assets in a complete or partial liquidation * * * and within five years from the date of the final distribution in such liquidation *transfer* more than fifty per cent of such assets * * * to one or more corporations controlled by one or more of such individuals * * * " (Italic supplied).

If one of these persons does not participate in this type of transfer but his assets are transferred to the corporation by another, does that make the statute inapplicable even to his associates? Clarification seems desirable in this respect.

Where a considerable length of time has passed between the liquidation and the reincorporation, it seems a little harsh to put upon the taxpayer the burden of proving that such transaction did not have as one of its principal purposes the avoidance of tax. Perhaps the problem is only theoretical, but after the passage of a year or two it would seem that the burden should be shifted to the Commissioner.

It is suggested that the attribution of ownership principle may enable persecution or extortion by adverse members of families in a case where part of the family participate in the reincorporation and thereby cause other members to suffer a dividend tax on the portion of the assets which they do not contribute to the new corporation.

The section fails to make provision for a refund of the tax on the capital gains previously reported on the liquidation. Such tax may have been paid more than the normal period of limitations prior to the event which causes a dividend tax to be imposed.

It is not made clear whether section 357 is to apply to a reincorporation occurring after the effective date of the subchapter, where the previous liquidation occurred under prior law.

Section 357 contains no requirement like those in section 359(c) that the corporation which acquires the assets issue solely participating stock for such assets or that the ownership of its participating stock by its and the liquidated corporation's shareholders be within certain percentage limitations. Thus, it appears that a practical merger of corporations which cannot meet these two requirements of section 359(c) might be accomplished under section 357, provided the shareholders either have the tax avoidance motive described in section 357(b) or are not required to establish their lack of such motive. It is suggested that section 357 be amended to make clear that it cannot be used to avoid the substantive requirements of section 359(c), if these requirements are to be retained in section 359(c).

Section 358

Section 243(a) allows a dividend received credit only for amounts received from domestic corporations. Subchapter C, part II, section 332(b)(1) provides that, first, any gain received by a corporate shareholder upon partial or complete liquidation of another corporation shall be treated as a dividend, but that, second, for a parent corporation receiving gain upon the liquidation of its subsidiary, "the deduction for dividends received provided in section 243(a) shall be 100 percent". Section 358 provides that "so much of part II of subchapter C as relates to the liquidation of a subsidiary corporation by its parent corporation" shall not be applicable to a foreign corporation unless prior to the transaction it has been established to the satisfaction of the Secretary that tax avoidance was not a principal purpose of the plan.

Presumably it is intended that gain received upon the liquidation of a foreign subsidiary shall be treated as a dividend, unless the requirements of section 358 have been satisfied, in which event the 100 percent dividends received credit prescribed by section 332(b)(1) will be allowed. If this is the intention, section 332(b)(1) or section 243(a) should be amended to permit the 100 percent dividend received credit in respect of amounts received from a foreign corporation.

Section 359

In the preceding discussion of various sections of the bill, it has been suggested that discrimination based upon whether a corporation is publicly-held should be eliminated. Assuming that such distinctions are retained, it is suggested that the test of a publicly held corporation in section 359(a) be reexamined. The test adopted by the statute may be both too narrow and too liberal in different situations. On the one hand, a corporation with as few as twenty equal unrelated stockholders is considered as a publicly-held corporation. On the other hand, a corporation which may itself be listed on a stock exchange and which is partially owned by a corporation with thousands of stockholders is regarded as not being a publicly-held corporation.

It is noted that section 359(a) omits the second requirement for a publicly-held corporation which is found in section 532(c) of the bill, providing that not only must the controlling power in the corporation be in more than a specified number of stockholders, but that the total stock must be held by more than fifteen hundred persons.

The situation of the subsidiary, which is as truly public as its parent, would be remedied if section 311 were modified to look through corporate ownership of stock to determine beneficial ownership by the ultimate stockholders, as is done with respect to personal holding companies in section 544. There has already been discussed the virtual impossibility of a corporation's knowing its stockholders and their constructive ownership under section 311, in order to know whether such corporation is a publicly held corporation or not. See discussion under section 311. The value test which is also injected into section 359(a) adds further serious difficulties. Where no ten stockholders or their families own more than half of the voting stock, but some of them also own other classes of non-voting stock, such as preferred, it will be necessary to place a value on both classes of stock in order to determine whether any ten individuals have more than fifty percent of the value of the stock. It is not specified whether such value is to be determined by the aggregate value of the outstanding stock as listed on a stock exchange (if it is so listed), or by the liquidating value or the going concern value. Whatever test is adopted, the determination of status as a publicly-held corporation may involve difficult and costly valuation problems. The test seems to be an unnecessary addition to the statute, since the fact that a few individuals own a large part of the value of the stock means nothing if they and their families own non-voting stock and cannot control the actions of the corporation.

Under former section 112(g)(1)(B), I.R.C., it was required that stock be acquired "solely" in exchange for voting stock. In section 359(b) of the bill, which is the comparable provision, the word "solely" is omitted. From discussions in the Committee Report relating to the "boot" provisions (at pages A85 and A119), it appears that the omission was intentional. Yet the Report makes no mention of the change in its discussion of section 359(b). Some clarification of the section in this respect, or at least a clear statement in the Report, is desirable.

The question is raised whether the requirement of section 359(c) that an acquisition of property be solely in exchange for participating stock, rather than for stock and securities generally, continues to serve a useful purpose in the corporate adjustment provisions. If the requirement is intended to differentiate between reorganizations on the one hand and sales of business on the other, on the theory that a preferrred stock is too readily marketable and thus the transaction is equivalent to a cash sale when such stock is received, it seems a questionable test since many common stocks are more marketable than some preferred stocks. Therefore, it has been suggested that the phrase in subsection (c), "in exchange for all or part of its participating stock," and also the parenthetical reference to participating stock in subsection (c) should be changed to read "in exchange for its stock or securities".

Many correspondents have expressed strong opposition to the 25%-400% rule found in subsections (b) and (c) of section 359. Apparently, the requirement is based on the theory that unless the stockholders of one corporation get a considerable percentage of the stock in the other corporation, it is a sale rather than a reorganization. That seems wrong in theory. Whether they get a 40% or 10% or 1% interest in the acquiring corporation, what they get merely represents their former corporate interest, in the same amount and proportion, except that it is in a much larger combined corporate enterprise. Regardless of relative sizes, the interests of the stockholders are still in corporate solution. If it is thought that the receipt of stock in a larger corporation results in having a more marketable asset, so that it is the equivalent of a sale, it should be noted that that is not necessarily the case, since the acquiring corporation (even though larger) may still be a closely held corporation whose stock is not marketable. Furthermore, if the receipt of a marketable security is the test for taxability, the logic of that position would require that mergers of widely held corporations with listed stock should be taxable in all cases. It is suggested, therefore, that the relative size test should be deleted from both subsections.

The relative size test apparently results from an effort to interpret what the Supreme Court said in the *Minnesota Tea* case, 296 U.S. 378, 386, that the transaction "was no sale, but partakes of the nature of a reorganization in that the seller acquired a definite and substantial interest in the purchaser". There was a second aspect to the *Minnesota Tea* test, requiring that the taxpayer receive an interest in the affairs of the transferee which represents "a material part of the value of the transferred assets". Since the tests of reorganizations are to be limited to those expressed in the statute, without such non-statutory tests as continuity of interest, it may be desirable (if the present relative size tests are omitted) to devise a statutory formula to express that second aspect of the *Minnesota Tea* test. Otherwise, a high corporate basis may be taken over and the carry-overs provided in section 381 may become available to a corporation when it acquires property for cash and securities and a negligible amount of stock. Such a test ought to be made applicable not only to transactions under section 359, but also to statutory mergers and consolidations.

If the relative size test is left, and is not omitted as here suggested, there are certain technical changes that should be made. In section 359(c)(2) the phrase "immediately after the transaction" should be conformed to the phrase "immediately after the acquisition" which is used in paragraph (1).

Subsection (b) and subsection (c) each contain a sentence regarding the circumstances in which the relative size test shall not apply, which sentences include three undefined and questionable phrases: "substantially all", "directly or indirectly", and "same interest". Two alternative suggestions have been made for substitute language. On the one hand, the sentence in each case might be changed to read:

> "Paragraph [(1) or (2), as the case may be] shall not apply if at least 80% of the fair market value of the stock in each of the corporations, parties to the transactions, is owned by a group of ten or fewer shareholders, or some of them. For the purpose of the subsection, the ownership of stock shall be determined in accordance with section 311."

An alternative suggestion is to make it read:

> "Paragraph [(1) or (2), as the case may be] shall not apply if all of the acquiring and acquired corporations are under the control of the same shareholders."

It should also be considered whether the relative size test is too stringent in requiring that the stockholders of each corporation acquire an interest in *each class* of participating stock. It may not be practical in many instances to increase all classes of participating stock that may exist in some corporations.

In paragraph (1) of section 359(c), after the words "acquiring corporation" in the two places where the words occur, should be added "or corporation in control of the acquiring corporation." Without this addition, paragraph (1) would never be satisfied by participating stock of the parent of the acquiring corporation given in exchange. In other words, unless this addition is made, the *Bashford* and *Groman* cases are not really reversed as intended. It should also be noted that the language of the relative size test would make impossible a tax-free statutory consolidation of corporations not qualified under section 354(b), since the new corporation which would result from the consolidation is the acquiring corporation, and that corporation would have had no shareholders immediately prior to the acquisition.

In two places in Section 359(c), the phrase appears "less liabilities or properties used or retained to meet claims against such other corporations". Since there may, in some instances, be both actual liabilities paid and properties retained to meet other liabilities, the word between liabilities and properties should be "and" rather than "or".

In the case of property retained to meet claims, the Committee Report (p. A133) says "claims" means only those that it is reasonably certain will result in a liability. What about a filed or threatened lawsuit for negligence, infringement, breach of contract, treble damages under the anti-trust laws, etc.? Who can say what is reasonably certain to be the liability? If the acquiring corporation is unwilling to assume such a contingent liability, how can anyone be sure whether the eighty percent test is met? The tax-free character of an acquisition should not depend upon hindsight, if it turns out that some sure claims are really worthless claims and some doubtful claims were not as serious as they may have appeared at the time of the transaction. Why should not claims and liabilities cover any amount businessmen estimate and reserve for them? In the absence of evidence of bad faith, that should suffice.

In paragraph (2) of section 359(c), the phrase "within the period prescribed in section 336(b)" should read "within the period prescribed or as extended under section 336(b)", to clarify the right of the Secretary to extend the time, just as he can in the case of a complete liquidation.

In section 359(d), it is suggested that the phrase "a transfer by a corporation of a part of its assets to another corporation" be amended to read "a transfer by a corporation of all or a part of its assets to one or more other corporations". That is intended to make sure that the definition covers a split-up in which all assets and liabilities are transferred to two or more corporations. The present definition covers a split-off and probably a spin-off. It covers a split-up only if one interprets the definition as encompassing two simultaneous split-offs which combined transfer all assets. Section 112(g)(1)(D) of present law has been so interpreted in practice, but it has been a troublesome problem which should be eliminated under the new Code. Since a split-up was intended to be included, why not say so? A few more words would clear up the matter. In addition, the phrase "all . . . assets" will cover the practical so-called downstairs merger. Such a merger does not very well fall within section 359(e), and in any event should not be subject to its restrictions. In addition, the addition of "all . . . assets" takes care of the situation of a reincorporation of all assets in another state or in the same state after the expiration of a charter. Such reincorporation was formerly taken care of under clause (F) of section 112(g)(1) ("a mere change in identity, form or place of organization"). The Report states that the provision was found unnecessary, which was true as long as section 112(g)(1)(D) was in its original form. But the restriction of section 359(d) to transfers of a part only of a corporation's property, plus the restrictions which are imposed on other forms of reorganization, will make it impossible in some instances to have a tax-free reincorporation. The amendment suggested will take care of that.

A definite cut-off day should be provided in order to set the time as of which control is to be determined. The phrase "immediately after the transfer" has always been one of the most indefinite in the reorganization provisions. It is suggested that the quoted language be changed to "immediately after the documents of transfer of the assets have been delivered to the transferee corporation."

In the last sentence of subsection (d), it appears that the phrase "solely for participating stock" has been used inadvertently and should be changed to "solely for stock or securities".

The word "control" is defined in section 359(e), and also in a great many other places throughout the Code. Since the word is used so frequently in the Code in the sense defined, it is suggested that it be defined only once, namely, in section 7701, which sets forth definitions of recurring words. Since "control" is specifically defined in different ways in different places, it is apparent that if the word is used anywhere without being directly tied to a certain definition, then the word necessarily has a completely indefinite and ambiguous meaning. In such an extensive revision of the Code, through some oversight there is a chance that the word "control" may be used in some chapter or title or minor section without being tied up to a definition of the word. Caution dictates that the word be defined in section 7701, and that the definition be eliminated wherever else it occurs. Furthermore, good draftsmanship would suggest that the phrase "controlled by" should be changed to "under the control of" in both section 353(a) and 359(d), in order to use the precise word which is defined in section 359(e).

Section 381

Section 381 makes provision for carry-overs of certain benefits and burdens in the case of liquidations of subsidiaries and certain corporate adjustments. It fails to make provision for the situation where there is a corporate separation, although many of the same problems and equities exist in such a case. The problem of allocation of the carry-over items should not be insurmountable, since this problem was handled under Part II of the Excess Profits Tax Law, relating to the carry-over of earnings experience, by providing a general rule of allocation on the basis of ratio of fair market value of assets transferred to each company, with a further provision in the alternative that the companies might agree among themselves, subject to the Commissioner's approval, on another basis of allocation. In addition, a number of the provisions would create no problems of allocation. It seems particularly important to make paragraph (16) of subsection (c) available to a separated corporation, where it is charged with certain liabilities of the transferor corporation. The failure of the law to deal adequately with the inheritance of earnings and profits in the case of a corporate separation has already been discussed in connection with section 310.

Section 381(c)(1) and (3) provide what in some cases may be a triple penalty in the case of a corporate liquidation on which a loss is incurred. When a subsidiary corporation has liquidated, and the market value of the assets is less than the parent corporation's basis for the stock, section 331 now allows a loss to the parent, which was denied under prior law. That loss allowance, however, carries with it a reduction of the basis of the property to the present market value.

Such reduction of basis means that the corporation will have less depreciation deductions in the future or will have a smaller loss or a larger gain upon the disposition of the property at a later date. Despite the fact that the allowable loss has thus been fully charged against the parent, section 381(c)(1) provides that such loss shall again be charged against the available net operating loss carry-overs of the former subsidiary corporation which the parent may avail of. That loss is then charged against the parent a third time by section 381(c)(3), which denies *any* carry-over of capital losses from the subsidiary if there was any loss allowed to the parent under section 331. In respect of this third charge against the parent, even $1.00 of recognized loss on the liquidation will result in a complete disallowance of any capital loss carry-overs which the subsidiary may have had. The rules seem inequitable and it is suggested that they be restudied.

Section 381(c)(1) makes no provision for the *carry-back* of net operating losses where there has been a merger or other reorganization. Some limitation upon carry-backs in reorganizations and mergers is justifiable on the ground that it is too complex in some cases to determine to which of several component corporations the loss of the surviving corporation is attributable. In two important areas, however, the problem of allocating the loss is not involved and it is suggested that in such cases, at least, there should be no limitation on carry-backs. One is the case of a reincorporation of the same corporation in a different state, or upon expiration of its charter. In such a case, the corporation suffering the loss is essentially the same corporation against whose income the loss would be applied. Another instance is that of the wholly owned subsidiary which is liquidated into its parent, which parent suffers a net operating loss in the following year. Unless amended, the law would permit the parent to carry this loss back only against its own income for the preceding year, even though the assets of the subsidiary caused the entire loss in the subsequent year. It is suggested that a carry-back to the subsidiary in such a case would be appropriate, since the two corporations in the preceding year were owned by the same interest, and were essentially the same enterprises before liquidation as they were afterward. It is suggested that the parent should be permitted to utilize the loss carry-back to its fullest extent against either its own or its subsidiary's income prior to the liquidation. If the two corporations had remained separate, they could have consolidated their income for income tax purposes.

Section 381(c)(4) provides that an acquiring corporation must obtain approval of the Secretary with respect to the method of accounting to be used where different methods were used by the separate corporations involved in the transaction. The same section recognizes that the Secretary may require the use of a combination of methods. This does not seem desirable. It is suggested that the acquiring corporation, if it existed prior to the acquisition, should continue to use the method of accounting theretofore used by it, and that if the acquiring corporation is a new taxpayer, it should be entitled to elect whichever method of accounting best serves its purposes. For example, suppose that one of the transferors of the corporation used straight-line depreciation for individual assets, that another used composite depreciation, and that a third used unit-of-production depreciation. After the transaction, it would be very impractical to use a combination of these methods, segregating the assets for that purpose. It is suggested that section 381(c)(4) be revised as follows:

> "The acquiring corporation shall use the method of accounting used by it prior to the distribution or transfer, except that if it has no existence prior thereto the acquiring corporation shall use such standard approved method of accounting as it may elect on its first return filed under subtitle A after the distribution or transfer."

Section 381(c)(6) is ambiguously worded. It states that the acquiring corporation shall be treated as the distributor or transferor corporation for purposes of computing depreciation on property acquired in the transfer or distribution, with respect to that part of all of the basis of the acquiring corporation which does not exceed the basis of the distributor or transferor corporation. In a case where a parent corporation has recognized gain under section 331(b), section 334(a) apparently gives such property a stepped-up basis, despite the fact that no tax was actually incurred on the gain by the corporation by virtue of the 100% credit allowed under section 332(b)(1). Section 167(f) fixes the basis for depreciation by reference to the basis established under section 1011, which in turn refers to the basis fixed by Subchapter C. If it is intended to deny the corporation a basis to the extent of such recognized but untaxed gains, as is stated at page A140 of the Committee Report, it should be much more clearly expressed in the statute. A literal reading of section 381(c)(6), in conjunction with the cited basis provisions, would seem merely to hold the acquiring corporation to its transferor's methods of depreciation, to the extent of the amount of the transferor's basis, while leaving the transferee free to compute depreciation on the excess basis in its own way.

Section 381(c)(11) preserves to the transferee the transferor's deduction with respect to pension trusts, employees' annuity plans, stock bonus and profit-sharing plans. Since the transferor may be entitled under section 403(a)(5) to deductions for payments under a pension plan which is not a trust, the phrase "pension plans" is more appropriate than "pension trusts" in this subsection. It is suggested that subsection (11) be revised to read as follows:

> "(11) Contributions to pension trusts, employees' annuity plans, stock bonus and profit-sharing plans and other plans.—The acquiring corporation shall be considered as the distributor or transferor corporation after the date of distribution or transfer for the purpose of determining the amounts deductible under section 403(a)(1), (2), (3), and (5)."

Section 382

The purpose of this section is to eliminate the present tax advantages in acquiring control of deficit corporations. Undoubtedly abuse is possible in this field, but the remedy provided seems unreasonably harsh. If there is to be a general averaging of income and losses over an eight-year period, as provided by section 172(b), it appears that such theory should apply even to closely held corporations, whether or not control changes during the period, if those corporations continue to carry on business in the same field. In other words, there seems to be no real justification for refusing to apply the averaging principle, regardless of change in stock ownership, to a bona fide business operation, as distinguished from the trafficking in deficit corporations which have been substantially liquidated and which are then used to acquire profitable businesses in other fields, or are used as investment companies. It is noted that a much larger than 50% shift of corporate ownership occurring by reason of a merger or other corporate readjustment would not cause the loss of carry-overs. (See section 381.) There seems no sound reason for distinguishing between a change of ownership by merger or other adjustment and one which occurs simply by a purchase of shares.

Section 382 operates harshly on minority shareholders when there is a change of ownership of the majority shares. That portion of the operating loss of which they, as shareholders, will enjoy the benefit when it is carried forward, is reduced as a result of the transfer of majority shares, and to that extent the purchasers of the majority shares enjoy some of the carry-overs which the corporation previously had the right to. The minority shareholders are powerless to prevent such stealing of their carry-over rights by the purchasers from the majority holders. The American Law Institute, in considering this problem (February 1954 draft, page 303 of Vol. II) recognized that this inequity is inherent in any method of denying any operating loss carry-overs upon a partial change in ownership. To narrow this area of inequity, the American Law Institute limited the operation of its provision (section X561(c)) to cases in which 80% or more of the corporate stock is sold. The pending bill extends the provision to a 50% change of ownership and thus greatly widens the area in which the inequity to minority stockholders may operate.

There has previously been discussed, in connection with section 311, the serious effects of that portion of section 311 which provides that the owner of more than 50% of the stock of a corporation shall be deemed to own all stock held by that corporation, and similarly that a 50% beneficiary of a trust or estate shall be deemed to own all stock owned by such trust or estate, there being no attribution of ownership where the interest of a party is less than stated above, and there being no proportional attribution of ownership in any case. The same failure to look through the corporation or trust to determine true proportionate interests causes unwarranted results in the application of section 382, the provision which denies or limits carry-overs to the extent that there has been a substantial change in the ownership of stock of a loss corporation. Suppose that A owns 50% of the stock of X Corporation, which in turn owns all the stock of M Corporation, which has incurred net operating losses. If A, for cash, buys half of X's holdings of M stock, it would be considered that A had increased his holdings in M from zero to 50%, and half of M's carry-overs would be taken away. Yet, in true beneficial ownership, A has increased his interest from 50% to 75%, not enough to make section 382 applicable. If A were to buy all of X's holdings of M stock, it would be considered that a 100% change of ownership occurred (losing all the carry-overs), though the true increase was only 50% (which should cause loss of half the carry-overs). If A had held 51% of the stock of X, however, all of X's holdings at the beginning of the year would have been attributed to him, so his purchase of all or any part of X's holdings would cause no loss of carry-overs.

Similarly, a 49% beneficiary of a trust, which owns all the stock of a corporation, may buy half such stock from the trust and cause loss of half the carry-overs, or may buy all of it and cause loss of the entire carry-overs, since he is not deemed to have had any interest prior to the purchase. But a 50% beneficiary may buy all the stock from the trust and no change in ownership will be deemed to have occurred.

The failure to apply the rules of section 311 (corrected as here urged) in connection with section 382(c), coupled with the narrow reference to "such stock" in section 382(a)(2), creates a loophole by which any well advised person may avoid section 382 (so that it will actually catch only those changes in ownership that occur without tax advice or motivation). The intervention of a holding company will prevent application of section 382. Suppose X Corporation owns all the stock of M Corporation, which has suffered heavy losses. A new group, who are in a position to put a profitable operation into M Corporation, buy all the stock of X Corporation. They are not among the persons whose stockholdings are taken into account under section 382(c), and in any event their increase in indirect ownership under section 382(a) did not result from purchase of "such stock" (i.e., purchase of the loss corporation's stock). Therefore, the new group get the advantage of M's carry-overs.

Nor is that loophole available only where there is an existing parent-subsidiary relationship. The individual stockholders of a loss corporation can create a marketable carry-over by contributing their stock to a new holding company. Since that is not a purchase by the holding company but a tax-free acquisition under section 351, that transfer will not affect the carry-overs. Then a new group may purchase the holding company's stock, and will escape section 382 for the same reasons stated in the preceding paragraph.

To make section 382 work properly, section 311(b) and (c) should be put on a true-proportion basis, and section 382(c) should be made subject to section 311 (except that provision should be made for not counting more than once the persons to whom the same stock is attributed). In addition, the words "such stock" in section 382 (a)(2) would have to be changed to include purchases of, or reductions in the amount of, a parent corporation's stock.

In what was intended as a liberalization of the attribution of ownership rule found in section 24(b) of the prior law, section 311 provides that the stock owned by a divorced or legally separated wife shall not be attributed to her husband, and vice versa. That has an adverse effect, however, in connection with section 382. If a husband and wife each own half of a corporation, and they are legally separated, that event will reduce from 100% to 50% the ownership attributed to each of them. If one then buys out the other, that person's interest will again rise from 50% to 100%. If the end of a year intervenes between the two events, it will be held that there was a 50% increase in ownership in the second year and half the carry-overs will be denied.

If section 382 represents sound policy, there is some question whether it should not extend equally to a public corporation. The exemption of public corporations is based on the fact that such corporations would not ordinarily engage in such transactions, but that seems hardly a reason for not making it impossible or difficult for them to do so, if they should wish to. It should be noted that a public corporation may have, under the definition in 359(a), as few as 20 equal unrelated stockholders.

It is noted that, although a bequest of stock is not treated as a "purchase" for purposes of applying section 382, the section could become applicable as a result of a redemption of stock held by an estate for the purpose of raising funds to pay the estate tax liability. In order to provide relief in this situation, as well as to take care of the case of a bona fide continuing business, such as was discussed in the first paragraph under this section, it has been suggested that a new subsection be added at the end of section 382, as follows:

"(g) Exempt Transactions. If—

"(1) a change in the percentage ownership of stock results from a decrease in the amount of stock outstanding, in a transaction to which section 303 is applicable, or

"(2) the corporation continues to carry on a trade or business substantially the same as that conducted immediately before any change in the percentage ownership of stock, such change in the percentage ownership of stock shall be disregarded under subsection (a)."

Section 391

The question of the effective date of Subchapter C has been discussed generally earlier in this presentation. Certain technical details are discussed under this heading.

Section 391(a) makes the Subchapter effective generally with respect to distributions and transfers occurring after March 1, 1954. Part II of the Subchapter, however, is made effective only with respect to distributions (and liquidations) made in pursuance of a plan adopted after March 1, 1954, irrespective of the date of distribution. The net effect is an ambiguity with respect to the effective date of section 333. Although section 333 is in Part II, a section 333 sale is not a "distribution", and it may be, therefore, that it was intended to apply the new law to section 333-type sales as "transfers" occurring after March 1 (or whatever date is ultimately selected).

The reason is not apparent, in any event, why the effective date of the new provisions on liquidation was made to depend on the date of adoption of the plan, whereas the effective date of the reorganization provision depends on the date of the transfer. Therefore, the suggestion has been made that section 391(a) be amended to read as follows:

> "(a) This Subchapter shall be effective with respect to distributions or transfers occurring after March 1, 1954, except that—
>
> > "(1) the provisions of section 333 with respect to nonrecognition of gain to liquidating corporations shall be applicable only with respect to sales occurring after March 1, 1954, and
> >
> > "(2) the tax imposed by section 309 shall be applicable only with respect to amounts distributed after the enactment of this Act."

If a new effective date for Subchapter C is adopted, as has been urgently recommended by many persons, it could of course be substituted in the foregoing. However, it is understood that plans to avail of the relief provided by section 333 were formulated as early as last January, when it was first announced that such a change would be made. It has been suggested, therefore, that section 333, particularly since it provides relief from double taxation, should be made effective with respect to sales at any time in 1954, irrespective of the date of adoption of the plan of liquidation. If this suggestion is adopted, it is further suggested that (with respect to sales prior to enactment of the bill) the requirement that the sale follow the adoption of a formal resolution for liquidation be dispensed with, subject to proof that liquidation (or partial liquidation) was in fact intended at the time of the sale (which intention shall be conclusively presumed if liquidation occurs within a specified time). This suggestion is based on the fact that, in many closely held corporations, the intentions of the directors and stockholders are often not fully recorded in formal minutes, since there is no real necessity for formal resolutions in advance of the act of liquidation, even though steps are taken which irrevocably commit the corporation to liquidation. Thus, in the case of sales occurring before enactment of the new requirements, it would be wholly fortuitous if formal resolutions adopted prior to a sale recited the intention to follow the sale with a liquidation. In many instances, the resolution, adopted prior to sale would be a simple authorization of the disposition, primarily for the protection of the purchaser, and the enabling resolution for liquidation would not be adopted until the liquidation was about to occur.

It is noted that there are several subsections of other sections in Part II that depend on section 333 and their effective date should conform to that of section 333.

Section 391(b) makes section 382 applicable to purchases and redemptions of stock consummated after March 1, 1954. It is suggested that section 382 should not be applicable to purchases or redemptions of stock to which taxpayers were committed before March 1, 1954. In any case where the principal purpose of a stock purchase or redemption was tax avoidance, section 129 of the present law and section 269 of the proposed Bill will deny net operating loss carry-overs, regardless of the date of the transaction. By making motive irrelevant, the effect of section 382, therefore, is to apply an objective standard which denies these carry-overs even in the case of acquisitions motivated by bona fide purposes. In any such acquisition, the tax benefits available to the corporation will have entered into the purchase price. Thus, if section 382 is applied to transactions to which purchasers were committed by March 1, 1954, and which, because of the absence of tax avoidance motives, are outside the scope of section 269, such purchasers will be retroactively deprived of rights for which they have paid in good faith.

To obviate this inequity, it is suggested that a new sentence should be added to section 391(b), in form as follows:

> "Section 382 shall not apply to any purchase of stock consummated as a result of a course of action to which the purchaser was committed prior to March 1, 1954, or to any decrease in the amount of outstanding stock consummated as a result of a course of action to which the corporation or the shareholder who has increased his percentage of participating stock was committed prior to March 1, 1954."

The model for the immediately foregoing language is section 722(b)(4) [fourth sentence] of the World War II excess profits tax law, relating to changes in capacity for production or operation. This language was interpreted in Treasury Regulations 112, section 35.722-3(d)(5) to include commitment by contract, by the expenditure of money, by the institution of legal action, and by any other change in position unequivocally establishing the intent to make the change. Similar interpretative language should be written into the committee reports on section 391(b) of the proposed Bill.

Section 1032

Section 1032 provides that a corporation shall not realize any income upon the receipt of money or property in exchange for its stock, including treasury stock. It is suggested that this should extend equally to the receipt of services for stock.

Section 1232

Section 1232(a)(1) states that:

> "Amounts received by the holder upon retirement of * * * bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those with interest coupons, or a registered form, as of March 1, 1954)."

This provision eliminates the present requirement of Section 117(f) of the 1939 Code, under which the retirement of bonds is considered as an exchange only if they are in registered form or are issued with interest coupons. The change is effective, however, only for the future period. As the provision is expressed above, however, no bonds or other evidences of indebtedness issued after March 1, 1954 and before January 1, 1955, could qualify at all, even if they were issued in registered form or with interest coupons. It is probable that it was intended that the date January 1, 1955, should read January 1, 1954, which would eliminate the hiatus which now exists.

Concluding paragraph as to Subchapter C comments

In view of the haste with which this memorandum has been prepared, no attempt has been made to present a cohesive analysis of Subchapter C as a whole. Certain general observations, however, have been included in the forepart of this material.

DEFERRED COMPENSATION PLANS

Subchapter D of Chapter I, Subtitle A

These comments relate to the sections of H. R. 8300 which cover "qualified pension, profit sharing and stock bonus plans", non-qualified plans, "restricted stock options", taxation of annuities and related subjects. Primary consideration has been given to provisions describing the tax treatment of qualified pension, profit sharing and stock bonus plans because of their importance. Insofar as such plans are concerned the stated purposes of the proposed changes in the law are (1) to continue to encourage the growth of such plans, (2) to simplify the provisions of the law covering such plans and to provide more precise rules for qualification of such plans in order to avoid the necessity of obtaining advance rulings of approval from the Internal Revenue Service, and (3) to provide greater flexibility to an employer to tailor a plan to suit the individual needs of his employees. The Ways and Means Committee in stating these objectives recognized that adequate safeguards would have to be adopted to prevent tax avoidance.

The Tax Section of the American Bar Association is in accord with the basic objectives stated by the Committee. It is apparent to us, however, that numerous changes must be made in the proposed provisions relating to qualified pension, profit sharing and stock bonus plans if the objectives of the Committee are to be attained.

The most serious trouble spots contained in the proposed 1954 Internal Revenue Code relating to qualified pension, profit sharing and stock bonus plans and to related subjects are as follows:

First, it is strongly recommended that section 505, describing allowable investments for employees' trusts, be deleted entirely from the Bill. The numerous reasons for this recommendation are described in detail hereinafter. If these provisions are not deleted, it is strongly recommended that they be drastically revised as described hereinafter.

Second, the provisions of section 501(e)(3) describing non-discriminatory classifications of employees are much too restrictive as applied to qualified plans for (a) *salaried employees*, and (b) *employees who earn in excess of $1,000 per year*. Again our reasons for this conclusion are stated in detail hereinafter.

Third, the provisions of section 501(e)(4) which describe the "ratio of contributions and benefits" in a qualified plan are much too restrictive in that contributions or benefits must be geared 100% to compensation in the case of a pension plan, and 75% to compensation in the case of a profit sharing plan. This requirement, unless changed, would result in the disqualification of more than half of all plans now in existence because under numerous existing plans, contributions or benefits are geared to *years of service, employee deposits* and/or *the age classification of an employee,* as well as to compensation.

Fourth, there is no adequate reason why qualified pension trusts should be required to conform to the provisions of section 503 describing prohibited transactions or particularly to section 504 prescribing a rule against unreasonable accumulations of income. Such provisions properly apply to charitable foundations, but are not relevant to qualified employee trusts. This is particularly true in the case of section 504 prohibiting unreasonable accumulations of income since employee trusts must accumulate income in order to provide the benefits presribed by the plan.

Fifth, the *effective date* of the proposed law should be subsequent to the date the law is enacted, and

Sixth, the status of the many *plans which qualify under section 165(a) and which are amended* after the date of enactment of H. R. 8300 into law must be clarified.

A detailed discussion of the above-described objections as well as a discussion of other sections related to the subject of deferred compensation follows hereinafter.

Section 72

Section 72(e)(2) refers to an "adjustment in investment where there is refund feature." Subparagraph (B) should in such section refer to "a payment or payments" rather than only to "payments" inasmuch as a lump sum payment is contemplated.

Section 72(d), if intended to apply to joint and survivor annuities, should refer to "aggregate amount receivable by the employee *or his beneficiary.*"

In section 72(e) it is suggested that the phrase "and if no other provision of this subtitle applies" should be eliminated and in lieu thereof there should be substituted the phrase "except in the case of proceeds of a life insurance policy payable by reason of the death of the insured." Other exceptions, if any, should be referred to specifically.

Section 101(b)(2)(B)

Section 101(b)(2)(B) provides that the $5,000 exemption from income tax on account of payments by or on behalf of an employer on account of the death of any employee "shall not apply to amounts with respect to which the employee possesses immediately before his death a non-forfeitable right to receive the amounts while living (other than total distributions payable as defined in Section 402(a)(3) which are paid to a distributee *by a profit sharing or stock bonus trust* described in Section 501(a) which is exempt from tax under Section 501(a) within one taxable year of the distributee by reason of the employee's death)"

The italicized words include only a profit sharing or stock bonus trust. There is no reason why payments from a qualified pension trust should not be treated the same, by statute. The word "trust" should be deleted in order to make it clear that the exemption applies to payments from qualified non-trusteed plans as well as trusteed plans. The above-quoted words in parentheses contain a modification of the general rule which is so important that the parentheses should be removed and the exception should be made a part of the sentence. The two references to Section 501(a) are in error, the first reference should be to Section 501(e).

Section 105

Criticism has been directed to subparagraph (D) of Section 105(e)(1) which states one of the requirements of a "qualified employers' accident or health plan" is that it must provide *"a waiting period before the time when payments are to begin under the plan."*

This duration of the waiting period is not specified. Apparently one day would satisfy this requirement. Although it may not be too difficult for an employer to amend its plan prospectively by adding a short waiting period, the retroactivity of this provision to January 1, 1954 will cause discrimination and hardship. Employees who have been receiving disability benefits from plans with a waiting period will receive their exemption retroactively while in the case of employers who were slightly more generous in providing benefits without a waiting period, their employees will be fully taxed upon all benefits received before the plans are amended to conform to the new law.

Moreover, those employees will have to pay the tax out of pocket since there has been no withholding on the benefit payments. Although the provisions of Sections 104 and 105 are stated to be effective as of January 1, 1954, applicable withholding provisions will not become effective until final enactment of the new law.

It was suggested by one writer that the burden of record-keeping under the new law might be great enough to eliminate distinction between "compensation for personal injuries or sickness" and "compensation for loss of wages." Thus the $100 per week exemption would apply to and limit both types of benefits. Whatever loss of exemption this may entail could be more than compensated for by the greater clarity and simplification of treating all benefits under qualified plans on the same basis, according to this writer.

It is suggested that the provisions of Section 105 should be effective only with respect to payments made and received after the date of enactment of this title.

Section 105(e)(1)(C)(ii)(iii) requires that plans providing compensation for personal injuries or sickness must cover a non-discriminatory group of employees. The same standards are applied as are applicable to pension and profit sharing plans. One such standard is that contributions or benefits must be geared solely to compensation. This subject is discussed in detail under Section 501(e)(4). It would be well to note that many plans providing income for personal injuries or sickness are geared to years of service as well, as to compensation. Thus, employees having less than 5 years of service may receive half pay for a maximum of 6 weeks. Employees having between 5 and 10 years of service may receive 75% of pay for a maximum of 9 weeks, etc. This is an additional reason why the language of Section 501(e)(4) should be broadened and clarified.

Sections 401(a), 401(c), 402(b), 403(a)(5), 403(b)

Taxation of Employee

Under Section 401(a) an employee who receives an annuity contract under a non-qualified plan is required to include in his gross income *"the amounts received under such contract for the year received."*

Under Section 401(c) if an employee is entitled to deferred compensation (other than an annuity contract and other than a distribution from a non-qualified pension, profit sharing or stock bonus trust) the amount paid is taxable to the *recipient* in the year in which the *payment is made.*

On the other hand, Section 402(b) provides that if an employee is entitled to a payment from an employees' trust which is not exempt under Section 501(a), the amount actually distributed or *made available* is taxable to him "in the year in which so distributed or *made available.*"

Thus it would appear that an employee who is a beneficiary of a non-qualified pension, profit sharing, or stock bonus trust is treated differently and more severely than an employee who is entitled to an annuity contract or other deferred compensation under a non-qualified plan. This is true because the concept of constructive receipt, i.e., distributed or *made available*, is used only in the case of distributions from non-qualified trusts.

Employer's Deductions

Insofar as the deductibility of payments by an employer under a non-qualified plan is concerned, Section 403(a)(5) provides that the employer is entitled to a deduction "in the taxable year when the amount is actually distributed or made available to a distributee." The above-quoted rule applies apparently in the case of (1) the purchase of an annuity contract taxable to an employee under Section 401(a) or (2) a long-term employment contract payments under which are taxable to the employee as described in Section 401(c) or (3) to payments under a non-qualified trust taxable to the employee as described in Section 402(b).

It is suggested that the language of the above-quoted sections of the law referring to non-qualified plans be made consistent. In other words, if the rules of constructive receipt or constructive payment are to apply, such rules should apply to all types of non-qualified deferred compensation. Conversely, if the rules of constructive receipt are not to apply insofar as certain types of deferred compensation are concerned, such rules should not apply with respect to any non-qualified deferred compensation.

Unless reference is made to the committee report it would appear that an employer who purchases an annuity contract for one employee and assigns it to him would obtain a deduction for the cost of the contract since it could be argued the contract had been *made available* to the employee in the year of assignment. Under Section 401(a), the employee would be required to include in gross income only such amounts as were actually received under the contract. The committee reports make it clear that no such result is intended; the statutory language does not.

Consideration should also be given to the case where an employer purchases for an employee a life annuity contract without death benefits, at a cost, for example, of $20,000. If the employee receives $500 of annuity income and then dies, is it intended that the employer should lose a tax deduction for the remaining $19,500?

Section 403(a)(1)(A)

This subparagraph permits an employer to deduct contributions to a pension trust in an amount which does not exceed 10% of the compensation otherwise paid or accrued during the taxable year to all the "*employees under the trust*" with the limitation that after the past service benefits of an employee are paid up the employer's deduction for any such employee may not exceed the normal cost of his future service benefits.

Subparagraph (A) contains the further sentence:

> "In determining whether past service costs have been fully funded and deducted separate computations need not be made for individual covered employees or classes of employees, *except where different rates or types of benefits apply or where the normal rates of benefits are subject to being offset by benefits provided under some other plan or program.*"

In the first place, the italicized phrase "employees under the trust" is ambiguous. In other sections pertaining to pension trusts references are made to "regular employees" which are defined, to "participants" which are defined, and to "covered employees" which are not defined, and to "beneficiaries under the plan" which are not defined. Here a fifth term is used, namely, "employees under the trust." In a pension plan which provides retirement income for all employees who have 25 or more years of service by age 65, are all employees of the company "under the trust" or does the phrase refer only to employees for whom funding of benefits has commenced. Thus if funding of retirement benefits does not commence until an employee is age 35 and has at least 5 years of service, are only employees who meet these qualifications "under the trust"? Since the purpose of increasing the limitation of deductions to 10% of compensation is to make it easier to determine whether a contribution is deductible without actuarial calculations, it is highly important to specify precisely the employees' compensation to which the 10% limitation applies.

Although the Commissioner's authority to reduce the deduction on account of actuarial calculations has been eliminated, in some cases, the exception specified is troublesome. The effectiveness of a simple flat percentage of compensation deduction is impaired by the necessity of establishing whether "different rates or types of benefits apply or where the normal rates of benefits are subject to being offset by benefits provided under some other plan or program." If there is a full and complete offset of past service benefits so that no past service benefits are provided under the plan in question, the 10% rule should not apply, but how about *partial* offsets?

Section 403(a)(3)(B)

The new provision concerning a profit sharing plan of affiliated groups is confusing in two respects. First, in the case of an affiliated group which files consolidated returns a great deal of bookkeeping is involved for no purpose at all. An exception covering this situation is suggested. Second, the concept of having members of an affiliated group who have profits contribute for other members of the group who do not have profits in accordance with precise allocation standards is difficult to correlate with the new concept that no definite contribution formula is required in the case of any profit sharing plan. The ratio of contributions to be made by the profitable members of the group for the loss member or members of the group under the proposed language of the bill is determined by reference both to current and *accumulated* earnings or profits, a difficult allocation at best. On the basis of the committee report it would appear that the ratio of excess contributions (excess over what if there is no definite formula) should be determined by reference to current profits rather than *accumulated* earnings and profits of the other members of the group.

Section 403

It is suggested that the provisions of Section 403 be broadened to define the term "payment." The Commissioner has taken the position that notes of the employer do not constitute payment. The Court of Appeals for the Third Circuit has reversed. The Commissioner refuses to follow the decision of the Court of Appeals. If the law as adopted permits qualified trusts to lend money to the employer and to hold notes of the employer, there is no reason why the transfer of the employer's notes to such a trust should not constitute "payment."

Section 403(c)

The provisions of Section 403(c) relate to the continued exempt status of trusts which qualify under Section 165(a) of the Internal Revenue Code of 1939. Since these provisions relate to the exemption of income of the trust rather than to the deduction of the contributions of an employer, these provisions should be contained under Section 501(c) rather than in 403(c).

While it is fair and proper that the income of trusts which qualify for exemption under the provisions of Section 165(a) of the 1939 Code and which do not qualify for exemption under Section 501(e) of the 1954 Code should continue to be exempt, the law is devoid of any provisions describing the tax status of trusts which qualify under Section 165(a) of the 1939 Code and which are amended after the enactment of the Internal Revenue Code of 1954. May such amended trusts continue to meet the standards of Section 165(a) or must an amended trust meet the standards of Section 501(e)? The objectives of the Ways and Means Committee with respect to simplification of the law and elimination of advance rulings will be frustrated if two standards of qualification are continued indefinitely. On the other hand, unless the provisions of Section 501(e) are substantially broadened as suggested elsewhere in this memorandum, it is grossly inequitable to require any trust which is amended to meet the standards of the new law. Certainly, amendments to an old trust or plan of a type which do not substantially increase the benefits of the employees should not necessitate qualification under the provisions of Section 501(e). Clarification of the law in this regard is highly desirable. In addition, the tax treatment of future contributions to such a trust and of future payments from such a trust should be clarified.

Section 404

Section 404 entitled "Life Insurance Salesmen" overlaps Section 7701(a)(20). One provision or the other and probably the latter should be omitted.

Section 421

Few criticisms have been received with respect to the "restricted stock option" rules prescribed in Section 421. There is one technical error in this section. The reference to "paragraph (1)" contained in subparagraph (d)(6)(B) should refer apparently to "subparagraph (d)(6)(A)".

Section 501(e)(3)(A)

Paragraph (3)(A) sets out seven categories of regular employees, numbered (i) to (vii), inclusive, who may constitute the participants in a qualified plan. A proviso is added that the classification must not be discriminatoy in favor of employees who are shareholders or key employees. A plan which covers 50 percent of the regular employees, if total regular employees are not in excess of 20, is non-discriminatory. If there are more than 20 regular employees, a plan is non-discriminatory if it covers the greater of 25 percent of such employees, or 10. If a plan does not meet these percentage requiremnts, it must pass the following two tests in order to be non-discriminatory: (1) the 30 percent shareholder benefit test and (2) the 10 percent key employee test. The 10 percent key employee test is passed only if 10 percent or fewer of the participants are key employees; and key employees are defined as employees who are in the highest paid 10 percent of all regular employees (up to a limit of 100 highest paid employees). "Regular employees" are defined to be those who have been employed for a specified period not exceeding 5 years.

The key employee test is particularly objectionable insofar as it relates to plans for *salaried employees*. In an average company the ratio of hourly paid employees to salaried employees may be 5-to-1. The hourly paid employees may be unionized so that the employer can not adopt a plan for their benefit except by collective bargaining. The employer may desire to include provisions in the plan for salaried employees different from those acceptable to the union. Now look at the examples:

(1) Total regular employees	(2) Salaried employees (1 salaried employee per 5 regular employees)	(3) No. of employees required for qualified plan under 25% (or 50%) rule	(4) % Col. (3) to Col. (1)
10	2	5	50%
20	4	10	50%
40	8	10	25%
100	20	25	25%
1,000	200	250	25%
5,000	1,000	1,000	20%
10,000	2,000	1,000	10%
100,000	20,000	1,000	1%

It is apparent from the above statistics that the "key employee test" discriminates against the small employer. Where the ratio of hourly paid employees to salaried employees is 5-to-1, an employer must have at least 5,000 employees before he can adopt a qualified plan for salaried employees.

An objection equally serious is that after a plan qualifies under the mathematical rules of Section 501(e)(3) it may become disqualified unexpectedly due to factors which normally have no bearing on qualification of a deferred compensation plan. Assume, for example, that an employer has 1,000 regular employees of whom 250 are salaried employees and that a pension plan for salaried employees is adopted. If one salaried employee dies and is not replaced in 90 days the plan becomes disqualified; or if the employer decides to hire 50 additional employees only two of whom are salaried employees (total employees 1,050; salaried employees 252; ratio 24%), the plan will soon be disqualified since the number of salaried employees will no longer equal 25% of all regular employees. Such results are unduly harsh and probably unintended.

It is recommended that clauses (vi) and (vii) be rewritten and that the stockholder and key employee tests should be made applicable only to clause (vii). We further recommend that consideration be given to providing that as many as 50% of the employees covered by a plan may come within the definition of key employee. Clauses (vi) and (vii) would then read as follows:

> "(vi) who qualify under any classification which is a combination of any of the classifications specified in Clauses (i) through (v); or
>
> "(vii) who are employed in a designated plant, division, department or other operating unit of the employer or who meet a classification set up by the employer, provided that any classification under this clause (vii) is not discriminatory in favor of employees who are shareholders or key employees. A classification shall be considered discriminatory only if more than 30 percent of the contributions under the plan are used to provide benefits for shareholders or more than 50 percent of the participants in the plan are key employees, except that a classification shall not be considered discriminatory in any case if, in the case of an employer having not more than 20 regular employees, 50 percent or more of all such regular employees are participants in the plan, and in the case of an employer having more than 20 regular employees, 10 of such regular employees or 25 percent or more of all such regular employees, whichever is greater, are participants in the plan. A plan shall be considered as meeting the requirements of this paragraph during the whole of any taxable year of the plan if on one day in each quarter it satisfied such requirements."

Section 501(e)(4)

In order to have a qualified pension or annuity plan Section 501(e)(4)(A) requires in effect that contributions or benefits of or on behalf of the employees must be in proportion to the compensation of each covered employee. Compensation is defined to mean the "basic or regular rate of compensation or total compensation if amounts other than the basic or regular rate of compensation are determined under a definite formula."

While this section, at first blush, seems equitable, the requirement that contributions or benefits must be geared solely to compensation is so restrictive that it would not permit half of all existing pension or annuity plans to qualify in the future. The reason is that contributions or benefits in many existing plans are geared not only to the compensation of an employee but also to his *years of service* or other factors. A pension plan which provides retirement income in an amount equal to 1% of compensation per year of service could not be qualified under the proposed law because an employee having 40 years of service would receive a benefit twice as large in ratio to compensation as an employee having 20 years of service. In such a plan benefits are not geared to compensation; nor are contributions geared to compensation because of variations in Employer contributions and variations in cost on account of actuarial factors such as interest, mortality, gains, etc.

Similarly, pension plans which permit increased retirement income for employees who contribute a part of their own compensation would not qualify because the language of subparagraph A does not differentiate between employer contributions and employee contributions but refers collectively to "contributions . . . *of* or *on behalf of* the employees."

Similarly, the language of Section 501(e)(4)(B) requires that in the case of a profit sharing or stock bonus plan at least 75% of Employer contributions each year, togther with all forfeitures, must be allocated in ratio to the compensation (as defined) of the covered employees. While some discretion may be exercised in allocating the remaining 25% of Employer contributions, no one employee may receive in any year a share which is more than twice as large in ratio to compensation as a lower paid employee. Since 75% of Employer contributions must be geared solely to compensation, the result of the requirement will be to disqualify all profit sharing plans in which Employer contributions are allocated in accordance with *years of service, employee deposits,* or *the age classification of the employee.*

For example, assume an employer contributes annually to a profit sharing fund 5% of net income which amount is credited among the accounts of all employees in accordance with a point system under which one point is awarded for each year of service and one point is awarded for each $100 of annual compensation. Obviously, a plan of this type could not qualify in the future.

Thrift plans which permit employees to deposit, for example, 2%, 4% or 6% of compensation and which provide that the Employer's contribution will be allocated in proportion to the deposits of each employee will not qualify because an employee who elects to deposit 6% of compensation will receive three times the share, in ratio to compensation, of an employee who elects to deposit only 2% of compensation.

Finally, profit sharing plans of the "Sears Roebuck type" will not qualify. Thus, assume the employer agrees to contribute annually 9% of net income to a Profit Sharing Fund. Employees, in order to participate, are required to deposit 5% of their compensation up to a stated maximum. Covered employees are divided into four categories, (1) those having less than 5 years of service, (2) those having between 5 and 10 years of service, (3) those having 10 or more years of service who are not in classification (4), and (4) those having 15 or more years of service who are at least 50 years of age. The Employers' contribution is allocated annually in ratio to employee deposits, except that employees in the first classification receive for each dollar deposited only one share of Employer contributions, the second classification receives two shares for each dollar of deposits, the third classification three shares, and the fourth classification four shares. Such a plan could not qualify in the future because 75% of Employer contributions are not allocated in accordance with compensation alone.

Insofar as the definition of "compensation" is concerned, it is ambiguous because it fails to refer to the element of time. Compensation during what period? Is such definition intended to refer to current annual compensation, average annual compensation, aggregate compensation over the entire service of an employee, final pay, or what? Many pension plans base past service benefits on annual compensation during the year preceding adoption of the plan, whereas future service benefits may be based on average compensation in the future or final pay. Thus benefits may be geared to compensation during two different periods of time. The definition of compensation does not appear broad enough to permit this practice in the future. The definition of total compensation is phrased in a manner which includes "bonuses" only if determined under a definite formula. This provision is more strict that existing law, where bonuses are includible in total compensation if bonuses constitute an integral part of compensation, whether or not computed by reference to a definite formula.

In summary, contributions or benefits under many, many existing plans are geared not only to the *compensation* of the eligible employees at various periods of time but also are geared to *years of service, employee deposits* or to *an age classification* of the employee.

We doubt seriously whether it was intended to prohibit the adoption in the future of any pension or profit sharing plan unless contributions or benefits are geared solely to compensation. We urge that the language of Section 501(e) be broadened to permit qualification of most types of plans which meet the requirements of Section 165(a) of the 1939 Code.

Section 504

Section 504 which formerly applied only to exempt charitable organizations provides that an employees' trust shall be denied exemption if the amounts accumulated out of income during the taxable year or any prior taxable year and which are not actually paid out are unreasonable in amount or duration. The rule against unreasonable accumulations of income has obvious merit in the case of charitable foundations, since charitable foundations are established to distribute their income to accomplish charitable objectives. By contrast, employees' pension and profit sharing trusts are established in order to accumulate income to provide the benefits described in the plans. It is inappropriate that a rule against unreasonable accumulations of income should have application to a qualified pension or profit sharing trust.

Section 505

It is strongly recommended that Section 505 be deleted entirely from the Bill. Among the reasons for this recommendation are the following:

(1) Trustees are already subject to many restrictions of local law with regard to investment as well as to the particular provisions of the specific trust instrument. To add a further governmental restriction on the investment policy of qualified trusts would seem unwise as well as unnecessary so long as such trusts are subject to the over-all requirement that the corpus and income be used for the exclusive benefit of the employees and their beneficiaries. Section 501(e)(2).

(2) A serious burden of policing trust investments would be imposed on the Internal Revenue Service.

(3) No similar investment limitations are imposed upon charitable and other exempt trusts or organizations.

(4) In view of the over-all requirement that a plan must be operated for the exclusive benefit of employees and their beneficiaries, the provisions of Section 505 are unnecessary.

(5) The penalties for failure to comply with Section 505 are too great. An employer may lose its deduction for contributions to a pension, profit sharing, or stock bonus trust because of a Trustee's acts or failure to take action, over which the employer has no control. It seems unfair to penalize the employer by disallowing its deduction and by taxing the income of the trust because of a negligent or inadvertent step taken by the Trustee over which the employer had no control.

(6) The imposition of stringent and arbitrary investment restrictions will discourage the establishment of employee benefit trusts, and the administration thereof by qualified independent trustees.

If, in spite of our arguments, it is deemed appropriate to prescribe the investment policy of qualified trusts, the following suggestions for changes and corrections in Section 505 are made:

(a) Section 505 is modeled apparently after the provisions of Supplement Q of the Internal Revenue Code which apply to regulated investment companies. It should be noted and emphasized that the limitations imposed by Supplement Q on the investments of regulated investment companies apply only to *50 per centum* of the value of total assets. Certainly no more than that proportion of the investments of an employees' trust should be regulated.

(b) While subsections (a)(6) and (7) are apparently aimed at diversification, this result may easily be defeated by investing the entire assets of the trust in one of the other permitted types of investment as, for example, securities of the employer.

(c) The imposition of the limitations of subsections (a)(6) and (7) in terms of "value" raises serious and burdensome problems of investment. Fluctuations in value of trust assets may result in unintentional and, in fact, unknown (until a later date) violation of the provision that the investment restrictions must be met at the close of each quarter. These subsections also raise the well-known problems of valuing closely held stock and valuing real estate. At the very least, the restrictions in these subsections should be based upon cost rather than value.

(d) The 5% limitation on real estate investments makes it practically impossible for small trusts to invest in real estate. Also what is meant by "real estate"? Does it include something less than a fee? What about interests in oil or other mineral rights. The phrase "any one investment" is also ambiguous.

(e) It is submitted that there is no sound reason for prohibiting investment in ordinary life insurance, or life paid up at age sixty-five. Many pension and profit sharing trusts have invested in these types of insurance for sound reasons and with good effect. Under the proposed section, some employees of such a trust would be protected by such life insurance while other employees could not. The proposed section would prohibit investment in so-called "key man" insurance for the protection of the interests of the employees.

(f) The proposed section would permit an investment in "receivables" without defining the term. Assuming a demand note is a receivable, it would appear that all of the funds of the trust could be loaned to a company on a demand note or open account without disqualifying the trust. This is inconsistent with the apparent attempt to require diversification in the holdings of securities.

(g) Investment in "government securities" is permitted without defining the term. Is the term broad enough to include foreign securities, as well as securities issued by instrumentalities of federal, state and local governments?

(h) The list of allowable investments should obviously include mortgages.

(i) Subsection (a)(4) is seemingly in conflict with Section 503(c)(1). Under the former provision, a trust could invest without limit in securities of the employer. Under the latter provision, however, the trust could not lend money to the employer without security even for a short period.

(j) Subsection (a)(5) permits the purchase of securities of regulated investment companies, but not investment in a common trust fund.

(k) The effective date of Section 505 is stated to be March 1, 1954 and both old Section 165 and new Section 501(e) trusts must meet its requirements, quarterly, after such date. The first quarter of the calendar year 1954 ended March 30th. Many trusts would be trapped because of investments made between March 1 and March 30, 1954, unless the effective date is postponed at least until the date the law is enacted.

The defects which should be corrected in Section 505 are so numerous and so complex that we again recommend that this provision be eliminated. If not eliminated, the major purpose of the section should be changed from a determination of what constitutes allowable investments to *a prohibition against acquiring by purchase voting control of any corporation actively engaged in the conduct of a trade or business.*

Section 2039

Section 2039 excludes from the gross estate of a deceased employee the value of "an annuity or other payment" receivable by any beneficiary under an employees' trust which at the time of the decedent's separation from employment met the requirements of section 501(e).

Because of the reference to section 501(e), the status of similar payments from trusts which qualify under the provisions of section 165(a) of the 1939 Code, but which do not qualify under section 501(e) of the 1954 Code is in doubt. Certainly, similar payments from a section 165(a) trust should receive the tax treatment described in section 2039.

The next to last sentence of section 2039 which reads "If such amounts payable after the death of the decedent under a plan described in paragraphs (1) and (2) are attributable *to any extent* to payments or contributions made by the decedent, *no exclusion shall be allowed for any part of the value of such amounts.*" The above-quoted sentence is not clear. It does not seem to conform to the intent of the Ways and Means Committee, as expressed in its report, which intent was that the value of such an annuity should be excluded from the taxable estate of the decedent except for the portion corresponding to the employees' contributions.

ESTATES, TRUSTS, BENEFICIARIES AND DECEDENTS

Subchapter J of Chapter I, Subtitle A

The purpose of this memorandum is to comment on the provisions of H.R. 8300 affecting the income taxation of estates, trusts, beneficiaries and decedents, and to point out the differences between the provisions of H.R. 8300 and the recommendations of the American Bar Association. The memorandum makes suggestions for changes in the present draft of this part of H.R. 8300, and gives the reasons for these suggestions.

The American Bar Association proposed a program for rewriting the provisions of the old Code in this area which involved seven principal amendments to existing law, namely:

(1) eliminating the 65-day and 12-month rules, and using a 2-year throwback device to prevent undue tax avoidance.

(2) limiting the taxation of a beneficiary to the taxable net income of the trust, employing a concept of distributable net income, A.B.A. Sec. 160.7, to accomplish this,

(3) avoiding wasted deductions,

(4) insuring retention of identity as to character of distributions,

(5) codifying the Clifford doctrine,

(6) providing for separate share treatment of a single trust with two or more beneficiaries, A.B.A. Sec. 163.4 (d),

(7) taxing decedent's estates as individuals with an election to be taxed as trusts.

H.R. 8300, Subchapter J, adopts the principles of all but (6) and (7) above. However, the elimination of (6) and more especially the substitution of a 5-year throwback device instead of a 2-year throwback substantially alters the concept of the A.B.A. recommendation. We strongly urge that the separate share treatment be included and that the 2-year throwback be substituted for the 5-year throwback.

The language under H.R. Section 665 and H.R. Section 666, which has been substituted for the language of A.B.A. Section 163.2, is much more difficult to understand and produces complicated computations which are not necessary to prevent tax avoidance through accumulative trusts. Considerable opposition developed to the concept of the "throwback" itself because of its necessary complexity but the Tax Section assured the members of the House of Delegates of the American Bar Association that it would press most vigorously for limitation of the "throwback" to a 2-year period. Attached to this report, as Exhibit A, is an example of the throwback under Subpart D of Subchapter J.

This example took many hours to prepare and is illustrative of the *simplest* example of the operation of the throwback under Subpart D which can be given. If complicating factors likely to be present in the average trust such as a net capital loss or partially tax exempt interest are also considered, the computation might be twice as voluminous and difficult.

The Section's recommendations were designed to fit into the 1939 Code so its Section Numbers and those of H.R. 8300, involving an extensive recodification, will vary widely. The existing law will be referred to as I.R.C. Sec. —, proposed Code as H.R. Sec. —, and our recommendations as A.B.A. Sec. —. This memorandum will follow the organization of Part I of Subchapter J of H.R. 8300 and discuss Subparts A through F in order.

Subpart A. General Rules for Taxation of Estates and Trusts

H.R. SEC. 641.—*Imposition of Tax.*

This section corresponds to I.R.C. Sec. 161 and A.B.A. Secs. 160.1 and 160.2.

The only distinction between H.R. Sec. 641 and A.B.A. Secs. 160.1 and 160.2 is that the former applies to income of estates and trusts whereas the latter applies only to income of trusts. The A.B.A. draft dealing with income of estates is a marked change from existing law and proposes to tax an estate exactly as an individual with but two exceptions—the optional standard deduction of Section 23 (aa) is not allowed, as it is inappropriate to an estate, and an unlimited deduction is allowed for income permanently set aside for charitable purposes. The estate pays the tax on its net income, computed with these two modifications, and no attention is paid to distributions, all of which the heir, legatee or devisee receives tax free as an inheritance under Code Section 22 (b) (3).

To place a deadline on this treatment, which is essential to prevent an unfair tax advantage by large estates or estates whose beneficiaries are in comparatively high tax brackets, and at the same time to reduce the area for litigation as to when administration of an estate has been completed, it is provided in A.B.A. Section 167.6 that if the period of administration extends into a taxable year of the estate which begins more than 51 months after the decedent's death, for that taxable year and thereafter the estate will be taxed as a trust. The period of 51 months was chosen to permit an estate to delay the final distribution until the statute of limitations for assessment of a Federal estate tax deficiency had expired, before being required to comply with the more complicated rules relating to trusts.

As the treatment of an estate as a taxable entity like an unmarried individual, with no deduction for distributions of income to its beneficiaries, could be very unfair to a large estate, particularly a large estate having many beneficiaries, the fiduciary is given the right in A.B.A. Sec. 167.5 to elect that the estate be taxed like a trust. If the election is filed, then the legatees and heirs are likewise taxed in the same manner as are the beneficiaries of a trust.

The adoption of this election will tend to eliminate widespread non-compliance with the law as it is today by individual executors and administrators, particularly of smaller estates, which is caused principally by ignorance of how an estate and its legatees should be taxed. Many smaller estates pay a tax on all of the estate income in complete disregard of the effect of distributions made during the course of administration, and sometimes without knowledge of the distinctions between income distributions, corpus distributions, allowances for widow and dependent children, and the like.

It is recommended that the distinction between taxation of income of estates and trusts as set forth in the A.B.A. draft be adopted and such distinction as contained in the A.B.A. Sec. 167 be inserted as new Subpart E and proposed Subparts E and F be renumbered Subparts F and G, respectively.

H.R. Sec. 642.—*Special Rules for Credits and Deductions.*

This section corresponds to A.B.A. Sec. 160.3 (Disallowance of Certain Deductions), A.B.A. Sec. 160.4 (Credit of Trust Against Net Income), A.B.A. Sec. 160.5 (Credit Against Tax), A.B.A. Sec. 163.3 (Deduction for Charitable Purpose) and A.B.A. Sec. 162.4 (Loss Carryover). Not included in the A.B.A. draft are H.R. Sec. 642 (a) (3) (Dividends Received Credit), H.R. Sec. 642 (f) (Amortization of Grain Storage) and H.R. Sec. 642(e) (Deduction for Depreciation). H.R. Sec. 642 is substantially equivalent to the corresponding A.B.A. Sections and its adoption is recommended.

It is also recommended that H.R. Sec. 662 (d) be inserted in H.R. Sec. 642 as Sub-section (d) (2) and that present Sub-section (d) be renumbered (d) (1) and retitled "LOSS DEDUCTIONS AND CARRYOVERS."

It is also recommended that A.B.A. Sub-section 163.4 (d) be inserted as Sub-section (e) of H.R. Sec. 642 and that existing Sub-sections (e) through (h) be renumbered (f) through (i).

A.B.A. Section 163.4 (d) introduces a new concept of separate share trusts which should facilitate ease of administration and prevent the creation of multiple trusts which can be administered as separate shares of a single trust. It will also prevent much litigation as to what is a separate trust for tax purposes.

Where a single trust has two or more beneficiaries, and the share of each is administered independently in substantially the way it would be managed had the grantor created multiple trusts in the first instance, then for the purpose of determining the amount of distributable net income deductible by the trust and taxable to the beneficiary under A.B.A. Sections 163.1 and 164.1, respectively, each share is treated as if it were a separate trust. Similarly, for purposes of the availability to the beneficiary of his share of a loss carry-over or excess deductions of a trust under A.B A. Section 162.4, the separate share treatment permits a final distribution to him of his share to be considered as a termination of the trust, regardless of the fact that the trust actually continues for other beneficiaries.

The presence of this provision will in many instances eliminate the necessity of a grantor deliberately creating multiple trusts, one for each beneficiary, where he intends each beneficiary to have a definite share. For example, assume a trust with beneficiaries A and B, and distributable net income of $20,000. One-half of the corpus must ultimately go to each beneficiary, together with any income which has been accumulated from his share. In the current year the trustee pays A his share of the income, $10,000., but accumulates B's share. The trustee also advances to A $10,000. from his share of corpus. If it were not for the separate trust rule of this section, A would be taxable on $20,000. By treating A's share as if it constituted a separate trust, the distributable net income of his separate share is $10,000., not the $20,000. distributable net income on the whole trust, and he is taxable only on the income on the whole trust, and he is taxable only on the income distribution of $10,000. The trustee pays the tax on the $10,000. accumulated for B, which is the fair result.

H.R. SEC. 643.—*Definitions Applicable to Subparts A, B, C, and D.*

This section corresponds to A.B.A. Sections 160.7 and 160.6 and its adoption is recommended. The addition of Sec. 643 (a) (4) with its exclusion from "Distributable Net Income" of extraordinary cash dividends and taxable stock dividends for purposes of trusts distributing current income only is a logical addition to the A.B.A. definition.

H.R. Sec. 643 (a) (3) referring to capital gains and losses entering into "distributable net income" provides that capital gains shall be excluded therefrom to the extent that such gains must be allocated to corpus and are not "paid or credited to any beneficiary during the taxable year." Thus, if the gain were "required to be distributed" the A.B.A. draft Sec. 160.7 (a) (1) would tax the beneficiary (at least under Subpart B) but apparently H.R. Sec. 643 (a) (3) and H.R. Sec. 652 would not except to the extent paid or credited during the year. On the other hand, in all cases where the trustee has the power to determine whether a particular capital gain shall be income or corpus, it would appear that such gains would not be a part of the exclusion of H.R. Sec. 643 (a) (3) and would increase distributable income as it is not necessary that such gains "must be allocated to corpus."

It is therefore recommended that the first sentence of H.R. Sec. 643 (a) (3) be changed to read "Gains from the sale or exchange of capital assets shall be excluded except to the extent that such gains are (A) utilized in the determination of the amount distributable to any beneficiary during the taxable year, or, (B) paid, permanently set aside, or to be used for the purpose specified in Sec. 642 (c).

H.R. Sec. 643 (a) (3) provides that capital losses shall decrease "distributable net income" only "to the extent that the excess of gains" * * * for such losses are paid, credited, or required to be distributed to any beneficiary during the taxable year. As a technical matter, H.R. Sec. 643 (a) (3) seems to allow the capital losses to be deducted only to the "extent" there is an excess of gains over losses. Under this interpretation, if there were $10,000. of capital gains and $9,000. of capital losses, the loss would reduce "distributable net income" only in the amount of $1,000. which would apparently result in an addition to "distributable net income" of $9,000. This result appears erroneous. It is probably intended that the capital losses are to be allowed in full as an offset against the gains which would result, in the former example, in an increase of $1,000. in distributable net income. In addition, this provision does not allow the deduction of capital losses in instances where there are no capital gains and where both capital gains and losses are utilized in the determination of the amount available for distribution to any beneficiary. It is, therefore, recommended that the second sentence of H.R. Sec. 643 (a) (3) be changed to read like comparable A.B.A. Sec. 160.7 (a) (2) as follows:

> "Losses from the sale or exchange of capital assets shall be excluded except to the extent that both capital gains and capital losses are, pursuant to the terms of the governing instrument, util-

ized in the determination of the amount distributable to any beneficiary."

It is recommended that this section be adopted in its amended form.

If the distinction in the A.B.A. draft and H.R. 8300 set forth in the second paragraph of comment under H.R. Sec. 641 is eliminated, subsection (b) of H.R. Sec. 643 should delete the words "estate or" in line 4 thereof, and subsection (c) of H.R. Sec. 643 should be eliminated.

Subpart B. Trusts Which Distribute Current Income Only

H.R. SEC. 651—*Deduction for Trusts Distributing Current Income Only.*

This section corresponds to A.B.A. Sec. 161.1 (a) and 161.2. However, the A.B.A. draft in its simple trust treatment also includes income of "its last preceding taxable year." It is possible that this type income is contained in the H.R. definition of "income * * * required to be distributed currently" as the Committee Report (p. A 196) states "The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until shortly after the close of the trust's taxable year." The question now seems to be,—How *close* is *close?* Is the old 65-day rule back with us? For example, would income of a trust for 1954 and 1955 required by the terms of the trust indenture to be distributed in its entirety on March 1, 1955 and March 1, 1956 be considered to be "income * * required to be distributed currently"? If not, should not this type trust, I.E., any trust which, while distributing less than the current trust income, is distributing all of the trust income of the preceding year or of a twelve month period falling partly within the preceding year and partly within the taxable year, be included in Subpart B? If so, the language of A.B.A. Sec. 161.1 quoted above is recommended.

The major distinction between the A.B.A. Sections 161.1 (a) and 161.2 and H.R. Section 651 is that there are two types of trusts which are simple under the A.B.A. draft, but complex under H.R. 8300—the *Dean* type of trust, where the income is distributable in the year subsequent to the year received, and the trust where part of the income is currently distributable with the remainder of the income accumulated until final distribution.

As clarified it is recommended that this section be adopted.

H.R. SEC. 652—*Inclusion of Amounts in Gross Income of Beneficiaries of Trusts Distributing Current Income Only.*

This section corresponds to A.B.A. Sec. 162 with the exception of A.B.A. Subsec. 162.4 which the H.R. 8300 draft places as H.R. Sec. 662 (d) and apparently limits in application to Subpart C, Estates and Trusts Which May Accumulate Income or Which Distribute Corpus. For example, H.R. Section 662 (d) in line 4 thereof, refers to, as an exception, a "deduction under Section 661", not "deductions under Section 651 and 661" which would be correct if H.R. Section 662 (d) was applicable to Subpart B trusts as well as Subpart C trusts and estates.

This omission should be corrected in either of the two following ways: (1) Relocate H.R. Sec. 662 (d) as H.R. Sec. 642 (d) (2) and renumber present H.R. Sec. 642 (d) as H.R. Sec. 642 (d) (1). Present H.R. Sec. 662 (d) could be retitled "Loss Deductions and Carryovers", or, (2) Relocate H.R. Sec. 662 (d) as H.R. Sec. 652 (d) and insert "651 and" on line 4 thereof between the words "Section(s)" and "661". It is suggested that (1) is preferable as the H.R. Sec. 662 (d) should be applicable to both Subparts B and C and therefore should be placed in the General Rules of Subpart A.

Another slight change in the A.B.A. Sec. 162.2 is the exception found in H.R. Sec. 652 (b) to the general rule under which the distributions by a simple trust are treated when received by the beneficiaries as consisting of the same proportion of each class of trust income. The exception "unless the terms of the trust specifically allocate different classes of income to different beneficiaries" presents a tracing problem which the A.B.A. draft sought to avoid in its simple trust treatment.

However, this exception gives greater flexibility to trust draftsmen to provide for a special tax status of a beneficiary even where all of the income is currently distributable. For example, it could be provided that a certain high income beneficiary should receive as his share of the distributable income, a certain amount or all of the tax-exempt interest or capital gain received by the trust or estate during the taxable year.

Two possible technical omissions are noted. Under H.R. Sec. 652 (b) a particular beneficiary can be allocated a particular type income by the trust instrument but there is no corresponding provision in H.R. Sec. 651 which allocates this inclusion as a specific type of deduction as there is in H.R. Sec. 661 (b).

Also, H.R. Sec. 1202 states that the trust shall not be allowed the deduction in respect of any capital gain which is gross income to the beneficiary under H.R. Sec. 652. Should not this reference be to both H.R. Sections 652 and 662?

After correction of the omissions or limitations set out above in this comment, it is recommended that this section be adopted.

Subpart C. Estates and Trusts Which May Accumulate Income or Which May Distribute Corpus

H.R. SEC. 661.—*Deduction for Estates and Trusts Accumulating Income or Distributing Corpus.*

This section corresponds to A.B.A. Sections 163.1 and 161.2 which allow an additional deduction to complex trusts, i.e., trusts which may accumulate income, allocate classes of net income and distribute corpus. H.R. Sec. 661 also includes a deduction for amounts paid or required to be distributed to beneficiaries of estates which A.B.A. Sec. 163.1 allows only upon the election (pursuant to A.B.A. Sec. 167.5) by the executor or administrator of the estate to be taxed like a trust.

It is recommended that this section be adopted.

H.R. SEC. 662.—*Inclusion of Amounts in Gross Income of Beneficiaries of Estates and Trusts Accumulating Income or Distributing Corpus.*

This section corresponds to A.B.A. Sections 164, 163.4 (a), 162.2, 162.3 and 162.4. The only difference in the two drafts is that H.R. Sec. 662 is applicable to beneficiaries of estates whereas the A.B.A. Sections listed above become applicable to beneficiaries of estates only upon the election (pursuant to A.B.A. Sec. 167.5) of the executor or administrator of the estate to be taxed like a trust.

It has been previously pointed out in the discussion under H.R. Sec. 652 that H.R. Sec. 652 (d) should be relocated as H.R. Sec. 642 (d) (2) and that the words "651 and" should be inserted on line 4 thereof between the words "Sections(s)" and "661". It has also been previously pointed out in the discussion under H.R. Sec. 642 that the beneficiaries should be allowed the benefit of the trust's losses upon the termination of a separate "share" of a trust. If the A.B.A. Sec. 163.3 (d) is not included as a part of H.R. Section 662 the next most appropriate place for its insertion is as H.R. Sec. 662 (e).

It appears that there should be inserted in H.R. Sec. 662 (a) (1) (on the third line from the bottom) after the word "amount", which should be changed to "amounts", the following phrase which should be set off by commas and inserted before the word "required", "other than those excluded by Sec. 663 (b)".

It is believed that H.R. Secs. 662 (a) (1) and (a) (2) would be clearer if they were renumbered (a) and (b), respectively, and old (a) (1) was broken up into paragraphs (a) (1) and (a) (2), (a) (2) commencing after the first sentence of old (a) (1). It could be entitled "(2) Pro Rata Rule in Case of Insufficient Distributable Net Income". Old (a) (2) would become new (b) (1) and (2) and (b) (2) would commence with the second sentence of old (a) (2). It could be entitled "(2) Pro Rata Rule In Case of Insufficient Distributable Net Income". This rearrangement would be similar to that provided by A.B.A. Sec. 164.1.

Subject to the foregoing additions, it is recommended that this section be adopted.

H.R. SEC. 663.—*Special Rules Applicable to Sections 661 and 662.*

This section corresponds to A.B.A. Sec. 163.4. H.R. Sec. 663 (a) provides that if any amount other than income of the taxable year required to be distributed currently (except a gift, bequest, devise, or inheritance which under the terms of the governing instrument is required to be paid other than at intervals and other than solely out of income) shall be distributed to a beneficiary, then such amount shall be considered distributed income of the estate or trust to the extent of the distributable net income. It specifically excludes final distributions except to the extent such final distribution consists of gross income of the taxable year (as capital gains allocable to corpus). Gifts or bequests, etc., payable in *installments* as distinguished from being paid at *intervals* are similarly excluded. Charitable distributions are likewise specifically excluded as these distributions are already allowed as a deduction under H.R. Sec. 642 (c) and they should not be allowed as an additional deduction.

A.B.A. Sec. 163.4 similarly provides that if any amount other than income of the taxable year required to be distributed currently shall be distributed to a beneficiary, then such amount shall be considered distributed income of the trust (or estate if the election has been made) to the extent of the distributable net income. Specifically excluded from this general rule by the A.B.A. draft as in the H.R. draft are final distributions except to the extent such final distributions consist of gross income of the taxable year (as capital gains allocable to corpus).

The A.B.A. draft (Sec. 163.4 (e) (2) (is somewhat more restrictive than the H.R. draft in its exclusion from the general rule of "any gift, bequest, devise, or inheritance which is to be paid * * * all at once or in installments * * * (which) under the terms of the governing instrument * * * is to be three or less". The A.B.A. draft also provides that that part of installment payment to the extent of the income of the current taxable year available for distribution to an income beneficiary shall be considered as distributed income, regardless of whether such installment is distributed as income or as principal.

The H.R. draft is therefore more liberal in that the installments are not specifically limited to three. For example, it would appear that under the H.R. exclusion, distributions of $10,000. at age 21, 25, 30, 35 and 40 would be sufficiently apart in time to be considered *installment* payments rather than *interval* payments. The Committee Report (p. A 205), in an example, excludes a $5,000. legacy paid in "several" installments (but not if paid at intervals). How much is "several"? Is it 3, 5, 7 or 9? This question appears to be a fertile field for litigation and should be clarified in a limitation in H.R. Sec. 663 (b) (2) or in the Senate Finance Committee Report.

Also it would appear that the $10,000. installments above mentioned could include income of the current taxable year of the trust available for distribution to an income beneficiary and still not be considered distributed income if pursuant to the terms of the governing instrument such $10,000. payments were not payable solely out of income. The vagueness as to the exact number of installments allowed could be eliminated by inserting in H.R. Sec. 663 (b) (2) the "three or less" installments provisions set out in A.B.A. Sec. 163.4 (e) (2).

Subject to the criticism of the vagueness of Sec. 663 (b) (2) which can be readily clarified, it is recommended that this section be adopted.

Subpart D. Treatment of Excess Distribution by Trusts

H.R. SEC. 665.—*Definitions applicable to Subpart D.*

H.R. SEC. 666.—*Accumulation Distribution Allocated to Five Preceding Years.*

These sentences are so integrated that it is necessary to discuss them together. They are somewhat similar to A.B.A. Sec. 163.2 but are much more difficult to understand, and A.B.A. Sec. 163.2 is by no means simple. In addition it appears that there are some technical errors in these proposed sections.

45094 O—54—pt. 1——29

However, before commenting on construction, a discussion of the two basic policy differences in H.R. Secs. 665 and 666 and A.B.A. Sec. 163.2 appears necessary. These differences are: (a) the "throw-back" of accumulated income to 5 preceding taxable years by the H.R. draft as compared to 2 preceding taxable years by the A.B.A. draft. In the A.B.A. draft the "averaging" period is 3 years as compared to 6 years in the H.R. draft. (b) the elimination from the 5 year "throw-back" of accumulated income by the H.R. draft (Sec. 665 (b) (2)) of "amounts properly paid or credited for the support, maintenance or education of the beneficiary."

The A.B.A. proposal provides that if the distributions to the beneficiaries are in excess of the distributable net income of the trust in the current taxable year, then the excess is to be treated as having been distributed in the preceding year. The beneficiary in computing his income for the current taxable year will include therein his pro rata share of the excess income and the tax on the trust attributable to the trust's having retained that income (which amounts are deemed distributed on the last day of the preceding year) but the tax on these two latter amounts shall not be greater than the additional tax thereon would have been if they had been distributed to the beneficiary in the preceding year.

If the excess distributions to the beneficiaries exceed the retained income of the trust and the tax paid thereon by the trust for the preceding taxable year, the throwback process is repeated and the remaining excess is in turn treated as having been distributed in the second preceding year to the extent of the beneficiary's pro rata share of the trust's retained income for that year and the tax on the trust attributable to the trust's having retained that income. However, these two latter amounts are included in the income of the beneficiary for the current taxable year and the additional tax thereon shall not be greater than it would have been if the trust had distributed these amounts on the last day of the second preceding year.

If the excess distribution in the current year represents in addition an accumulation of an earlier year, the A.B.A. throwback is terminated and the income from the third preceding year (upon which the trust in that year has already paid the tax thereon) is received without tax effect on the beneficiary. Therefore, in effect, the A.B.A. throwback provides the same tax result where income is being distributed currently and where it is accumulated for one or two years and distributed in the third year, i.e., "averages" for a period of three years.

The throwback does not necessitate the re-opening of old returns as the beneficiary computes his additional taxes on the receipts of income from the first and second preceding years and the taxes paid by the trust which is deemed distributed and is granted a credit for the taxes paid on these amounts by the trust in the first and second preceding years. The tax on the receipt in the current year of accumulated income from the 2 prior years (plus the amount of the tax paid thereon by the trust) is limited to the amount of tax which should have been payable by the beneficiary had he received such amounts in the first and second preceding years on the last day thereof.

Naturally certain administrative problems are presented by this recommendation but careful inquiry has revealed that these administrative problems will be minimized by limiting the throwback to two preceding years while at the same time the vast majority of those trusts utilized primarily for tax avoidance purposes will be rendered impotent as a tax avoidance device by these provisions.

H.R. Sec. 666 extends the throwbacks 5 preceding years. In our opinion this extended period is unnecessary to accomplish the desired results and will in addition substantially hinder and complicate the administration of trusts. Therefore, we strongly urge that this period be reduced to the two year throwback recommended by our Association.

The exceptions to the throwback of an excess of less than \$2,000. and accumulations for minors* and unborn beneficiaries will substantially aid in the administration of these sections and present little, if any, problems of tax avoidance. However, the exception previously referred to of amounts paid for the support, maintenance, or education of the beneficiary is too broad and it offers numerous opportunities for tax avoidance which will seriously limit the effectiveness of any throwback. If this exception is retained, we suggest that it be limited to beneficiaries who are students and that the definitions thereof in H.R. Sec. 151 (e) (4) and a specific limitation of the amount excepted from the throwback be applied. If this exception is not deleted or some limitation placed thereon, its effect will be to render inoperative in large part the purposes of the "throwback." In this case serious consideration should be given to the advisability including a complete throwback for the purpose of catching only a few of the instances of tax avoidance through accumulative trusts.

It is therefore recommended that these sections be deleted and that A.B.A. Sec. 163.2 (a)—(d) and (f) be renumbered and re-

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* Should be changed from minority to 21 year exception because of varying state laws dealing with age of majority.

arranged and substituted therefor. A draft of this proposed rearrangement follows this recommendation, which draft includes H.R. Sec. 667 and 668 with necessary rewording.

Subpart D. Treatment of Excess Distributions by Trusts

Sec. 665. Definitions applicable to subpart D.

Sec. 666. Excess distributions allocated to 2 preceding years.

Sec. 667. Denial of refund to trust.

Sec. 668. Treatment of amounts deemed distributed in preceding years.

SEC. 665.—DEFINITIONS APPLICABLE TO SUBPART D.

(a) UNDISTRIBUTED NET INCOME.—For purposes of this subpart, the term "undistributed net income" for any taxable year means the amount by which distributable net income of the trust for such taxable year exceeds the sum of—

(1) the amounts for such taxable year specified in paragraphs (1) and (2) of section 661 (a); and

(2) the amount of taxes imposed on the trust.

For purposes of this subpart, the determination under paragraph (1) shall be made without taking into account amounts deemed distributed under section 666 (c) and (d).

(b) EXCESS DISTRIBUTION.—

(1) DEFINITION.—For purposes of this subpart, the term "excess distribution" for any taxable year of the trust means the amount by which the total of any amount of income for such taxable year required to be distributed currently and any other amounts properly paid or credited or required to be distributed for such taxable year exceeds distributable net income for any taxable year by an amount in excess of $2,000.

(2) EXCEPTIONS.—For purposes of this subpart, "excess distribution" shall be determined without regard to section 666 and shall not include amounts paid or credited or required to be distributed to a beneficiary as income accumulated before birth of the or during the period when such beneficiary was under 21 years of age.

(c) REMAINING EXCESS.—For purposes of this subpart, the term "remaining excess" means the amount, if any, by which the excess distribution exceeds the amount treated under sub-paragraph (1) of Section 666 (a) as having been distributed by the trust on the last day of its first preceding taxable year. If the trust does not have undistributed net income for its first preceding taxable year, the term "remaining excess" means that portion of the excess distribution which does not exceed the undistributed net income of the trust for its second preceding year.

(d) TAXES IMPOSED ON THE TRUST.—For purposes of this subpart, the term "taxes imposed on the trust" means the amount of the taxes imposed for any taxable year on the trust under this chapter without regard to this subpart. The amount determined in the preceding sentence shall be reduced by any amount of such taxes allowed, under sections 667 and 668, as a credit to any beneficiary on account of any accumulation distribution determined for any taxable year.

(e) PRECEDING TAXABLE YEAR.—For purposes of this subpart, the term "preceding taxable year" does not include any taxable year of the trust beginning before December 31, 1953.

SEC. 666—EXCESS DISTRIBUTIONS ALLOCATED TO 2 PRECEDING YEARS.

(a) EXCESS DISTRIBUTION TREATED AS DISTRIBUTED IN FIRST PRECEDING YEAR.—In the case of a trust which for a taxable year beginning after December 31, 1953, is subject to subpart C, the amount of the excess distribution of such trust for such taxable year shall be deemed distributed in the first preceding taxable year in the following amounts:

(1) If the excess distribution is not less than the undistributed net income of the trust for its first preceding taxable year, then the trust shall be deemed to have distributed on the last day of its first preceding taxable year an amount within the meaning of paragraph 2 of Section 661 (a) equal to the aggregate of (A) its undistributed net income for that year, and (B) an amount equal to the total taxes deemed distributed for that year.

(2) If the excess distribution is less than the undistributed net income of the trust for its first preceding taxable year, then the trust shall be deemed to have distributed on the last day of its first preceding taxable year an amount within the meaning of paragraph 2 of Section 661 (a) equal to the aggregate of (A) its

excess distribution, and (B) an amount equal to the pro rata portion of taxes deemed distributed for that year.

(b) EXCESS DISTRIBUTION TREATED AS DISTRIBUTED IN SECOND PRECEDING TAXABLE YEAR.—In the case of a trust which for a taxable year beginning after December 31, 1953, is subject to subpart C, the amount of the excess distribution of such trust for such taxable year shall be deemed distributed in the second preceding taxable year in the following amounts:

(1) If the remaining excess is not less than the anticipated net income of the trust for its second preceding year, then the trust shall be treated as having distributed on the last day of its second preceding taxable year the amount within the meaning of paragraph 2 of Section 661 (a) equal to the aggregate of (A) the undistributed net income for that year, and, (B) an amount equal to the total taxes deemed distributed for that year.

(2) If the remaining excess is less than the undistributed net income of the trust for its second preceding taxable year, then the trust shall be treated as having distributed on the last day of its second preceding taxable year an amount within the meaning of paragraph 2 of Section 661 (a) equal to the aggregate of (A) the remaining excess, and, (B) an amount equal to the prorata portion of the taxes deemed distributed for that year.

(c) TOTAL TAXES DEEMED DISTRIBUTED.—If any portion of an excess distribution for any taxable year is deemed under paragraph 1 of sub-sections (a) or (b) to be an amount within the meaning of paragraph (2) of section 661 (a) distributed on the last day of any preceding taxable year, and such portion of such excess distribution is not less than the undistributed net income for such preceding taxable year, the trust shall be deemed to have distributed on the last day of such preceding taxable year an additional amount within the meaning of paragraph (2) of section 661 (a). Such additional amount shall be equal to the taxes imposed on the trust for such preceding taxable year. For purposes of this subsection, the undistributed net income and the taxes imposed on the trust for such preceding taxable year shall be computed without regard to such excess distribution and without regard to any excess distribution determined for any succeeding taxable year.

(d) PRO RATA PORTION OF TAXES DEEMED DISTRIBUTED.—If any portion of an excess distribution for any taxable year is deemed under paragraph (2) of sub-sections (a) or (b) to be an amount within the meaning of paragraph (2) of section 661 (a) distributed on the last day of any preceding taxable year and such portion of the excess distribution is less than the undistributed net income for such preceding taxable year, the trust shall be deemed to have distributed on the last day of such preceding taxable year an additional amount within the meaning of paragraph (2) of section 661 (a). Such additional amount shall be equal to the taxes imposed on the trust for such taxable year multiplied by the ratio of the portion of the excess distribution of the undistributed net income of the trust for such year. For purposes of this subsection, the undistributed net income and the taxes imposed on the trust for such preceding taxable year shall be computed without regard to the excess distribution and without regard to any excess distribution determined for any succeeding taxable year.

SEC. 667.—DENIAL OF REFUND TO TRUSTS.

The amount of taxes imposed on the trust under this chapter, which would not have been payable by the trust for its preceding taxable years had the trust in fact made distributions at the times and in the amounts deemed under section 666, shall not be refunded or credited to the trust, but shall be allowed as a credit under section 668 (b) against the tax of the beneficiaries who are treated as having received the distributions.

SEC. 668.—TREATMENT OF AMOUNTS DEEMED DISTRIBUTED IN PFECEDING YEARS.

(a) AMOUNTS TREATED AS RECEIVED IN PRIOR TAXABLE YEARS.—The total amounts which are treated under section 666 as having been distributed by the trust in the first or second preceding taxable years shall be included in the income of a beneficiary or beneficiaries of the trust when paid, credited, or required to be distributed to the extent that such total would have been included in the income of any beneficiary or beneficiaries under section 662 (a) (2) and (b) had such excess distribution actually been properly paid, credited, or required to be distributed on the last day of such preceding taxable year. The tax of the beneficiaries attributable to the amounts treated as having been received on the last day of such preceding taxable years of the trust shall not be greater than the aggregate of the taxes attributable to those amounts had they been included in the gross

income of the beneficiaries on such days in accordance with section 662 (a) (2) and (b).

(b) CREDIT FOR TAXES PAID BY TRUST.—The tax imposed on beneficiaries under this chapter with respect to amounts included in income of such beneficiaries in accordance with subsection (a) shall be credited with a pro rata portion of the taxes imposed on the trust under this chapter for the first or second preceding taxable years which would not have been payable by the trust for such preceding taxable years had the trust in fact made distributions to such beneficiaries at the times and in the amounts specified in section 666.

H.R. SEC. 667.—*Denial of Refund to Trusts.*

This section is comparable to A.B.A. Sec. 163.2 (e) and it is recommended that it be adopted.

H.R. SEC. 668.—*Treatment of Amounts Deemed Distributed in Preceding Years.*

This section is comparable to A.B.A. Sec. 164.2 (a) and (b) and it is recommended that it be adopted.

If the above recommendation as to the rewording of H.R. Sec. 665 and 666 are adopted, it will be necessary to delete the word "accumulation" on line 6 and 7 and substitute therefor the word "excess".

Subpart E. Grantors and Others Treated as Substantial Owners

H.R. SEC. 671—H.R. SEC. 678.

These sections are comparable to A.B.A. Sec. 166. The differences are minor, and the language of the two drafts is identical in most of the sections. It is recommended that these sections be adopted. A detailed discussion follows:

H.R. SEC. 671.—*Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners.*

This section, except as references to section numbers, is identical to A.B.A. Subsection 166.1.

H.R. SEC. 672.—*Definitions and Rules.*

This section, except as to arrangement which is improved, is comparable to A.B.A. Subsection 166.2, except that H.R. Sec. 672 (c) establishes a rebuttable (as distinguished from the A.B.A. irrebuttable) presumption that a "related or subordinate party" is subservient. This presumption can be overcome "by a clear preponderance of the evidence."

Also deleted from A.B.A. Subsection 166.2 is Subsection (e) which provides that if the grantor or a related or subordinate party has the power to remove a trustee without cause, then such persons shall be deemed to possess the powers of that trustee.

The effect of this addition and deletion from the A.B.A. draft is to eliminate two irrebuttable presumptions which are a bit restrictive but which would prevent litigation. The comparable A.B.A. provisions are preferred.

It is recommended that this Section be adopted.

H.R. Sec. 673.—*Reversionary Powers.*

This section, except as to the addition of Subsection (b) which was amended on the floor of the House of Representatives, is comparable to A.B.A. Sec. 166.4.

It is recommended that Subsection (b) be deleted altogether, together with its limiting amendment, and that charitable trusts be treated under the General Rule of Sec. 673 (a). As amended by the deletion, it is recommended that this Section be adopted.

H.R. Sec. 674.—*Power to Control Beneficial Enjoyment.*

This section corresponds to A.B.A. Sec. 166.5. H.R. Sec. 674 (a) states the general rule that the grantor shall be taxed when any nonadverse party has a power to control the beneficial enjoyment of the property. Certain limited types of beneficial enjoyment are then excepted from the general rule by subsection (b).

H.R. Section 674 (b) (1) excepts a power to pay income in discharge of the grantor's support obligation, except to the extent actually paid for such support. A.B.A. Sec. 166.5 does not contain this provision but it appears desirable to correlate with the similar exception in H.R. Section 667 (b).

H.R. Sec. 674 (b) (6) does not contain the additional exception to the limitation which allows any person to provide for after-born or after-adopted children. See the last 4 lines of H.R. Sec. 674 (b) (5). The A.B.A. printed draft before the addition of the mimeographed material at the annual meeting (August, 1953) contained this same omission.

It is recommended that with the correction of the omission set forth in the last paragraph that this Section be adopted.

H.R. Sec. 675.—*Administrative Powers.*

This section is comparable to A.B.A. Sec. 166.6. However, Paragraph (2) and (3) of H.R. Sec. 675, corresponding to A.B.A. Sec. 166.6 (b), is slightly less restrictive. It appears that the change is very slight and that adequate safeguards are retained to prevent any abuse.

It is recommended that this Section be adopted.

H.R. Sec. 676.—*Power to Revoke.*

This section corresponds to A.B.A. Sec. 166.5 (a) and I.R.C. Sec. 166 under which income of a revocable trust is taxable to the grantor.

As in the case of a power under H.R. Sec. 674, it seems appropriate to correlate this section with the short-term provision of H.R. Section 673. The A.B.A. draft (Sec. 166.5) includes the "power to revoke" as a "power of disposition". It appears that this subject is of sufficient importance to warrant the repetition by a separate additional section.

It is recommended that this section be adopted.

H.R. Sec. 677.—*Income For Benefit of Grantor.*

This section corresponds to A.B.A. Sec. 166.3 and I.R.C. Sec. 167 under which income is taxed to the grantor by reason of a power to vest the income in him or apply it to his benefit. The taxability of this power is correlated with the 10 year provision of H.R. Sec. 673 so consistent treatment is provided under that Section and under H.R. Sec. 676. Inclusion of taxability to the grantor under this section of income which *is* distributed to him, rather than inclusion under I.R.C. 22 (a) as in the present law, is appropriate and consistent with the A.B.A. draft. Accordingly I.R.C. Sec. 677 is made applicable to mandatory as well as discretionary trusts of the type described.

H.R. Sec. 677 has taken the 10-year corpus reversion rule and extended it, in part, to income which will be earned after 10 years. Thus, a grantor could establish a trust in which he has the power to take the income, or accumulate it for his benefit, and apparently he would not be taxable on the income therefrom (unless distributed) after 10 years. It should be noted that a power in one other than the grantor to take the income in the 11th year would make such other person taxable thereon under H.R. Sec. 678 (a) (1).

H.R. Sec. 677 taxes the grantor on income which may be applied or distributed to the payment of premiums upon insurance on the life of the grantor, none of the incidents of ownership which are possessed by the grantor even though such income is not applied or distributed. This standby power to have the income applied for this purpose is analogous to the standby power to apply the income for the support of dependents which is exempted from tax under H.R. Sec. 677. It is strongly recommended that this power be excepted from those considered taxable under H.R. Sec. 677. The language of A.B.A. Sec. 166.3 (a) (3) and (b) (2) could readily be added to H.R. Sec. 677 (a) (3) and (b).

As limited, it is recommended that this section be adopted.

H.R. Sec. 678.—*Person Other Than Grantor Treated as Substantial Owner.*

This section corresponds to A.B.A. Sec. 166.8, except for the addition of H.R. Sec. 678 (c) which provides that where the person other than the grantor has the power to use the income in satisfaction of his own support obligation, then he shall not be taxable except to the extent the income is so applied. The Committee Report (A 217) described this as "a liberalizing provision."

It appears that this provision instead of being "liberalizing" introduces an extension of the *Mallinckrodt* rule into an area not considered presently taxable, i.e., a person being considered taxable on discretionary distributions to dependents, even though he could not vest the income in himself. Does this give rise to an implication that such person might be a beneficiary of a non-discretionary support trust and taxed on its income instead of it being taxed to the income beneficiary?

As a technical matter, the last sentence of H.R. Sec. 678 (c) provides that a corpus distribution for support might be taxable to the *grantor* as a beneficiary of such a trust. It is probably intended that the person taxable thereon is the "owner of the power", not the grantor.

It is recommended that subsection (c) be deleted and the Section adopted as amended.

Reciprocal Trusts:

This subject is covered by A.B.A. Sec. 166.7 but is omitted in H.R. 8300. This problem is badly in need of statutory coverage and a provision comparable to A.B.A. Sec. 166.7 should be inserted.

Subpart F. Miscellaneous

H.R. Sec. 681.—*Limitation on Charitable Deduction.*

This section corresponds to A.B.A. Sec. 163.3(c) and is identical except for the change in limitations to I.R.C. Sec. 162(g). Its adoption is recommended.

H.R. Sec. 682.—*Income of an Estate or Trust in Case of Divorce.*

This section corresponds to I.R.C. Sec. 171, except for subsection (a) thereof which makes the provisions applicable to spouses separated under a written separation agreement, as well as those who are divorced or legally separated under a court order or decree. This change correlates the provisions with H.R. Sec. 71.

Its adoption is recommended.

H.R. Sec. 683.—*Applicability of Provisions.*

This section in subsection (b) would change the tax liability of trusts and estates for 1953 and 1954 with respect to distributions made within the first sixty-five days of 1954 in reliance upon existing law. This would necessitate many refund claims by beneficiaries, a lumping of 2 years income in one, etc. It is suggested that the change in the 65-day rule be made effective as to distributions within the first 65 days after the end of the first taxable year commencing after December 31, 1953.

H.R. Sec. 691.—*Recipients of Income in Respect of Decedents.*

This section corresponds to Sec. 126 of the Internal Revenue Code of 1939. However, the provisions of the existing law had been revised to incorporate several major changes in its present scope.

Section 126 of the present law deals with the troublesome question of the treatment of income items received by an estate, legatee, or similar person in situations in which the income item is traceable to the activity of the decedent. Its provisions were added by the Internal Revenue Code of 1942 and were designed to overcome the preceding requirement that there be included in the decedent's last return all of the income accrued up to the date of his death. Section 126 represented a compromise between the possible methods of treating the accrued income for income tax purposes which had been tried prior to Section 126. These two methods were the capitalization at death of the value of the right to the income accrued up to the death which gave such interest a section 113 (a) (5) basis, and the other was the inclusion of the entire accrued income in the decedent's last return. The first method allowed accrued income to escape income tax entirely whereas the second method had the effect of bunching more than 12 months income in one year. In Section 126 the income is taxable to the person who received it after decedent's death and such person receives a credit for the estate tax which may have been paid on this item. This treatment has met with general approval but the situation has arisen repeatedly which indicates that continued hardship has existed by bunching all income in the last return of the person who receives the right to the decedent's income on such person's death. This person has generally been the widow of the decedent. Sub-section (a) (1) of H.R. Sec. 691 amends the provisions of the present law in order to apply to existing principle to the case of one or more subsequent decedents. Conforming amendments are contained in Sub-section (a) (2) and (3) of this section to provide that the term "transfer" does not include transmission at death to the estate of successive decedents and under (a) (3) the character of the income determined by reference to the decedent is continued for successive decedents.

It is recommended that this change be adopted.

The second major change in the provisions of the existing law is contained in Sub-section (a) (4) of H.R. Sec. 691 which makes installment obligations items of income in respect of a decedent and replaces the provisions of section 44 (d) of the Internal Revenue Code of 1939. The requirement of a bond in such cases has been eliminated. Sub-section (a) (2) has been expanded to include within the meaning of the term "transfer", the satisfaction of an installment obligation at other than face value.

It is recommended that this change in Section 126 be adopted.

The provisions of Sub-section (c) of H.R. Sec. 126 have been changed to correspond with the basic revision of Sub-section (a) (1) making it applicable to successive decedents and authorizing the deduction in respect of the estate tax imposed not only on the estate of the immediate decedent, but of any prior decedent. The second amendment in Sub-section (c) has been made to coordinate the provisions of this section with the revised rules of Part I of Sub-chapter J. Where the estate or trust includes in its gross income income in respect of a decedent but such income is distributed to a beneficiary of such estate or trust the deduction on account of the estate tax attributable to such income is allowable to the beneficiary to the extent such income is distributed.

Certain other minor changes in Sub-section (c) have been made to correlate with other new statutory provisions.

It is recommended that this section be adopted.

Discussion

The express statement should be made in Section 126 that it is an exception to the general rule of Section 113 (a) (5) that the basis after death is the estate tax value in the decedent's estate and that the basis of an item covered by H.R. Sec. 691 (Sec. 126) is its basis in the hands of a decedent.

It is recommended that it be made clear, either in the Bill or in the Report of the Senate Finance Committee, that the amendments made by the Bill were not intended to extend Section 126 treatment to income in respect of decedents not includible in gross income under Section 126 (a) of the 1939 Code because the decedent died too early for Section 126 to apply.

Under present law it seems reasonably clear that Section 126 can never apply to income in respect of a decedent dying prior to January 1, 1954; that, moreover, it would not apply to income in respect of a decedent dying after December 31, 1933 and before January 1, 1943 unless a proper election was filed, pursuant to Section 134 (g) of the Revenue Act of 1942, to have Section 126 retroactively applicable.

H.R. Sec. 692.—*Income Taxes of Members of the Armed Forces.*

This section corresponds to Section 154 of the Internal Revenue Code of 1939 relating to abatement of tax of deceased members of the armed forces. It eliminates the termination date presently set forth for January 1, 1955.

It is recommended that this section be adopted.

Exhibit "A"

H.R. 8300—Subchapter J

ESTATES, TRUSTS, BENEFICIARIES, AND DECEDENTS

Example of Throw-Back Under Subpart D

Section

665 (d) The throw-back does not apply to any taxable year of the trust beginning before December 31, 1953. Hence it does not apply to accumulations of income in 1953 and earlier years.

Hypothetical Facts:

Trust is reporting on the calendar year cash receipts basis.

Trustee must pay $5,000 each year to A and has discretion to pay income or corpus to either A or B, or both.

A is single, has no income except from the trust ($5,000), and paid a tax for 1954 (on $3,900) of $818.

B is single, had an income of $5,600 from outside sources (total $8,600) and paid a tax for 1954 (on $7,140) of $1,702.

Neither A nor B have any 1955 income except from the trust.

1954

643(a)	Distributable net income of trust		$20,000
661(a)(1)	Currently distributable income to A	$5,000	
661(a)(2)	Discretionary payment to B	3,000	8,000
	Balance subject to tax		$12,000
	Tax on $12,000 paid by Trustee		3,362
665(a)	Undistributed net income for 1954		$ 8,638

1955

643(a)	Distributable net income of trust		$20,000
661(a)(1)	Currently distributable income to A	$5,000	
661(a)(2)	Discretionary payment to A	10,000	
661(a)(2)	Discretionary payment to B	12,000	
661(a)	Limitation on trust deduction	27,000	20,000
	Balance subject to tax		None

Accumulation Distribution in 1955

Section			
665(b)	The amount by which the Sec. 661(a)(2) deduction		$22,000
	exceeds distributable net income	$20,000	
	reduced by Sec. 661 (a) (1) deduction	5,000	15,000
	Accumulation distribution of 1955		$ 7,000

Allocation of 1955 Accumulation Distribution to 1954

666(a)	The 1955 accumulation distribution is now treated as if it were a Sec. 661(a) (2) deduction of the trust in 1954		$7,000

PLUS

666(c)	An amount equal to the 1954 taxes of the trust	$3,362	
	"multiplied by the ratio of the portion of the accumulation distribution ($7,000) to the undistributed net income ($8,638) of the trust for such year."	x 7,000	
		$8,638	

OR

$$\frac{\$7,000 \times \$3,362}{\$8,638} = 2,724$$

	Accumulation distribution allocated to 1954		$9,724

Tax of Trust in 1954 Under Throw-Back

643(a)	Distributable net income of trust in 1954		$20,000
661(a)(1)	Currently distributable income to A	$5,000	
661(a)(2)	Discretionary payment to B	3,000	
661(a)(2)	Accumulation distribution to A and B	9,724	17,724
	Balance subject to tax		$ 2,276
	Tax which would have been paid on $2,276		448
667	Refund to trust denied ($3,362 minus $448)		$ 2,914

Allocation Betwen A and B for 1955 Before Throw-Back

Section

662(a)(2) From the $27,000 total distribution in 1955, A and B each include an amount which bears the same ratio to that part of distributable net income ($20,000) which is not currently distributable ($15,000) as the non-currently distributable amounts received by each ($10,000 to A and $12,000 to B) bears to the aggregate ($22,000) of such amounts.

for A this would be $\dfrac{x}{\$15{,}000} = \dfrac{\$10{,}000}{22{,}000}$, or $6,818

for B this would be $\dfrac{x}{\$15{,}000} = \dfrac{\$12{,}000}{22{,}000}$, or $8,182

Total $15,000

Before throw-back A reports:

662(a)(1)	Currently distributable income	$ 5,000	
662(a)(2)	Allocation of discretionary payment....	6,818	
	Total for A so far..	11,818	
662(a)(2)	Before throw-back B reports:...................	8,182	
	Distributable net income for 1955..............		$20,000

Allocation of Throw-Back Between A and B

668(a) How is the throw-back accumulation distribution of $9,724 allocated between A and B? H.R. 8300 does not say.

It could be either 15/27 to A and 12/27 to B, or, since $5,000 is a mandatory payment to A, on the basis of 10/22 to A and 12/22 to B. The provision in Sec. 662(a)(2) relating to the allocation of distributions in excess of distributable net income indicates that the latter allocation would have been chosen by Congress if the point had been considered.

Assuming the latter will be correct, either by amendment or by litigation, the allocation will be:

10/22 of $9,724 to A...............	$4,420
12/22 of $9,724 to B...............	5,304
Total	$9,724

Tax Effect on A

Section		
668(a)	Tentative 1955 tax computed on:	
662(a)(1)	Currently distributable income	$ 5,000
662(a)(2)	Allocation of discretionary payment	6,818
	Subtotal	$11,818
668(a)	Throw-back distribution	4,420
	Total	$16,238
	Less: Exemption and standard deduction	1,600
	Taxable income	$14,638
	Tentative tax on $14,638	$ 4,560
	Tentative tax on $11,818 (minus $1,600)	$ 2,723
	Tentative 1954 tax computed on:	
661(a)(1)	Actual distribution in 1954	$ 5,000
668(a)	Throw-back distribution	4,420
	Subtotal	$ 9,420
	Less: Exemption and standard deduction	1,542
	Taxable income	$ 7,878
	Tentative tax on $7,878	$ 1,923
	Tax paid for 1954	818
	Attributable to throw-back	$ 1,105
	(forward)	1,105
668(a)	1955 tax without throw-back	$ 2,723
	Total 1955 tax before credit	$ 3,828
	Less:	
668(b)	Credit for 10/22 of $2,914 tax of trust in 1954 which would not have been paid if trust had distributed $9,724 more in 1954 than its actual distribution	1,326
	Tax of A for 1955	$ 2,502

Tax Effect on B

Section		
	Tentative 1955 tax computed on:	
662(a)(2)	Allocation of discretionary payment	$ 8,182
668(a)	Throw-back distribution	5,304
	Total	13,486
	Less: Exemption and standard deduction	1,600
	Taxable income	$11,886
	Tentative tax on $11,886	$ 3,357
	Tentative tax on $8,182 (minus $1,418)	$ 1,518
	Tentative 1954 tax computed on:	
661(a)(2)	Actual distribution in 1954	$ 3,000
	Other income	5,600
668(a)	Throw-back distribution	5,304
	Total	$13,904
	Less: Exemption and standard deduction	1,600
	Taxable income	$12,304
	Tentative tax on $12,304	3,531
	Tax paid for 1954	1,702
	Attributable to throw-back	$ 1,829
668(a)	1955 tax without throw-back	1,518
	Total 1955 tax before credit	$ 3,347
	Less:	
668(b)	Credit for 12/22 of $2,914 tax of trust in 1954 which would not have been paid if trust had distributed $9,724 more in 1954 than its actual distribution	$ 1,588
	Tax of B for 1955	$ 1,759

COMMENTS

No. 1 Except for a trust with a single beneficiary, the foregoing example is the *simplest* example of the operation of the throw-back which can be given.

If the trust has a charitable beneficiary, has capital gains or losses, tax-exempt interest, extraordinary cash dividends or taxable stock dividends, foreign income, or (if the new partial exclusion of dividends received, Sec. 116, becomes law) ordinary dividends on corporate securities, the computations increase in complexity. Also, if the accumulation distribution (the throw-back) exceeds the undistributed net income of the trust for its preceding year, recomputations of the beneficiaries' tentative tax in the earlier years, up to the fifth preceding year, must be made.

No. 2 Sec. 668(a) includes the amount of the throw-back distribution in the income of the beneficiary for the current year, but contains a limitation that the tax attributable to this inclusion shall not exceed the tax which would have been payable by the beneficiary had the throw-back distribution in fact been made in the earlier year or years. In the example "Tax Effect on B," the 1955 tentative tax of $3,357 is limited to $3,347 because the tax attributable to the throw-back in 1955 ($3,357 minus $1,518) is $1,839, whereas the tax attributable to the throw-back if received and taxed in 1954 is $1,829, or $10 less.

Had B had $10,000 of outside income in 1954, instead of $5,600, his 1954 tax attributable to the throw-back would have been $1,980, and, since the limitation would not apply, his 1955 tax would be $3,357, or only $10 higher, although his 1954 income was $4,400 higher.

PARTNERS AND PARTNERSHIPS

Subchapter K of Chapter I, Subtitle A

MATTERS OF SUBSTANCE

I. In General

The House Bill accepts some and rejects some of the premises of the ABA (American Bar Association) and ALI (American Law Institute) Draft. It appears that the draftsmen of the House Bill attempted to reproduce the ABA and ALI Draft in a simplified form. Unquestionably, the ABA and ALI Draft is complicated. It is believed, however, that complete simplification is not likely to be obtained along the lines followed in the House Bill.

The House Bill provisions dealing with taxation of partnerships need considerable redrafting to make them equitable and workable. It is our purpose to suggest some of the points which need attention.

II. The Nature of a Partnership for Tax Purposes

A. *The House Bill Provision.*

There is no provision in the House Bill setting forth a general rule as to whether the aggregate or entity theory of partnerships is to be applied in areas not specifically covered by statutory provisions.

B. *Comments on the House Bill Provision.*

This omission from the House Bill leaves in the realm of uncertainty and for eventual judicial determination such questions as:

1. Whether section 24(b) is inapplicable where a partnership sells property to a corporation controlled by the partners. The taxpayers unsuccessfully so contended in *Commissioner* v. *Whitney*, 169 F. 2d 562 (2d Cir. 1949).

2. How much of the rent received by a corporation from a partnership, where some but not all of the partners are stockholders of the corporation, is includable as personal holding company income under section 502(f) of the 1939 Code. See also in this connection section 503(a)(2) of the 1939 Code.

III. Section 704. Partner's Distributive Share

A. *The House Bill Provision.*

Subsection (c) deals with distributive shares of gain or loss on contributed property and provides that such gain or loss "shall be allocated among the partners in the same manner as items arising with respect to any other property acquired by the partnership."

B. *Comments on the House Bill Provision.*

1. It is not made clear either in the House Bill or in the Committee Report that the taxable gain or loss must be distributed in the proportions specified in the partnership agreement for the sharing of the economic gain or loss. Unless this is done, we can have questions concerning a partnership agreement that provides for an equal sharing of all gains or losses but that the taxable gain or loss on the sale of contributed property shall be allocated in a different manner. Perhaps such a distinction in the partnership agreement should be permitted. See comments below with respect to the rigidity of the House Bill provision under any other interpretation.

2. If, as apparently was intended, the taxable gain or loss on contributed property must be distributed in the same ratios as the economic gain or loss (considering the contributed value as contrasted with the contributor's basis), then the House Bill is subject to criticism for being too rigid in its application. A partner who contributes property at an agreed value that differs from his tax basis must by statute receive a tax benefit or suffer a tax detriment upon sale (or depreciation) of the contributed property by reason of the partnership's taxable gain or loss being allocated to all of the partners in proportion to their partnership interests.

Illustration:

a. *Facts.*

A and B want to form a partnership, to which A will contribute \$100 cash and B will contribute property having a value of \$100 but a tax basis to B of only \$10. The partners are aware that B's tax basis will carry over to the partnership, but A insists that he does not wish to pay a tax on the \$90 taxable gain in the event the contributed property is sold. B is quite willing to pay the tax if this can be worked out.

b. *Discussion.*

Apparently, under section 704(c) it cannot be provided in the partnership agreement that B will be taxable on the \$90 of pre-contribution appreciation. Furthermore, A and B cannot originally form the partnership with cash contributions and have the partnership purchase the property from B, for the reason that B will have a 50 per cent interest in the partnership and, consequently, under section 707(b)(2) a sale by him to the partnership would be treated as a contribution of property. See the later discussion of this point in connection with section 707.

C. *The ABA and ALI Draft.*

This Draft offered various elections under which the pre-contribution appreciation or depreciation could either be shared by all of the partners under the partnership agreement or allocated solely to the contributing partner.

D. *Recommendation.*

Either the various elections outlined in the ABA and ALI Draft should be offered or, in the alternative, it should be specified that if the partnership agreement specifically so provides, the pre-contribution appreciation or depreciation may be allocated solely to the contributing partner. Anything less than this sets up a highly undesirable state of inelasticity.

IV. Section 705. Adjustments to Basis of Partner's Interest

A. *The House Bill Provision.*

The House Bill requires a separate computation for each partner of the basis of his partnership interest. This basis is determined by using as a start the partner's tax basis for property contributed (section 722) and increasing that original basis under section 705 for his distributive share of taxable income, nontaxable income, and a percentage depletion adjustment, and decreasing it by his distributive share of losses, nondeductible expenditures, and distributions.

B. *Comments on the House Bill Provision.*

1. The House Bill sets up a rule that is unnecessarily complicated and which will involve an historical analysis that may run back over many years.

Illustration:

a. A and B have been partners in a law partnership for 12 years. They decide to terminate their partnership. Their capital accounts are equal, so each takes one-half of the cash and one-half of the furniture, fixtures, library and other assets.

b. It seems absurd in a case like this to require A and B to go back over a period of 12 years and build up a tax basis for their respective partnership interests which will take into account every contribution to the partnership, every withdrawal from the partnership, and all of the items of partnership gain or loss.

2. To obtain the final answer with respect to a partner's tax basis for his interest in the partnership requires reference to sections 705, 722, 731, 732, 733, 737 and 751. This complex cross-referencing should be avoided.

3. Section 705(a)(1)(C) provides that a partner's distributive share shall be increased by "the excess of the deduction for percentage depletion allowed to the partnership over the adjusted basis to the partnership for the property subject to such depletion." It is not at all clear whether the intended adjustment is the difference between the annual excess, if any, of percentage depletion over cost depletion, or whether it is only the excess, if any, of the total percentage depletion that has been allowed to the partnership on a particular property over the partners' tax basis of that property. The provision in the House Bill is inadequate, whichever interpretation is intended.

4. In determining a partner's tax basis, you must take into account his distributive share of taxable income of the partnership and losses of the partnership. However, under section 702(a), the partnership accounts separately for various classes of income and deductions. There is no concept of taxable income of the partnership or losses of the partnership under section 702(a) that will fit into the pattern of section 705. To be theoretically correct, the plus and minus adjustments under section 705 should be for each of the nine classifications of income or deduction under section 702(a). This emphasizes the rather absurd complication of House Bill section 705.

C. *The ABA and ALI Draft.*

Section X752(a) of ALI Preliminary Draft No. 160 sets up a very simple rule that "The basis of a partner's interest in the aggregate partnership property shall be the portion which he would be entitled to receive, upon the winding up the partnership, of the aggregate basis of all of the partnership properties (including money)." Cross reference is then made to the cases of the elective rules involving contributed property.

D. *Recommendation.*

The ABA and ALI Draft approach to the problem should be adopted in the House Bill. While the ABA and ALI Draft provision was designed particularly for application of the "shift of basis" theory, it also can be made applicable even though the shift of basis is not adopted.

V. The Shift of Basis Theory as to Contributed Property

A. *The House Bill.*

The House Bill provides for no shift of basis and that each partner shall retain as the initial basis for his partnership interest an amount equal to the adjusted tax basis of the property contributed. However, under section 704(c) of the House Bill, upon the sale of contributed property the entire taxable gain, including the pre-contribution appreciation or depreciation, is shared by all of the partners in their profit or loss ratios.

B. *Comments on the House Bill.*

1. The radical part of the change in the present concept of taxation of partnerships with respect to contributed property is that which makes all of the partners taxable on the pre-contribution appreciation or depreciation portion of the gain or loss on sale of the contributed property. Having gone that far, there seems little reason for not taking the balance of the step and accepting the shift of basis concept. The difference between the shift of basis and the retention of basis, as under the House Bill, is not reflected until the dissolution of the partnership, and the tax benefit or detriment at that time may depend upon the amount of other capital gain or loss in that year. The difference, being in the future and being speculative,

is not one that is likely to be of primary concern to the partners.

2. The shift of basis concept greatly simplifies the statutory pattern, particularly with respect to the determination of the partners' bases for their respective partnership interests.

C. *The ABA and ALI Draft.*

Under this Draft, the shift of basis is the general rule, with various elections permissible in the event the partners do not wish to shift basis.

D. *Recommendation.*

The ABA and ALI proposal for shift of basis should be adopted as a general rule, with adequate provision made for the partners to elect some other rule if they so desire.

VI. Section 706. Taxable Years of Partner and Partnership

A. *The House Bill Provision.*

Section 706(c)(1) provides that the taxable year of a partnership is not closed as the result of death of a partner, admission of a new partner, liquidation of a partner's interest, or sale of a partner's interest, except as to a partner whose interest is fully liquidated, and except in the case of "a termination of a partnership" as defined in section 761(e).

B. *Comments on the House Bill Provision.*

1. Under section 761(e)(1)(B), there is a termination of a partnership if within a 12-month period more than 50 per cent of the total interest in partnership capital and profits "is transferred to persons who are not partners." The Committee Report at page 67 refers to "the sale of an interest" and at page A238 to the case where an interest "is transferred." It is not clear whether the death of a partner owning more than a 50 per cent interest in capital and profits and the resulting transfer of his interest to his estate would be such a transfer as to constitute a "termination" of the partnership under section 761(e)(1)(B). It should be made clear that a sale to outsiders and not a transfer to the estate or to the heirs of a deceased partner is contemplated.

2. Presumably, under section 761(e)(1)(B) in the case of death of a partner and a sale by the executor of that partner's interest (assuming it to be an interest of 50 per cent or more) within a 12-month period, the partnership fiscal year would be terminated as of the date of death of the deceased partner. Thus, the determination of when the partnership year is terminated for income tax purposes may be deferred for a matter of almost 12 months, during which period of time the returns of the various individual partners reporting their shares of income from the partnership must be filed. The administrative job of going back and amending all previously filed returns is burdensome. Furthermore, substantively there appears to be no justification for terminating the partnership fiscal year at the date of death because of a subsequent sale of the decedent partner's interest. Until the interest of the deceased partner in the partnership is terminated, the fiscal year of the partnership should not be closed.

3. The provisions of section 761(e)(1)(B) may operate unfairly as to junior partners. If junior partners continue the firm, they should not be required to report income from the partnership on a short taxable year basis because a principal partner dies and his interest is sold, or a principal partner sells his interest while living. The only test that is meaningful is whether the partnership activities are continued and, if so, the partners whose interests continue should not be burdened with the problems of termination of a fiscal year.

4. Questions of interpretation arise with respect to the provisions of section 761(e)(1)(B) dealing with a transfer of "more than 50 per cent of the total interest in partnership capital and profits."

a. Presumably, a transfer of a 75 per cent interest in profits would not terminate the partnership if the partner had only a 49 per cent interest in the capital.

b. What is the crucial date for determining the 50 per cent interest in capital and profits? For example, if at the date of death the decedent had an interest in both capital and profits in excess of 50 per cent, but prior to the sale of his interest to outsiders his capital interest had been reduced to 40 per cent, would section 761(e)(1)(B) be applicable?

5. Section 761(e)(2) provides that in the case of merger or consolidation of partnerships, the partnership whose fiscal year continues is the one whose members own an interest in capital and profits of the resulting partnership of at least 50 per cent. This unrealistically assumes that the biggest of the predecessor partnerships is the continuing partnership. This assumption is not necessarily accurate. It may well be that a younger and smaller but more aggressive partnership is the one that will be carrying on. It would seem better to let the principal parties decide which partnership continues, inasmuch as the possibilities of tax avoidance in this situation are not great.

C. *The ABA and ALI Draft.*

Section X751 of ALI Preliminary Draft No. 160 contains a provision that is a model of simplicity and clarity. The test is simply one of whether the partnership activity continues. If the activity does continue, then the partnership year is not closed to those partners who retain an interest in the profits of the partnership.

D. *Recommendation.*

The ALI Draft should be adopted in lieu of the cumbersome provisions of the House Bill, which are believed to be inequitable in their operations, as well as difficult to interpret and apply.

VII. Section 707. Transactions Between Partner and Partnership

A. *The House Bill Provisions.*

1. Section 707(b) provides that if a partner has an interest of 50 per cent or more in the capital, or an interest of 50 per cent or more in the profits, a sale of property by that partner to the partnership will be disregarded, and it will be treated as a contribution of property with a carry-over of the adjusted tax basis of the contributing partner.

2. Section 707(c) states that a salary paid to a partner shall be treated as salary, rather than as a distribution of profits, only "to the extent determined without regard to the income of the partnership."

B. *Comments on the House Bill Provisions.*

1. Section 707(b) sets up a requirement that makes the relationship between the partners too rigid for practicality.

As has previously been noted, the House Bill is subject to criticism as being too rigid in requiring that the partners retain their respective tax bases for contributed properties and requiring that all partners share the tax consequences of the pre-contribution appreciation or depreciation upon sale of the contributed property. Section 707(b) should not be so broad as to prohibit the use of a taxable sale by a partner to a partnership as one avenue of adjusting the potential inequities when low basis property is contributed to a partnership. Under the 50 per cent rule, it will be impossible in any case of a partnership of two men with equal interests for there to be a tax adjustment worked out through the sale of the property to the partnership.

2. The restriction in section 707(c) of the treatment of a partner's salary to payments determined without regard to the income of the partnership is unnecessary to prevent tax avoidance, and is unrealistic considering the extent to which compensation is customarily tied in with profits of the business. The Commissioner of Internal Revenue and the courts can adequately protect the interest of the revenue in the extremely few cases where the Treasury will be unfairly deprived of tax through transferring income from one year to another by the employment of an artificial salary.

C. *The ABA and ALI Draft.*

Under section X755 of ALI Preliminary Draft No. 160, all transactions between a partner, unless acting in his capacity as a partner, and the partnership shall be considered as though made between the partnership and one who is not a partner, with the exception of losses on the sale to a partnership and certain sales of depreciable property by a principal partner. In the case of a sale of depreciable property, the transaction will be disregarded as a sale only if the property is sold by a partner having an interest of 80 per cent or more in the partnership and is depreciable property having a useful life of five years or less.

D. *Recommendation.*

1. The House Bill provisions with respect to the sale of property to a partnership should be changed to reflect the more liberal treatment of the ABA and ALI Draft. This is a point

of considerable importance inasmuch as it affords another means of the partners adjusting among themselves the tax consequences of pre-contribution appreciation or depreciation.

2. A salary paid to a partner should be considered as salary, even though determined on the basis of partnership income, except in those cases where it is fixed for tax avoidance purposes, in which event the Commissioner should be granted the discretion to disregard the salary arrangement in whole or in part. A comment in the Committee Report with reference to salaries fixed for tax avoidance purposes will suffice. The statute should not be burdened with any more "principal purpose to avoid or evade" provisions.

VIII. Section 722. Basis of Contributing Partner's Interest

A. *The House Bill Provision.*

The basis of an interest in a partnership acquired by a contribution ot property is the contributor's adjusted basis of the property contributed.

B. *Comments on the House Bill Provision.*

Comment has previously been made in connection with the discussion of sections 704 and 707 dealing with a partner's distributive share on the inadvisable rigidity of the House Bill provision as to contributions. An additional point that should be noted is the complete absence of any provision corresponding with the ABA and ALI Draft with respect to the contribution to a partnership of jointly-held property. The theory of the ABA and ALI Draft is that a special provision should be made in this case which would accord to the contributors, if partners, the same tax consequences as though they were tenants in common who were not partners. The purpose was to avoid technical problems of deciding whether under a particular set of facts tenants in common or other tenants holding joint interest in property should be considered technically as constituting a partnership.

C. *The ABA and ALI Draft.*

Under section X753(e) of ALI Preliminary Draft No. 160, where two or more partners contribute to a partnership property in which they held undivided interests prior to contribution, the basis of each for his interest in the partnership *and the allocation of gain or loss* *on sale or depreciation of the contributed property* are determined by reference to the tax basis of each contributor for his undivided interest in the contributed property.

D. *Recommendation.*

The special situation of contribution of jointly-held property should be recognized, as was done in the ABA and ALI Draft, so as to avoid troublesome problems of whether a particular situation involving joint ownership of property is a partnership or not.

IX. Section 731. Extent of Recognition of Gain or Loss on Distribution

A. *The House Bill Provisions.*

Gain or loss is recognized to the partners upon the distribution of property to the extent of the difference between the partner's tax basis for his partnership interest and the adjusted basis to the partnership of the property distributed. Under section 732(b), there is a limitation on this rule in that if the total adjusted basis of property distributed to a partner exceeds the total fair market value, then the fair market value shall be used in determining the partner's taxable gain or loss on the distribution.

B. *Comments on the House Bill Provisions.*

1. A fundamental premise of the ABA and ALI Draft was that there should be no taxable gain or recognizable loss upon the distribution of property to a partner, except in the case where the distribution of cash exceeds the basis of the partnership interest. The House Bill violates this concept, and it is believed that this is a matter of extreme importance. So long as the distribution is in property other than cash, it is contrary to the general taxing theories of the Code to recognize gain or loss. If gain or loss is not recognized on the contribution, logically there should be no gain or loss upon the distribution. Tht greatest of flexibility in forming and dissolving partnerships should be encouraged, and the recognition of gain or loss upon distributions of property operates in the opposite direction.

2. In determining the taxable gain or loss to the distributee, the House Bill uses the partnership's adjusted basis of the property distributed. This is a concept in the law that is new and startling. Some ridiculous results can flow from using the

adjusted basis, rather than fair market value of property. Furthermore, the provision of section 734 for the adjustment of basis of undistributed partnership property is completely inadequate to bring into balance the partnership's tax basis for its undistributed properties and the remaining partners' bases for their partnership interests.

Illustrations:

a. A contributes $10,000 in cash, B contributes Blackacre having a present value and an adjusted cost basis of $10,000, and C contributes Whiteacre having a present value of $10,000 but an adjusted cost basis of $1,000. Subsequently, Whiteacre is distributed to A in retirement of his interest at a time when its fair market value is $10,000. A has a deductible loss of $9,000, although Whiteacre has a fair market value of $10,000, so that economically A has sustained no loss. It is true that A will make up for his $9,000 deductible loss at some future time when he sells Whiteacre, which will have a tax basis to him of only $1,000. This, however, does not assure that the net tax result will be fair either to A or to the Treasury Department, since either the loss on distribution may be of no tax advantage to A, or the gain on subsequent sale of Whiteacre may be offset by some other loss.

b. Following the distribution of Whiteacre to A in Illustration *a.*, the remaining partnership assets consist of $10,000 cash and Blackacre, having a fair market value and a tax basis of $10,000. Thus, the partnership assets have a total tax basis of $20,000. B has a $10,000 tax basis for his partnership interest, but C has only a $1,000 basis, making a total of $11,000 for the two partners' tax bases for their partnership interests. Of course, some day this will be equalized when the partnership is dissolved and C picks up a $9,000 gain upon distribution in liquidation. However, the situation during the interim is a weird one and hardly justifiable on sound tax principles.

c. Cash and properties, as in Illustration *a.*, are contributed to a partnership. However, at the time of the distribution of Whiteacre to A, it has a fair market value of $16,000. A's one-third interest in the total partnership assets at fair market value is only $12,000 (one-third of $10,000 cash, plus one-third of Blackacre worth $10,000, plus one-third of White-acre worth $16,000). To offset a distribution of property worth $16,000 when his partnership interest is only worth $12,000, A contributes an additional $4,000 in cash, and thereafter Whiteacre is distributed to him. A has a basis for his partnership interest of $14,000, and he receives property having an adjusted cost basis to the partnership of $1,000. A, therefore, sustains a $13,000 deductible loss. It will be noted that when compared with Illustration *a.*, A's loss is $4,000 greater, which represents his additional cash contribution. It is indeed unusual that one can increase a deductible loss by payment of an additional amount as part of the purchase price.

d. Following the distribution of Whiteacre to A in Illustration *c.*, the remaining partnership assets consist of $14,000 cash and Blackacre with a fair market value and tax basis of $10,000. The cost basis to the partnership of its assets is thus $24,000. B has a tax basis for his interest of $10,000, and C has a tax basis of $1,000, making a total of only $11,000 for the partners' bases for their partnership interests.

3. The ABA and ALI Draft attempted to stay away from any requirement of determining fair market value of distributed property, feeling that the administrative problems of determining valuation should be avoided. The House Bill uses the fair market value concept only as a floor in the case where the adjusted tax basis exceeds fair market value. However, this situation is likely to come up a sufficient number of times to be burdensome to both the Treasury Department and the taxpayers.

4. Another inadequacy of the House Bill provision is that different tax results are reached as to the partners, dependent upon whether property is distributed in kind to a partner or is sold and proceeds distributed. Thus, take the case of a contribution by A of $10,000 cash, a contribution by B of Blackacre having a present value and a tax basis to B of $10,000, and a contribution by C of Whiteacre having a present value of $10,000 and a tax basis to C of $1,000. These are the basic facts of Illustration *a.* in paragraph 2, above. If Whiteacre, having a fair market value of $10,000, is distributed to A, he has a taxable loss of $9,000, and neither B nor C has any taxable gain or loss. If, however, Whiteacre is sold for $10,000

cash, A, B and C will each have taxable gain of $3,000 on the sale (their respective interests in the partnership gain of $9,000) and, in addition, A will have a $3,000 loss on the distribution to him of $10,000 cash. Thus, A will come out with a net result of no gain or loss, while B and C will each have a $3,000 gain. This is quite a different result from a $9,000 taxable loss to A, offset by a $9,000 gain when he sells Whiteacre.

C. *The ABA and ALI Draft.*

Under ALI Preliminary Draft No. 160, a distinction was recognized between current distributions of a partnership and distributions in winding up a partnership, on retirement of a partner, or reduction of his interest. In the case of current distributions (ALI Preliminary Draft No. 160, section X754), no gain or loss is recognized on the distribution, and the partner's tax basis of the property distributed carries over to the distributee. In the case of a distribution in winding up a partnership, on retirement of a partner, or the reduction of his interest, ALI Preliminary Draft No. 160, section X757, provides that gain is recognized to the distributee only to the extent of the excess of money received by him over the basis of his partnership interest. Losses are not recognized to the distributee partner unless the loss exceeds twice the value of the distributed property, other than money. Furthermore, under section X757(e), the bases of the remaining partnership properties are adjusted to reflect the distribution to the retiring partner of property having a tax basis differing from its distribution value. The ALI Draft also calls for the recognition of gain or loss to the remaining partners in the cases of certain distributions. This last provision recognizes a fact that the House Bill overlooks, namely, that where property of a partnership is distributed to a partner in retirement of his interest, the other partners, in effect, are selling their interests in that property to the retiring partner in consideration of his interest in the remaining partnership properties. Failure to appreciate this point may be responsible for a large portion of the unsound results flowing from the provisions of the House Bill.

D. *Recommendation.*

Sections 731 to 734, inclusive, of the House Bill should be rewritten so as to be more in line with the theories of ALI Preliminary Draft No. 160.

X. Section 736. Payments to a Retiring Partner or a Deceased Partner's Successor in Interest

A. *The House Bill Provision.*

Section 736(a) provides as a general rule that payments made within five years after the partner's retirement or death shall be considered a distributive share of the partnership income, and that payment made more than five years after the partner's retirement or death shall be considered income to the remaining partners and shall be excluded from the gross income of the recipient.

B. *Comments on the House Bill Provision.*

There is little justification for drawing an arbitrary line of five years as to whether the payments shall be treated as taxable income to the recipient or to the remaining partners. If the retiring partner or the deceased partner is to have a continued interest in profits for a period in excess of five years, there is no reason why the recipient should not pay tax on the distributive share of such income for the entire period specified in the partnership agreement. The statement at page A230 of the Committee Report that payments made after expiration of the five-year period shall be treated "as a gift of such amounts to the recipient" is an amazing new concept.

C. *The ABA and ALI Draft.*

Section X758 of ALI Preliminary Draft No. 160 provides that if an estate of a deceased partner has an interest in the partnership profits, then the estate shall be treated as a partner and taxed on those profits without any arbitrary time limit being placed on such procedure.

D. *Recommendation.*

The five-year provision of section 736 should be eliminated.

XI. Section 743. Optional Adjustments to Basis of Partnership Property

A. *The House Bill Provision.*

In the case of death of a partner or sale of a partnership interest, the partnership may elect to adjust the bases of its properties to reflect fair market value in the case of death or selling price in the case of a sale. The tax benefit of an adjustment, upon sale of the properties by the partnership, is not confined to the estate of the deceased partner or to the purchaser of the partnership interest, but goes to all of the members of the partnership in accordance with their profit and loss ratios.

B. *Comments on the House Bill Provision.*

The purpose of the ABA and ALI recommendation in this respect was to give the estate of the deceased partner or the purchaser of a partnership interest full recognition of the stepped-up basis of the partnership properties. The House Bill, however, spreads this stepped-up adjustment to all of the partners, and, consequently, does not give a fair break to the estate or to the purchaser.

Illustrations:

A has a 10 per cent interest in a partnership. Among the partnership assets at the time of A's sale of his partnership interest to X is inventory having a cost basis of $100 but a fair market value of $500. A sells his interest on the basis of a $50 value for his 10 per cent interest in the partnership inventory. Following the sale to X, the partnership sells the inventory for $500.

Under the House Bill, the $40 appreciation in A's interest in the partnership inventory would be allocated to all of the members of the partnership in determining the gain on sale of the inventory. X, as successor to A, would receive the benefit of only $4 of the stepped-up basis. On the sale of the inventory by the partnership, X would have taxable income of $36, although he had paid $50 for A's interest in the partnership inventory and should have no taxable gain. The other partners would get a windfall to the extent of the $36 of increased basis allocated to them. This assumes that section 751 is not applicable.

C. *The ABA and ALI Draft.*

Under the ABA and ALI Draft, the stepped-up basis in the above example would only benefit X. Upon the subsequent sale of the inventory by the partnership, there would be a partnership income of $360 (selling price of $500, minus original cost of $100, plus $40 adjustment on sale of A's interest). X would have no taxable income resulting from the sale of the partnership interest, and the other partners would report the full $360 of income.

D. *Recommendation.*

The House Bill is definitely deficient in this respect. If there is to be an elective adjustment, the decedent partner's estate or the distributee of the interest is the only one entitled to the benefit of the stepped-up basis.

XII. Section 751. Unrealized Receivables or Fees and Inventory or Stock in Trade

A. *The House Bill Provisions.*

This section is designed to prevent the tax avoidance possibilities under existing law with respect to a sale of an interest in a partnership whose underlying assets consist of unrealized receivables or fees or of appreciated inventory or stock in trade. The section is specifically made nonapplicable to a distribution in kind of the described items.

B. *Comments on the House Bill Provisions.*

This section of the House Bill clearly demonstrates the fallacy of attempting to apply a consistent entity theory. The provisions regarding sale of a partnership interest seem generally adequate, but those dealing with a distribution in kind to one or more partners fall far short of according fair treatment to all partners and open opportunities for important tax avoidance.

Illustration:

ABC is an equal partnership. Its assets consist of the following:

	Basis	Value
Cash	$ 90	$ 90
Ranch	90	90
Cattle	-0-	90
TOTALS	$180	$270

A, B and C each has a basis of $60 for his partnership interest. The cattle are distributed to A in retirement of his interest.

1. Section 751 is inapplicable by virtue of section 751 (a)(3)(A).

2. Under section 731, A has a capital loss of $60 (his $60 basis for a partnership interest, minus the partnership's adjusted

basis of the cattle distributed, which is zero). A's tax basis of the cattle is zero and upon sale, he will have ordinary income of $90. (Section 736.)

3. The continuing BC partnership has assets whose tax bases total $180 and also are worth $180. If these assets are distributed in kind to B and C, each will have a capital gain of $30. (Section 731.)

4. What a splendid opportunity for tax avoidance! A has a large ordinary loss in another transaction, so that it will cost him nothing to report the entire $90 ordinary income on sale of the cattle. B and C, who are in high tax brackets, pick up their gain, all of which is attributable to the cattle inventory, as capital gain. Furthermore, B and C can postpone the capital gain so long as they continue the BC partnership.

C. *The ABA and ALI Draft.*

1. By applying the aggregate theory, the ABA and ALI Draft recognizes that a distribution in kind of unrealized receivables or inventories truly represents an exchange of the interests of the continuing partners in the distributed property for the interest of the distributee in the remaining partnership property.

2. Thus, in the illustration under *B.*, above, distributee A is exchanging his one-third interests in cash and the ranch for the two-thirds interest of B and C in the cattle. Basically, gain is recognizable to A, B and C on the transaction. However, the gain is deferred, at least in part, by applying capital gain in reduction of basis of capital assets and ordinary income in reduction of basis of noncapital assets.

D. *Recommendation.*

1. The House Bill should be revised to avoid its present inequities of tax consequences among the partners.

2. The House Bill should be revised to eliminate the present tax avoidance possibilities. It is not fair to the Treasury Department that tax minimization of all partners be possible through adroit selection of the property to be distributed in kind to a particular partner.

3. The ABA and ALI Draft on this point (ALI Preliminary Draft No. 160, section X761) is complicated, but it should be adopted unless a simpler but equally satisfactory statutory formula can be evolved.

XIII. Effective Dates of New Partnership Provisions

The partnership provisions, whether in the House Bill or the ABA and ALI Draft, introduce new concepts of taxation. The provisions are complicated and difficult for even a technician to comprehend. To make them effective prior to January 1, 1955, will be unfair to those who engage in business as partners. A reasonable period of time should be allowed for taxpayers to familiarize themselves with the new provisions.

DRAFTING COMMENTS

I. Section 704(b). Distributive Share Determined by Income or Loss Ratio

A. *The House Bill Provision.*

A partner's distributive share of any item of income or deduction is determined in accordance with his distributive share of the general partnership income or loss if there is no agreement as to his distributive share of the particular item and if "(a) the principal purpose of any provision in the partnership agreement with respect to a partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle."

B. *Comments on the House Bill Provision.*

1. Terminology involving "principal purpose" of evasion or avoidance has been markedly unsuccessful when employed in section 129. It is believed that it would be equally unsuccessful in the proposed use.

2. There is no greater opportunity for tax avoidance through "rigging" the distributive shares of income or loss with respect to a particular item than there is in setting the general distributive shares of profit or loss. It is believed that more successful results would be obtained if this provision were omitted from the statute and, instead, there was a comment in the Committee Report that the Committee is satisfied the courts will see to it that the distributive shares specified in the partnership agreement reflect economic realities, rather than tax fictions.

C. *The ABA and ALI Draft.*

There is no specific reference in the suggested statutory language of the ABA and ALI Draft which would bring into play the test principal purpose to avoid or evade taxes. The situation is taken care of at page 69 of the Comments on ALI Preliminary Draft No. 160 that "a partner will be entitled to a distributive share of partnership loss only if under the partnership agreement he actually suffers a monetary loss." A comment in the Committee Report seems preferable to the use of statutory language which in the past has proved ineffective.

D. *Recommendation.*

It is believed that section 704(b)(2) should be eliminated and that the Committee Report should cover the possibilities of a partnership agreement designed for the purpose of avoiding or evading taxes.

II. Section 704(d). Limitation on Allowance of Losses

A. *The House Bill Provision.*

A partner's distributive share of the partnership loss is limited to the extent of the basis of his partnership interest or to the extent the partner is obligated to repay such loss as provided in section 737. Under section 737, if a partner is obligated to make repayment to the partnership for a distribution to him or for his share of a partnership loss, the amount of his obligation shall be considered a loan from the partnership.

B. *Comments on the House Bill Provision.*

1. The House Bill does not make it clear whether the partner's obligation to make repayment must be unqualified in order that the transaction be considered a loan. This will be particularly material in a situation where a partner's share of the partnership loss is in excess of the basis of his partnership interest and his only liability for such excess arises out of subsequent partnership profits, if any.

The Committee Report at page A231 indicates that where a partner withdraws money from the partnership under an obligation to repay it "either in cash or by applying against the amount of the withdrawal his share of future partnership income," such amount shall be considered as a loan by the partnership to the partner. This may be broad enough to cover the situation commented on above. It is believed, however, that it should be made unmistakably clear, at least in the Committee Report, that the excess of a partner's distributive share of the loss over the basis of his partnership interest shall be considered a loan, even though his obligation to repay is contingent upon future profits and he has no personal liability.

2. Presumably, if the limitation of section 704(d) is applicable with respect to one partner, his distributive share of a loss would then be allocated to the other partners. This would have to follow as an interpretation of the partnership agreement with respect to distributive shares of the loss in such a situation. It would seem advisable to clarify this point, at least by comment in the Committee Report.

C. *The ABA and ALI Draft.*

Section X750(c)(1) of ALI Preliminary Draft No. 160 provides that the partner's distributive share shall be determined by the partnership agreement. There is no restriction in that Draft predicated upon the basis of the partnership interest or the existence of a loan transaction. Instead, in the accompanying comments it is specified that under proper interpretation of the suggested statutory language "A partner will be entitled to a distributive share of partnership loss only if under the partnership agreement he actually suffers a monetary loss."

D. *Recommendation.*

It is believed that a statement of legislative intent in the Committee Report would be preferable to attempted inclusion of the limitation in the statute itself.

III. Cross-Referencing

A. *The House Bill.*

At the end of each section of ALI Preliminary Draft No. 160 there is a cross reference to other sections containing definitions of terms used in the preceding section. The House Bill completely drops this idea.

B. *Comments on the House Bill.*

The House Bill lacks adequate warning of definitions found elsewhere. Thus, section 706(c)(1) refers to "a termination of a partnership," but gives no clue that this is a term of art that is specifically defined in section 761(e).

C. *The ABA and ALI Draft.*

The idea of cross references at the end of sections is one of the important improvements in statutory construction of the ALI Draft. See, for example, the cross references following section X756 of ALI Preliminary Draft No. 160.

D. *Recommendation.*

There should be cross references to definitions in other sections as was done in ALI Preliminary Draft No. 160.

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MISCELLANEOUS INCOME TAX PROVISIONS

The bill achieves the laudable purpose of embodying prior recommendations of many responsible groups including the American Bar Association. Most of our prior recommendations have been adopted in substance but not all of them. The bill also makes many substantive changes on matters which we have been considering but with respect to which we have as yet made no formal recommendation. In some respects the bill coincides in substance with the trend of our thinking; in other respects it is radically different; and in still other respects there are differences largely of detail. In many respects the bill contains new and different provisions which we have not had the opportunity to study except during the limited period since the bill was released to the public.

The omission from this summary of certain important provisions should not be considered as evidencing any lack of interest therein on our part but rather as representing our policy of refraining from taking a position on broad policy matters primarily within the fields of economics and broad fiscal policy. Among such aspects as to which we express no views are the provisions with respect to mitigation of the double tax on corporate dividends, the amounts of personal exemptions and credits for dependents, and acceleration of time for payment of corporate income taxes.

The following summary is broken down into headings which follow primarily the divisions into subchapters of the proposed new Internal Revenue Code. Our comments are confined to subtitle A, Income Taxes, chapter 1, Normal Taxes and Surtaxes, except for certain related provisions in subtitle F. Our comments are not directed to all of chapter 1 but only to those portions which are not specifically allocated to other committees of the section of taxation.

Matters Relating to Filing of Returns

Subtitle A, Chapter 1, Subchapter A

Subtitle F, Procedure and Administration, insofar as related to the foregoing

A. TIME FOR FILING RETURNS AND OTHER DOCUMENTS

1. Returns in general

The time for filing returns and other documents is specified in subtitle F, chapter 61, subchapter A, part V. In general, under section 6072, calendar year income tax returns are to be filed on April 15 except those of corporations and a few special entities. Corporations will file on March 15 except for an automatic 3 months' extension of time for filing the return under section 6081 (b). However, such extension of time does not eliminate the requirement that a corporation pay the first instalment of its estimated tax by March 15.

The above schedule of timing appears to be a compromise between the desires of taxpayers for additional time in which to report the results of increasingly complex transactions under a complex tax structure and the fiscal needs of the Treasury including the requirements of the Internal Revenue Service for a reasonably balanced flow of material to be processed. We are not at the present time prepared to state any objections to this general scheduling of time for filing of returns except for the items mentioned under 2 below. On the whole, it appears desirable that taxpayers and those attending to their affairs be granted a limited additional period within which to prepare and file returns as provided by the bill.

2. Amended declarations of estimated tax returns in lieu of declarations and payments due thereon

The American Bar Association in March 1954, adopted our recommendation to change to February 15 the final date for filing amended declarations of estimated tax and for filing returns in lieu of declarations and for payments due thereon. H. R. 8300 does not reflect such change. The change would be accomplished in the following three sections:

Section 6083: Change January 15 to February 15 wherever appearing.

Section 6153: Change January 15 to February 15 wherever appearing.

Section 6015 (f): Change the words "January 15 or February 15" wherever appearing to "February 15"; and omit the references to farmers.

H. R. 8300 recognizes the difficulty of filing or amending a final estimate only in the case of farmers, for whom the present January 31 date would be changed to February 15.

Many taxpayers other than farmers find it difficult to determine their net income in sufficient time to permit filing an amended estimate by January 15, and accordingly the relevant date should be February 15 for all taxpayers. It is believed, moreover, that with the adoption of the later date, a substantial number of taxpayers would be able and willing to file a final return in lieu of an amended declaration, thereby accelerating the flow of tax revenues into the Treasury and spreading more evenly the burden of processing returns and payments.

B. PENALTIES RELATING TO DECLARATION OF ESTIMATED TAX AND FOR SUBSTANTIAL UNDERESTIMATION

The American Bar Association in March 1954, adopted our recommendation with respect to mitigation of penalties and relief from double penalties in various respects.

We believe that our recommendations in these particulars are in substance satisfactorily embodied in section 6654.

C. TIMELY MAILING TREATED AS TIMELY FILING

The American Bar Association in March 1954, adopted our recommendation that a timely mailing of a return, claim, statement or other document, or payment thereon should be deemed to be a timely filing or payment. We have previously recommended that a timely mailing be deemed a timely filing with respect to Tax Court documents.

H. R. 8300 adopts in section 7502 the general spirit of this recommendation and a prior recommendation including the filing of documents in the Tax Court, but excludes from this treatment returns and apparently payments.

We therefore recommend that section 7502 be amended to include returns and payments. This could be accomplished as follows:

(*a*) By changing the first three lines of section 7502 to read as follows:

"(a) GENERAL RULE.—If any return, claim, statement or other document, and any payment, required or permitted to be filed or made within a prescribed period or on * * *"

(*b*) By changing the words "claim, statement, or other document" wherever appearing to read "return, claim, statement or other document, or payment."

(*c*) By changing the words "filed" and "filing" to read "filed or made" and "filing or making."

COMPUTATION OF TAXABLE INCOME

The matters included under the above heading are contained in subtitle A, chapter 1, subchapter B. We have arranged the major points which we have considered under the following functional headings:

A. ADJUSTED GROSS INCOME

In general, it appears desirable to allow employees to deduct their costs of earning income in arriving at adjusted gross income even though such costs may not be reimbursed or incurred away from home as required under section 22 (n) of the present Internal Revenue Code. The addition of new provisions permitting the deduction of transportation expenses in section 62 (2) (C) and expenses of outside salesmen in section 62 (2) (D) are desirable but may discriminate somewhat unfairly in favor of salesmen. Many other employees incur nonreimbursed expenses to earn their income. Such costs include union dues, cost of uniforms, work gloves, safety glasses and shoes, and the like. Consideration might be given to permitting such expenses to be deductible in arriving at adjusted gross income.

B. ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME

1. Prizes and awards (sec. 74)

Section 74 of the bill is new and in general desirable as is related section 117 relating to scholarships and fellowship grant. Two problems arise in connection with the exceptions to tax-free prizes and awards:

(*a*) The requirement in section 74 (b) (1) that the recipient be selected without any action on his part to enter the contest or proceedings. As stated in the report on the bill, the exception is intended to exempt such awards as the Nobel and Pulitzer prizes but to tax Pot O' Gold prizes and the Ross essay contest prizes. We submit that there is a considerable difference between Pot O' Gold prizes and the Ross essay contest which is awarded by the American Bar Association. We submit that there is a sufficient safeguard in the preliminary language in section 74 (b) to prevent tax-free receipt of Pot O' Gold prizes; and if the word "professional" were added to the preamble and section 74 (b) (1) eliminated, the Ross essay contest prize would be nontaxable. Section 74 (b) (1) as it stands would make a recipient ineligible for relief if he even answered a letter of inquiry and purports to render ineligible the recipient who takes an affirmative action to enter a contest.

(*b*) Even with respect to such prizes as are involved in the Pot O' Gold contest, some hardship often results when the prize is in nonmonetary form, such as a house, automobile, or trip. A possible remedy for such hardship would be to permit the taxpayer to pay the tax with interest in installments over a period of years where substantial amounts are involved.

2. Discharge of indebtedness (sec. 76)

Section 73 of the bill contains various provisions which are generally desirable with respect to income from the discharge of indebtedness.

In enumerating the situations in which gross income does not result from discharge of indebtedness, it would seem desirable to make specific provision that no income result from discharge of debt by payment in property as well as in the case of payment in money. This could be done by adding the words "or property" after "money" in section 76 (a) (1). We also suggest adding at the end of section 76 (a) (1) the words "in an amount or value not less than the amount of the indebtedness discharged"; and by appropriately modifying section 76 (b). The possible gain or loss to be recognized on the difference between the basis and the value of the property transferred in full or partial payment of the indebtedness would, of course, be a separate problem.

3. Alimony and separate maintenance agreements (sec. 71)

Present law taxes to a recipient and allows the payor a deduction for periodic alimony or separate maintenance payments if the payments are a legal obligation imposed by a court decree or by a written agreement incident to a decree.

The bill extends this tax treatment to periodic payments made under a written separation agreement even though the husband and wife are not separated under a court decree if they are living apart and have not filed a joint return. This embodies our prior recommendation to this effect.

Consideration should be given, however, to extending the same treatment to payments made under written agreements between divorced former spouses even though not embodied in a decree of the court granting the divorce. It is possible to construe section 71 (a) (1) as having this effect, but if this effect is intended it should be made clear by the Senate Finance Committee report.

A serious question exists whether the provisions of section 71 should be applicable to agreements already in existence at the effective date of the bill, since the obligations embodied in such agreements contemplated present law. One solution would be to apply the section to existing agreements only if amended after the effective date of the bill.

C. ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

1. Certain death benefits (sec. 101).

(*a*) *Insurance transferred for valuable consideration.*—The American Bar Association in 1951 recommended amendment of section 22 (b) (2) (A) of the present code to make exempt the proceeds of life insurance paid by reason of the death of the insured, even though the policy may have been transferred for a valuable consideration. The proceeds of the surrendered policy would still be taxed to the extent of any gain. This recommendation is apparently embodied in section 101 (a), as appears in the House committee report. For the sake of clarity, it would be desirable to emphasize this in the Senate Finance Committee report.

(*b*) *Interest element in life-insurance proceeds.*—Section 101 (d) of the bill contains provisions which are in the whole desirable to exempt the interest element contained in life-insurance proceeds payable in installments at dates subsequent to death whether the decedent had exercised an option to have the proceeds paid in such manner or whether such payments are as the result of a subsequent agreement between the beneficiary and the insurance company. The new bill places certain monetary limits on the annual amount of interest which can be so excluded. We do not consider that it is within our province to comment on the propriety of the specific amount set forth in section 101 (d) (1) (B).

(c) *Employees' death benefits.*—Section 101 (b) makes changes in section 22 (b) (1) (B) of the present code to eliminate the necessity of a contract with the employer and to limit the total exclusion to $5,000 regardless of the number of employees. The new section also extends the exclusion to amounts paid "on behalf of an employer" rather than directly. Both the liberalization and the new limitations appear desirable.

However, it might be desirable to make it clear that the elimination of any contractual requirement will not prevent a deduction to the employer and to make it clear that the amount up to $5,000 paid other than by reason of a contract will not be included in the employee's gross estate for estate tax purposes. Naturally, these clarifying provisions will have to be made in other sections of the code.

2. Qualified employers accident and health plans (sec. 105)

Section 105 of the bill appears desirable in most respects. It is desirable, for example, to eliminate the requirement that compensation for sickness or injuries received by employees be under a contract of insurance to be entitled to the exclusion from gross income, thus eliminating a distinction between insured plans and uninsured plans, as we have previously recommended.

Section 105 (c) (1) (D) requires that qualified plans provide a waiting period before payment of compensation for loss of wages. It might be desirable for the statute to specify the length of such period or provide some standard by which the length of the period may be prescribed in the regulation.

While the general concept of a qualified plan is reasonably clear, the definition in section 105 (c) (1) (A) might be clarified to read as follows: "A. Which provides (through insurance or otherwise) compensation for personal injuries, sickness, or loss of wages resulting therefrom." The bill itself makes it clear that loss of wages through personal injuries or sickness, with certain limitations, are contemplated but the definition should make this clear.

By the same token, the third line of section 106 should be amended to read "otherwise) to his employees for personal injuries, sickness, or loss of wages resulting therefrom."

3. Income from discharge of indebtedness (sec. 108)

Section 108 of the bill in substance embodies the American Bar Association's recommendation that the exclusion from gross income of income from discharge of indebtedness be extended to apply to noncorporate taxpayers and to debts not evidenced by securities.

However, in the case of individuals, section 108 (a) (1) (A) (ii) requires that the indebtedness be incurred or assumed in connection with property used by the individual in his trade or business. This requirement is somewhat more narrow than that of section 108 of the Reed-Camp bill under which the indebtedness is to be attributable to the taxpayer's business "or to a transaction entered into by the taxpayer for profit."

As stated in connection with our comment under section 76, it is not clear from a limited study why payment of indebtedness by a transfer of property should not be treated (to the extent of value) in the same way as payment in money.

4. Income taxes paid by lessee corporation (sec. 110)

Section 110 of the bill corrects an inequity which results from pyramiding the lessor's taxable income where a lessee agrees to pay a given rental plus the lessor's tax thereon.

This provision in effect restores to a very limited extent the rule which existed prior to the promulgation of mimeograph 6770, 1952-1 CB 8, and Internal Revenue mimeograph 51, 1952-2 CB 65. Since the rule set forth in mimeograph 6770 is extended to all types of income payments by Internal Revenue mimeograph 51, some consideration might be given to extending the effect of the provisions of section 110 to other areas and not merely to the rather narrow situation where both parties to a lease are corporations and the lease was entered into prior to 1954.

5. Contributions to the capital of a corporation (sec. 118)

Section 118 of the bill appears desirable. Although it has no counterpart in the present code, it will not change existing tax laws since it merely embodies existing decisions and regulations. However, it might be desirable to define the phrase "contribution to capital," which involves contributions to capital not merely by stockholders but also contributions made for various reasons by nonstockholders, the possible cancellation by stockholder-creditors of debt items which have previously been deducted by the company, the distinction between contributions and loans or payments for services, and other problems.

6. Fringe benefits

The term "fringe benefits" is a most imprecise terms which is sometimes used to mean nonmonetary benefits which an employer permits its employees to receive and is sometimes used more broadly to include monetary reimbursement for expenses or even monetary payments which are considered to be sufficiently desirable to justify their exclusion from gross income or to justify their deduction. The bill provides for such benefits in the broad sense with respect to direct and indirect payments for injury and sickness under sections 104, 105, and 106; tax-free transportation expenses under section 62 (2) (C); tax-free business expenses of outside salesmen under section 62 (2) (D); and tax-free cost-of-living allowances for Government, civilian, and Foreign Service employees under section 912. In a sense, employee death benefits under section 101 might be considered such fringe benefits. A tax-free subsistence allowance not to exceed $5 per day for policemen is allowed by section 120. It is not clear why items which are somewhat related functionally should be scattered over widely separated provisions of the code or should even be separated between sections 119 and 120. It might be appropriate to consider the application of nonmonetary benefits on a somewhat broader basis.

The term "fringe benefits" is used by us in considering section 119 of the bill because this is the section which appears to involve the closest approach to the traditional concept of fringe benefits. This section excludes from gross income the value of meals or lodging of employees if mandatory and furnished on the employer's premises. Some of our members consider that the requirements of section 119 go too far, while others consider that they do not go far enough. Assuming that a policy decision has been made by the House of Representatives to exclude the value of meals and lodging from gross income under certain circumstances, it would appear that the requirements are too narrow and would apply primarily to restaurant, hospital, hotel, and domestic employees and perhaps not even there in certain situations. Such an exclusion could not be availed of by employees who work for employers who do not have facilities at the exact place of employment for furnishing board and lodging. For example, a construction engineer might be required for the employer's convenience to accept quarters near the building project, although there might be doubt as to which location was his place of employment. It would also appear that an employee required to work overtime who is paid supper money because his employer did not have facilities for furnishing meals should be entitled to avail himself of the statutory exclusion from gross income. The bill does not use as such, except in the title of section 119, the rule which has been recognized in the past that benefits "for the convenience of the employer" should be excluded. We suggest that the exclusion contemplated by section 119 might be allowed by language somewhat as follows: "There shall be excluded from gross income of an employee the value of free board and lodging furnished to him by his employer primarily for the convenience of the employer."

D. DEPENDENTS AND MEDICAL EXPENSES

1. Multiple support agreements (sec. 152 (c))

One of the most troublesome problems in the area of dependents is that arising when two or more persons contribute to the support of an individual who would be a dependent of any of them except for the fact that none contributes more than half the support. We have considered three different methods of solving this problem. While we have made no formal recommendation, section 152 (c) solves the problem by the method which we would consider on the whole to be the most satisfactory; namely, by permitting one of the contributing group to take the benefit of the dependency exemption with appropriate safeguards.

2. Dependency Status of Nonresident Citizen (sec. 152 (b) (3))

Section 152 (b) (3) of H. R. 8300, as does section 25 (b) (3) of the present code, excludes from the definition of a dependent "any individual who is a citizen or subject of a foreign country" unless a resident of the United States or of a contiguous country. This language was introduced by the Revenue Act of 1944. A problem arises with respect to the status of taxpayers who are American citizens but who by reason of marriage to aliens are also citizens or subjects of another country and therefore have dual citizenship and may well live outside of the United States. The purpose of the present and the proposed provision was obviously to exclude nonresident dependents of resident taxpayers because of the difficulties of proof. This policy, however, should not apply in the case of persons who by reason of citizenship must pay taxes regardless of residence and whose children are actually living with them. It is suggested, therefore, that the exclusion might be changed to read "any individual who is a nonresident alien unless such an individual is a resident of a country contiguous to the United States."

3. Medical, dental, etc., expenses (sec. 213)

The major changes in this area are (*a*) reduction of the threshold of 5 percent of adjusted gross income to 3 percent, (*b*) doubling the maximum deduction, and (*c*) imposition of certain additional limitations. While we have not taken a position with respect to such liberalization, we have had under study various methods of relieving taxpayers of hardships in catastrophic situations. The trend of our thinking in fact had been more along the lines of relief from hardship in special types of situations than along the lines of liberalization for all taxpayers of the type illustrated by the reduction of the threshold from 5 percent to 3 percent. Assuming the framework of the new section 213, we suggest that consideration be given to the following:

(*a*) Eliminate the 3 percent threshold if the taxpayer becomes totally disabled during the first 9 months of the taxable year and is totally disabled on the last day of the year.

(*b*) Eliminate the percentage threshold requirement for a dependent so totally disabled regardless of age, and possibly for a dependent 65 or over.

4. Child-care expenses (sec. 214)

We have not formally made any specific recommendation with respect to this subject matter, although we have considered it. Accepting the policy decision of the House of Representatives that expenses of this general nature should be deductible with appropriate limitations, we suggest that section 214 of H. R. 8300 might be liberalized in two particulars:

(*a*) To allow the deduction to a husband whose wife is incapable of caring for the children because mentally or physically defective.

(*b*) To permit the deduction for spouses living apart although neither divorced nor legally separated.

We also suggest that consideration be given to amendments which would serve to protect against abuse to some extent as follows:

(*a*) Limit the deduction to the amount of earned income of the taxpayer.

(*b*) Extend the limitation in section 214 (b) to make the deduction inapplicable to amounts paid to individuals who are not treated as employees for social security tax purposes. The limitation provided in section 214 (b) (2) is desirable; the only question is whether the limitation should not go further as a safeguard against abuse.

E. MISCELLANEOUS EXPENSE DEDUCTIONS

1. Net operating loss (sec. 172)

Under existing law certain statutory adjustments must be made in computing a net operating loss. One of the important adjustments so required is with respect to the dividends-received credit. The effect of the present law is to require a taxpayer with a combination of loss and profit years to pay a tax on 100 percent of the dividends received; whereas a taxpayer with profit years is required to pay a tax on only 15 percent of the dividends received.

Under section 172 of H. R. 8300, some relief is granted in the first year to which the loss is carried; but the same adjustment for dividends received is required to be made as under present law if the loss is carried to more than one taxable year.

If the specific purpose of the net operating loss provisions is to tax the fluctuating income-tax payer upon the same basis as the steady income-tax payer, that purpose is frustrated by the present provisions of the law and are only partially relieved under section 172 of H. R. 8300. It is therefore desirable that the more liberal provisions under section 172 be made applicable to all taxable years to which the loss is carried and not merely to the first year.

2. Determination of gift tax matters (sec. 212 (3))

Section 212 (3) of H. R. 8300 allows the deduction of expenses in connection with the determination, collection, and refund of any tax. This adopts our prior recommendations with respect to reversing the inequitable administrative and judicial rule established by the majority opinion of *Lykes* v. *United States* (343 U. S. 118). The new provision would give full effect to the dissenting opinion of Mr. Justice Jackson that the expense of contesting a gift tax deficiency should be deductible for income-tax purposes.

While the language of section 212 by itself would appear not to present any particular problems, the language of the committee report on page A59 does raise a new problem with respect to the language of the bill. The language of the committee report appears to confine expenses in connection with tax matters to contested tax liabilities under paragraph (3) of section 212. Since a specific provision ordinarily controls a general provision, this might have the effect of limiting deductions with respect to all taxes, including even income taxes, to contested matters. It is believed that this result was not intended.

This problem might be eliminated by adding the word "computation" before "determination" in section 212 (3). In any event, the Senate Finance Committee report should clarify the point that deductions with respect to taxes are not hereafter to be confined to contested taxes.

F. ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

1. Losses

It is suggested that a paragraph be added to section 165 dealing with losses to provide that business losses sustained by a taxpayer's obligation of guaranty or endorsement will be treated as an ordinary loss deduction under section 165 and not as a bad debt loss under section 166. This suggested change would reflect the results of certain recent decisions.

2. Bad debts

Consideration might be given to eliminating the problem of allocating to a business or a nonbusiness bad debt status, a bad debt which has arisen from a taxpayer's investment in a business in which he is actively interested. This problem would be minimized by addition to section 166 of language somewhat as follows: "The loss from the worthlessness of a debt owing to the taxpayer by a business in which the taxpayer is substantially interested and in the management of which the taxpayer is substantially engaged shall be deemed incurred in the taxpayer's trade or business."

3. Depreciation

Section 167 of the bill liberalizes depreciation with respect to both the estimate of useful life of property and the method of allocating the depreciable cost over the years of service.

Many taxpayers are concerned with the fact that under the declining balance method permitted by section 167 (b) (2) 100 percent of cost will never be recovered, unless they use unit accounting. The report indicates that if the taxpayer keeps sufficient basic subsidiary records to show when the costs of the items acquired in the particular year are retired, he will then be permitted to deduct the undepreciated balance of the cost which would otherwise not be recoverable. Many large businesses which by sheer weight of the number of depreciable units have been required to use the group method fear that they will find themselves faced with the alternative of not availing themselves of this declining balance method or going to unit accounting which would involve expense approaching in many instances the saving in the early years which might result from use of the declining-balance method.

Consideration might be given to providing in section 167 that a taxpayer using the group method will be able to recover 100 percent of cost, without going to the unit method, by a modification of the declining-balance method. This could be accomplished by an amendment of section 167 (b) which would expressly permit the sum-of-the-digits method which results in a depreciation allowance in the early years somewhat less than under the declining-balance method but in the later years somewhat more and results in recovery of 100 percent of cost.

G. DEDUCTION FOR PROPERTY TAXES

1. Apportionment of tax on real property between seller and purchaser (sec. 164 (d))

Section 164 (d) of H. R. 8300 attempts to deal in a realistic way with the problem of allocating between seller and purchaser the deduction for real-estate taxes on real estate sold during a taxable year. We consider that the problem requires solution and the bill endeavors to solve it. We consider, however, that the bill requires change to accomplish its basic purpose in the following respects:

(*a*) The proposed apportionment applies only in the case of a sale. The same problem arises in connection with various types of conveyance which are not sales. We therefore suggest that the words "sale or other disposition" or appropriate variations thereof be substituted for the single word "sale" in the bill.

Examples of types of disposition other than sales are transfers in liquidation, transfers pursuant to tax-free exchanges, and transfers by gift.

(*b*) Although the major problem exists with respect to real property, analogous problems exist with respect to local taxes on tangible personal property. Consideration might be given to extending the provision to taxes on all tangible property.

(*c*) A problem exists in a few other States such as Illinois which have a lien date of April 1 or otherwise have a lien date different from the assessment date or different from the date on which the local property tax year begins. This problem is more complex than would at first appear and there are several methods of varying complexity for solving it. One solution would be to eliminate the words "on the date of the sale" from section 164 (d) (2) (A).

(*d*) The provisions of section 164 are related to the computation of the amount realized on sale of real property under section 1001 (b) and in computing the basis of property in section 1012.

The House committee report on section 164 states that in applying section 1001 (b) the amount realized on sale of real property will not include any amount of tax treated under section 164 (d) as imposed on the seller. Section 1001 (b) itself, however, is silent on the point. Consideration might be given to amending section 1001 (b) to provide expressly that no tax apportioned to either the transferor or the transferee under section 164 (d) shall be included in the amount realized.

The House committee report also states in reference to section 1012 that the transferee's share of tax shall not be included in the basis of the property. It would be appropriate to state in section 1016 that the basis shall not be adjusted for any tax apportioned to either the transferor or the transferee under section 164 (d) except to the extent charged to capital account in accordance with regulations under section 266.

2. Accrual of real property taxes (sec. 461 (c))

A somewhat related provision with respect to accrual of real property taxes is found in section 461 (c) of H. R. 8300. This new section is new. A problem exists in the provisions intended to cover transition from the present code to the new code. The problem exists primarily in the States where real property taxes accrue on January 1 even though the municipal government's fiscal year begins on a later or earlier date. Although the new accrual provisions of section 461 (c) are desirable, the special rules for transition in section 461 (c) (2) may deny certain taxpayers any deduction for real property taxes in the year of transition or may seriously reduce the deduction otherwise allowable.

For example, Detroit and Wayne County taxes accrue on January 1. Detroit taxes for the fiscal year July 1, 1955, through June 30, 1956, and Wayne County taxes for the fiscal year December 1, 1955, through November 30, 1956, accrue under present law on January 1, 1955. Under the proposed section 461 (c) (2), no accrual on that day will be permitted and thus an accrual basis taxpayer whose fiscal year ends on January 31, for example, will obtain no deduction for real property taxes for its fiscal year ending on January 31, 1955; and in its fiscal year ending on December 31, 1956, it will be able to deduct only seven-twelfths of the Detroit and two-twelfths of the Wayne County taxes.

To be sure, such fiscal year taxpayers have in the past obtained an acceleration of the deduction for real property taxes by accruing them; but in most instances the present basis was established many years ago and to deny or reduce the deduction now would distort current income. One solution to this problem would be to transfer the transition adjustment to the year of disposition of the property. A better solution would be to make section 461 (c) optional at the election of the taxpayer.

H. TRANSACTIONS BETWEEN RELATED TAXPAYERS (SEC. 267)

Section 267 of H. R. 8300 contains in substance the provisions of sections 24 (b) and (c) of the present code disallowing losses, expenses and interest in transactions between related taxpayers, but tightens present law by expanding the concept of related taxpayers somewhat and eliminates one inequity by recognizing gain to the original transferee only to the extent that it exceeds the amount of loss not previously allowable to the transferor. Consideration might be given to an alternative method of preventing this hardship, leaving the basis to the original transferee the same as the basis to the transferor so that tax results other than realization of gain will not be confined to the reduced basis.

Section 267 (a) (2) fails to reflect our prior recommendation that unpaid expenses and interest shall not be disallowed if actually included in the income tax return of the related taxpayer even though not paid to him within $2\frac{1}{2}$ months after the close of the taxable year of the payor.

I. INCOME BONDS

Section 275 disallows a deduction for any amounts paid with respect to nonparticipating stock as defined in section 312 (d). Section 312 (d) includes as nonparticipating stock certain income bonds of a type which have generally been regarded as indebtedness, the interest on which is deductible even though contingent in whole or in part upon earnings of the debtor. These two sections should be revised to use terms somewhat more descriptive of debt than the phrase "nonparticipating stock" and to permit the deduction of interest paid on indebtedness which is customarily regarded as true indebtedness in the financial community.

ACCOUNTING PERIODS AND METHOD OF ACCOUNTING

A. ACCOUNTING PERIODS

Section 441 contained new provisions for election of a year consisting of 52 to 53 weeks. These provisions are on the whole desirable despite several possible defects of a technical nature in section 441 and section 443 with respect to 52 to 53 week years.

B. METHODS OF ACCOUNTING

The changes from existing statutory law in the sections of the bill beginning with section 446 are in general designed to bring the income-tax provisions of the law into harmony with generally accepted accounting principles. This appears to be an important and on the whole desirable move away from the developing concept of a strict accrual method enunciated in court decisions and Internal Revenue Service rulings which follow them. It is inevitable that with such an important move there will be some transitional uncertainties in interpreting the new bill. To minimize these uncertainties some clarification would be desirable. We suggest that these uncertainties be minimized not by introducing further complexities into the bill itself but rather by clarification by means of a few examples in the Senate Finance Committee report. For example, uncertainty may exist as to whether the new provisions contemplate reversal or permissive disregard of revenue ruling 54-83 for a taxpayer who estimates and accrues the amount of redeterminations of price on Government contracts.

Section 452 attempts to deal on a realistic basis with prepaid income. Several problems arise:

1. Section 452 is limited to taxpayers who are not on a cash receipts and disbursements method of accounting. Yet many such problems arise with respect to taxpayers who report on this method.

2. This section is limited to prepaid items received in connection with the trade or business of the taxpayer. If the section were extended to all types of prepaid items there would be eliminated any questions of construction as to whether the transaction out of which the prepaid item arose constituted the trade or business of the taxpayer, particularly in the cases of individuals who rent property.

3. The term "ceases to exist" in section 452 (c) may be too limiting. Consideration might be given to expanding this phrase to "ceases to exist or to do business," if the prior suggestion should not be adopted.

4. Presumably the election under section 452 would extend beyond the year for which made. There should be some provision as to how the election might be revoked or ended.

Under section 462 providing for reserves for estimated expenses, etc., there is no provision for the termination of an election to come within the section, once made.

Under section 472 (and sec. 1321) dealing with last-in first-out inventories there is no provision corresponding to section 109 of H. R. 4825 under which interest would be allowed on any deficiency or credit arising from the adjustments relating to the involuntary liquidation and replacement of elective inventories under present IRC section 22 (d) (6) (a).

Under section 481 (a) (2) adjustments shall be taken into account which are determined to be necessary to prevent amounts from being entirely omitted. The word "entirely" might well impose an undue limitation on the adjustment which might be necessary.

The provisions of section 481 must be considered in relation to section 167 dealing with depreciation. Under the latter section taxpayers would be permitted to adopt declining balance depreciation and change to such method without first obtaining permission from the Commissioner provided depreciation is computed under such method for the first taxable year ending after December 31, 1953. Apparently, however, if the taxpayer desires to adopt the declining balance, method in any subsequent year, the Commissioners' permission would be required. In the past, when taxpayers have attempted to change their method of depreciation accounting, the Commissioner has sometimes required that a reserve be set up in excess of the depreciation which theretofore had been allowed or allowable. Section 481 provides that if a different method of accounting is used in the current year than was used for the prior year the Commissioner is authorized to prescribe such conditions as will result in no deduction being taken twice and no income taxed twice. There is no provision relating to the situation where the Commissioner may try to require the taxpayer to give up some of its basis as a condition to changeover. Possibly depreciation that is neither allowed nor allowable might have to be set up in a reserve as a condition to changing to another recognized method of depreciation accounting.

It may well be that some taxpayers will not be able to adopt the declining balance method of depreciation in the first year of change because their depreciation records may not be adequate or for other reasons. Such taxpayers may as a practical matter be unable to adopt such method in the future if the Commissioner is entitled to require the taxpayer to give up some of its statutory basis for depreciation as a condition precedent to changeover.

We suggest that the law be clarified to provide that upon such a change of depreciation accounting method no further reduction should be required in basis and the general provision respecting clear reflection of income in section 481 should not be considered as overriding the specific provision. Consideration might also be given to extending the 1 year permitted for changeover of depreciation methods to a longer period.

Gain or Loss on Disposition of Property

The relevant provisions of the new code are in the sections beginning with section 1001.

Among the numerous changes of form if not in substance made under subchapter O, the one which will have perhaps the greatest effect upon the greatest number of individuals in the country is section 1014 (a) (9) which gives to property acquired from a decedent a basis equal to its value required to be included in determining the value of the decedent's gross estate for Federal estate-tax purposes. This provision in substance provides what the American Bar Association has long recommended. However, the bill grants this treatment only in the case of property acquired from decedents who die after December 31, 1953. The new bill will in any event be prospective in the sense that it will apply only in determining the basis of property sold after December 31, 1953. No logical reason appears, however, why the basis should depend upon whether the decedent died before or after December 31, 1953. We submit that the basic purpose of the new provision could be better accomplished by revising this section to read somewhat as follows:

"(9) Property (other than annuities described in sec. 72) acquired from the decedent by reason of death, form of ownership, or other conditions, if by reason thereof the property was includible in determining the value of decedent's gross estate under chapter 11 of subtitle B or section 811 of the Internal Revenue Code of 1939."

To be consistent, a comparable revision of section 1014 (a) (3) would be indicated.

While the above appears to be the major point involved in subchapter O, there are various other problems which appear to have been left unsettled including the following:

1. Property acquired in return for the relinquishment of a disputed or unliquidated claim. The bill might provide that the basis of such property shall be its value at the time it is acquired by the taxpayer.

2. Property acquired through the exercise of an option. Here, it might be provided that the basis for such property with respect to the option shall be the taxpayer's basis for the option.

3. Property which was acquired in a situation in which the value of the property was required to be included in the taxpayer's gross income, as where property is acquired by way of compensation for services or as a dividend. Here, it might be provided that the basis of such property is the amount which was includible in income.

4. Terminable interest acquired by gift or bequest. Such property would be, for example, a life estate. It might be advisable to prescribe how basis on sale of such asset is to be adjusted for the passage of time.

Capital Gains and Losses

Capital gains and losses are covered by subchapter P in the sections of the bill beginning with section 1201.

A. CAPITAL LOSSES

Section 1211 (b) continues the present system of limiting the deduction of capital losses of noncorporate taxpayers to their capital gains plus $1,000 of ordinary income. In view of the substantial revisions of the code, it is appropriate at this time to consider increasing this ceiling.

The existing $1,000 limitation perhaps works rough justice where an individual over a period of time has gains and losses of about equal magnitudes. However, we are informed that several studies have indicated that capital losses are frequently sustained by individuals who never realize capital gains. For such individuals, the existing limitation is harsh. An increasing number of middle-aged persons are turning to investment in equities. The price level for equities is historically high. It is not unlikely that the growing population of shareholders will result in a larger number of taxpayers who have capital losses but no offsetting gains.

B. STATUS OF RENTAL PROPERTY

In view of the substantial revisions of the code, some uncertainty may arise as to the status of rental property held as an investment. It might be well in the Senate Finance Committee report to make it clear by example or otherwise that under both section 1221 and section 1231 such rented property is to be regarded as "used in trade or business."

C. LITERARY PROPERTY

Section 1221 (3) continues the provisions of the present code which became law in 1950 in substance eliminating from the capital assets category literary and artistic property in the hands of the producer or his donees. It is appropriate at this time to consider whether these provisions which discriminate against authors and artists might not be modified somewhat.

D. SALE OR EXCHANGE OF PATENTS BY THE INVENTOR

An example of inequitable modification of present law under subchapter P is section 1235. This section provides that an outright sale by an inventor, whether amateur or professional, of a patent or application for a patent shall with certain restrictions be considered the sale of capital assets. Although the elimination of the distinction between amateur and professional inventors is intended to liberalize the present law, the proposed section 1235 imposes harsh restrictions which do not exist under present law and which make worse the position of the inventor who is not in the business of selling his patents or inventions, and which make largely illusory the purported relief for the professional inventor.

We submit that the new bill should fully recognize the effect of Edward C. Myers (6 T. C. 258). Section 1235 in the House bill places two restrictions on capital gains treatment for inventors which from a practical business point of view are unrealistic. They are (1) the requirement that the seller upon sale must retain no interest whatsoever in the patent, and (2) the requirement that the entire sales proceeds must be received within 5 years from the date of sale, under penalty of losing the capital gain treatment which the inventor would enjoy under present law.

The 5-year rule is particularly indefensible in the case of applications for patents. Patents are frequently issued only after many years. The 5-year rule applied to such inventions would have the practical effect of dissuading inventors from ever selling their inventions until final issuance of the patent with consequent financial inconvenience in many instances and the discouragement of prompt development and marketing of inventions.

Frequently, the value of a patent is not known at the time it is sold nor for many years after sale. For that reason, it is quite common to base the sales price not on a flat sum but rather on the productivity of the patent itself—either on a formula based on the number of units sold or produced or on the dollars received therefrom by the purchaser or his licensees. Sometimes the sales formula is based on productivity of improvements as well as the basic patent, and the payment period is longer than 17 years. The proposed 5-year rule forces an inventor in effect either to refrain from selling it at all, with the result that the patent is not used to its maximum potential, or to take a financial sacrifice either by selling it for a flat sum or an inadequate price based on five or fewer years of productivity with capital gains treatment or by disposing of it on a realistic basis but with the proceeds being taxed at ordinary rates.

The rule of denying capital gains treatment if any interest in the invention is retained prevents the inventor from holding any kind of security for performance of the sales arrangement and would also seem to prevent sales of different interests in the patent to different persons. The proposed rule ignores realistic reservations of functional or geographic rights, even on a nonexclusive basis. Under the bill the inventor would be the only person in the world who would be discouraged by the Federal tax laws from being a licensee of his own patent.

The section should cover inventions, and not merely patents or applications therefor.

E. REQUIREMENT OF SALE OR EXCHANGE

Section 1222 keeps intact the present requirement that a disposition of a capital asset does not receive capital gain or loss treatment unless the disposition is classified as a sale or exchange. A strong argument can be made for dispensing with this requirement and instead providing that any taxable disposition of a capital asset results in capital gain or capital loss treatment. If the requirement is to be kept, however, it would seem advisable to specify what type of dispositions are or are not to be classified as exchanges.

F. DISCOUNT ON BONDS

Section 1232 precludes the possibility of turning interest into capital gain with the purchase of bonds issued at a discount. While it appears advisable to close the discount loophole, it is possible that the proposed provision is too elaborate and needlessly refined and that some consideration might be given to a general clause to the effect that "the portion of the gain properly allocable to the discount is to be treated as interest."

There may also be a problem under the proposed section with respect to holders of a bond issued at a discount other than the first holder. It is difficult to see how a second or third holder will become aware what portion of his gain is to be treated as interest income.

G. DEALERS IN REAL PROPERTY AND REAL PROPERTY SUBDIVIDED FOR SALE

Section 1237 provides elaborate provisions for dealers in real property, and section 1238 contains elaborate provisions directed at the taxation of real estate subdivisions.

It is doubtless more appropriate that real estate organizations rather than the American Bar Association testify as to the propriety of the standards proposed. It would appear, however, that these standards may be too elaborate and inflexible and are likely to be too liberal in some instances and too restrictive in others. We would suggest that a considerable amount of further study would be desirable before such complex and specific provisions are crystallized into the code. In the meantime, more general and flexible provisions would appear to be desirable.

READJUSTMENT OF TAX BETWEEN YEARS AND SPECIAL LIMITATIONS

These somewhat unrelated provisions are contained in subchapter Q and are dealt with in the sections beginning with section 1301.

A. INCOME ATTRIBUTABLE TO SEVERAL TAXABLE YEARS

Sections 1301 to 1304 embody with same modifications the rules in present section 107, which permits averaging, or spreading back, income received in 1 year for several years' work.

(1) Definition of an employment

An employment is defined in section 1301 (b). Many are concerned whether the use of the term "employment" restricts application of this section to an employer-employee situation, thereby denying the benefits of this section to an independent contractor. While it is clear from the Committee report that this is not the intent but that on the contrary the change in language from the present code was intended to eliminate ambiguities in the present law in a way more favorable to taxpayers, some consideration might be given to clarifying this point further.

(2) Period of spread-back

Section 1302 of the bill extends the spread-back period in the case of inventors from 36 months to 60 months. We approve this much needed statutory change in the case of inventors, but see no good reason why it should not also be extended to the case of an artistic work as well, inasmuch as such works frequently involve substantial periods of preparation and the income derived by the author is often pyramided into a relatively short period.

(3) Inclusion of income received after the taxable year

We recommend that under both section 1301 and section 1302, income received after the taxable year should not be taken into consideration. We renew our long-standing recommendation, which was embodied in section 120 of the Reed-Camp bill, H. R. 4825, that the averaging of income treatment be granted to cases in which 80 percent of the total compensation for work done to date over the requisite period of months is received or accrued in a single taxable year.

Consideration might also be given to eliminating from the formula income received after the taxable year, even if attributable to work done to date. Income received after the taxable year from work done to date is usually unpredictable and beyond the control of the taxpayer. An inclusion in the formula of income which may or may not be received in the future breeds uncertainty and tends to defeat the purpose of these statutory provisions.

(4) Income from back pay

Consideration might be given to eliminating the requirement in section 1303 (b) (1) (B) of the requirement that determination of back pay be made "after the commencement of court proceedings." Such requirement tends to encourage litigation and places a hardship on the average taxpayer. Court decisions under this section in the present law indicate its unsatisfactory nature.

(5) Parnership problems

Section 1301 (c) does not by its terms apply to a partner if and while he was an employee of the parnership during certain of the years during which the protracted services were rendered. Section 1304 (d) does not expressly cover the situation of an estate of a deceased partner who would be entitled to the benefits of section 1301 if living.

B. MITIGATION OF EFFECT OF LIMITATIONS AND OTHER PROVISIONS

1. Related taxpayer

Section 149 of H. R. 4825 embodied our prior recommendation to eliminate the requirement that the item be erroneously included in the gross income of the taxpayer or of a related taxpayer and would extend this section to an item which was erroneously included in the return of the taxpayer or any other taxpayer. This recommendation, which was made in connection with section 3801 of the existing code, is not adopted in the present section 1312.

2. Method of adjustment

The special committee on section 3801 of the section of taxation recommended in 1953 that relief be given in the primary proceedings which formed the basis of the determination and that the 1-year rule be abandoned. The proposed section 1314 (b) has retained the rule of existing law that relief must be sought in a separate action commenced within one year from the date of determination.

C. WAR LOSS RECOVERIES

The proposed sections 1331 to 1337 do not purport to alter or amend the present rules except insofar as they eliminate the present sections 127 (a) and (b) which applied to pre-1954 taxable years. The effect of the proposed sections is to set forth the rules governing the tax effect of recovery of property actually lost or deemed lost during World War II.

Several problems exist both under the present law and the proposed new sections. The difficulties are largely in the area of proof. The taxpayer must meet the burden of proof that the property once lost was actually recovered by him or by an agent in his behalf after cessation of hostilities. While this burden may not be too heavy on a taxpayer whose recovered property lies within a country that is now friendly and which has been friendly since the end of World War II, it becomes virtually impossible if the property lies within any of the Iron Curtain countries. Moreover, some of the property while recovered has now been nationalized or otherwise seized by an Iron Curtain country, but it is difficult to prove even this. This subject is too complex to attempt to make any revisions to meet these points before the date when H. R. 8300 should be enacted. Further study should be given, however, with a view to later revision, to set forth presumptions as to loss and thus relieve the taxpayer of the burden of proving actual loss with respect to property in Iron Curtain countries.

D. CLAIM OF RIGHT

It is obviously desirable to make a realistic effort to cope with the problem of repayment in 1 year of income which was received under claim of right and therefore includible in gross income in a prior year.

Section 1341 of the bill makes a realistic attempt to solve these problems. We have had this problem under consideration for a considerable period of time. There are various methods of solving the problem. The general formula of section 1341 is doubtless the most satisfactory on the whole. It is not surprising, however, that many would consider some further improvement possible. Among the items which might be improved, or which might be considered further, are the following:

1. The rule is brought into play if the deduction is allowable for the taxable year because it was established after the close of a prior taxable year that the taxpayer did not have an unrestricted right to the income. The wording of this section appears to cloud somewhat an already complicated rule in that neither the section nor the committee report explaining this section defines what is meant by the word "established." Under the present case law, there is a great deal of confusion as to whether the repayment must be compelled by law or whether a voluntary repayment qualifies. It is recommended that it should be clear that a voluntary repayment will qualify and it is recommended that the word "established" be clarified either in the section or by the committee reports, presumably in a liberal manner.

2. The section does not state the time at which the establishment of the lack of an unrestricted right to the income must take place. It is assumed that it is intended that such establishment must be in the year of adjustment. However, this is not clear from the section and it would be desirable to clarify the point.

3. It should be made clear that the rule would apply if the repayment occurs in the year of original receipt. This would be a special problem to which much of the language of section 1341 would be inapplicable.

4. It is not clear whether the claim of right adjustment is to apply only if the repayment constitutes a deductible item in the year of repayment or whether a repayment which is nondeductible may also qualify. It should be made clear that the repayment would be deductible by reason of section 1341, even though not deductible under any other section of the code; since the item repaid by hypothesis constituted income before repayment.

5. It is not clear whether the rule of section 1341 is to apply with respect to an accrual taxpayer if he does not actually repay the amount in question but his obligation to repay is sufficiently established to meet the normal test of an accrual of the amount to be repaid. The rule should be clearly set forth either in the statute or in the committee report as to what constitutes a sufficient accrual of liability to permit the adjustment.

6. A problem exists with respect to income which was actually included in income in a prior year under the claim of right theory, but was not technically includible by reason of a restriction on use or otherwise. Such income should be expressly covered by this section.

Mr. CHAIRMAN. The next witness is Mr. MacLean, Jr., of the association of the bar of New York City.

STATEMENT OF CHARLES C. MacLEAN, JR., ASSOCIATION OF THE BAR, CITY OF NEW YORK

The CHAIRMAN. Will you identify yourself for the reporter please.

Mr. MACLEAN. My name is Charles C. MacLean.

I appear on behalf of the committee on taxation of the association of the bar of the city of New York.

Mr. John H. Alexander, chairman of our committee found it impossible to be here today and asked me to substitute for him. Our committee very much appreciates this opportunity to be heard, and to file reports on various sections of the bill.

Since the bill was not made public until March 9, and was not generally available until a few days thereafter, our study of many of the provisions of the bill has not advanced beyond a preliminary stage.

We have, however, been able to make substantial progress in consideration of a few of the more important parts of the bill, and we are filing at this time a report covering these sections.

The CHAIRMAN. It will be made a part of the record.

(The document referred to appears at p. 504.)

Mr. MACLEAN. We hope to follow this with one or more additional reports relating to other parts of the bill.

Our committee recognizes the tremendous effort that has gone into the preparation of this bill. We are in complete agreement with the overall objectives of simplifying the structure of the Internal Revenue Code and bringing a higher degree of certainty to its operations.

It was, however, quite a shock to be confronted in mid-March with a proposed new code containing extensive changes, which had not previously been made public, and to learn that we had only a few weeks in which to digest the bill and submit out comments, and that your committee had similar time to make the necessary amendments.

The CHAIRMAN. The Senate Committee on Finance is under the same difficulty.

Mr. MACLEAN. I appreciate that, Senator.

We decided then to undertake the job and within a few days after the bill was released we met and assigned the major topics to subcommittees and topics of less importance to individuals. And since then we have devoted as much time as humanly possible to a study of the bill. Within the limited time available, no member of our committee has been able to analyze more than a relatively small segment of this bill. This experience has served to emphasize to us the magnitude of the task that confronts your committee and its staff. In our view the bill presents many problems on both the policy and technical levels.

Further study and revision are, we believe, necessary, and it is our earnest hope that the Finance Committee will be able so to schedule its consideration of the bill so that sufficient time may be allowed for the work that remains to be done.

Some of the problems suggested by the bill are not complicated and should be subject to solution without reference to other provisions of the bill. The retroactive effect of the provision relating to payments of estimated income tax by individuals is an instance of such a problem. Under present law, if an individual underestimates his tax, he normally has until January 15 of the following year to bring it up to 80 percent. Under section 6654 of the bill, this rule would no longer apply, and unless the taxpayer was within one of the exceptions, he will be liable for a penalty unless he estimates and pays each quarter on a basis of the amount equal to 70 percent of his final tax. The bill would make this change effective for the year 1954, even though only a handful of people could have known on March 15 of the change proposed.

Another instance of a problem that might be considered as a separable problem is a proposed change in the estate-tax law, which Mr. Tarleau mentioned. For many years a decedent has been permitted to elect to use for valuation purposes the value of the estate 1 year after death, in place of the value of the estate at the date of death. Section 2032 of the bill permits the use of the alternate valuation date only if the value of the estate has declined in value at least one-third. And to illustrate the difficulties which this presents, a comparison can be made between two estates, each with gross valuations at the date of death of $600,000. After the exemptions and deductions, the taxable estate in each case as of the date of death is, say, $500,000. A year later, one estate has declined in value from $600,000 to $450,000. Since this decline is less than one-third, the optional valuation date may not be used and the tax is $145,700. The other estate declines in value from $600,000 to $400,000, and the taxable estate is $300,000. In this case, since the decline is equal to a third of the value of the gross estate, the optional valuation date is available. The tax is only $81,700. The balance left, after paying the estate tax, would actually exceed the balance left in the case of the estate with a smaller decline in value.

These two illustrations are problems in the bill that can be separately considered. The bill, however, makes extensive changes in entire areas covered by the code. Thus the field of employees' trusts has undergone considerable revision, and an examination of the changes indicates problems which it is believed require further consideration.

For example, section 505 would prescribe the manner in which funds of a pension trust may be invested without loss of exemption. One limitation is that any one investment in real estate may not exceed in value 5 percent of the value of the total assets of the trust.

In the case of a small pension trust, this probably means virtual elimination of real estate as an investment.

On the other hand, no limitation is imposed upon the amount which may be invested in securities of the employer. Our committee believes that there should be some limitation on investments in such securities, and that there should be a more liberal rule with respect to investments in real estate.

The consideration our committee has been able to give the bill so far has led us to the conclusion that probably the two most troublesome areas are those relating to the taxation of partnerships, and to the treatment of corporate distributions and adjustments.

The present Internal Revenue Code contains relatively few rules with respect to partnerships. The bill under consideration deals with this subject in detail.

An example might be the case of a brokerage partnership holding in its inventory stock which costs $1,000 and which is now worth $2,000. This stock is distributed to a partner who has a basis for his partnership assets in excess of these amounts. Under the bill no gain or loss would be recognized at the time of the distribution, and the distributee would have a basis of a thousand dollars for the stock. Upon subsequent sale for $2,000, the profit of $1,000 would be taxed to the partner. Although the $1,000 gain would be treated as ordinary income by virtue of provisions in the bill, the ability to shift among partners in differing tax brackets the incidence of tax in such cases has obvious tax avoidance possibilities.

A somewhat more startling example of the problems inherent in the new partnership provisions is illustrated by the following case. A partner retires from a partnership and receives as his liquidating distribution an asset worth $200, with a basis to the firm of only $100. The basis to the retiring partner of his partnership interest is $150. The retiring partner thus has a true economic gain of $50 on his retirement. The new law, however, would require a comparison to be made between the basis to the partner of his interest in the partnership and the basis to the partnership of the asset distributed.

Since the basis to the retiring partner of his interest in the partnership would exceed by $50 the basis to the partnership of the asset distributed, the retiring partner would have a loss on the liquidation of $50. He has, of course, a potential taxable gain of $100 upon the eventual disposition of the property, but whether he will ever have a taxable gain will depend upon whether he sells the asset prior to his death.

Clearly, the rule in the bill would permit considerable latitude to a partnership in determining the incidence of taxation on its partners in the case of liquidation.

It is, however, in the revisions of the law relating to corporate distributions and adjustments that our committee has found the greatest difficulties.

The revisions are incorporated in subchapter C. The bill proposes a complete structural revision of the law governing the field of corporate distributions, liquidations and readjustments. There is no need to emphasize the importance to the Nation's business of maintaining the ability of corporations to conduct normal transactions in this field with at least a reasonable degree of certainty. It is also of vital importance, in this area, particularly, that the provisions be carefully designed to circumvent tax avoidance.

The approach of our committee to subchapter C was to consider how the new techniques employed would operate in practice, what difficulties there might be in various provisions, and to the extent possible in the time available, how such difficulties might be corrected.

As a result, our first report contains many detailed recommendations for revision of subchapter C.

As a further result, however, our committee, after careful reviewing of its studies of subchapter C has concluded that the problems posed by subchapter C cannot be answered by piecemeal patching in time for inclusion in a bill which is scheduled for early action by the Congress. We think that there are far too many difficulties presented for such an effort to hold any prospect of success. It cannot be emphasized too strongly that virtually every change in a provision of subchapter C requires restudy and probably revision of other sections of that subchapter covering this whole integrated area.

Our committee recommends that subchapter C be supplanted by reenactment of the existing provisions relating to corporate distributions and adjustments. There should follow, we urge, a period of further intensive study by legislative, administrative and professional groups, looking toward the presentation as soon as feasible, of provisions that will effectuate the legislative intent manifested by subchapter C to improve and clarify the law in this important area. It is believed that, on the basis of such a study, it would be possible to develop provisions that will give effect to congressional intent, and would not unduly interfere with either the collection of the revenue or the carrying out of normal transactions.

We shall try to illustrate a few of the difficulties which our committee has found in part I, subchapter C, dealing with distributions by corporations. One of the problems which the authors of our internal revenue laws have always faced is the development of a satisfactory means of frustrating attempts to withdraw corporate earnings at capital-gain rates through the medium of stock redemptions. As long as the stockholder holds the same proportion of interest in the corporation, it makes little difference to him how many shares represent that interest.

In an effort to provide more precise rules than those employed in previous legislation, the bill has attacked this question by setting up an elaborate statutory scheme based upon varying treatments of redemptions of participating and nonparticipating stock. This treatment has involved the drawing of arbitrary distinctions. For example, an individual who owns 1 percent or more of the participating stock of a corporation, purchases for cash 1,000 shares of nonparticipating stock at $100 per share. "Participating stock," and "nonparticipating stock" are defined in terms intended generally to cover the usual common stock and preferred stock, respectively.

A year later, the nonparticipating stock which he purchased is called by lot at a redemption price of $105. Under the bill, the shareholder will receive a taxable dividend of $105,000. In addition, since the bill makes no provision to the contrary, it would appear possible that he would lose permanently his $100,000 basis for his nonparticipating stock. If, however, he had received adequate warning of an impending redemption, he could have avoided the dividend tax by selling his nonparticipating stock to a third party, in which case he would incur only capital gains tax on about $5,000 gain.

Now, it may be said that arbitrary results, while unfortunate, are the reasonable price that must be paid for certainty and precision. But the inevitable——

Senator BENNETT. Mr. MacLean, do I understand and I haven't studied the bill as carefully yet as I will before we get through it—that under the provisions of the bill, if a man makes a purchase of preferred stock and within 1 year his stock is called by redemption, he is assumed to have had no cost on that stock and it is all to be treated as dividend?

Mr. MACLEAN. If he is the holder of more than 1 percent of the participating stock, that is what will happen, Senator.

Senator BENNETT. That is obviously——

The CHAIRMAN. Mr. Stam, what is the theory of that?

Mr. STAM. Well, he could reduce his participating stock and that wouldn't apply, but the theory back of this, what we were trying to do was to get around this problem of bailouts, of where the shareholder is attempting to get a distribution without paying the dividend tax. And the bill, as written, thought the best way to do that was to put some kind of a tax on a corporation when it redeemed the stock, the theory being that the corporation would not necessarily have to redeem the stock, and the shareholder would have a free disposition of that stock in his hands. I mean he could sell that stock, and there would be no uncertainty about whether it is going to be taxed as an ordinary dividend or not. But the corporation in that type, where there had not been a reduction of his participating stock, his common stock, the corporation would know if he redeemed that stock and would have to pay this penalty. That is theory of it.

We are looking into some of the problems that have come up about it, and we may have some suggestions to make to the committee on that.

Mr. MACLEAN. But in the case I put, the corporation would not, as I understand it, Senator, be subject to the 85 percent tax, because the stockholder would have been subject to the dividend tax.

The CHAIRMAN. Take a good look at that, Mr. Stam.

Senator BENNETT. Wouldn't that have the effect of denying to small closely held corporations all use of the preferred stock basis of getting initial capital?

Mr. MACLEAN. Mr. Tarleau pointed that out correctly this morning, Senator.

Senator BENNETT. A man who is one of a small group, holding substantial amounts in a corporation, couldn't reduce his common stock to 1 percent. That would be impossible.

Mr. MACLEAN. But that could also work inequities where a man holds stock, listed on the New York Stock Exchange, to the extent of 1 percent in a large company, inherited from his father, and was thereafter called pursuant to a sinking-fund provision.

The CHAIRMAN. We will take a good look at that. Go ahead.

Mr. MACLEAN. I think the inevitable consequence of drawing a precise line of the nature embodied in the provisions under discussion is that for future transactions taxpayers may choose to sail close to the line. More than one method is frequently available to the taxpayer to accomplish the substance of what he wants. Unless a line is drawn to cover each method, he can often conduct himself in a way that will avoid a particular rule. It is our belief that any endeavor to perfect the wide variety of specific rules, which would protect the revenue and at the same time prevent undue hardship, would be a time-consuming task.

The point is illustrated by the definitions in the bill of interests in a corporation. All such interests fall into three classifications under the bill—securities, nonparticipating stock, and participating stock. The definition of participating stock is so restricted that it would be possible to capitalize a corporation with no nonparticipating stock and with at least two types of participating stock, one of which would contain special redemption features. This stock could be sold to a person holding no other stock of the corporation, and the subsequent redemption thereof would result in capital gain to the purchaser and the corporation would not be liable for 85 percent tax on redemptions, since that is limited to nonparticipating stock.

It would also seem entirely possible to set up a corporation with no participating stock. Since the application of many of the provisions of this subchapter C is based on the distinction between participating stock and nonparticipating stock, their operation can hardly be effective.

Taxpayers may also take similar advantage of the definition of "securities." The definition excludes corporate obligations held by persons owning 25 percent or more of the participating stock of a corporation, where such obligations are subordinated to the claims of trade creditors. Thus a dividend of debentures that are so subordinated to trade creditors would constitute a distribution of nonparticipating stock, rather than of securities. As such, as I understand it, the distribution would not be subject to tax. If the corporation is in sound financial condition, a provision in short-term debentures, subordinating them to trade creditors should not have any material effect on their salability. When the debentures are sold, capital gain will result to the selling stockholders. In the hands of the purchasers, the debentures are securities rather than nonparticipating stock, because they don't own 25 percent of the participating stock of the corporation. As such, their redemption by the corporation is without any adverse tax effect on either the corporation or its shareholders.

The bill deals with the problem of distribution of nonparticipating stock, followed by sale and subsequent redemption by imposing this 85 percent penalty tax on the corporation on redemption of such stock, with exceptions specified in certain cases. The penalty tax is imposed only on redemptions within 10 years of issuance. Presumably, the theory is that the distribution of preferred stock as a dividend for the purpose of subsequent sale will be deterred if any redemptions of such stock within a period of 10 years are subject to the penalty tax.

Aside from the question of whether the tax, if imposed, would deter redemptions in the case of closely held corporations, it is doubtful whether 10-year postponement of redemption would destroy the salability of a nonparticipating stock of a company; and perhaps even more important, if there is a difficulty in this respect, it could probably be avoided by advance planning.

Thus, a liberal dividend of preferred stock declared today, with sinking fund provisions operative 10 years hence, might be held by the stockholders until a date close to the scheduled time of redemption, at which time the stock may be readily salable.

While the primary problem here is one of tax avoidance, the provision can penalize unfairly corporation that issued preferred stock many years ago with mandatory sinking fund provisions that are operative today. Although for the future, the bill requires only a 10-year waiting period after issuance, all outstanding issues will be subject to possible application of the penalty tax, if redeemed within the next 10 years, even though they have been outstanding for many years. That results from the provisions of section 309 (c) to the effect that if they are issued before January 1, they are deemed issued that date.

Now, to our committee, it seems that if a 10-year waiting period is sufficient to eliminate the danger of bailout with respect to future issues, the same period should be adequate with respect to past issues. The question is also presented of the extent to which a new legislative rule should be applied to redemptions pursuant to a sinking fund agreement entered into prior to the development of the new rule. Also, it seems unfair to impose an 85 percent tax on a corporation that redeems nonparticipating stock, such as certain types of debt obligations issued in years past, where the value of the property paid in will be extremely difficult to prove, because of the lapse of years.

The difficulties which our committee finds with subchapter C may be further illustrated by the provisions of part III relating to spin-offs, which are now governed by provisions formulated by the Congress as recently as 1951. Here, also, the provisions must operate to permit legitimate business adjustments and at the same time prevent taxpayers from taking advantage of such transactions by realizing on accumulated corporate earnings of a continuing business at capital gain rates. The classic pattern of the spin-off is the transfer by a corporation of a portion of its assets to a newly organized subsidiary, followed by the distribution to its stockholders of the stock of the new corporation. Although such transactions may often be motivated solely by business reasons, the tax avoidance possibilities are presented of transferring corporate surplus to the company to be spun off with the eventual realization of capital gain on the sale or liquidation of the spun-off company by the stockholders.

The technique adopted in the bill for dealing with the "spin off" situation is altogether different from that of the 1951 legislation. The problem of tax avoidance is attempted to be met by introducing the concept of an "inactive corporation." Any stockholder who, within 10 years of a "spin off," receives money or property with respect to the stock of an inactive corporation received or held as a result of the "spin off," is taxable thereon at ordinary income-tax rates. The principal test for determining whether a corporation is an inactive corporation is an income test. Under this test, a corporation is inactive unless 90 percent or more of the gross income of the business of the corporation for each of 5 years was other than personal holding company income—that is, the income was not from interest, dividends, and certain other types of investment income.

Thus, a manufacturing corporation which, in any year of the 5-year period, suffers a loss from operations, perhaps as a result of a strike, or simply a decline in inventory values, may be an inactive corporation if it had any investment income. If this corporation is liquidated, the stock is sold; the entire proceeds are taxed as ordinary income under the bill.

On the other hand, where an investment subsidiary is "spun off," an escape is afforded from the inactive class of corporation by selection of investments which produce income not within the personal holding company classification, as, for example, where all the assets are invested in tax-exempt securities, income-producing real estate, or oil leases.

In the judgment of our committee, virtually every provision contained in subchapter C contains difficulties similar to those that have been discussed. Our initial report, filed this morning, contains more than 50 pages devoted to problems we have so far seen in subchapter C. We know, certainly, that we have not developed all of them. Whether the structural concept of subchapter C could be retained if time were available to study and to iron out the problems, we cannot say. We do recommend, however, that in the limited time remaining before action on H. R. 8300 is scheduled, the efforts of all concerned be spent on revision of other parts, where the work has a real prospect of success.

Reference has been made only to a few provisions of the bill. As pointed out in the report which we are filing, limitations of time require us to confine ourselves largely to comments of a critical nature, and our committee is, of course, fully aware of the many valuable improvements that the bill would make in the structure and operation of the internal revenue laws.

Two things that we have wanted to emphasize today are, first, that there is need for careful consideration and further work on various parts of the bill, and second, that in the judgment of our committee, there is insufficient time for the preparation of a workable subchapter C for enactment at the current session of Congress.

Thank you, Senator, and I would like permission to file a later report on other sections of the bill which we have not been able to cover.

The CHAIRMAN. I wish you would. And I suggest to you, also, that if you have any amendments that you wish in the bill, submit them in definite shape for consideration of the committee when we take this bill up in executive session.

Mr. MACLEAN. We have incorporated a good many already.

Senator BYRD. Mr. MacLean, how long would it take your committee to make a critical examination and recommendations on the entire bill?

Mr. MACLEAN. On the entire bill, Senator?

Senator BYRD. Yes.

Mr. MACLEAN. I hesitate to say. This report covers a few. Our next report, which will be in by sometime near the end of next week, we hope, will cover other major portions.

Senator BYRD. What percentage of the bill does this present report cover?

Mr. MACLEAN. The major revisions?

Senator BYRD. The one you are now testifying on.

Mr. MACLEAN. I would say of the major revision, we have, perhaps, covered 25 percent.

Senator BYRD. Then if time won't permit you to testify on the balance of the bill—Mr. Chairman, will he have an opportunity to testify again?

The CHAIRMAN. He will have an opportunity if he is ready by the date that we agreed to close these hearings.

Senator BYRD. But your present testimony covers about 25 percent of the major parts of the bill?

Mr. MACLEAN. We have not touched foreign income, partnerships, consolidated returns, for example.

Senator BYRD. Do I understand at the beginning of your testimony that you thought parts of the bill should be deferred in enactment at this session?

Mr. MACLEAN. Subchapter C, dealing with corporate distributions and readjustments. Our position is, Senator, that the present provisions of law should be incorporated in that subchapter C, and made effective with the rest of this bill, and that the rest of the time this year will be needed for preparation of a revised subchapter C for submission to the next session of Congress.

Senator BYRD. Are there any major parts of the bill that you think should be deferred, and given the same study and same treatment later?

Mr. MACLEAN. The one I would like to reserve on particularly is the partnerships, on which our committee has been unable, so far, to complete its work and resolve on a group view.

Senator BYRD. But you think that you could make a report on that before the committee goes into executive session?

Mr. MACLEAN. We are doing our best, Senator.

The CHAIRMAN. I urge that you report in by the end of next week at the very latest. We will have 2 weeks of hearings, but the staff, in the meantime, has a prodigious task. And immediately following the hearings, we will have our staff hearings, so they must have their material in hand before then.

(The reports referred to in Mr. MacLean's testimony follow:)

THE ASSOCIATION OF THE BAR
OF THE CITY OF NEW YORK

42 WEST 44TH STREET

THE COMMITTEE ON TAXATION

First Report on H. R. 8300

April 8, 1954

Members of the Committee

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DAVID BRETT CARLSON
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CONTENTS

PART TWO:

PART THREE:

PAGE

PART FOUR:

THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

42 West 44th Street

THE COMMITTEE ON TAXATION

First Report on H. R. 8300

This initial report of the Committee on Taxation of The Association of the Bar of the City of New York on H. R. 8300, 82d Congress, 2d Session, the Internal Revenue Code of 1954, has been prepared for submission to the Senate Finance Committee at the outset of its hearings on the bill. Because of the limited time available between publication of the bill and scheduled action on it, much of the benefit of our Committee's efforts would be lost if it deferred presentation of a report until completion of its consideration of all matters that our Committee has under review. Accordingly this initial report is limited to those topics of major importance as to which our Committee has been able to reach conclusions prior to the appearance of its representative before the Senate Finance Committee. One or more supplementary reports will be submitted as soon as possible covering such matters as the taxation of partnerships, foreign income, provisions relating to procedure and administration, and some of the less important revisions of existing law.

Our Committee is clear from the review already made of the bill that it makes many valuable improvements in the structure and operation of the internal revenue laws. Limitations of time and space prevent us, however, from commenting on these matters and require us to confine our reports largely to comments of a critical nature and, where feasible within the time allowed, to suggestions designed to meet particular difficulties.

PART ONE

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS

Corporate distributions and adjustments are dealt with in Subchapter C of Chapter I. There is universal recognition of the importance to the economy of the country that the provisions governing the organization, readjustment and liquidation of corporate entities should impose a minimum of restrictions and uncertainties consistent with revenue requirements. The complete structural revision of the law dealing with these subjects is therefore among the most important changes contained in the bill.

Our Committee approached Subchapter C with a view to considering how the new techniques employed would operate in practice, what defects there might be in the various provisions and, to the extent possible within the time available, how such defects might be corrected. The following portion of the report was written from this approach, and accordingly contains many detailed recommendations for revisions of Subchapter C. Upon review of the results of its studies, however, our Committee has concluded that the problems posed by Subchapter C cannot be answered by piecemeal patching for inclusion in a bill which is scheduled for early action by the Congress. We think that there are far too many difficulties presented for such an effort to hold any prospect of success. It cannot be emphasized too strongly that virtually every change in a provision of Subchapter C requires restudy and probably revision of other sections in this highly integrated area.

Our Committee recommends that Subchapter C of the bill be supplanted by reenactment of existing provisions relating to corporate distributions and adjustments. There should follow, we submit, a period of intensive study by legislative, administrative and professional groups looking toward the presentation as soon as feasible of provisions which will implement the legislative intent manifested by Subchapter C to settle the law in many important areas in this field. It is believed that on the basis of such a study it would be possible to develop provisions which would effectuate such intent and which would not unduly interfere with either the collection of the revenue or the carrying out of normal transactions.

I.

DISTRIBUTIONS BY CORPORATIONS

The bill represents a comprehensive revision of the internal revenue laws and contains many changes both of a substantive nature and by way of terminology. The provisions relating to corporations and their shareholders which are the subject of this part of our Committee's report are expressly designed to make tax law more certain. They are, therefore, exceedingly detailed and treat of the effects under such law of a wide variety of transactions.

This approach represents a marked departure from existing law. By seeking to make a specific enumeration of tax effects in this field the bill implies that such enumeration is an exclusive one. Apparently, therefore, it should be inferred that results which obtain under the present Code will no longer obtain if not expressly incorporated in the bill.

The principal innovations to tax law contained in this portion of the bill are, first, the rules of Section 305 which provide that a corporation's distributions of its own stock, whether by way of dividend or in recapitalization, will not be taxable to the shareholders receiving them; and, second, the provisions of Sections 301, 302, 304 and 309 which attempt to prevent so-called "bail-outs." The classic bail-out is a device for putting a shareholder in possession of his corporation's earnings and profits at capital gains rates. Generally speaking, it consists of the issuance of redeemable preferred stock as a dividend in respect of outstanding common shares, the sale of such preferred stock to an outsider at a gain taxable at capital gains rates, and the ultimate redemption of the stock by the corporation.

To prevent transactions of this sort the bill adopts a rigid pattern of taxation unlike anything contained in existing law. Section 302 of the bill enumerates six specific situations in which a redemption of stock will constitute a distribution in full or part payment in exchange for such stock. The difference between the amount distributed in any of these situations and the shareholder's basis for the stock in respect of which the distribution is made will constitute capital gain or loss.

But any redemption which does not meet one of these tests will be treated as the distribution of a dividend under Section 301.

The other part of the pattern is set forth in Section 309. This provides for a penalty tax of 85% of the amount of money or the fair market value of securities or property transferred in redemption of "nonparticipating" (i.e., generally speaking, preferred) stock within ten years from the date of its issuance. This tax, however, will not be imposed if the distribution is treated as a dividend or if certain other conditions that are not deemed to be characteristic of a bail-out obtain.

A. Definitions

(1) Dividend

The definition of "dividend" under Section 312 of the bill is essentially that contained in existing law. However, there appears to be an inadvertent omission. According to Section 312(a), a dividend will consist of a distribution of "property" only and this latter term is defined in subsection (f) to exclude instruments representing indebtedness of the distributing corporation. From this it would appear possible for shareholders to receive a distribution of their corporation's bonds or debentures without being taxed on the value thereof as a dividend. The House Report [H. R. Rep. No. 1337, 83d Cong., 2d Sess. (1954)], however, at page A98 makes it clear that this result is not intended; accordingly it is recommended that the term "dividend" be redefined to include distributions of "securities" as defined in Section 312(c) (see discussion, *infra*) as well as property.

(2) Participating Stock

The bill defines "participating stock" in Section 312(b) as stock representing an unlimited interest in the earnings of the issuing corporation and which is not preferred in any way (except in respect of voting rights), either as to distribution of earnings or as to distribution of assets in liquidation. The term apparently includes the usual form of common stock whether or not such stock carries voting rights and even if provision has been made for the redemption of such stock at a fixed price other than upon liquidation of the corporate issuer. Conceivably a corporation might have outstanding no participating stock at all, having assigned a preference in earnings to one outstanding class and a preference in liquidating distributions to another. It is believed that the definition in its present form would permit tax avoidance not intended by the Ways and Means Committee as hereinafter mentioned.

(3) SECURITIES

"Securities" are defined in Section 312(c) as instruments representing an unconditional obligation to pay a sum certain in money (other than open account indebtedness) provided that such instruments where "held by persons who together own 25 percent or more of the participating stock" are not subordinated to the claims of trade creditors generally, and provided that payments of interest thereon (if any) are not dependent upon earnings and are payable in any event not later than the maturity date of the principal. A failure to meet these tests would convert what would otherwise constitute debt into nonparticipating stock for the purposes of Subchapter C. This would result in the disallowance of deductions on account of interest payments in accordance with Section 275 of the bill, and the application of the provisions of Part I with respect to the redemption of nonparticipating stock if obligations of this sort were retired.

(a) This seems to produce a conflict with Section 1232(a)(1) of the bill dealing with the taxation of amounts received by the holder of bonds, debentures, notes, certificates or other evidences of indebtedness (which may or may not constitute securities within the meaning of Section 312) on retirement thereof. It is recommended that appropriate exceptions precluding such a conflict be added to Sections 312(c) and 1232.

(b) As noted above, one of the tests for determining if particular instruments are securities or merely nonparticipating stock depends on whether or not they are held by the owners of 25% or more of the issuer's participating stock. This suggests a possible method of tax avoidance. A corporation issues as a dividend in respect of its outstanding participating stock bonds subordinated to the claims of trade creditors. By definition such bonds constitute nonparticipating stock which, under Section 305 of the bill, may be distributed tax-free. The shareholders then sell the bonds to an outsider and realize a gain taxable at capital gains rates. The outsider owns no participating stock. Presumably, at that point the bonds immediately become "securities" within the meaning of Section 312(c), interest thereon is deductible by the issuing corporation and the bonds can be retired in due course without any danger of incurring the 85% tax provided by Section 309 since that provision as hereinafter mentioned refers only to a redemption of nonparticipating stock. Nor would there appear to be any danger of the bondholders' being taxed upon the proceeds as a taxable dividend. It is not believed that this possibility was intended. Our Committee therefore recommends a change in the wording of the definition of the term "securities" to take care of the above situation.

(c) The provisions of Section 312(c)(1) disqualifying for treatment as a security a corporate obligation held by the owners of 25% or more of the issuer's participating stock if such obligation is "subordinated to the claims of trade creditors generally" do not make it clear whether the subordination referred to must be by the terms of the instrument or may occur by operation of law. For example, in a situation analogous to that in the "Deep Rock" case, *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307 (1939), debts of any sort owed to an individual or corporate parent owning a high proportion of the stock of the issuing corporation might be subordinated in bankruptcy to the claims of all other creditors. In the light of this possibility the use in the bill of the term "subordinated" without qualification introduces an uncertainty which was presumably unintended. Our Committee recommends the addition of the words "by its terms" following the word "subordinated" in Section 312(c)(1).

(d) It is not clear whether Section 312(c)(2), in excluding interest payments dependent on income, refers to interest payments in a given year or to the aggregate interest payments due not later than the maturity date. Thus a bond may provide that interest accrues at a fixed annual rate, is payable prior to maturity only as income is available, and that unpaid accruals are due in all events at maturity. It is recommended that this ambiguity be resolved. Our Committee also invites attention to the fact that if a bond provides for fixed interest and in addition an amount dependent on earnings, deduction of the fixed interest as well as the variable interest is disallowed under Section 275.

(4) Nonparticipating Stock

As used in the bill, nonparticipating stock is defined in Section 312(d) to mean any instrument "known generally as a corporate stock or security" which is neither participating stock nor a security as above defined.

(5) Property

Property is defined in Section 312(f) to include money, securities other than those representing indebtedness of the distributing corporation and stock other than stock of the distributing corporation.

B. Attribution of Ownership

(1) Section 311 establishes rules for determining the constructive ownership of stock for certain purposes in Subchapter C. It represents a departure from present law to the extent that this principle of constructive ownership is extended to the area of corporate distributions. In doing this the pattern of Sections 24, 333 and 503 of the 1939 Code has been followed, but with significant variations. For example, under Section 503(a)(1) of existing law, for the purpose of determining whether a corporation is a personal holding company, any stock owned by or for a corporation or trust is considered as being owned proportionately by its shareholders or beneficiaries. It is believed that this method is a fairer method of attributing ownership than that proposed in Section 311 of the bill for use in the determination of what constitutes a publicly held corporation under Section 359.

(2) Section 311(a) attributes the ownership of stock by a husband or wife to the other spouse except where such spouse is "legally separated from the individual under a decree of divorce or of separate maintenance." This provision discriminates (as do the alimony deduction provisions of existing law which the Ways and Means Committee has sought to correct) against husbands and wives who have separated although not under a court decree. It is recommended that there should be no attribution of ownership between husbands and wives who live apart pursuant to a written separation agreement and do not file joint returns.

(3) Section 302(c) provides that the attribution of ownership rules of Section 311 concerning stock held by members of a family

shall not be applicable in determining the ownership of stock in the case of a complete termination of a shareholder's interest in a corporation. In such case, however, the distributee can escape the rule only if he has no interest in the corporation (not only as a stockholder but also as an officer, director or employee) immediately after the distribution and acquires no such interest except by bequest or inheritance within ten years from the date of the distribution. Even then, except as provided in Paragraph (3) hereinafter discussed, if he has made gifts of stock of the corporation within ten years before the distribution the family attribution rules will apply; and they will also have a limited application to the extent that any part of the stock redeemed was received by him as a gift within the same prior ten year period. Paragraph (3) of subsection (c) excepts any gift which "did not have as one of its principal purposes the avoidance of income tax." The House Report at page A76 suggests that a gift "made for bona fide business reasons" will qualify for this purpose. Inasmuch as a failure to meet the precise conditions of the exemptions of Section 302(c) will subject a taxpayer to extremely adverse tax treatment and in view of the fact that his exposure to such treatment continues over a considerable period of time, clarification should be provided to indicate what sort of gifts are "made for bona fide business reasons."

(4) Section 302(c)(2) specifies that in determining whether there was a complete redemption of participating stock held by a shareholder, the family attribution rule of Section 311(a) will not be applied if thereafter the distributee does not have and does not acquire an interest in the corporation. The House Report at page A75 gives as an example of the application of Section 302(c)(2) a case in which the husband's shares were redeemed but the wife continued to hold similar shares. Our Committee concludes that in determining under Section 302(c)(2) whether the distributee has or acquires an "interest" in a corporation, none of the stock ownership attribution rules of Section 311 should be applied. It recommends, however, that this be clarified.

C. Effect of Corporate Distributions on Shareholders

(1) Section 302(a) enumerates the specific situations in which a distribution of securities or property in redemption of stock will be

deemed for tax purposes to constitute a distribution in full or part payment for such stock. A distribution will so qualify only if:

(a) *It is in redemption of nonparticipating stock and is subject to the transfer tax provided in Section 309.* A discussion of this provision occurs in connection with the comments hereinafter made on Section 309.

(b) *It is in partial or complete liquidation of the corporation.* The meaning of these terms is defined in Section 336 and comment thereon will appear in connection with the discussion of that section.

(c) *It is in complete redemption of all of the participating and nonparticipating stock held by a shareholder.*

(i) An opportunity for tax avoidance seems to be available under this paragraph through the use of non-voting participating stock containing a provision for redemption other than upon liquidation at a price in excess of the amount of money or fair market value of property (if any) for which such stock was issued. Even though the absence of a preference in liquidation might make these shares less saleable than a nonparticipating stock, the possibility of sale should be recognized. If such sale were made to an outsider owning no other participating stock he could promptly turn the non-voting stock in for redemption. Both buyer and seller would then realize capital gains and the tax provided by Section 309 would not be imposed since that relates only to redemptions of nonparticipating stock. It is recommended that appropriate revisions be made to make the distribution in redemption in this case taxable under Section 309 or as a dividend under Section 301.

(ii) By operation of Section 302(c) the family "attribution of ownership" rules of Section 311(a) will not apply in determining whether or not a shareholder's interest has been terminated for the purposes of Section 302(a)(3). It would appear therefore that related shareholders to whom all of a corporation's participating stock was originally issued (and who might thereafter have received dividends thereon in nonparticipating stock) could siphon off earnings as they became available by a series of successive redemptions of all the holdings of a number of them without effectively changing the control or management of the corporation. These redemptions would be taxable at capital gains rates under Section 302(a)(3); they would be exempt from the tax provided in Section 309 because each such redemption would either involve no nonparticipating stock or, to the extent such stock had been issued, constitute a corresponding redemption of both participating and nonparticipating stock which is exempted from the tax by Section 309(a)(2). It is recommended that the effectuation of such a plan be discouraged by adding to Section 302(a)(3) appropriate language such as that contained in the last sentence of Section 304(b) of the bill.

(iii) Section 302(a)(3) apparently overrules the case of *Zenz* v. *Quinlivan*, 106 F. Supp. 57 (N. D. Ohio 1952), which held that a shareholder owning 100% of a corporation's outstanding stock who sold part of such stock to outsiders and turned in the balance to the corporation for redemption out of earned surplus had received a taxable dividend to the extent of the cash received from the corporation. The bill also makes no provision for imputing a dividend to the persons who are put in control of the corporation as a result of the redemption, as suggested by *Frank P. Holloway*, 10 TCM 1257 (1951), *aff'd*, 203 F. 2d 566 (6th Cir. 1953). Our Committee believes that if these results are intended the bill's legislative history should explicitly so state. It is also deemed advisable to establish safeguards against the use of this device for the purpose of tax avoidance. To this end a recommendation with respect to the treatment of earnings and profits in a transaction of this sort is hereinafter made. See Section I-D(2)(b), *infra*.

(d) *It is a "substantially disproportionate" distribution.* To meet this requirement, a shareholder must, immediately after the redemption, own less than 80% of the percentage of the fair market value of the participating stock which he owned prior to the distribution. This paragraph will make it possible for any corporation having two or more unrelated shareholders to issue non-voting participating shares to them as a dividend in respect of their voting participating stock and subsequently to effect redemption of the non-voting shares held by each stockholder separately, by successive disproportionate redemptions, resulting finally, however, in all shareholders being restored to their original proportions of ownership of the participating stock and in a position to repeat the transaction. The redemptions of stock would be taxed at capital gains rates and the subsequent redemption would not be subject to the 85% tax provided by Section 309 since that is imposed only in respect of transfers in redemption of nonparticipating stock. It is suggested that language analogous to that contained in the last sentence of Section 304(b) of the bill be added to Section 302(a)(4) to except from the latter's general rule such planned successive redemptions. Such a provision would be in accord with existing law [see *James F. Boyle*, 14 T. C. 1382 (1950), *aff'd*, 187 F. 2d 557 (3d Cir. 1951)] and with the recommendations of the American Law Institute. See: Cohen, *et al.*, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 Col. L. Rev. 1, 33 (1952).

(e) *It is made to shareholders holding less than 1% of the participating stock.*

(i) This provision seems to invite tax-avoidance through the capitalization in future of a corporation with nothing but nonparticipating stock. Such stock could be redeemed at capital gains rates and, if this occurred after ten years from the date of issuance, the redemption could be effected without giving rise to the tax imposed by Section 309. This difficulty might be resolved by defining a minority interest for this purpose as "the ownership of stock possessing less than 1% of the combined voting power of all of the outstanding stock of the corporation."

(ii) By limiting capital gains treatment upon a stock redemption to the cases specified in Section 302(a) the bill will have the effect of taxing as a dividend distribution many redemptions over which the shareholder has no control. Thus, for example, under Section 302(a), a redemption by lot of the nonparticipating stock held by a shareholder owning 1% or more of the participating stock of the corporation would constitute a taxable dividend to such shareholder even though such corporation may be one whose stock is publicly held and even though the shareholder had subscribed and paid for his nonparticipating stock at par or had purchased it for full value in the open market. The situation is made to appear even more acute when it is noted that there is no saving exception in Section 302(a) to protect such a shareholder from dividend taxation not only with respect to the redemption of future issues of stock but also in respect of those issues already outstanding whose provisions for redemption are automatic and were fixed long before H. R. 8300 was under consideration. It is recommended that appropriate provisions for relief be adopted.

(iii) The House Report at page A74 indicates that the wording of Section 302(a)(5), "a shareholder holding less than 1 percent of the participating stock" applies to a shareholder holding no such stock. It is suggested that any doubt be eliminated by inserting "none or" immediately after "holding".

(f) *It is one to which Section 303 is applicable.* This refers to provisions covering redemption of stock to pay death taxes.

(2) Section 302(b) provides that to the extent that a distribution in redemption of stock does not fall within one of the six paragraphs of subsection (a), it shall be treated as a distribution under Section 301. Generally speaking, this will mean taxation of the redemption distribution as a dividend.

Neither existing law nor the bill makes any mention of the effect of such treatment upon the shareholder's basis for his redeemed stock. Apparently, however, in the absence of contrary provision, such basis will be lost. In the case of an individual shareholder this result seems inequitable. In the view of our Committee such taxpayer should at least be allowed to recover the cost of his redeemed stock by adding it to the basis of his remaining shares.

Different tax consequences follow in the case of redemption of shares held by a corporate stockholder. A corporation derives a substantial advantage with respect to that part of its income taxable as a dividend in consequence of the 85% dividends received deduction provided in Section 243(a) of the bill. At present rates this results in the taxation of dividend income at not more than 7.8% (15% of 52%). Conversely, capital gains of corporations are subjected to a maximum tax of 25%. To allow corporate distributees to increase the basis of that part of their holdings not redeemed would have the effect of reducing the amount of gain potentially subject to such 25% rate. Such a result is deemed undesirable. Since there is no substantial danger of bail-outs at the instance of corporate shareholders a possible solution to the above problem might be the addition of a new paragraph to Section 302(a) providing that distributions in redemption of stock held by corporations other than personal holding companies will in all cases be treated as distributions in full or part payment in exchange for such stock.

(3) Section 304 of the bill parallels Section 115(g)(2) of the existing law with respect to purchases of a shareholder's stock by a subsidiary of the issuer of such stock. Section 304 is broader than its existing counterpart, however, in that it covers purchases not only by subsidiaries of the issuer but also by a corporation controlled by the same persons as those who control the issuer. On the other hand, Section 304 has apparently created a new tax avoidance device by providing, in subsection (b) thereof, that "the determination of whether such distribution [by the related corporation to purchase the shareholder's stock] constitutes a dividend . . . shall be made solely by reference to the earnings and profits of the corporation which purchased the stock of the other corporation." Under this rule, Corporation X could use its surplus cash to acquire the stock of a corporation Y having no earnings and profits; Y would then use its assets to purchase all or part of the stock of X owned by Shareholder A; since Y has no earnings and profits A will have made a sale at capital gains rates and will not be deemed to have received a taxable dividend as was intended by the Ways and Means Committee. It is recommended that Section 304(b) be revised to prevent this result.

D. Effect of Corporate Distributions on Corporations

1. Section 309 provides for a tax of 85% upon the transfer by a corporation of securities or property in redemption of its nonparticipating stock within ten years from January 1, 1954 or the date of the stock's issuance (whichever is later). No provision is made for imposition or collection of the tax, although the House Report at page 36 states that it is imposed "at the corporate level."

The tax provided by Section 309 will not apply if any of certain specifically enumerated conditions are met:

(a) *The tax will not apply if the transfer is made as part of a partial or complete liquidation of the corporation.* No comment on this paragraph appears necessary.

(b) *In the case of a redemption of nonparticipating stock from the original recipient thereof, the tax will not apply if and to the extent that the participating stock in respect of which the nonparticipating stock was issued is simultaneously redeemed.* It is possible, as heretofore noted, that a corporation may have outstanding nothing but nonparticipating stock. The effect of Section 309 in such a situation might be to make impossible any revision of an existing corporation's capital structure by way of stock redemption for ten years without incurring the 85% tax. Our Committee's recommendation on this point is covered in subsection (f), *infra.*

(c) *"If the transfer is in redemption of nonparticipating stock issued for securities or property (or which takes the place of nonparticipating stock which was issued for securities or property) to the extent of 105 percent of the fair market value of such property."*

(i) It is believed that the omission of the words "securities or" immediately before the final word of this sentence is unintentional since it produces the anomalous result of treating securities exchanged for stock as if they had no value at the time of the exchange. The 85% tax would then be imposed on any part of the redemption price of the stock in excess of 105% of whatever cash or other property, if any, had been used with the securities to acquire the stock. Since such result was presumably not intended, addition of the omitted words is recommended.

(ii) This exception suggests that there is no intention to tax redemptions of nonparticipating stock originally issued for a fair consideration if the redemption price is not set in such a manner as to serve as a device to siphon off earnings. Nevertheless, the tax will apply to any redemption to the extent that the redemption price exceeds 105% of the amount paid for the stock, even though such redemption price was established for bona fide business reasons having nothing to do with tax avoidance. Redemption premiums in excess of 5% are not uncommon, and there are many non-redeemable preferred stocks which can be recapitalized only by paying a substantial premium. It is suggested, therefore, that the allowable redemption premium be increased.

(iii) As heretofore suggested bail-outs comparable to those effected under existing law by use of preferred stock may under the bill be accomplished through the medium of non-voting participating stock with redemption provisions. Such a stock should either be included in the definition of nonparticipating stock in Section 312 so that its redemption would be subject to the tax provided in Section 309 or its redemption should be made taxable as a dividend by an appropriate exception in Section 302.

(d) *The tax will not apply if the transfer is treated under Section 302(b) as a distribution not in redemption of stock.* This exemption is ambiguous. Section 302(b) provides that any distribution in redemption will be treated as a distribution under Section 301 unless one of the provisions of Section 302(a) is applicable. Section 302(a)(1) provides that a distribution in redemption of stock will be treated as a distribution in full or part payment in exchange for such stock if the Section 309 transfer tax is applicable thereto. It is not believed that such a circle of cross-references is desirable. Qualifying amendments are recommended.

(e) *Finally, the tax will not apply if the transfer in redemption qualifies under Section 303.* No comment on this paragraph appears necessary.

(f) Section 309(c) provides that for the purpose of determining liability for the 85% tax nonparticipating stock will be deemed to have been issued on its actual date of issuance or January 1, 1954, whichever is later. The effect of this provision will be to impose the new tax on transfers in redemption of stock issued long before such tax was ever proposed and whose redemption provisions were adopted for completely bona fide reasons. Moreover, the provision is discriminatory against all pre-1954 issues. By its use of a 10-year period beyond which a redemption of nonparticipating stock will in no event be subject to the 85% tax, the Ways and Means Committee appears to have indicated its belief that the possibility of bail-outs after such a period is negligible. If this will be true of new issues it should certainly also be true with respect to those already in existence. Furthermore the problem of proving the value of property paid in for stock as far back as the nineteenth century will prove most burdensome. Accordingly, it is recommended that the tax provided in Section 309 be applicable only as to a redemption of stock within 10 years of its actual date of issuance, and that subsection (c) thereof be deleted from the bill.

(g) It is not believed that the tax law should penalize corporations for redeeming issues of nonparticipating stock already in existence where the manner of issuance is not likely to have been connected with tax avoidance motives. Therefore, with respect to all of such existing nonparticipating stock issued for money, property or securities (or which takes the place of nonparticipating stock so issued) and not originally issued as a stock dividend or in connection with a recapitalization or mere rearrangement of capital structure, it is recommended that an appropriate exemption be added to Section 309 which would permit the redemption of these issues at any time without giving rise to the 85% tax.

(2) Section 310 of the bill deals with the effect of corporate distributions upon the earnings and profits of the distributing corporation.

(a) Section 310(a) provides generally that a distribution of securities or other property will result in a reduction of earnings and profits by the amount of money, the principal amount of securities and the adjusted basis of other property distributed. This resolves a conflict in the courts in respect of the effect on earnings and profits of dividends in kind. According to the House Report at page A94, the amount of a distribution in kind which is taxable as a dividend is limited to the lesser of the distributing corporation's earnings and profits or the fair market value of the property distributed. Thus, if a corporation has property with an adjusted basis of $100 and a fair market value of $150 and distributes such property to its stockholders at a time when its earnings and profits amount to $120, the amount taxable as a dividend to the shareholder will be $120; the remaining $30 will be applied to reduce the basis of the stockholder's shares. This result is contrary to that suggested by the American Law Institute [2 FED. INC. TAX STAT. X §507(b)(8) (Feb. 1954 Draft)] and adopts the holding in *Estate of Ida S. Godley*, 19 T. C. No. 124 (1953) (now on appeal 3d Cir.).

In the example given above, by reducing earnings and profits by no more than the basis of the property distributed ($100) the bill in effect provides for future dividend taxation of the $20 excess of earnings and profits over such basis. This amount, however, will already have been taxed to the shareholder when the property was distributed to him. To eliminate this inequity it is suggested that in such cases earnings and profits be reduced by the amount taxable as a dividend.

(b) Section 310(c) provides that distributions considered to be in redemption of stock (other than nonparticipating stock issued for property) shall reduce earnings and profits by an amount having the same ratio to earnings and profits immediately prior to the transaction which the adjusted basis of the assets distributed bears to the adjusted basis of all assets immediately prior to the distribution. It has already been pointed out that it will be possible under the bill for a stockholder to sell part of his stock to outsiders and turn the balance in for redemption without the realization of a dividend by either the retiring stockholder or his successors in control. (See Section I-C(1)(c)(iii), *supra.*) In such an event it would seem proper to provide that the redemption would result in no decrease in earnings and profits. The addition of such a rule to Section 310 is accordingly recommended.

II.

CORPORATE LIQUIDATIONS

A. Revisions of Existing Law

The provisions of the bill with respect to corporate liquidations embody substantial departures from the pattern of existing law in the following respects:

The unrealized appreciation in the value of corporate property distributed in liquidation is not taxed to the shareholder at the time of liquidation. It is intended that a parent corporation will in general receive the benefit of the cost of the stock of a subsidiary either as the basis of assets received on liquidation or through a loss recognized on liquidation. The collapsible corporation problem is attacked by perpetuating the corporation's basis of particular types of assets rather than by treating the gain on sale or liquidation as ordinary income. Corporations are permitted to sell their assets in connection with a liquidation without incurring the second tax involved in *Commissioner* v. *Court Holding Company,* 324 U. S. 331 (1945). A partial liquidation is limited to a distribution in connection with a complete termination of one of several separate businesses carried on by the corporation.

B. Definitions

(1) Partial Liquidations

(a) Section 336(a) limits a partial liquidation to a distribution "attributable to the complete termination" of a separately operated business of the corporation. It is not clear whether the business must be terminated merely as to the distributing corporation, or whether the stockholder-distributee and the purchaser of the assets are also precluded from continuing the activity. Compare the definition of "complete termination of the business of the employer" in Section 401(b)(2)(B).

(b) Section 336(a)(2) requires that for at least five years prior to the partial liquidation, separate books and records of the business terminated must have been kept "by the distributing corporation" and the business must have been operated separately from the other business of "the corporation". Our Committee recommends that the term "corporation" be enlarged to include predecessors in tax-free acquisitions.

(2) Inventory Assets

To meet the problem of the collapsible corporation, the bill provides a carry-over of the corporation's basis of certain assets "which, under normal circumstances, would not be distributed in kind to shareholders." These comprise inventory, property held for sale to customers in the ordinary course of business, "rights to income", and, where held less than five years, real property and depreciable property, used in the trade or business.

(a) *Rights to income.* The House Report at page A113 cites as an example of "rights to income" a contract calling for a certain percentage of the profits of a business. It is the stated intention that all rights to future income shall, for this purpose, be considered susceptible of valuation.

Our Committee believes that this subsection is indefinite, will prove troublesome to interpret and will involve burdensome valuation problems. It does not appear, for example, that "rights to income" should include unmatured coupons attached to a bond, future dividends on stock, or a percentage of profits to be paid for future services.

Our Committee recommends that the subsection be limited to rights to income not yet received or accrued, but already earned in the sense that there remains no further rendering of services or furnishing of capital as a condition of collection.

(b) *Real property and depreciable property.* Our Committee questions the necessity or desirability of including within the definition of "inventory assets" in Section 336(d)(4) real property used in the trade or business and depreciable property used in the trade or business and held for a period of less than five years.

Under this section if stock, having a basis of $1,000, in a corporation holding depreciable assets with a basis of $1,000, is sold to a purchaser for $10,000, who thereupon liquidates the corporation, the selling stockholder will realize a capital gain of $9,000 but the purchaser will have a basis of only $1,000 for the depreciable assets. If, however, the selling stockholder liquidates the company first and then sells the depreciable assets to the purchaser, the selling stockholder again will realize a capital gain of $9,000 but the purchaser will have a basis of $10,000 for the depreciable assets.

Our Committee believes that different results should not be obtained through utilizing different forms in casting the same transaction. Under Section 1231 depreciable assets and real property used in the trade or business may be sold at capital gains rates by the corporation before liquidation or by the stockholder-distributee after liquidation, and in either case the purchaser will take cost as its basis. It is not believed that under the general approach adopted in Part II a different result should obtain in a purchase of stock followed by liquidation. Accordingly our Committee recommends elimination of Section 336(d)(4) from the definition of inventory assets.

(3) APPRECIATED INVENTORY. Section 336(e) defines "appreciated inventory" as meaning inventory assets if the fair market value of such assets exceeds 120% of the basis of such assets and 10% of the fair market value of all other assets, and is less than the basis of the stock allocable thereto. Neither the statutory language nor the House Report indicates whether the determination should be made on the basis of aggregate inventory assets or on an asset-by-asset basis, although in Section 333(a)(2) the assets are clearly treated separately. Since a substantial difference in results may obtain, our Committee recommends that this point be clarified.

(4) PARENT CORPORATION. Section 336(g) provides that a "'parent corporation' means a corporation owning stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock of another corporation."

Under Sections 312(c) and (d), for the purposes of Subchapter C income debentures are included within the definition of "nonparticipating stock". The general definition of "stock" in Section 7701(a)(7) does not exclude income debentures. Our Committee recommends clarification of whether all types of nonparticipating stock are to be considered stock for purposes of the definition of parent and subsidiary.

C. Amount of Gain or Loss Recognized to Shareholders in Corporate Liquidations

Section 331(a), by reference to subsections (b), (c) and (d), limits the amount of gain to be recognized in corporate liquidations. The treatment of the recognized gain or loss, whether as capital gain or loss, dividend income or other income, is specified in Section 332.

(1) APPLICATION OF SECTION 358

Section 358, corresponding to Section 112(i) of existing law, is intended to make the ordinary rules as to distributions and liquidations inapplicable to a foreign corporation unless prior to the transaction it has established to the satisfaction of the Secretary or his delegate that the transaction is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. The operation of this section is not clear, as is demonstrated by reference to the provisions with respect to liquidations.

Section 358 provides in part that "The provisions of Section 1002, limiting the recognition of gain under subchapter C of chapter 1 to the extent provided in such subchapter, shall not be applicable to a foreign corporation * * * with respect to * * * so much of part II of subchapter C as relates to the liquidation of a subsidiary corporation by its parent corporation" unless the prior ruling is obtained.

(a) Although it is presumed that the foregoing provision is intended to apply where the foreign corporation is the parent rather than the subsidiary, our Committee recommends that this be clarified.

(b) It is also recommended that the cross-references be clarified. Section 1002 provides that "On the sale or exchange of property the entire amount of the gain or loss, determined under Section 1001 shall be recognized, *except as hereinafter provided in* this subchapter and *subchapters C* (relating to corporate distributions and adjustments) and *K* (relating to partners and partnerships)". (Italics supplied.)

The effect of Section 358 apparently is to eliminate the italicized provisions in the case of the liquidation of a subsidiary corporation by its parent. However, Section 1001, to which reference remains, contains in subsection (c) its own provision as to recognition of gain or loss, which appears to duplicate Section 1002. Our Committee recommends that unless either Section 1001(c) or Section 1002 is eliminated, Section 358 should contain a cross-reference to both sections.

(c) The operation of Section 358 in case of the liquidation of a subsidiary remains obscure. The portion of Subchapter C specifically relating to the liquidation of a subsidiary corporation by its parent corporation is Section 332(b)(1). This section does not limit recognition of gain, but provides that the gain will be treated as a dividend and will be offset in the case of the liquidation of a subsidiary by a 100% deduction for dividends received. Thus it is not clear whether the failure to obtain a ruling under Section 358 will result in (i) reduction of the deduction for dividends received to 85% (but see Section II-D(2)(a), *infra*, as to allowability of any deduction), (ii) treatment of the gain recognized under Section 331(b) as capital gain, or (iii) recognition of the entire realized gain, without benefit of the limitation of the gain by Section 331(b) to the extent of the excess of the adjusted basis or fair market value of the assets, whichever is less, over the adjusted basis of the stock. Our Committee recommends that the operation of the provision be clarified.

(2) Recognition of Loss

Section 331(c) provides that "no loss shall be recognized in the case of a distribution in complete liquidation of a corporation to the extent that the stock of such corporation was acquired by an acquiring corporation in a corporate acquisition of stock described in section 359(b)." The explanation of the exception for acquisitions under Section 359(b) lies in the provision of Section 355(b) that the basis of the stock so acquired shall be an amount equal to the basis of the assets within the corporation acquired. The acquiring corporation's basis of the stock is thus established without regard to cost, and some disallowance of loss in liquidation may be proper. However, an actual loss may have been incurred by reason of post-acquisition losses or decreases in value of assets of the company whose stock is acquired.

Our Committee therefore questions whether a complete disallowance of loss in all cases is warranted. To the extent that the loss is attributable to post-acquisition losses or decreases in value of assets of the subsidiary it should be allowed.

(3) Debt Held by Stockholders

Section 331(e)(1) provides that securities of a subsidiary held by its parent shall be treated as stock. The House Report, at page A103, states that this provision removes the problem represented by the case of *Northern Coal and Dock Co.*, 12 T. C. 42 (1949). Accordingly, if a subsidiary in liquidation transfers appreciated or depreciated property to its parent in satisfaction of a security (excluding open accounts), no gain or loss is recognized to the subsidiary. This provision eliminates in the parent-subsidiary relationship the troublesome problems which have arisen in connection with debt held by stockholders. Our Committee recommends that this treatment be extended to stockholders other than a "parent" by providing that securities of a corporation held by the owner of participating stock shall be treated as stock up to an amount which bears the same ratio to the amount of all securities of the corporation which the participating stock held by the stockholder bears to all participating stock of the corporation.

(4) Basis Adjustments

The bill has approached the problem of the collapsible corporation by removing "appreciated inventory" from the operation of the general rules applicable to liquidations. For this purpose the basis and the fair market value of all of the corporate assets is reduced by the basis and fair market value, respectively, of the appreciated inventory, and the basis of the stockholder's stock is reduced in the proportion that the fair market value of appreciated inventory bears to the fair market value of all corporate assets.

The adjustment eliminating from the basis of the stock the portion allocable to appreciated inventory distributed is provided in Section 331(e)(2)(A). However, several other adjustments to the basis of the stock are also provided in Section 331(e). Section 331(e)(3) increases the basis of the stock by reason of attribution to the stockholders under Section 332(c) of gain from the sale of corporate assets in liquidation. Section 331(e)(5) increases the basis of the stock by reason of assumed liabilities. If these basis increases are effected before elimination under Section 331(e)(2)(A) of a portion of the basis allocable to appreciated inventory, the benefit of the basis increases may be partly lost, since only in unusual circumstances will application of Section 331(e)(2) result in a loss under Section 331(d)(2).

For example, assume that a stockholder has a basis of $20,000 for all the stock of a corporation holding (i) depreciable inventory assets with a basis of $5,000 and a value of $50,000, and (ii) securities with a basis of $5,000 and a value of $50,000. The corporation adopts a plan of liquidation, sells the securities for $50,000 in cash, and distributes the cash proceeds and the appreciated inventory to the stockholder.

Under Section 332(c) the stockholder reports a capital gain of $45,000 and under Section 331(e)(3) the basis of his stock is increased by $45,000, to $65,000. If Section 331(e)(2) is thereafter applied his basis of the stock is reduced by 50%, or $32,500, since 50% in value of the assets consists of appreciated inventory. Inasmuch as the fair market value of the assets is reduced by a greater amount, $50,000, no loss is recognized under Section 331(d)(2). The stock has a remaining basis of $32,500 and therefore on the distribution of the $50,000 proceeds from the securities the stockholder will report a capital gain of $17,500. His total reported gain is thus $62,500. Yet if the corporation had distributed the securities to him in liquidation no gain would have been recognized to him on the liquidation and a capital gain of only $30,000 would have been recognized if he thereafter sold the securities for $50,000.

If the reduction of basis of stock under Section 331(e)(2)(A) is made before basis is increased under (e)(3) and (e)(5), the total capital gain reportable on the transaction first described is $40,000. The income distortion is thus minimized. Our Committee therefore recommends that the section be amended to provide that the adjustment under Section 331(e)(2) shall be made before those provided in subsections (e)(3) and (e)(5).

D. Treatment of Gain or Loss to Shareholders in Liquidations

(1) Long-Term Capital Gain or Loss

Section 332(a) provides that the gain or loss to a non-corporate shareholder in a liquidating distribution will be long-term or short-term capital gain or loss. Our Committee invites attention to the fact that in the case of shares of stock which are not capital assets, such as those held by a dealer for sale to customers, this constitutes a change from existing law, under which ordinary income and loss would be realized.

(2) Treatment of Gain to Corporate Stockholders as Dividend Income

Section 332(b)(1) provides that as to a corporate shareholder the gain on liquidation shall be treated as a dividend, and that in the case of a liquidation of a subsidiary the deduction for dividends received provided in Section 243(a) shall be 100%. In several respects, however, treatment of the gain as a dividend will have effects which may not have been anticipated and are not provided against.

(a) The deduction for dividends received provided in Section 243(a) is limited to dividends from domestic corporations. The deduction allowed by Section 245 for dividends received from foreign corporations engaged in trade or business within the United States is quite limited in scope. Accordingly the gain recognized to a domestic corporation on the liquidation of a foreign corporation will generally be taxable as ordinary income, rather than as capital gain, or will be tax-free under Section 112(b)(6) and Section 112(i) of existing law.

(b) Under Section 881(a) foreign corporations not engaged in trade or business within the United States, as under existing law, are taxed at the rate of 30% on dividends, but are not taxed on gains from the sale or exchange of capital assets. Although under existing law such corporations are not taxed on the gain on the liquidation of a domestic company, under Section 332(b)(1) the gain is treated as a dividend, taxable at 30%, without the benefit of any offsetting deduction for dividends received. Furthermore, under Section 1442 the domestic corporation in liquidation is required to withhold tax on dividends paid to the foreign corporation. Since the amount of the "dividend" received by the corporate stockholder in the liquidation may depend on the basis of the stock, the liquidating company may not know how much to withhold.

(c) Section 246(b) limits certain deductions, including the deduction for dividends received allowed under Section 243(a), to 85% of the taxable income computed without regard to such deductions. Accordingly, in any case in which taxable income is less than 117.7% of the "dividend" received by a corporation as gain on a liquidation, a portion of such gain will be taxed as ordinary income, even in the case of the liquidation of a wholly owned subsidiary.

(d) In the computation of undistributed personal holding company income, Section 545(b)(3) disallows the deduction for dividends received provided in Part VIII. Accordingly the "dividend" received by a personal holding company in a corporate liquidation must either be distributed to its stockholder in the form of dividends or will be subject to the personal holding company surtax. Previously as to a personal holding company the gain on such a liquidation either was tax-free under Section 112(b)(6) or was subject only to capital gains tax.

Our Committee recommends that if the gain to a corporate stockholder in a liquidation is to be treated as a "dividend", amendments be made to provide proper integration with other provisions affecting dividends.

(3) Attribution of Gain to Shareholders

Under Section 332(c) the gain not recognized to a corporation on the sale of its assets in connection with a liquidation is taxed to the holders of participating stock. As has previously been indicated, however, a corporation may have no participating stock. Alternatively, a corporation may have a class of stock which participates generally in earnings and on liquidation, but which has preferences which classify it as "nonparticipating stock". The participating stock under these circumstances would bear the full tax burden of the tax under Section 332(c) without full enjoyment of the income which gave rise to it. Corrective amendments are recommended.

III.

CORPORATE ORGANIZATIONS, ACQUISITIONS AND SEPARATIONS, AND EXCHANGES IN CONNECTION THEREWITH.

A. The Provisions Which Replace the Definition of Reorganization in Section 112(g) of Existing Law (Sections 354 and 359)

The class of transactions which may furnish the basis for tax-free exchanges in connection with corporate readjustments has been narrowed considerably by the provisions of the bill (Sections 354, 359). With substantial modifications, the bill retains provisions corresponding to the provisions of the existing law with respect to statutory mergers and consolidations, acquisitions of stock for stock, acquisitions of property for stock and transfers of corporate property to controlled corporations. The bill eliminates recapitalizations as a separate type of transaction and deals with them under the heading of corporate distributions. The present provision with respect to a mere change of identity, form or place of organization is eliminated and no corresponding provision substituted.

(1) Statutory Mergers and Consolidations (Section 112(g)(1)(A) of Existing Law)

Section 359(a) defines "publicly-held" corporations. Section 354(b) permits mergers and consolidations of "publicly-held" corporations without any restriction as to the nature of the stock received. Statutory mergers and consolidations of other companies will not qualify unless they also meet the requirements of Section

359(c) (dealing with acquisitions of property for stock) which include important restrictions on the types of stock and securities that may be issued and also a requirement that the stockholders of the acquired corporation have an interest in the participating stock of the acquiring corporation which, in the ordinary two-corporation transaction must amount to at least 20%.

(a) Section 359(a) contains the definition of "publicly-held" corporations which may merge pursuant to the provisions of Section 354(b). Under this definition a subsidiary of a publicly-held corporation would not itself be considered a publicly-held corporation. This would prevent the merger of a parent corporation into its subsidiary under Section 354(b) and confine such a transaction to cases in which the relatively strict requirements of Section 359(c) could be satisfied. It is suggested that there be added to the subsection a provision to the effect that a controlled subsidiary of a publicly-held corporation shall be deemed to be publicly held.

The effect of this definition may well be that many of the large corporations of the country in which the investing public has a substantial interest will not be within the classification of publicly-held corporations although this fact may not always be ascertainable by the corporation itself. On the other hand, any corporation with more than twenty unrelated shareholders holding equal amounts of stock will be classified as publicly-held, notwithstanding the absence of any interest therein on the part of the investing public generally. Under the bill, the merger of such a corporation would not be subject to the requirements of Section 359(c), whereas the merger of another company with thousands of stockholders and security holders might well be subject to such requirements. Our Committee feels that the line drawn in this respect by the bill does not afford a rational basis for distinction.

(b) Section 354(b)(1) provides that no gain or loss shall be recognized to a publicly-held corporation which transfers its property "in exchange for stock or stock and property" of another publicly-held corporation in a statutory merger. Omission of the word "solely" from the quoted phrase would seem to indicate that securities could also be received in such a transaction. However, the specification of "property" without mention of "securities" suggests the contrary. It is believed that "securities" were intended to be included. In any event, it is submitted that this important clause should not be left ambiguous.

(c) The word "stock" is nowhere defined in Subchapter C (cf. Section 7701(a)(7)). Query whether it is limited to interests commonly known as stock or embraces all interests coming within the statutory definitions (Section 312) of "participating stock" and "nonparticipating stock," e.g., income debentures. The fact that "nonparticipating stock" embraces any stock or security not within the definition of "participating stock" and "securities" would not seem a conclusive answer to the question.

(d) While Section 354(b)(1), dealing with statutory mergers of publicly-held corporations, specifies the property which may be received by the transferor corporation, Section 354(b)(2), dealing with consolidations of such corporations, contains no such specification. The reason for this difference is not apparent. If no difference was intended the two clauses should be conformed in order to remove any ground for later argument.

(e) In order to insure continuity of interest in the case of statutory mergers and consolidations of publicly-held corporations, Section 354(b) requires that holders of a minimum number of shares in the merged corporation continue as shareholders of the surviving corporation. No minimum number of shares is required to be received, and property other than stock may be received without limitation. In view of the definition of nonparticipating stock the requirement apparently could be satisfied by income debentures.

The minimum number of shares required to be exchanged is specified only by reference to state law, which will vary not only from state to state, but also in a single state as to different classes of stock. Also, the requirement may be affected by provisions of the certificate of incorporation. To our Committee, it seems undesirable to have federal tax consequences depend upon whether a corporation is organized under the law of one state or another. It is suggested that the minimum number of shares required to be exchanged be specified by reference to a stated percentage.

(2) Acquisitions of Stock for Stock (Section 112(g)(1)(B) of Existing Law)

Section 359(b) defines a "corporate acquisition of stock" as an acquisition of stock by a corporation "in exchange for all or part of its participating stock," etc. The House Report states at page A132 that this provision is generally similar to Section 112(g)(1)(B) of existing law, "but with several important differences." The most significant difference would seem to be the inclusion of a requirement that the shareholders of a corporation whose stock is acquired, hold, after the transaction, not less than one-quarter of the amount of participating stock of each class of the acquiring corporation held by the stockholders of the acquiring corporation before the acquisition or by the stockholders of any other corporation acquired. In the ordinary two-corporation transaction the stockholders of the corporation acquired must obtain an interest of 20% in the participating stock of the acquiring corporation.

Obviously, this new requirement may operate to prevent many corporate acquisitions which would otherwise occur. Our Committee points out, however, that the requirement can be obviated by amending the corporate charter to give present participating stock a slight preference in liquidation (thereby converting it into nonparticipating stock) and by creating a new class of stock, to be used for acquisitions, with all the rights of the first class except the preference in liquidation. Again, the stockholders of the two corporations might transfer their shares to a new corporation in exchange for its participating stock, one group receiving 90% and the other 10%. The transaction would not qualify under Section 359(b) because it would not comply with the 20% requirement. It could, however, qualify under Section 351(a).

(a) Section 112(g)(1)(B) of the Code refers to the acquisition by a corporation "in exchange solely for all or a part of its voting stock" of stock of another corporation. The omission of the word "solely" in Section 359(b) would seem deliberate. This is confirmed by illustrations given in the House Report at pages A85 and A119. It would seem important, however, for Section 359(b) to state expressly (as is done in the third sentence of Section 359(c)) that the fact that the exchange also includes property, securities or nonparticipating stock will not disqualify the transaction as a corporate acquisition of stock.

(b) Section 359(b)(1) refers to the acquisition of control of "such other corporations" (in the plural) whereas the introductory clause of the subsection refers only to the acquisition of stock of "another corporation" (singular). Presumably, the introductory clause was intended to be in the plural.

(c) The House Report makes clear that Section 359(b) is intended to permit tax-free acquisition by a corporation of small blocks of stock of another corporation if "control" is thereby obtained and also after "control" thereof has been obtained. This purpose, however, may well be frustrated by the provisions of paragraph (2) of Section 359(b), requiring that after the exchange the shareholders of the corporation whose stock is acquired must have at least 20% of the participating stock of the acquiring corporation. It would seem likely that in many cases the small block of stock proposed to be acquired would not be entitled to any such percentage of the participating stock of the acquiring corporation. Modification of the 20% requirement in order to make such small acquisitions possible would seem indicated.

(d) The last sentence of Section 359(b) provides that the 20% continuity requirement shall not apply "if substantially all of the stock of all the corporations parties to the transaction is owned directly or indirectly by the same interest." Clearly, a test of "substantially all" introduces uncertainties of the very kind which the bill seeks to avoid in other connections. Also, the phrase "the corporations parties to the transaction" presents difficulty because a corporation whose stock is being acquired can hardly be considered a party to the transaction. Existing law avoids this difficulty by defining (in Section 112(g)(2)) "a party to the reorganization" as including such a corporation. The phrase "the same interest" also introduces doubt. (While the word "interest" is used in the statute, the House Report at pages A133 and A134 uses the word "interests.") Query, whether it is intended that a *single* legal entity must own, directly or indirectly, "substantially all" the stock of the corporations involved, or whether it will suffice if *several* individuals or entities own in varying proportions "substantially all" of the stock of each of such corporations.

(3) Acquisition of Property For Stock (Section 112(g)(1)(C) of Existing Law)

Section 359(c) defines the term "corporate acquisition of property" which corresponds to the transaction specified in Section

112(g)(1)(C) of existing law in much the same way that Section 359(b) of the bill corresponds to Section 112(g)(1)(B) of existing law. As stated, statutory mergers or consolidations of non-publicly-held corporations would have to comply with the provisions of Section 359(c) in order to qualify for non-recognition treatment.

(a) The introductory clause of Section 359(c) refers to the acquisition of properties "of another corporation," whereas paragraph (1) of the subsection refers to the possibility of there being more than one transferor corporation.

(b) The introductory clause of Section 359(c) would permit the acquisition to be made in exchange for stock of a corporation in control of the acquiring corporation, thus changing the rule of the *Groman* and *Bashford* cases, according to the House Report at page A134. But the subsection does not accomplish this change because paragraph (1) thereof (containing the 20% continuity of interest requirement) limits the exchange to stock of the acquiring corporation. Revision of paragraph (1) is required to refer also to stock of the corporation in control of the acquiring corporation.

(c) The next to the last sentence of Section 359(c) provides an exception to the 20% rule, like that contained in Section 359(b), for corporations substantially all of the stock of which is owned directly or indirectly by the same interest. The test of "substantially all" seems particularly inappropriate in a provision which is itself designed to avoid a similar test by replacing a requirement of "substantially all" in Section 112(g)(1)(C) of existing law by a specification of 80%.

(4) Transfers of Corporate Property to a Controlled Corporation (Section 112(g)(1)(D) of Existing Law)

Section 359(d) permits a transfer by a corporation "of a part of its assets" to another corporation "solely in exchange for stock or securities" of the transferee where the transferor or some or all of its stockholders are in control of the transferee immediately after the transfer. The House Report states at page A134 that Section 359(d) is similar to Section 112(g)(1)(D) of existing law "with several important modifications." Section 112(g)(1)(D) refers to a transfer by a corporation of "all or a part of its assets." If the omission of the word "all" from Section 359(d) was intentional, it would seem desirable to make this clear by referring in Section 359(d) to a transfer by a corporation "of a part (but not all) of its assets" to another corporation. If the omission was inadvertent it should be corrected.

The last sentence of Section 359(d) provides that in determining whether the exchange authorized "is solely for participating stock," the assumption of liabilities shall be disregarded. Obviously, this is a clerical error in view of the specification of "stock or securities of the transferee corporation" in the introductory clause of the subsection.

(5) RECAPITALIZATIONS (SECTION 112(g)(1)(E) OF EXISTING LAW)

The bill does not specify recapitalizations as constituting one of the classes of corporate adjustments under which exchanges of stock and securities may be made without recognition of gain of loss. Instead, the bill leaves the tax effect of such exchanges to be determined under Sections 305 and 306 as though the shareholders and security holders had received a distribution of stock and securities from the corporation.

(6) MERE CHANGES IN IDENTITY, FORM OR PLACE OF ORGANIZATION, HOWEVER EFFECTED (SECTION 112(g)(1)(F) OF EXISTING LAW)

The bill fails to provide for non-recognition of gain or loss on exchanges of stock and securities in connection with "a mere change in identity, form or place of organization, however effected." This represents a departure from present law under which such changes are included in the definition of a reorganization. Among other things, the present provision enables a corporation to reincorporate in another state without a tax resulting to it or its shareholders. Under Section 359(c) of the bill a non-publicly-held corporation could not, in many cases, effect such a change without drastically altering its capital structure. For example, a corporation with a heavy preferred stock capitalization would have to reclassify at least a portion of such shares in order to satisfy the "solely in exchange for" provision with respect to its participating stock. The same would be true in the case of a publicly-held corporation if applicable state law did not permit merger across state lines, because in that case it could not proceed under Section 354(b).

Because existing law includes statutory mergers and consolidations in the definition of "reorganization", without restrictions as to whether the corporations involved are publicly-held, it has not been necessary under existing law to rely in many cases on the specific provision of Section 112(g)(1)(F) with respect to mere changes in form, identity and place of organization. This apparently led to the impression that a replacement for Section 112(g)(1)(F) was unnecessary (House Report, at page A115). However, such a conclusion can be reached only by overlooking the fact that, in many cases, the restrictions imposed by the bill exclude the possibility of effecting such changes by statutory mergers or consolidations.

(7) EFFECT OF ASSUMPTION OF LIABILITIES (SECTION 112(k) OF EXISTING LAW)

Section 356 provides that, in certain tax-free exchanges in connection with corporate adjustments, the assumption of liabilities shall not be considered as money or other property received by the taxpayer, which might serve to prevent the transaction from qualifying for such treatment.

(a) Paragraphs (1) and (2) of this section purport to state two exceptions to the general rule. Paragraph (1) provides that where the principal purpose of the taxpayer with respect to the assumption was to avoid taxes or was not a bone fide business purpose, the *total amount* of the liabilities assumed shall be considered as money received by the taxapayer. Subparagraph (2) provides that, on certain exchanges, if the liabilities assumed exceed the total adjusted basis of the property transferred, the *excess* of such liabilities over the basis shall be considered as a gain from the sale or exchange of a capital asset. Nothing is said, however, as to the tax treatment to be given an assumption of liabilities in any situation to which both exceptions are applicable. Paragraphs (1) and (2) are set forth in the disjunctive.

(b) Paragraph (1) is in terms stated to be "for the purposes of this section," whereas it is obviously intended to be for the purposes of the sections cited in the introductory clause of the section.

(c) The introductory clause of the section refers to Section 359(c) although that section specifically deals with the effect of the assumption of liabilities on transactions there described and under Section 359(c) the exceptions contained in paragraphs (1) and (2) of Section 356 could have no application.

B. The Provisions Which Replace the Non-Recognition Provisions of Section 112(b)(3), (4) and (11) and Section 112(d)(1) of Existing Law

Under existing law, gain or loss is not recognized with respect to specified exchanges of property of a party to a reorganization and stock and securities in a party to a reorganization. The bill adds stock and securities of a controlled subsidiary to this list of items which may be exchanged without recognition of gain or loss, and modifies the circumstances under which the exchanges can be made. The bill also adds to the list by extending the meanings of "stock" and "securities" to include many forms of indebtedness not formerly included.

(1) Exchanges by a Party to a Reorganization (Section 112(b)(3) and (4) and Section 112(d)(1) of Existing Law)

Sections 308(a), 354 and 1032 of the bill replace the provisions of existing law with respect to non-recognition exchanges by a party to a reorganization. Except as indicated below, the bill makes no change of substance.

(a) The bill does not provide for non-recognition of gain or loss to a corporation which, in connection with a transaction described in Section 359(c) or Section 359(d), transfers stock or securities of another corporation in exchange for its own securities. This is apparently an oversight (see Section 308(a) as to distributions with respect to stock).

(b) Section 354(a)(1) of the bill permits the transferor corporation in a corporate acquisition of property described in Section 359(c) to receive without recognition of gain not only stock and securities of the transferee but also other property of the transferee (cf. Section 112(d) of existing law).

(c) The bill does not provide for non-recognition of gain or loss to a corporation which transfers its own securities in exchange for its outstanding securities in a debt recapitalization (cf. Sections 76 and 108 of the bill). The failure to embody the substance of Section 112(b)(3) of existing law to this extent was presumably not intentional.

(2) EXCHANGES BY PERSONS NOT PARTIES TO A REORGANIZATION (SECTION 112(b)(3) OF EXISTING LAW)

Except as indicated below, Sections 305 and 306 of the bill (applied as provided in Sections 352 and 353 in the case of exchanges under Sections 354 and 359 of the bill with respect to statutory mergers and consolidations, corporate acquisitions of stock or property and corporate separations) replace Section 112(b)(3) of the Code.

(a) The bill does not provide for non-recognition of gain on receipt of securities by a shareholder in respect of his stock. By this method the bill deals with the type of situation presented by the *Adams* and *Bazely* cases.

(b) Section 306(d) is apparently intended to provide, among other things, for recapitalizations involving only changes in the debt structure of a corporation. However, Section 306(d) would literally not seem applicable to such recapitalizations in view of the definite provision contained in subsection (a) thereof limiting the application of Section 306 to distributions in transactions described in Sections 305, 352 and 353, none of which apply to mere security recapitalizations. This omission was presumably an oversight.

(c) Section 353 of the bill imposes certain conditions on the exchange of stock or securities in a corporation for stock or securities of a controlled subsidiary even though the subsidiary would have the status of a party to a reorganization under existing law. These conditions will be discussed below in connection with distributions of stock or securities of a controlled subsidiary without the surrender of stock or securities in the distributing corporation.

(d) Section 352(a) refers to the tax treatment of a shareholder or security holder who "receives a distribution of stock or property." The omission of "securities" from this phrase is assumed to have been inadvertent. Similarly, it would seem that the words "or securities" should be added at the end of the first sentence of the subsection.

(3) DISTRIBUTIONS OF STOCK AND SECURITIES OF CONTROLLED CORPORATIONS (SECTION 112(b)(11) OF EXISTING LAW)

The provisions of Section 112(b)(11) of existing law for non-recognition of gain in connection with a spin-off have been modified in Sections 353 and 359(d) of the bill by the removal of some restrictions and the imposition of others. In lieu of the requirement of Section 112(b)(11) that both the distributing corporation and the corporation spun-off continue the active conduct of a trade or business, the bill provides for the inclusion in income (without regard to earnings and profits) of any amounts received within ten years upon the disposition of any stock of an "inactive corporation" received or held as a result of a spin-off.

(a) *Section 353(a)—General rule.*

(i) Under the expanded spin-off provisions of the bill, the distribution may be made to security holders as well as to shareholders, and both stock of any class and securities may be distributed. There is, however, no provision for non-recognition of gain on the receipt of securities distributed with respect to stock, which is consistent with the provisions of the bill which do not permit a shareholder to receive securities without recognition of gain on a recapitalization or on a corporate acquisition of stock or property.

(ii) Section 353(a) provides that it is applicable to a distribution received by a shareholder or security holder *if*, among other things, such holder complies with the provisions of subsection (d) (the cross-reference to subsection (c) is a clerical error) with respect to the filing of the agreement to notify the Secretary of any disposition of stock in an inactive corporation made within ten years. Seemingly, therefore, this section grants to a stock or security holder an option to elect to receive the treatment provided by Section 353 or to be treated as the bill otherwise provides. It would be desirable to clarify this point, particularly in view of the provisions of Section 353(d), which are worded in the form of a requirement that an agreement be filed. In the absence of clarification, it would be possible to construe the provisions of Section 353(a)(2) as merely providing a condition for the protection of the revenue which might be waived by the Commissioner. Of course, it would hardly seem fair to make the applicability of Section 353(a) mandatory in view of the fact that Section 353(b), under which distributions from a spun-off corporation which is inactive and the proceeds of disposition of its stock are treated as ordinary income, does not depend on whether the corporation which controlled the spun-off corporation had accumulated earnings and profits at the time of the spin-off.

(iii) Although Section 353(a) specifies the sections of the bill which are to govern the taxability of distributions under Section 353(a) of stock and securities of a controlled corporation, it is silent as to which section is to govern the taxability of a distribution of "property" accompanying a distribution of stock and securities. Under the circumstances, it is not clear whether such a distribution is to be taxed under Section 306, like a distribution of securities, or whether it is to be taxed under one of the following: (a) Section 301, in the case of an ordinary distribution not involving the surrender or redemption of stock or securities of the distributing corporation, (b) Section 302, in the case of a distribution in redemption of stock, (c) Section 1232, in the case of a distribution in redemption of securities of the distributing corporation, or (d) Section 331, in the case of a distribution in complete or partial liquidation of the distributing corporation. It would be desirable that the bill state specifically how the taxability of any "property" distributed in connection with a distribution to which Section 353(a) is applicable is to be determined.

(iv) If it is intended to give each holder of stock or securities an election as to whether the treatment provided in Section 353(a) shall apply to the stock or securities received by him, there still remains the question whether the tax treatment provided by Section 353(b) of amounts received upon disposition of stock of, or distributions from, an inactive corporation may be imposed even where the holder of stock or securities has not filed an agreement. Such treatment applies with respect to stock of an inactive corporation received or held "as a result of a distribution to which subsection (a) is applicable". It would be possible for a person to hold stock of an inactive corporation as a result of a distribution by such corporation of stock of another corporation to persons as to whom Section 353(a) would be applicable, either because such other persons had filed an agreement or because in their cases none was required to be filed. The tax treatment provided by Section 353(b) should be confined to stock held or received by a person who has elected to receive the benefit of Section 353(a).

(b) *Section 353(b)—Tax on disposition of stock in an inactive corporation.*

(i) The tax imposed by Section 353(b) is applicable with respect to stock of an inactive corporation received or held as a result of a distribution to which Section 353(a) is applicable. Section 7087(b)(1) states that any provision of the bill which depends on the application to a prior period of any portion of the bill, when appropriate and consistent with the purpose of such provision, shall be deemed to refer to the corresponding provision of existing law. The marginal note opposite Section 353(a) of the bill indicates that the corresponding section of the Internal Revenue Code of 1939 is Section 112(b)(11). This could be interpreted as making the tax imposed by Section 353(b) applicable with respect to stock of an inactive corporation which was received as a result of a spin-off in 1953 pursuant to the provisions of Section 112(b)(11) of existing law. It should be noted that a corporation continuing the active conduct of a trade or business could easily be classified as an inactive corporation, as defined in Section 353 of the bill. Application of the treatment provided by Section 353(b) should, of course, be limited to stock acquired or held as a result of distributions subsequent to the effective date of Subchapter C.

(ii) Section 353(b) provides an exception from the tax imposed thereby if at the time of disposition or distribution at least 90% of the gross income of the corporation for each of the five preceding taxable years had been other than personal holding company income. This exception would literally include a corporation the stock of which was acquired by the distributing corporation with the intention of spinning it off. That a corporation so acquired might be within the definition of an inactive corporation would not in terms prevent it from coming within the exception in question. It may be questioned, however, whether this was the intention of the draftsmen of the bill.

(iii) The House Report states at page A122 that disposition of stock of an inactive corporation in a merger or other transaction qualifying under Section 352 would constitute a disposition subject to tax under Section 353(b). Sections 305 and 306, to which Section 352 refers, do not incorporate any exception with respect to a disposition of stock of "inactive corporations" and in this respect are unlike Sections 301 and 302. It would seem that an exception for inactive corporations would be as much required in Sections 305 and 306 as in Sections 301 and 302.

(iv) It is surprising to find that the House Report at page A122 gives as an example of the disposition of stock of an inactive corporation, the pledge of such stock for money or other property without personal liability with respect to the pledgor. There is nothing in the bill to indicate that such a pledge is a realization transaction.

(v) Apparently, if stock in an inactive corporation is disposed of in such way as to give rise to the treatment provided by Section 353(b), the basis of such stock disappears. It would seem that, as a minimum, a capital loss should be allowed to the extent of such basis.

(c) *Section 353(c)—Definition of an inactive corporation.*

(i) The term "inactive corporation" is defined as meaning any corporation unless, among other things, for five years its "business" has been held directly or indirectly by the corporation which distributed its stock or, subsequent to such distribution by the corporation the stock of which was distributed. (Query whether a business held by an 80% subsidiary or by a predecessor in a tax-free acquisition satisfies this requirement.) The bill does not specify which five-year period is controlling. It would appear that the bill means any five-year period ending with or including the date of distribution. Thus, whether a corporation is inactive as of the date of distribution may not be ascertainable until five years later.

(ii) The other requirements necessary to prevent a corporation from being classified as inactive are that for five years separate books and records were maintained for the business of the corporation and at least 90% of the "gross income of such business" for each year of the period was other than personal holding company income. The question may arise as to the consequence of the corporation having no gross income from its business, as, for example, where gross receipts are less than cost of goods sold or where a corporation simply retains non-productive property.

(iii) The requirement that 90% or more of the gross income be other than personal holding company income would reach a result that would be most unfair, but was presumably not intended, in the case of a corporation deriving a substantial amount of income from operating subsidiaries. For example, if a holding company at the top of a three-tier corporate organization were to spin off the stock of an intermediate company holding the stock of operating companies, the intermediate company would technically be an inactive corporation. It is suggested that the personal holding company income test be applied on a consolidated basis with respect to the affiliated group of which the corporation whose status is being determined is the common parent and that intercompany income should be left out of account.

(iv) Although classification of a corporation as an inactive corporation is made dependent on the nature of the income from its "business" over a five-year period, there is no definition of the word "business." From the House Report it appears that a different meaning may have been intended than the meaning which the term has in other sections of the bill, e.g., in Section 871(a)(1) relating to aliens not engaged in trade or business within the United States. The House Report indicates that the classification was intended to depend on the assets of a corporation rather than its business, as evidenced by the reference at page A124 to "assets constituting an operating business" and to "operating assets." However, if "business'" is given its more conventional meaning, a corporation having a large amount of personal holding company income from investments might escape classification as an inactive corporation because it carried on a relatively minor business which did not produce any personal holding company income and for which it kept separate books of account.

(v) In the case of the spin-off of a corporation not within the classification of inactive corporations, there would appear to be no obstacle to making a transfer to it prior to the spin-off of cash or other quick assets, thereby creating additional values which could be disposed of on a capital gain basis.

(vi) The tax on the disposition of stock of an inactive corporation is obviously a trap for the unwary. On the other hand, it may be questioned whether the tax is an effective safeguard against the tax-free withdrawal of earnings. The section plainly extends an invitation to avoid the receipt of any substantial amount of personal holding company income, as, for example, by investing in income-producing real estate, tax-exempt securities or oil leases.

(d) *The effect of the agreement.*

The provisions of Section 353(d) requiring an agreement on the part of a stockholder (and also a security holder) in an inactive corporation to notify the Secretary of any disposition of stock (or securities) of such corporation within ten years from the distribution do not in terms extend to the donee or legatee of such stock or security holder. The subsection, therefore, leaves it uncertain as to whether such donee or legatee is obliged to give the notice specified, and, if so, what the effect will be of his failure to give such notice.

C. The Provisions Which Supersede the Boot Provisions of Section 112(c) of Existing Law.

Section 112(c) of existing law provides that in an exchange of stock or securities in a party to a reorganization, which would otherwise be entirely tax-free, gain shall be recognized to the extent of any other property (or money) received on the exchange and shall be taxed as a dividend to the extent its effect is the same as the distribution of a taxable dividend, the balance being taxed as gain from the exchange. Such property (and money) is commonly referred to as "boot".

The bill takes a quite different approach to the treatment of boot, taxing it in certain cases irrespective of the presence or absence of gain and treating as boot securities received with respect to stock. This is done in Section 306 of the bill, which (together with Section 305, relating to distribution of stock and stock rights) is made applicable to such exchanges by certain fictions contained in Sections 352 and 353. Section 306 depends for its effect on Sections 301 and 302. The reason for this complication is that, in Sections 301, 302, 305 and 306, the bill attempts to establish a pattern which may be made to govern the tax effect on holders of stock or securities of a wide variety of transactions between them and the issuing corporation, or a corporation acquiring the stock or property of the issuing corporation. These transactions include ordinary distributions, redemptions or purchases of stock or securities, recapitalizations, mergers, stock acquisitions, and adjustments of capital resulting from intercorporate transfers. The result of the effort made to integrate the treatment of all such transactions is that the provisions relating to the treatment of boot are extremely difficult to understand and apply.

(1) Recapitalization of Preferred Stock With Accumulated Dividends

The provisions of Section 305(c)(1)(A) and (c)(2) appear unduly to restrict the power of a corporation to recapitalize outstanding preferred stock with dividend arrearages. In the past, corporations emerging from periods of depression or other financial difficulty have been able to adjust heavy preferred stock dividend charges, both current and in arrears, by exchanging for such preferred stock, including dividend arrearages, new lower dividend preferred stock, plus in some cases a smaller amount of common. Under the existing rule as established by the courts, the stockholders incur no tax as long as they received no money or other property.

If such stockholders are to be taxed on the amount of the dividend arrearages upon mere receipt of the new stock certificates it may be impossible to obtain the necessary consents to such recapitalizations and to eliminate these undue burdens on business. To the extent that there are either accumulated or current earnings and profits, as there will be in many cases, there will be taxed as ordinary income this receipt of what is merely a different form of the same interest in the issuing corporation. Our committee questions the desirability of this change both because of its effect upon corporate business and because of the lack of any actual realization of income.

(2) Boot Where Securities Only Are Held

Section 306(d) sets forth the treatment of boot received by a security holder where no stock was held by him or any person, corporation, estate or trust related to him as specified in Section 311, providing for attribution of ownership. As under Section 112(c) of existing law, boot in the case of such a security holder consists of property (including money) other than stock or securities in a corporation a party to a recapitalization, qualifying merger or consolidation, corporate acquisition of stock or property, or corporate separation.*

Under Section 306(d) gain (or loss) is recognized by such a security holder to the extent that boot exceeds (or is exceeded by) the part of the security holder's basis for securities surrendered which is attributable to the excess of the principal amount of such securities over the principal amount of securities received (after deducting therefrom the basis for the portion of the securities surrendered attributable to any stock of the distributing corporation received). However, if the principal amount of securities received is at least as great as the principal amount of securities surrendered, the amount of the boot is includible in the security holder's income. Presumably no loss is recognized.

It would seem that these provisions could result in unfair and discriminatory treatment. Assume, for example, a statutory merger of two publicly-held corporations. The merging corporation has outstanding first mortgage bonds which are currently selling for 110% of principal amount. X, a holder of some of these bonds who does not hold any other securities or stock, paid $110 for the bonds. As part of the merger transaction the bondholders received bonds of the merged corporation in equal principal amount, plus $10 in cash per $100 bond. Under Section 306(d)(2)(A), X appears to have *ordinary income* of $10 for each $100 bond exchange. This result would not be altered even if X in fact sustained a loss on the transaction.

A different result would follow if X received instead $99 in principal amount of bonds of the merged corporation plus $11 in

* There is no specific provision in the bill concerning the receipt by a security holder of both stock and securities. Section 305(b) provides for non-recognition of gain or loss by a security holder who surrenders his securities solely in exchange for stock, and Section 306(d)(1) contains a similar provision with respect to the receipt of securities solely in exchange for securities. Although the use of the word "solely" in the two provisions referred to would suggest a difference in result where securities are surrendered for both stock and securities, there is nothing in Section 306 to require or permit the recognition of gain or loss on such an exchange except where a portion of the stock and securities received is attributable to accrued interest on the securities surrendered. However, inclusion of a specific provision on the point would seem important from the standpoint of Section 1002 of the bill.

cash. Under Section 306(d)(2)(B), X would be subject to tax *at capital gain rates* on \$9.90—the excess of \$11 over that part of his basis attributable to the reduction in the principal amount of his bonds (\$1.10).

An even more striking anomaly is presented by the case of a security holder who surrendered \$100 of securities, for which he had a basis of \$100, in exchange for \$90 principal amount of new securities. Under Section 306(d)(1) the security holder would recognize neither gain nor loss if he received nothing else on the exchange. On the other hand, if he received \$1.00 in cash in addition to the \$90 principal amount of new securities, he would, under Section 306(d)(2)(B), recognize a loss of \$9.00.

If these examples represent a correct application of Section 306(d), then our Committee submits that this subsection is in need of substantial revision.

(3) BOOT WHERE STOCK IS HELD

Section 306(b) deals with the receipt of boot by shareholders (including security holders who are also shareholders). It requires that the boot be allocated among various interests held or surrendered by the stockholder in a five-level order of priority set forth in Section 306(c). The House Report indicates at page A86 that the purpose of such allocation is to determine the extent to which stock or securities held immediately prior to the transaction were redeemed as a result thereof.

After boot received by a shareholder has been classified according to the order set forth in subsection (c), it is made subject to the rules of paragraphs (1) and (2) of subsection (b). However, subsection (b) does not state how the application of paragraphs (1) and (2) thereof is affected by the allocation under subsection (c). Further, the House Report at page A86, in giving examples of the operation of the section, proceeds to apply the results of the allocations made under subsection (c) without any reference whatever to paragraphs (1) and (2) of subsection (b).

Our Committee is very far from clear as to the meaning and effect of subsections (b) and (c). While the House Report refers at page A85 to the elimination of all the "complexities" attendant upon the application of Section 112(c)(2) of existing law, our Committee is of the view that equal or greater complexities are embodied in these subsections of the bill. It is submitted that, if the theory behind these subsections is to be retained, the provisions thereof should be subjected to substantial revision. In this connection, attention should be given to the interplay of Section 306 and Section 311, concerning attribution of ownership.

D. The Provisions Which Replace the Basis Provisions of Sections 113(a)(6), (7), (19) and (23) of Existing Law

(1) Basis of Property Acquired by a Party to a Reorganization (Sections 113(a)(6) and (7) of Existing Law)

Section 355 of the bill sets forth the rules for determining the basis of property (other than stock or securities) acquired by a corporation in a corporate organization, acquisition or separation. In general the rule is the same as under Sections 113(a)(7) and (8) of existing law except that the provisions for decreasing the basis with respect to loss recognized on the transfer are omitted. However, the treatment of a corporation's basis for stock and securities acquired in connection with a corporate adjustment has been altered from present law.

(a) There appears to be no provision in the bill determining a corporation's basis for stock or securities received by it in connection with a corporate separation (pursuant to Section 359(d)) to which it was a party. Presumably it was intended to make specific provision for this, since otherwise the basis for such stock and securities would be their cost as provided in Section 1012 of the bill.

(b) The bill makes a significant change with respect to a corporation's basis for stock acquired in exchange for its own participating stock in a transaction described in Section 359(b). Under Section 113(a)(7) of existing law, the corporation's basis for such stock would be the same as the basis for the stock in the hands of the transferors, increased in the amount of gain or decreased in the amount of loss recognized to the transferors upon the transfer. Under Section 355(b) of the bill the corporation's basis for such stock would be equal to the basis which the corporation would have had for the assets of the corporation issuing the stock "if a similar part of the assets of such other corporation had been acquired in a corporate acquisition of property, as defined in section 359(c)."

The purpose of this change is to integrate with the treatment which the bill gives corporate liquidations of controlled subsidiaries. The intention is to give an acquiring corporation the same basis for corporate assets acquired by it whether the assets are acquired directly, pursuant to Section 359(c), or indirectly by a corporate acquisition of stock, pursuant to Section 359(b), followed by a liquidation of the acquired corporation. The merits of this change are therefore closely related to the merits of the revised treatment given corporate liquidations. The change would, however, make the corporation's basis for stock acquired pursuant to Section 359(b) extremely complicated to determine.

(c) Aside from this, conflict may arise between the different rules provided by Section 355(a) and Section 355(b) for determining the basis of stock acquired by a corporation in a transaction which meets the requirements both of Section 351, relating to corporate organizations, and Section 359(b), relating to corporate acquisitions of stock. For example, if the sole stockholder of a corporation transferred all of the stock of that corporation to another corporation solely in exchange for participating stock of such other corporation and was in control of such other corporation immediately after the transfer, the requirements of both Section 351 and Section 359(b) could be satisfied. Therefore, Section 355(a) would be applicable in determining the second corporation's basis for the stock acquired by it in the transaction, whereas Section 355(b), applying an entirely different rule, would be equally applicable.* The conflict between these sections should be resolved.

(2) Basis of Property Acquired Upon a Tax-free Exchange by Persons Other Than Parties to a Reorganization (Sections 113(a)(6), (19) and (23) of Existing Law)

The basis of shareholders and security holders for stock, securities and other property received by them in a tax-free exchange in connection with a corporate adjustment is determined under Section

* The still different basis rule provided by Section 307 would also be literally applicable although it appears from the title of the section (which under Section 7806(b) of the bill apparently is to be given no weight) that it was not intended to apply.

307, which apparently intends to establish the same rule as that contained in Sections 113(a)(6), (19) and (23) of existing law.

(a) This provision is defective in form since it provides for transferring to the assets received by the taxpayer the entire basis for the assets with respect to which the new assets were received, notwithstanding the fact that he may have retained some or all of the assets held prior to the transaction.

(b) Section 307(a), in distinguishing between stock and rights to acquire stock, creates a doubt as to whether rights to acquire stock are to be considered to be stock for the purposes of Section 352, Section 353, Section 359(c) and Section 359(d). The definitions of "participating stock" and "nonparticipating stock" contained in Section 312(b) and (d) appear broad enough to include rights to acquire participating stock and rights to acquire nonparticipating stock. Indeed, if rights to acquire stock are not to be classed as stock, they would clearly fall within the definition of "property" contained in Section 312(f) and would consequently be treated as boot by Section 306, in conflict with the provisions of Section 305 which apparently intends that rights to acquire stock may be received (at least by a shareholder) without tax.

(c) Section 307(a)(2), which reads "by allocating the basis of the stock or property held," was apparently intended to read "by allocating the basis of the stock, securities or property held."

IV.

CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS

Section 381 of the bill, although bearing the above title, provides for carryovers in a sense not heretofore used in the tax statutes. In addition to net operating loss and capital loss carryovers, it provides that numerous other items involved in computing taxable income or earnings and profits shall be carried over from a predecessor corporation to its successor if the acquisition of the predecessor's property by the latter was a distribution in complete liquidation of a subsidiary as defined in Section 336, or a transfer pursuant to either a corporate acquisition of property, as defined in Section 359(c), with respect to which no gain or loss is recognized under Section 354(a), or a statutory merger or consolidation with respect to which no gain or loss is recognized under Section 354(b).

(1) Acquisitions Covered.

Although the decision in *Stanton Brewery, Inc.* v. *Commissioner,* 176 F. (2d) 573 (2d Cir. 1949), would indicate that under the present statute a successor corporation resulting from a statutory merger or consolidation would succeed to many of the deductions to which Section 381 relates, certainty in this area is greatly to be desired. Except for Section 381(c)(16), which is expressly made applicable to deductions for payment of certain liabilities by certain successor corporations in distributions or transfers which occurred before the effective date of Subchapter C, Section 391 limits the applicability of Section 381 to successor corporations in distributions and transfers which occur after such effective date. Since these provisions impose certain restrictions, it would be inappropriate to apply them universally to mergers and other acquisitions which occurred prior to the effective date of Subchapter C. Many uncertainties could be resolved, however, if the bill would provide for an election to apply the new provisions, from the effective date of the section, to past mergers and other transfers which would qualify under Section 381 if they had occurred after its effective date. Alternatively, the bill should expressly provide that the right of a successor corporation which became such in a transfer or distribution before such effective date to carryovers and other deductions of the predecessor corporation should be determined under the Internal Revenue Code of 1939.

(2) Net Operating Loss Carryovers.

(a) Under Section 381 (c)(1)(B) and (D) such carryovers are reduced by the amount of loss recognized to the parent corporation under Section 331 in a parent-subsidiary liquidation. Such loss would be a capital loss (Section 332 (b)(2)) which as a practical matter would in many cases result in no tax benefit to a corporation, and under Section 334(b) the basis of the subsidiary's assets would be reduced to fair market value in any case where the value was less than such basis. As a result the capital loss recognized to the parent would to this extent already have been offset by a loss of basis, and accordingly, of ordinary business deductions to the extent that the property was subject to depreciation. It appears difficult to justify a further reduction of the group's business deductions by the amount of such capital loss. This duplication should be avoided by eliminating this adjustment of the operating loss carryover, at least to the extent that the basis of the assets was reduced in the transaction.

(b) Section 381(c)(1)(C) limits the carryovers of the transferor into the first taxable year of the acquiring corporation ending after the date of distribution or transfer, to a proportion of the acquiring corporation's taxable income, computed without the modifications specified in Section 172(b)(2)(A). But the income for the post-acquisition part year provided for by clause (ii) of subparagraph (D) is to be computed with respect to the taxable income computed *with* such modifications. Clarification of the last sentence of said clause (ii) is therefore required. The House Report at pages A136-37 interprets this sentence as providing for reducing the carryover to a later year by the full amount of the post-acquisition part year income computed with such modifications ($18,180 in the example) although the amount of the carryover deductible under subparagraph (C), computed without regard to such modifications, was a smaller amount ($18,000 in the example). If this interpretation were correct it would seem that there should be added to said last sentence of clause (ii) the words "as modified by this section but without regard to the limitation of subparagraph (C) above".

Such reduction of the carryover by an amount in excess of the deduction allowed is immaterial in the example given in the House Report because the carryover of the acquiring corporation's loss would have been reduced to the extent that that of the transferor was not. This would not be so, however, if the acquiring corporation had had no carryover from its own loss year, and, in such event, if the modification under Section 172(b)(2)(A) were larger in amount and the example in the House Report properly states the meaning of this provision of the bill, a substantial part of the carryover would be eliminated without reason. Our Committee suggests that Section 381(c)(1)(D)(ii) be modified to make it clear that this is not its meaning.

(2) Earnings and Profits.

Section 381(c)(2) of the bill provides that in the case of a corporate acquisition of property under Section 359(c) or a statutory merger or consolidation under Section 354(b), there shall be transferred to the acquiring corporation the earnings and profits or deficit in earnings and profits of the transferor corporation. It provides, however, that a deficit of either the transferor or acquiring corporation shall be used only to offset earnings and profits accumulated after the date of transfer.

Since this is a codification, with some changes, of the existing rule as applied by the courts, it would seem that the bill should cover the entire field. Section 381(c)(2) does not cover either the liquidation of a subsidiary, transfers to controlled corporations under Section 351, or corporate separations under Section 359(d), including those related to spin-offs or split-ups. Although Section 310(c) provides for reduction of the earnings and profits of the transferor corporation in cases of corporate separation, there does not appear to be any provision that the amount of such reduction in earnings and profits shall be added to the earnings and profits of the transferee corporation in such a corporate separation.

The House Report at page A96 states that while it is to be noted that Section 310(c) provides no rules as to the amount of earnings and profits which are carried to a recipient corporation, the Committee does not intend a result, under existing law, which will produce more earnings and profits immediately after the transaction than were in existence immediately prior to such transaction. This leaves the situation uncertain and our Committee recommends that express provision should be inserted in the bill with regard to the amount of earnings and profits to be transferred to the transferee corporation in corporate separations which would be consistent with the reduction of the transferor's earnings and profits provided by Section 310(c). The purpose and effect of the omission of parent-subsidiary mergers from Section 381(c)(2) is also not clear.

(3) CAPITAL LOSS CARRYOVER.

As noted above, the loss recognized to a parent corporation on a distribution in complete liquidation is deducted from the net operating loss carryover and reduces basis as well. Section 381(c)(3)(D) also disallows the entire capital loss carryover, in any case where there was such a recognized loss, even though the carryover might largely exceed the loss recognized on the liquidation. Such multiplication of the effect of the parent corporation's capital loss should be eliminated.

(4) METHOD OF COMPUTING DEPRECIATION ALLOWANCE.

Section 381(c)(6) provides that the acquiring corporation shall be treated as the transferor for the purpose of computing certain depreciation allowances on property acquired in a distribution or transfer with respect to "that part or all of the basis in the hands of the acquiring corporation as does not exceed the basis in the hands of the distributor or transferor corporation". The statute apparently contemplates that the distributor's method of depreciation shall be used by the acquiring corporation as to an amount of basis not exceeding the distributor's basis. A different method apparently may be used as to the excess.

However, the House Report at page A140 states that the acquiring corporation's total depreciation allowance with respect to a particular asset shall not exceed the basis of such asset in the hands of the transferor even though the adjusted basis of the asset in the hands of the acquiring corporation may exceed such basis. Under Sections 331 and 334 the parent corporation, in the liquidation of a subsidiary in which gain or loss is not recognized because the value is more than the basis of the stock but such basis exceeds the basis of the assets in the subsidiary's hands, would have a basis for the assets in excess of their basis in the hands of the subsidiary. Under these circumstances the House Report appears to attempt to impose a restriction which is contrary to the wording of the statute. Our Committee recommends that this be clarified.

(5) INDEBTEDNESS OF CERTAIN PERSONAL HOLDING COMPANIES.

Section 381(c)(15) provides that the acquiring corporation shall be considered to be the transferor for the purpose of determining the applicability of Section 545(b)(8). The latter section provides that a personal holding company in determining its undistributed personal holding company income shall be allowed as a deduction amounts used or irrevocably set aside to retire indebtedness incurred before January 1, 1934. The House Report at page A142 imposes a requirement that the acquiring corporation have assumed such indebtedness as a part of the acquiring transaction. Although the statute does not support this interpretation, our Committee recommends that the legislative history be corrected or that the provision be amended clearly to indicate that it applies to situations in which assets were taken subject to such indebtedness, as well as cases of assumption.

(6) Certain Obligations of Distributor or Transferor Corporation.

Section 381(c)(16) provides that if the acquiring corporation assumes an obligation of the transferor which, after the date of the distribution or transfer, gives rise to liability, and such liability, if paid or accrued by the transferor, would have been deductible in computing its taxable income, the acquiring corporation shall be entitled to deduct such items when paid or accrued by it, as if it were the transferor. As in the case of Section 381(c)(15), our Committee recommends that the provision be expanded to cover cases in which the assets were taken subject to such liabilities as well as cases involving an assumption of such liabilities.

The last sentence of subparagraph (16) provides that it shall not apply "if such obligations are reflected in the amount of stock, securities, or property transferred by the acquiring corporation to the transferor corporation for the property of the transferor corporation". This proviso would preclude application of Section 381(c)(16) in cases in which the existence of a contingent liability is known but the risk of the contingency occurring is appraised, and reflected in the amount of stock, securities or property transferred, at a small percentage of the maximum amount of the liability. Under these circumstances the proviso appears unduly restrictive. Our Committee recommends that if the proviso is to be retained it be limited in operation to disallowance of the deduction to the extent that the liability was reflected in the amount of stock, securities and property transferred.

V.

THE EFFECTIVE DATE OF THE ENACTMENT OF SUBCHAPTER C

Under Section 7851 the income tax provisions of the bill apply in general to taxable years beginning after December 31, 1953 and the provisions of Chapter 1 of the 1939 Code are repealed with respect to such years. However, Section 391 of the bill makes the provisions of Subchapter C effective with respect to distributions occurring after March 1, 1954. There seems, however, to be no coordinate provision keeping the appropriate provisions of Section 112 and Section 115 in effect for taxable years beginning after December 31, 1953 with respect to distributions and exchanges occurring on or before March 1, 1954. It is vital that this omission be supplied.

VI.

ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAXES

Section 269 of the bill corresponds to Section 129 of existing law. Although neither this provision nor those relating to corporations used to avoid income tax, next discussed, are included in Subchapter C, they are discussed in this Part One because of their close relationship to Subchapter C transactions.

Section 129 was enacted in 1943 for the purpose of disallowing tax benefits where control of a corporation was acquired (or the assets of a corporation were acquired) with the principal purpose of using the tax benefits in the acquired corporation to evade or avoid income taxes. The House Report at page 32 states that the effectiveness of this provision has been impaired by the difficulty of establishing whether or not tax avoidance was the principal purpose of the acquisition.

It appears that the Commissioner's difficulty with Section 129 of existing law has arisen as much from judicial interpretation of its provisions as from the burden of proof. See Tarleau, *Acquisition of Loss Companies,* 31 Taxes 1050 (December 1953). The bill, however, reenacts the provisions of Section 129 of existing law, but in an effort to increase their effectiveness the bill has added a provision obligating the acquiring person or corporation to carry the burden of proof "by a clear preponderance of the evidence" that the principal purpose of evasion or avoidance of Federal income tax was not present, where the consideration paid for the control of the corporation (or of the corporate property) is substantially disproportionate to the sum of the adjusted basis of the corporate property (to the extent attributable to the interest acquired) and of the value of the "tax benefits (to the extent not reflected in the adjusted basis of the property)" not otherwise available to the acquiring entity.

(1) In determining the applicability of the presumption, Section 269(c)(1) takes into consideration the aggregate adjusted basis of property of the corporation rather than the adjusted basis of individual assets. Inasmuch as the effect on aggregate basis of a depreciable asset having a high basis and a low value may be offset by a non-depreciable asset, such as a security, having a low basis and a high value, the criterion selected is not a reliable one for determining the existence of tax benefits attributable to basis.

(2) Section 269(c)(2) requires a valuation of the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to the acquiring person or corporation otherwise than as a result of the acquisition. The difficulties involved in attempting such a valuation are apparent.

(3) The test prescribed in Section 269(c) apparently is based on the assumption that tax benefits fully paid for should be available even though the principal purpose of the acquisition was to obtain the tax benefit. The soundness of this assumption is questionable.

By the terms of the provision the presumption is apparently invoked where the consideration paid is substantially greater than the excess basis and tax benefit as well as in the case in which it is substantially less. There is further involved the determination of what is "substantial". One of the purposes of the bill in revising Section 112(g)(1)(C) of existing law was to eliminate the uncertainties which attend this word.

(4) There seems to be serious doubt as to the value and effectiveness of a provision which does nothing more than create a rebuttable presumption to be controverted by the taxpayer by a clear preponderance of the evidence. In all areas of the tax law there is a presumption of the correctness of the Commissioner's determination. Thus, if under circumstances which do not give rise to the rebuttable presumption created by Section 269(c), the Commissioner nevertheless determines that an acquisition was made for the purpose of avoiding income taxes, the presumption of correctness would require that the taxpayer come forward and present his proof. The only distinction that is readily apparent between such a situation and one where the presumption created by the statute arises is that in the former instance

the taxpayer would have to rebut the presumption of correctness merely by a preponderance of the evidence, whereas in the latter instance it would have to be rebutted by a clear preponderance of the evidence. Our Committee questions the desirability of the introduction of such nebulous distinctions as to degrees of proof.

In view of the limited benefits to be obtained and the defects and uncertainties in the statutory provisions by which the bill seeks to obtain them, our Committee recommends the elimination or substantial revision of Section 269(c).

VII.

CORPORATIONS USED TO AVOID INCOME TAX ON SHAREHOLDERS

A. Corporations Improperly Accumulating Surplus

Sections 531 through 536 of the bill correspond to Section 102 of existing law, which imposes a penalty tax on any corporation formed or availed of for the purpose of avoiding the surtax on shareholders by permitting earnings or profits to accumulate in the corporation. The bill would make the following changes in the substance of Section 102:

(i) Publicly-held corporations (as defined) would be exempt from the penalty tax.

(ii) A corporation could justify accumulation of earnings and profits on the basis of the "reasonably anticipated needs" of its business as well as the "reasonable needs" of its business.

(iii) The Commissioner would be required to notify a taxpayer in advance of a proposed deficiency based on improper accumulation of surplus. If the taxpayer responded by submitting a statement of the grounds relied on to justify the accumulation, the burden of proof would be on the Commissioner, with respect to the grounds stated, to show that the accumulation was beyond the reasonable needs of the business.

(iv) In puting the accumulated income subject to the penalty tax foreign income taxes not allowable as a deduction in computing taxable income would be allowed as a deduction.

(v) A corporation would be permitted to accumulate \$30,000 of earnings and profits before the penalty tax could be asserted.

(1) *Definition of publicly-held corporation.* Section 532(b)(1) exempts from the tax imposed by Section 531 a publicly-held corporation as defined in Section 532(c)(1). Our Committee recommends that the provisions specify the date on which the stock ownership requirements of the definition must be met.

(2) *Corporate shareholders.* Section 532(a) provides that the tax imposed by Section 531 shall apply to corporations formed or availed of for the purpose of avoiding "income tax with respect to its shareholders or the shareholders of another corporation" by accumulating earnings. It might be contended that a subsidiary was liable for the tax imposed under Section 531 because its retention of earnings avoided the income tax at the effective rate of 7.8% with respect to inter-corporate dividends to its parent. If Section 531 was not addressed to this type of situation, our Committee recommends that the term "shareholders", twice appearing in Section 532(a), be limited to "individual shareholders".

B. Personal Holding Companies

Sections 541 through 547 of the bill correspond to Sections 500 through 511 of existing law, which impose a penalty tax on the undistributed income of personal holding companies (*i.e.*, corporations most of whose stock is owned by a few individuals or their families and which derive a specified percentage of their gross income from investments). The bill has made a number of changes in the substance of the present provisions.

(1) *Section 542(a)(2).* The cross-reference in this section to "an organization described in section 503(b)" would be better phrased as "an organization to which section 503(b) is applicable", since the only organizations described in Section 503(b) are described by way of exception. Section 503(b) itself merely contains a cross-reference to the organizations described in Sections 501(c)(3) and 501(e), with certain exceptions.

The cross-references to Sections 504(b)(3) and 681(c)(2)(C) are incorrect. The sections referred to do not appear in the bill.

(2) *Section 542(b)(2)(B).* Section 542(b) provides that the personal holding company tax shall not apply in the case of certain affiliated corporations filing a consolidated return unless the consolidated gross income of the group meets the gross income test. Section 542(b)(2)(B), however, would disqualify an otherwise qualified affiliated group from this treatment if any member of the group could be separately classified as a personal holding company if income derived from members of the group were excluded from the computation. An affiliated group headed by a non-operating common parent would be disqualified for group treatment simply because the common parent received during the taxable year an insignificant amount of interest from sources outside the group. For example, if the common parent derived more than 90% of its gross income from its subsidiaries and the balance of its gross income from interest on tax notes purchased in anticipation of federal income taxes, treatment of the group on a consolidated basis for personal holding company purposes would not be available.

It is believed that the Ways and Means Committee did not intend to deny consolidated treatment to an otherwise qualified affiliated group unless some member of the group had a substantial amount of personal holding company income from outside the group. Accordingly, our Committee recommends that Section 542(b)(2)(B) be revised to correct the result above described.

(3) *Section 542(c)(10).* This section is designed to exclude a foreign corporation from classification as a personal holding company if its gross income from United States sources for a specified period has been less than 50% of its total gross income and if all of its stock is owned during the last half of the taxable year directly or indirectly by non-resident alien individuals. This would enact into law the present provisions of Section 39.500-1(b) of Regulations 118.

(a) The stock ownership requirement in Section 542 (c)(10)(B) is related to ownership "by nonresident alien individuals, whether directly or indirectly through other foreign corporations". Our Committee understands that the practice under the Regulations has been to permit exemption where the indirect ownership of a non-resident alien individual was indirectly through a foreign estate or trust, as well as through a foreign corporation. Our Committee recommends that this be expressly provided for in the Code.

(b) The gross income requirement of Section 542(b)(10)(A) refers to the corporation's gross income from United States sources during the "period specified in section 861(a)(2)(B)". This cross-reference may leave in doubt the period actually intended. Section 861(a)(2)(B) is concerned with whether dividends received from a foreign corporation constitute income from United States sources and provides that such dividends shall be regarded as being from United States sources "unless less than 50 percent of the gross income of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends . . . was derived from sources within the United States". Thus, for the purposes of Section 861(a)(2)(B), the period specified is measured with reference to the date on which certain dividends are declared. This has no meaning as applied to Section 542(a)(10), where the declaration of dividends is not involved. If the period intended is the 3 years immediately preceding the taxable year, our Committee recommends that this be stated in Section 542(b)(10)(A) and that the cross-reference be deleted.

(4) *Consent dividends.* The consent dividend provisions contained in Section 28 of existing law are not included in the bill, on the ground that they were enacted in connection with the undistributed profits tax and that since the expiration of that tax the consent dividend provisions have been used only by personal holding companies and then rarely. Our Committee believes that retention of the consent dividend provisions would be desirable as they permit stockholders of personal holding companies, by consenting to the inclusion in their own taxable income of undistributed profits of the corporation, to avoid the subsequent imposition of the personal holding company penalty tax. The liberalized allowance of a deduction for deficiency dividends under the bill does not fully meet this need as it does not prevent the running of interest on the personal holding company tax, which may be substantial.

PART TWO

EMPLOYEES' TRUSTS

This part of our Committee's report sets forth its recommendations with respect to provisions of the bill dealing with employees' trusts. These include the requirements for exemption of such trusts, the consequences of denial of exemption, the deductibility of contributions to such trusts, the taxability of their beneficiaries, and the filing of returns.

I.

REQUIREMENTS FOR EXEMPTION

Section 501(e)(3) corresponds to Section 165(a) of existing law and prescribes the tests which must be met by employees' trusts to qualify for exemption. Sections 503 and 504 correspond to Sections 3813 and 3814 of existing law relating to prohibited transactions and improper accumulations of charitable organizations and make these sections applicable to employees' trusts. Section 505 has no equivalent in existing law and prescribes the investments permissible to employees' trusts.

A. Nondiscriminatory Classifications

Section 501(e)(3) is more specific than Section 165(a) of existing law in setting forth the classifications which will be considered not to discriminate in favor of employees who are shareholders or key employees. Six different classifications are expressly permitted, provided that the classification does not discriminate in favor of shareholders or key employees. Section 503(e)(3)(A) then goes on to provide that a classification "shall be considered discriminatory only" if more than 30% of the contributions are used to provide benefits for shareholders or more than 10% of the participants in the plan are key employees. However, a classification is in no case to be considered discriminatory if in the case of an employer having not more than 20 regular employees 50% or more of them are participants and in the case of an employer having more than 20 regular employees, 10 of them or at least 25%, whichever is greater, are participants. The term "key employees" is defined in Section 501(e)(3)(B)(ii) to mean the highest paid 10% of the regular employees up to a limit of the 100 highest paid employees.

(1) The House Report at page 44 indicates that a trust will automatically be considered discriminatory if it violates the above provisions with respect to the use of benefits for stockholders or the permissible percentage of key employee participants. The language of the bill itself, however, is susceptible of the interpretation that these factors are the only ones which will permit the Secretary to determine that a trust is discriminatory but will not require such a determination. If the operation of this provision is automatic, it will disqualify plans which would normally be considered nondiscriminatory. For example, assume that a corporation with 1,000 regular employees, as defined in Section 501(e)(3)(B)(iv), adopts a plan for its 200 salaried employees, a classification expressly permitted in Section 501(e)(3)(A)(ii). If, as would probably be the case, more than twenty of the participants were key employees, as defined in Section 501(e)(3)(B)(ii), the plan would be disqualified, since 25% of the regular employees would not be participants. This result is presumably not intended. Accordingly, our Committee recommends that the provision be clarified to give the Secretary power to determine whether under such circumstances the plan is in fact discriminatory.

(2) Section 501(e)(3)(A) provides that a classification shall in no case be discriminatory in the case of an employer having not more than twenty regular employees, 50% or more of whom are participants in the plan. This provision would apply even if 30% of the contributions are used for the benefit of shareholders and would open the door for substantial abuses in the case of closely held corporations. We recommend that this provision be omitted. The Secretary should be given power to pass upon the question of discrimination in the case of such corporations.

B. Prohibited Transactions

Section 503(c), which extends the concept of "prohibited transactions" contained in Section 3813 of existing law to employees' trusts, specifies as its first prohibited transaction the lending of any trust assets to the creator of the trust "without the receipt of adequate security and a reasonable rate of interest". This might prohibit the trust from investing in debentures and other unsecured obligations of the employer corporation, which is probably not intended, and seems inconsistent with the provisions of Sections 402(a)(1) and (2), giving preferred treatment to distributions of securities of the employer corporation. The term "securities" is expressly defined in Section 402(a)(3)(A)(i) to include debentures. It is therefore recommended that Section 503(c)(1) be made inapplicable to trusts exempt under Section 501(e).

C. Denial of Exemption

Section 504(a)(3) provides for the denial of exemption to exempt employees' trusts if accumulated income is invested "in such a manner as to jeopardize the carrying out of the * * * purpose or function constituting the basis for exemption * * * of an organization described in section 501(c)(3) or (e)". This constitutes an extension of Section 3814 (a)(3) of existing law to employees' trusts. Since the investment of the entire assets, and not merely accumulated income, of employees' trusts is prescribed in detail in Section 505, it seems anomalous and unnecessary to regulate the investment of the accumulated income. It is accordingly recommended that Section 504(a)(3) be made not applicable to organizations exempt under Section 501(e).

D. Allowable Investments

Section 505 prescribes allowable investments for exempt employees' trusts and provides for the denial of exemption unless the tests are met at the close of each quarter of the taxable year of the trust. Two serious questions are raised by this section.

(1) Investment Requirements

Section 505 provides that the assets of an employees' trust must consist of seven classes as listed in subdivisions (1) through (7) of Section 505(a). Subdivision (6) limits the investment in real estate to an amount "in respect of any one investment" not greater in value than 5% of the value of the total assets of the trust. Subdivision (7) limits the investment in securities other than Government securities, securities of the employer corporation, or securities of regulated investment companies, which are expressly permitted in subdivisions (2), (4) and (5), respectively, to securities of any one issuer in an amount not greater in value than 5% of the value of the total trust assets and 10% of the total combined voting power of all classes of stock of the issuer. Section 505 places no limitation on the extent to which trust assets may be invested in securities of the employer corporation.

(a) The provisions of subdivisions (6) and (7) appear to be unreasonably burdensome, especially in the case of small trusts. Subdivision (6) would virtually prevent small trusts from investing in real estate, since no single investment could be in excess of 5% of the total assets of the trust. Subdivision (7), by requiring arbitrary diversification, would unnecessarily hamper the investment of small trusts, and even that of large trusts. For example, under the definition in subdivision (7), the securities of American Telephone & Telegraph Co. and all of its subsidiaries would be considered securities of one issuer. On the other hand, it is felt that some restrictions should be imposed on the investment in securities of the employer corporation by pension trusts, especially since under present Treasury practice such investments are the only ones that are closely scrutinized and require prior approval. The same consideration does not apply to investments in employers' securities by stock bonus and profit sharing trusts, where the emphasis is on participation in the growth of the employer corporation and not on safety.

(b) It is suggested that consideration be given to the approach followed in Section 851 of the bill relating to the investment of regulated investment companies under which 50% of the value of the trust assets might be required to be invested in the items described in Section 851(b)(4)(A)(i) and (ii), *i. e.*:

(i) Cash and cash items (including receivables), government securities and securities of regulated investment companies; and

(ii) Other securities with the 5% and 10% limitations now contained in Section 505(a)(7).

The remaining 50% of the trust assets could be invested without restrictions, including investments in securities of the employer corporation and real estate.

(c) If the above suggestion is not adopted, consideration may be given to the changes in Section 505 which are hereinafter described.

(i) In the case of pension trusts, some limitation should be placed on the extent to which trust assets can be invested in securities of the employer corporation.

(ii) Subdivision (3) should permit the continuance of the not uncommon practice of investments in insurance contracts convertible into retirement policies, which is expressly recognized in Section 402(a)(4).

(iii) Subdivision (7) would prevent investment in the securities of a corporation formed by the trust to acquire real estate. This could be corrected by inserting in subdivision (4) permission to invest in securities of a corporation wholly owned by the trust organized for the exclusive purpose of holding title to property, collecting income therefrom and turning over the entire amount thereof less expenses to the trust.

(iv) The restrictions contained in subdivisions (6) and (7) should apply to all the exempt trusts of the employer in the aggregate, so that if an employer has several trusts, the limitations would not apply to each one. Section 501(e)(3)(A) contains language dealing with a similar problem.

(v) Section 505 would apparently not permit investment in any tangible personal property such as furniture and equipment.

(vi) The terms "securities" and "real estate" in subdivisions (6) and (7) are not defined and uncertainty may arise as to their application to the various types of assets generally held by trusts, such as mortgages, oil interests, etc.

(vii) The March 1, 1954 date in Section 505(b)(2) should be moved forward to a later date.

E. Consequences of Denial of Exemption

Under Section 505(a) and Section 403(a)(1) the failure of a trust to meet the requirements of Section 505 would not only result in the loss to the trust of its income tax exemption but would also result in the non-deductibility of employer contributions for the year in which the violation occurred. Moreover, distributions which under Section 402(a)(2) depend for capital gains treatment on the exempt status of the trust would lose this preferred treatment. These penalties would, in most cases, be out of all proportion to the offense and penalize corporations and employees for mistakes made by independent trustees. Our Committee recommends that either the penalty for violation of Section 505(a) be limited to denial of the income tax exemption to the trust, in accordance with the rule under Section 3814 of existing law, relating to improper accumulations by charitable organizations, or that the deduction be disallowed only after notification by the Secretary of a violation of Section 505 and a failure to correct the violation within a certain period. This would be in accordance with the principle embodied in Section 503(a)(2), relating to the denial of exemption in the case of prohibited transactions.

II.

DEDUCTIBILITY OF CONTRIBUTIONS

The provisions of Section 403, relating to deductions for contributions to both qualified and nonqualified plans and trusts correspond to Section 23(p) of existing law. The formulae governing deductions for contributions to qualified plans and trusts liberalize to some extent the corresponding formulae in Section 23(p) of existing law. These provisions call for no comment.

Section 403(a)(5) provides that a contribution to a non-qualified plan shall be deductible in the taxable year when the amount is "actually distributed or made available to a distributee." This provision appears inadequate in that it prescribes no rule for the time or the amount of the deduction in cases where the employee may receive benefits over a period of years and in an amount which would not necessarily bear any close relation to the contribution of the employer. Thus, if an employer purchases a deferred annuity, the amount which the employee may ultimately get may be much greater or much less than the cost of the annuity. Our Committee recommends that this provision should be amplified to prescribe some rule under which the employer would be sure of obtaining a deduction for the full amount of, but not more than, his contribution.

III.

TAXABILITY OF BENEFICIARIES

Sections 401 and 402 of the bill deal with the taxation of recipients of employees' annuities and deferred compensation and of beneficiaries of employees' trusts.

The treatment of beneficiaries of qualified plans and trusts follows that of existing law except that it has been liberalized by extending capital gains treatment and by removing certain restrictions on the investment by qualified trusts in insurance contracts.

A. Termination of the Business

Section 401(b) and Section 402(a)(2) extend capital gains treatment to lump sum distributions made by reason of the death of the employee or his separation from service as in existing law and also by reason of his death after separation from service or by reason of the termination of the plan as a result of the "complete termination of the business of the employer".

The term "complete termination of the business of the employer" is defined in Section 401(b)(2)(B) and Section 402(a)(3)(B)(ii), to mean the complete liquidation of the corporate employer, whether or not such liquidation is incident to a tax-free transaction. This might lead to abuse in the case of small corporations, since the provision could be technically complied with, even though the business were continued. It is recommended that the termination giving rise to the capital gain treatment be limited to situations where the business itself is terminated. Such treatment should, however, be permitted where the termination occurs in connection with a partial liquidation as defined in Section 336(a).

B. Employee Annuities

(1) Sections 401(a) and 402(b) change existing law with respect to the treatment of recipients of annuities and beneficiaries of trusts under non-qualified trusts. Section 401(c) clarifies existing law with respect to deferred compensation. Under these sections,

no tax is imposed until the actual receipt of the deferred compensation, the proceeds of the annuity contract or the distributions of the trust.

(2) Some ambiguity is caused in Sections 401, 402 and Section 403(a)(5), relating to the taxability of distributions and deductibility of contributions, by the use of the phrase "amount actually distributed or made available" in some places and not in others. The phrase "or made available" may suggest an intent to enlarge the ordinary principles of the doctrine of constructive receipt which it is not believed is intended. (House Report, pages 42, 43.) The phrase may also suggest that the distribution of an annuity or an insurance contract covered by these sections is taxable to the recipient upon its receipt although it is clear that no taxability is intended until the proceeds of the contract are received. (Sections 401(a) and 401(c); compare Regulations 118, Section 39.165-6(a)(2).)

Our Committee recommends that there be substituted in these sections for the phrase "amount actually distributed or made available" the phrase "amount distributed". It is also recommended that there be added a new subsection (c) in Section 402 making it clear that the delivery of annuity contracts or insurance contracts described in Sections 401 and 402 shall not be considered the distribution or payment of an amount.

IV.

RETURNS

Section 6033 would require employees' trusts to file annual information returns. Under existing practice a trust exempt under Section 165 is not required to file an annual return if the employer corporation files with its tax return the data required to substantiate the deduction and the continued exemption of the trust. It would seem that Section 6033 should give the Secretary the power to continue this practice.

PART THREE

INCOME TAXATION OF ESTATES, TRUSTS AND BENEFICIARIES

This part of our Committee's report sets forth its recommendations with respect to Part I of Subchapter J of Chapter 1, treating the income taxation of estates, trusts and their beneficiaries.

A. Imposition of Tax

Section 641 is substantially a restatement of Section 161 of the present Code. It states the general rule that the income tax applicable to individuals shall also be applied to the income of estates and trusts.

Cooke v. *United States*, 115 F. Supp. 830 (D. Hawaii, 1953), decided that under Section 161 of existing law, the sale of securities held in a legal life estate did not give rise to taxable gain to either the life tenant or remainderman. It would seem that the proposed Section 641 should be amended to treat legal life estates as if they were trusts for purposes of income taxation.

B. Distributions

Section 651 of the proposed statute, relating to the deduction provided for trusts distributing current income only (the "simple" trust), provides for a deduction to the trust for its income for the taxable year "required to be distributed currently". The House Report at page A196, in discussing this section, states that: ". . . The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed *until shortly after the close of the trust's taxable year* . . ." (italics ours). This statement and the examples given in the House Report throw at least some doubt on the income tax consequences of an actual payment of currently distributable income of a "simple" trust where the actual payment is made several months after the close of the taxable year. It is recommended that the point be clarified.

C. Loss Carryovers

Section 662 of the bill relates to the inclusion in the beneficiaries' income of distributions made by estates and the "complex" trusts which accumulate income, distribute corpus or do both. Subsection (d) of that section provides for the use by "the beneficiaries succeeding to the property of the estate or trust" of any capital loss or net operating loss carryovers.

It is believed that these loss carryovers should be available not only to the beneficiaries of estates and of the "complex" type of trusts but also to the beneficiaries of the "simple" type of trust. It is therefore suggested that subparagraph (d) be removed from its present subordinate position and placed in a separate section or possibly even a new sub-part of Subchapter J in view of its considerable importance and novelty.

D. Multiple Trusts

It is believed that Subchapter J should have provisions to the effect that if a trust has more than one beneficiary, separate and independent shares of different beneficiaries shall be treated as if they were separate trusts. For example, assume a trust has three income beneficiaries, each of whom is entitled to share in the income equally, each beneficiary's estate to receive his share of principal upon his death. If one of the beneficiaries dies, the entire trust would not terminate, yet it would seem only fair for his estate which succeeds to the principal of his share of the trust to receive the benefit of the excess deductions provided in Section 662(d) of the bill.

Moreover, it would seem that a provision for separate shares is also necessary (despite the two-tier system provided in Section 662) in the situation where a trust pays out only a portion of its distributable income in a particular year to one of several beneficiaries and then makes a discretionary distribution of principal to the same beneficiary. For example, suppose that A and B are the income beneficiaries of a trust with distributable net income of $20,000 and the trustee pays A $10,000 of the income but accumulates B's $10,000 share of income and, in the same year, the trustee advances A $10,000 from his share of the corpus of the trust. If the separate share rule is not adopted, it would seem that A would be taxable under Section 662 of the proposed statute on $20,000 instead of $10,000, his share of the income.

E. Accumulations During Minority

Section 665 contains definitions applicable to the complex "throwback" provisions of Section 666. In defining terms there are excluded from the operation of the "throwback" amounts accumulated during the minority of, or before the birth of, a beneficiary and "amounts properly paid or credited for the support, maintenance, or education of the beneficiary". The House Report is silent as to the reason for inclusion of the language last quoted. (House Report, pp. 62-63, A206.) The term "beneficiary" is not limited to dependents or even relatives or limited to a minority. Probably the vast majority of all trusts are created for the "support, maintenance or education" of some beneficiary. This exclusion as presently worded would prevent the application of the "throwback" rule in the case of a very large number of trusts and thus would permit accumulations whenever the trust was created for "the support, maintenance or education" of a beneficiary without even having the benefit of the imperfect restrictions of the present "65 day rule". It is suggested that this situation could easily be remedied if there were added to the end of Section 665(b)(2), after the word "beneficiary", the words "during his or her minority".

F. Effective Date

Section 683 provides that these provisions relating to the income taxation of estates and trusts shall not apply to any amounts paid, credited or to be distributed by an estate or trust in any taxable year of the estate or trust commencing before January 1, 1954. There should be a further amendment to provide that where distributions were made to beneficiaries during the first 65 days of 1954 and hence treated as distributions of 1953 income under Section 162 of existing law that such amounts shall not be taxed again in 1954.

G. Grantors and Others Treated as Substantial Owners

(1) In Section 676, relating to trusts with a power in the grantor to revoke, the reference is to a power in the grantor to revest in himself "any portion of a trust". This section, like Section 166 of existing law, should provide a test based on the revesting of *the corpus* of the trust. The present language is capable of a possible construction that a power in the grantor to revest *the income* in himself would make this section applicable. The language should be clarified in this respect.

(2) There should be added to Section 672 (a) a sentence to the effect that a trustee is not an adverse party merely by virtue of his office.

(3) In the last sentence of Section 678(c) of the bill the words "to the grantor" seem to be incorrect and should read: "to the holder of the power".

PART FOUR

ESTATE AND GIFT TAXES

This part of our Committee's report sets forth its recommendations with respect to the estate tax and the gift tax, Chapters 11 and 12, which comprise Subtitle B.

I.

ESTATE TAX

A. Credit for Tax on Prior Transfers

Section 2013 revises the provision of existing law to permit a credit for the estate tax (not gift tax) paid on property by the estate of a prior decedent. The credit cannot be larger than the reduction in tax if the second decedent had not received the property. The present tracing requirement is eliminated by basing the credit upon the value of the property at the time of the death of the prior decedent. In addition, property transferred to a spouse is eligible for the credit to the extent no marital deduction was previously obtained. The full credit is allowed for two years following the death of the prior decedent and decreases of 20% are made for every two years up to the tenth year.

It is recommended that consideration be given to the allowance of a similar credit for any gift tax paid within ten years before death. Present law allows a deduction for property with respect to which a gift tax was paid within five years of death. Such deduction was first enacted in the Revenue Act of 1924 (Section 303(b)(2)) when the first gift tax statute was passed and has been retained ever since. Since the gift tax and estate tax are both directed toward taxing transfers of property, there would seem to be no reason for a policy which allows a credit with respect to a transfer by reason of death but denies it with respect to an *inter vivos* transfer.

It is recognized that considerable complexity attends the allowance of a credit for gift taxes and that, under certain circumstances, a very considerable reduction of the aggregate tax on a transfer of property may be accomplished by the allowance of such credit. Nevertheless, the disallowance of a credit for gift tax represents a departure from a policy which has been followed ever since the enactment of the gift tax.

B. Alternate Valuation

Section 2032 provides that the executor may elect to value the gross estate as of one year after death only if the aggregate value of the gross assets had decreased by at least one-third at that time. There is no such limitation in existing law. Our Committee recommends that it be eliminated.

The House Report at page 90 justifies the limitation on the grounds (1) that the section was enacted in the early 1930's when values dropped drastically; (2) that the existence of the optional date tends to retard the distribution of assets; and (3) that it frequently requires the valuation of property as of two dates. It is hard to see how these reasons justify the drastic limitation of a privilege presently enjoyed by the taxpayer.

A more important objection is that the bill denies the privilege unless the *gross* estate declines by one-third. This test, however, will invariably mean that the *net* estate must have declined by a much more considerable percentage before the privilege is available. It is even possible to envisage a not too unlikely situation where the *net* estate will have completely vanished without the privilege becoming available, thus:

	Date of death	Optional date
Gross Estate	$1,000,000	$700,000
Deductions	700,000	700,000
Net Estate	$ 300,000	—0—

Despite the disappearance of the net estate, the estate will be liable to a tax of approximately $65,000.

A further result of this statute is to create substantial differences of estate tax on estates of substantially similar value. Thus, if two gross estates are each valued at $1,000,000 at the date of death, and each has deductions of, say, $200,000, a decline of value of gross assets of one estate of $350,000 (i.e. more than one-third) will serve to reduce its tax by approximately $125,000 whereas a decline of

$325,000 in the value of the second estate will produce no reduction of tax.

An even more startling example is presented by an estate having a value of $20,000,000 as of the date of death. Assuming no deductions, such an estate would pay an estate tax of approximately $14,000,000. If the estate declined by 30% during the first year after death, there would be practically no residue left after payment of the tax. On the other hand, if the estate declined 34% in value, thus making it eligible for the optional valuation, there would be over $4,000,000 left after payment of the tax.

It is recommended that the optional valuation procedure of existing law be preserved.

C. Proceeds of Life Insurance

Section 2042 eliminates premiums paid as a test for inclusion of proceeds of life insurance in the estate. It provides that the proceeds of a policy are includible only if the insured retained an incident of ownership. Section 2042(2) provides that the term "incident of ownership" includes a reversionary interest ". . . only if the value of such reversionary interest exceeded 5 per cent of the value of the policy immediately before the death of the decedent". In such event the proceeds of the policy are taxable to the decedent.

It is considered that the quoted phraseology is inaccurate because most policies, at least under certain concepts of their value, have a very small value, compared to their face amount, or no value, immediately before the death of the decedent. Accordingly, our Committee recommends that the ambiguous concept of "value of the policy" should be eliminated from Section 2042.

D. Estates of Nonresidents Not Citizens

It is intended in Sections 2103 and 2104 of the bill to include in the gross estate of a nonresident alien all shares, wherever the certificates may be located, of stock of domestic corporations and to exclude all shares of stock of foreign corporations. Our Committee recommends that Sections 2103 and 2104 be clarified by adding to the end of Section 2103 the phrase "except shares of stock issued by foreign corporations" and by deleting from the end of Section 2104(a) the phrase "only if issued by a domestic corporation".

II.

GIFT TAX

A. Imposition of Tax

It is suggested that Section 2501 be revised to incorporate therein the provision of Section 2511 that a nonresident alien is taxed on transfer of property only if it is located in the United States. As Section 2501 of the bill reads, it would appear that the section imposes a tax even on transfers by a nonresident alien of property located outside of the United States, excepting only transfers of intangibles by a nonresident alien not doing business in the United States. It is clear, however, from Section 2511 that this is not intended.

B. Tenancies by the Entirety

It is suggested that Section 2515 be enlarged to include tenancies by the entirety in personal property. There are several states which recognize such interests.

C. Property Settlement Incident to Divorce

Section 2516, which does not appear in existing law, would eliminate any gift tax on transfers of property in settlement of marital or property rights or to provide maintenance for infants. This provision requires amendment in several respects. Many couples, particularly those of advanced years, do not desire a divorce, but intend to live apart. It would seem, therefore, that provision should be made for a transfer free of gift tax if a decree of divorce or a decree of separation is entered. Suitable provision, however, must be made so that property transferred within the terms of this section is not included in the computation of the marital deduction under Section 2523.

Moreover, the provisions for a divorce occurring "within a reasonable time" after the agreement of settlement would give rise to extensive litigation on the question of what is a "reasonable time". In the circumstances, it is suggested that a stated period of say two or five years be placed in the statute.

It is also recommended that consideration be given to an amendment to the estate tax provisions to incorporate the principle of Section 2516.

D. Releases of Powers of Appointment

It is suggested that there be added to the bill the equivalent of Section 1000(e) of existing law, which exempts from gift tax releases of powers in certain discretionary trusts if accomplished on or before December 31, 1947 or such later date at which the Commissioner finds that reasonable cause exists for having failed to act earlier. It is conceivable that such "reasonable cause" may exist even after December 31, 1954 when the bill will become effective with respect to gifts.

Respectfully submitted,

THE COMMITTEE ON TAXATION,

THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

April 8, 1954

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Second Report on H. R. 8300

April 16, 1954

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CONTENTS

ii

iii

PART TEN:

PAGE

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THE COMMITTEE ON TAXATION

Second Report on H. R. 8300

The Committee on Taxation of The Association of the Bar of the City of New York on April 8, 1954 filed with the Senate Finance Committee its First Report on H. R. 8300. The report was limited to comments on corporate distributions and adjustments, employees' trusts, the income taxation of estates, trusts and beneficiaries, and estate and gift taxes.

Our Committee files this Second Report on H. R. 8300 pursuant to permission granted by the Senate Finance Committee at the time of the appearance of our Committee's representative. As in the case of our First Report, limitations of time and space prevent us from commenting on the valuable improvements in the structure and operation of the internal revenue laws made by the bill, and require us to confine our report largely to comments of a critical nature, and, where feasible within the time allowed, to suggestions designed to meet particular difficulties. It should be emphasized that time has not permitted us to complete a review of all of the provisions of the bill.

PART FIVE

PARTNERS AND PARTNERSHIPS

Subchapter K of Chapter One contains for the first time a comprehensive statute relating to the income tax treatment of partners and partnerships. The tax problems which exist in this area are attributable principally to the dual nature of the partnership as an entity and as an aggregate of individuals. Subchapter K represents a laudable attempt to solve these problems in as simple a manner as is reasonably possible with the design of doing rough justice where greater precision would involve excessive complexity. Our principal criticism is that in the effort to achieve a comparative degree of simplicity, certain provisions of the bill, particularly those dealing with distributions in kind of partnership property, produce inequitable results. After discussing certain technical deficiencies in various sections of Subchapter K, consideration will be given to the problems presented by distributions in kind of partnership property and to the revision proposed by our Committee.

I.

DETERMINATION OF TAX LIABILITY

A. Contributed Property

Section 704(c) provides that, in determining a partner's distributive share of income, items arising with respect to contributed property or property the basis of which has been adjusted under the election provided in Section 743 shall be allocated among the partners "in the same manner as items arising with respect to any other property acquired by the partnership". It may be urged that since under Section 704(a) a partner's distributive share is determined by the partnership agreement, the treatment of items arising with respect to contributed property may equally be made the subject of agreement among the partners. However, the House Report at page A223 considers that Section 704(c) requires that gain upon the sale by the partnership of contributed property will be taxable to each of the partners in accordance with his distributive share of gains "in the identical manner as if the property had been purchased by the partnership". It is therefore implied that the partners cannot by agreement make special provision for distribution of income and deductions attributable to contributed property.

An example will illustrate the inequities which may arise as the result of the application of the Ways and Means Committee's interpretation of this provision. The ABC Partnership is composed of three equal partners, A, B and C. On the creation of the partnership, B and C each contribute $100 in cash. A contributes to the new firm an asset which cost him only $50 but which is now worth $100. Subsequently, the partnership sells the asset for $100. Under Section 704(c)(1) each partner will be required to report one-third of $50, or $16.66, as his share of gain on the sale. Although the value of the asset has not changed in the hands of the partnership, there has been shifted from A to the other partners two-thirds of the taxable gain on its sale. This follows if Section 704(c)(1) requires that gain or loss on the sale of contributed property be distributed among the partners in the same ratio as gains realized with respect to any other property acquired by the partnership.

The bill allows broad discretion to the partners in permitting the basic distribution of income and loss to be controlled by the partnership agreement, but has safeguarded the revenue by providing in Section 704(b)(2) that the partnership agreement will not control if the principal purpose of its provisions is the avoidance or evasion of tax. In view of the existence of this safeguard, it would appear appropriate to permit the distribution of gains and losses from the sale of contributed property to be separately provided for in the partnership agreement. Our Committee recommends that Section 704(c) be amended so as clearly to reflect this interpretation of the present statutory language.

B. Optional Adjustment to Basis of Partnership Property

Similar inequities in the tax treatment of the several partners result if Section 704(c)(2) is interpreted as preventing the partners from separately adjusting the distributive shares under the partnership agreement by reason of adjustments to basis of partnership property under Section 743. The latter section provides that in the event of a transfer of a partnership interest by reason of sale or exchange or the death of the partner, a partnership which has made or makes the election provided in Section 743 shall increase or decrease the basis of partnership assets by the amount by which the basis of the new partner's partnership interest exceeds or is exceeded by that of the old partner. The operation of this provision may be illustrated by another example:

The ABC Partnership is composed of three equal partners, A, B and C. On the creation of the partnership each contributed $100 cash, which is the basis for their partnership interests. The partnership retained $200 in cash and bought an asset for $100 which now has appreciated in value to $400. A then sells his interest for $200 to D, realizing a gain of $100, representing his share of the appreciation in partnership assets. The partnership elects under Section 743(d) to adjust the basis of its assets as a result of the sale. Therefore, the basis of its cash remains unchanged, but under Section 743(b) the basis of its other asset is increased from $100 to $200. D's basis for his purchased interest is $200. Upon the subsequent sale by the partnership of the appreciated asset for $400, each partner will report a gain of one-third of $200, or $66.66.

If the asset had been sold while A was still a partner the gain taxable to B and C would have been one-third of $300, or $100, each. Although their economic position was not changed by the sale by A, as a result of the adjustments under Section 734(b) their share of subsequent taxable gain on the sale of the asset by the partnership is reduced by $33.33 each. Similarly, although the increased partnership basis and reduced partnership gain is made possible by D's increased investment, his share of partnership gain is calculated as if he and all the remaining partners had made the increased investment pro rata. Although he must report a taxable gain of $66.66 on the sale, he actually has realized no economic gain since the purchase price for his interest was based upon the valuation of this particular asset at $400, the price at which it was later sold.

The operation of this provision would thus impose a tax penalty upon the new partner and grant a tax windfall for the remaining partners. If the statute is to adopt the present approach, the parties should be free in the partnership agreement to agree to a more equitable result.

II.

ADJUSTMENTS TO BASIS OF PARTNER'S INTEREST

Section 705(b) provides that the basis of a partner's interest is reduced by his distributive share of partnership losses (apparently without regard to tax benefit to the partner), "but not below zero". It would seem that this rule might allow a partner an excessive basis for his interest in the partnership under certain circumstances. Assume, for example, that at the beginning of the partnership year a partner has no basis for his interest in the partnership. During the year the partnership sustains losses and the partner becomes liable to repay his $10,000 share of the losses. Because of the zero basis rule of the statute it would seem that upon repayment he would acquire a basis of $10,000. This result is obviously inconsistent with the result which would follow if the partner had commenced the partnership year with a basis of, say, $15,000 for his partnership interest. In this case, Section 705(a) would operate, and it would seem properly, to restore his basis to $15,000 when he repaid the partnership his $10,000 share of the partnership losses.

III.

TAXABLE YEARS

Section 706 relates to the taxable years of partners and partnerships. Section 706(c)(1) provides that the partnership's taxable year closes on the termination of the partnership. Under Section 761(e)(1)(B), a partnership "may be considered as terminated" if within a 12-month period "more than 50% of the total interest in partnership capital and profits is transferred to persons who are not partners." Taken together, these two sections might prescribe the closing of the partnership's taxable year upon the death of a 51% partner and the transfer of his interest to his estate or heirs. This result is apparently not intended and to clarify this point it is suggested that a transfer by reason of death of a partner be expressly excepted from the operation of Section 761(e)(1)(B).

IV.

TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP

A. Sales Between Partnerships

Section 707 relates to transactions between partners and partnerships. It fails to include rules governing sales of property between partnerships with common partners. Section 267, relating to the disallowance of losses between related taxpayers, does not cover this situation. Adequate safeguards should perhaps be set up to protect the revenue against fictitious sales of depreciated property at a loss between related partnerships.

B. Definition of Controlling Partner

Section 707(b)(2) provides that in determining whether a partner is a controlling partner owning 50% or more of the capital interest in the partnership, the ownership of a capital or profits interest in a partnership shall be determined in accordance with the rules of constructive ownership of stock provided in Section 267(c). Section 267(c)(3) provides that an individual is considered to own the stock (or in this case, the partnership interest) owned directly or indirectly by or for his partners. A literal application of this rule would apparently attribute to every partner 100% of the aggregate partnership interests. Our Committee does not believe this was intended, and corrective language is recommended.

C. Guaranteed Salaries

Section 707(c) in effect provides that payments to a partner for services shall, to the extent determined without regard to the income of the partnership, be considered as a salary paid or incurred with respect to one who is not a member of the partnership. In the case of a fiscal year partnership, this section would appear to require a pyramiding of income with respect to a calendar year partner receiving a guaranteed salary in the year in which such subsection becomes effective. Our Committee recommends that an exception be added to this subsection so that if a partnership is on a fiscal year basis, such guaranteed salaries shall continue to be includible in the income of the recipient in his taxable year in which the partnership fiscal year terminates.

V.

PAYMENTS TO A RETIRING PARTNER

Section 736(a) relates to the tax status of payments to a retiring partner or deceased partner's successor in interest. It provides an arbitrary rule for taxability as between deceased and surviving partners based upon the mere passage of a period of five years. It is difficult to find economic justification for the restrictions which this rule will impose on arrangements of this nature. Moreover, the statute also imposes a severe penalty upon the remaining partners for payments beyond the five-year period by providing in Section 736(a)(1)(B) and (2)(B) that the bases of their partnership interests shall not be increased by the amounts of such payments.

It may also be noted that the House Report at pages A230 and A231 indicates that payments to retiring partners after expiration of the five-year period are treated "as a gift". Inasmuch as these payments are normally made for an adequate consideration and not with any donative intent, it would appear that they should not be subject to gift tax. Accordingly, it is recommended that if the provision is retained the legislative history be clarified on this point.

VI.

DISTRIBUTIONS BY A PARTNERSHIP

The most perplexing problems presented by Subchapter K are those which arise by reason of the rules as to realization of income and basis of property in the case of distributions in kind of partnership property, either currently or in liquidation of a partner's interest.

The problems involved may be illustrated by examples. Assume that a partner retires from a partnership and receives as his liquidating distribution an asset worth $100 which has a basis to the firm of only

$90. The basis to the retiring partner of his partnership interest is also $100 and he thus has no economic gain or loss on his retirement. The bill, however, would require a comparison to be made between the basis to the partner of his interest in the partnership and the basis to the partnership of the asset distributed. Since the basis to the retiring partner of his interest in the partnership would exceed by $10 the basis to the partnership of the distributed asset, the retiring partner would have a $10 loss on the liquidation. If he eventually disposes of the asset he may of course have a taxable gain of $10, but this will be avoided if he retains the property until death. On the other hand, if the asset distributed is non-capital in nature the $10 gain on a subsequent sale would be ordinary income notwithstanding the fact that the loss on the distribution was a capital loss. See Sections 731(a), 735 and 751(a)(3).

An even more striking result may follow if the partnership distributes appreciated property to a partner who realizes economic gain on his retirement. Assume a liquidating distribution to A upon his retirement of an asset worth $100 that had a basis in the hands of the partnership of only $50. Assume that A's basis for his partnership interest is $75. In this situation, he has an economic gain of $25 upon his retirement, but a deductible tax loss of $25 (the difference between his basis for his interest of $75 and the partnership's basis for the distributed asset of $50). Here again, A will have a counterbalancing gain of $50 if he disposes of the property prior to his death, but this allowance to him of an immediate but artificial tax loss presents definite tax avoidance possibilities.

Our Committee recognizes the great difficulty of developing a completely satisfactory solution to the problems presented by distributions of partnership assets. It is the conclusion of our Committee that the defects in the bill can be minimized by applying to partnership distributions a modification of the plan proposed for liquidations of corporations in Part II of Subchapter C. We believe that such a proposal would achieve the desired result of simplicity with a minimum of tax avoidance. No attempt is here made to submit definitive statutory language, but the following summary will indicate the principles which might be followed in revising Sections 731(a), 732 and 733.

(1) *Recognition of Gain.* Where the adjusted partnership basis and fair market value of the assets distributed exceed the adjusted basis of the interest of the partner in the partnership, gain shall be recognized to the extent of the excess of the adjusted partnership basis or fair market value of such assets, whichever is less, over the adjusted basis of such interest.

(2) *Recognition of Loss on Liquidating Distribution.* Where the adjusted basis of the interest of the partner in the partnership exceeds the fair market value of assets distributed in liquidation of such interest, loss shall be recognized to the extent of such excess.

(3) *General Rule for Non-Recognition of Gain or Loss.* Where the fair market value of the assets distributed equals or exceeds the basis of the interest of the partner in the partnership, and the adjusted partnership basis of the assets distributed is not greater than the adjusted basis of such interest, then no gain or loss shall be recognized.

(4) *Non-Recognition of Gain or Loss on Distributions Not in Liquidation.* Where the adjusted basis of the interest of the partner in the partnership exceeds the fair market value of assets distributed in a distribution not in liquidation, then no gain or loss shall be recognized.

(5) *Basis of Distributed Property—Gain Recognized.* In the case of a distribution in which gain was recognized pursuant to paragraph (1), *supra,* the basis of the assets with respect to which such gain was recognized shall be the adjusted partnership basis of such assets or their fair market value at the time of distribution, whichever amount was used in determination of gain under such paragraph.

(6) *Basis of Distributed Property—Loss Recognized.* In the case of a distribution in which loss was recognized pursuant to paragraph (2), *supra,* the basis of the assets with respect to which such loss was recognized shall be the fair market value of such assets at the time of distribution.

(7) *Basis of Distributed Property—Gain or Loss Not Recognized.*

(a) In the case of a distribution in which no gain or loss was recognized pursuant to paragraph (3), *supra,* and the distribution was in liquidation of the partner's interest in the partnership, the basis of the assets with respect to which gain or loss was thus not recognized shall be the adjusted basis of the interest of the partner in the partnership with respect to which the distribution was made, allocated among the various assets received in accordance with the relative amounts of the partnership's bases of such assets immediately prior to the distribution.

(b) In the case of a distribution in which no gain or loss was recognized pursuant to paragraph (3), *supra,* not in liquidation of the interest of the partner in the partnership, or pursuant to paragraph (4), *supra,* the basis of the assets with respect to which gain or loss was thus not recognized shall be the adjusted partnership basis of such assets or their fair market value at the time of distribution, whichever amount is less.

(8) *Basis of Distributee-Partner's Interest.* In the case of a distribution by a partnership to a partner the adjusted basis of any remaining interest of such partner in the partnership shall be reduced (but not below zero) by the adjusted basis of the property distributed in the hands of the distributee as determined under paragraphs (5) or (7), *supra.*

If the pattern suggested were adopted, in drafting the actual statutory provisions there could be included appropriate provision for treatment of cash distributions and the distribution of inventory assets.

It is believed that the foregoing pattern of treating distributions in kind of partnership property would not interfere with the intended operation of Section 734, relating to adjustments to basis of undistributed partnership property. Thus in any case in which the distributee-partner is required to take as his basis the fair market value of the distributed assets, the difference between such value and the partnership basis for the assets might be allocated to increase the basis of the retained partnership assets. It is suggested, however, that consideration be given to providing that such basis increases should be applied not only to assets retained by the partnership, but also to the assets concurrently distributed to another partner if the fair market value of such assets exceeds their basis.

It might be appropriate to provide for determination of the holding period of a partner's interest in the partnership; the bill contains no provision with respect thereto.

VII.

EFFECTIVE DATE

Because of the extensive changes which Subchapter K will make in the taxation of partners and partnerships, our Committee recommends that the effective date with respect to certain transfers and distributions, presently stated in Section 771(b) to be March 1, 1954, be extended to the date of enactment of the bill or to a later date.

PART SIX

FOREIGN INCOME

The bill makes three substantial changes in the treatment of foreign income:

(1) it grants domestic corporations a credit of 14% of certain business income from foreign sources (Sections 37 and 923);

(2) it permits certain income of domestic corporations from foreign branches to be deferred (Subchapter N, Part IV, Sections 951-958); and

(3) it revises the foreign tax credit to eliminate the "over-all" credit limitation and to introduce a new concept of a "principal tax" (Sections 901-905).

A. Credit of 14% of Certain Business Income

Section 37 allows a tax credit of 14% of a domestic corporation's taxable income which meets the requirements of Section 923. Income meeting the requirements of Section 923 consists of branch income as computed in Part IV; compensation for the rendition of technical, engineering, scientific or like services; and dividends and interest from a foreign corporation; all subject to strict limitations set forth in Section 923. Generally speaking, the branch income or the income from dividends and interest must be income of a year the gross income of which (1) has been derived, to the extent of at least 95%, from sources without the United States, and, to the extent of at least 90%, from the "active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business situated within a foreign country," and (2) does not consist of more than 25% of gross income derived from the sale of articles or products manufactured in the foreign country and "intended for use, consumption or sale in the United States". Under Section 923(b)(1) the term "trade or business" excludes "the operation of an establishment engaged principally in the purchase or sale (other than at retail) of goods or merchandise" and the maintenance of an office or agent in connection with the importing of goods.

A further limitation applicable to the credit with respect to dividends and interest from a foreign corporation is that the domestic corporation is allowed such credit only if it owns (1) either alone or "in association with" no more than three other domestic corporations, more than 50% of the voting stock of such foreign corporation, or (2) at least 10% of the voting stock of such foreign corporation and the trade or business of the two corporations are related by reason of the rendition of technical, engineering, scientific or like services incidental to the operation of the trade or business of such foreign corporation. See Section 923(a)(3)(B), (4).

The highly restricted nature of the provisions of Section 923 suggests the question whether they may exclude businesses and activities from the benefits of the section which would seem to be within its policy. The fixed percentage rules governing the classes of income which are permissible for qualification purposes could operate erratically and cause qualification to depend upon the form of the business rather than its substance. The exclusion from the term "trade or business" of the operation of an establishment engaged principally in the purchase of goods and their sale, other than at retail, appears to disqualify types of business activities carried on either independently or as part of manufacturing operations which should, it is believed, receive the benefit of the section. The definition in Section 923(a)(3)(A)(ii) setting forth the type of establishment or means through which the permitted business can be conducted, while described in the House Report, page A255, as not exhaustive, would appear to exclude from the benefits of the section, agricultural operations and perhaps other types of business which the bill may have been intended to cover.

Section 923(a)(1) provides that the benefit of the section shall be allowed to "branch income includible in gross income under Part IV". Part IV deals with the deferment of branch income and requires definite accounting procedures to be complied with and lays down a rule for the determination of the income taxable to the domestic corporation based on the withdrawal of the domestic corporation's investment in the branch. Section 923(a)(1) as drawn is susceptible of the interpretation that branch income is not entitled to the benefits of Section 923 unless it is an "elected branch" under Part IV. This would mean that a domestic corporation would have to elect to defer foreign branch income if it wished to qualify under Section 923. It is questionable whether this was intended.

Moreover, by its reference to Part IV, Section 923(a)(1) may cause the benefits of the section to be lost in cases where relief was probably intended. Section 951(a)(2) prescribes as a condition to qualification for relief under Part IV that 90% of the gross income of the elected branch be from the active conduct of a trade or business. Section 923(a)(2), however, permits the credit for income received as compensation for the rendition of technical and similar services. It might be that a branch would derive less than 90% of its income from the active conduct of "a trade or business," but the balance of its income from the rendition of technical services. Thus it could not qualify for the benefits of Part IV, an exclusion which is apparently intended, but it would also lose the benefits of Section 923, although all its income would be either from the active conduct of a trade or business as defined in Part IV or compensation for technical services, both of which types of income are permissible under Section 923. It is therefore recommended that Section 923(a)(1) be clarified on this point.

It should be noted that under Section 923 dividends from a foreign corporation would apparently not qualify for the application of the credit if the foreign corporation derived more than 10% of its income from excluded sources, including the rendition of technical services. It is not clear why a different rule is applied in the case of a foreign corporation than in the case of a domestic corporation.

The alternative qualifying provision in Section 923(a)(3)(B)(i) may work a hardship in situations where American corporations would not be permitted to own as much as 50% of the stock of the foreign corporation. It is recommended that this provision be modified to require only that the stock ownership, if 50% or less, constitute the maximum percentage of stock (not less, perhaps, than 25%) which under the laws of the foreign country can be owned by the American corporations.

Section 923(d) lists corporations which are ineligible for the benefits of Section 923. At least two of these exclusions may be questioned:

Insurance companies are excluded. This exclusion is presumably related to a similar denial of the individual and corporate dividends received credit in the case of insurance company dividends. Presumably the exclusion is based on the belief that insurance companies are taxed on a different and more favorable basis than other corporations and are therefore not entitled to the benefits of the relief provisions in question. However, stock companies taxable under Section 831 of the bill are taxed at the same rates as other corporations. Accordingly, it is recommended that the exclusion not apply to corporations taxable under Section 831 of the bill.

Personal holding companies are excluded. No reason appears for this exclusion. The exclusion would presumably operate only with respect to dividends and interest received by such companies. If the foreign corporations paying the dividends met the requirements of Section 923, it is believed that the credit should be available.

B. Deferment of Foreign Income

Sections 951-958 (Part IV of Subchapter N) permit income from foreign branches to be deferred under certain conditions. The type

45994 O—54—pt. 1——39

of income which may be deferred is substantially the same as the type of income entitled to the benefits of Section 923, and the comments made with respect to the limitations as to the types of activities entitled to the benefits of Section 923 are equally applicable here.

Sections 952 and 953 contain elaborate provisions for the treatment of the branch whose income is to be deferred and for the determination of branch income. Section 953 is designed to place branch income on the same basis as income of foreign subsidiaries so that income subject to deferment will approximate the earnings and profits of the foreign subsidiary withdrawn by way of dividends. Section 953(d)(4), allowing a deduction for taxes, including income taxes paid by the elected branch, is criticized in the report of the minority of the Ways and Means Committee (House Report, page B23-24) as allowing a double credit, but this treatment would seem consistent with the purpose of the section to assimilate branch income to corporate earnings since foreign income taxes would reduce the income of a corporation available for dividends.

It should be noted, however, that no loss is allowed on the winding up of an elected branch. This is intentional (House Report, page A264). Such denial appears inconsistent with the assimilation of an elected branch to a foreign subsidiary since, on the liquidation of a foreign subsidiary, a capital loss would be allowed. Accordingly, it is recommended that a capital loss be allowed with respect to losses realized on the termination of a branch.

Section 954, providing for the determination of the extent to which branch income is withdrawn and therefore subject to tax, bases the determination on the excess of the taxpayer's investment in the elected branch at the beginning of the year over the taxpayer's investment in such branch at the close of the year, with appropriate adjustments for income or losses of the year. The minority of the Ways and Means Committee (House Report, page B23) contends that this would permit easy evasion by a temporary year-end reinvestment. This abuse appears to be a real possibility. However, Section 954(a) gives the Secretary the power by regulation to determine the basis of the taxpayer's investment in the elected branch and it would seem that abuses could be prevented under this power.

Among corporations excluded from the benefits of Part IV is a corporation more than 50% in value of the stock of which is owned by alien individuals, determined in accordance with the attribution principles of Section 544, relating to attribution of ownership in connection with personal holding companies. See Section 951(c)(8). Under this formula, a corporation would be excluded if, for example, an alien owning only 1% of the stock (or indeed no stock at all) had an American father or brother owning 99% of the stock. This attribution formula should be changed to prevent the attribution of essentially American ownership to aliens.

Attention is called to the fact that Part IV apparently does not cover the case where a domestic corporation's entire activities are conducted in a foreign country and it has only a statutory office in this country. It is believed that Section 951 should be amended to make it clear that such a corporation will be entitled to the benefits of Part IV.

It is suggested that Section 953(b) would be clarified if it were amended to read as follows:

> "The branch income of an elected branch for a taxable year shall be the taxable income of such elected branch, which shall be the excess of the items of gross income allocable to such branch over the items of expenses, deductions, and losses allocable thereto."

C. Foreign Tax Credit

Provisions relating to the credit for foreign taxes have been changed to eliminate the over-all limitation contained in Section 131(b)(2) of the 1939 Code and to substitute for the "in lieu of" tax with respect to which a credit is allowed in Section 131(h) of the 1939 Code a so-called "principal tax". Section 131(h) of the 1939 Code provides that "the term 'income, war-profits, and excess-profits taxes' shall include a tax paid in lieu of a tax upon income, war-profits, or excess-profits otherwise generally imposed by any foreign country or by any possession of the United States". This provision has been narrowly interpreted. Under the Regulations the "in lieu of" tax does not qualify unless (1) the foreign country has in force a general income tax law, (2) the taxpayer, in the absence of a specific provision applicable to such taxpayer, would be subject to such general income tax, and (3) such general income tax is not imposed upon the taxpayer thus subjected to the substituted tax.

Section 901(b)(1) of the bill replaces Section 131(a)(1) and (h) of the 1939 Code by providing either for (A) a credit of the familiar "income, war-profits and excess-profits taxes paid or accrued during the taxable year to a foreign country or to a possession of the United States", or (B) a new alternative credit. The new alternative credit is a credit for a "principal tax" for each separate trade or business of the taxpayer paid to the "national government" of a foreign country or possession, plus any income, war-profits and excess-profits taxes paid to "any political subdivision" of such foreign country or possession. "Principal tax" is further defined in Section 903 as that "one" tax "which is attributable to the operation of a trade or business regularly carried on by the taxpayer" and "which constitutes for such year the principal source of tax revenue to such government from such trade or business". A principal tax cannot be a "social security, income, war profits, or excess profits tax" whether or not such taxes are generally imposed; and it is not a "sales, turnover, property, or excise tax, which is generally imposed". Thus, a principal tax may be a "sales, turnover, property, or excise tax" which is not generally imposed, but which, in the words of the House Report (page A251) is "selectively" imposed.

Section 903 limits the amount of the principal tax available as a credit to an amount computed by multiplying the taxpayer's taxable income from the trade or business with respect to which such tax is imposed by a percentage equal to the sum of the effective normal tax and surtax rates of the taxpayer.

It may be doubted whether the proposed principal tax concept represents a satisfactory solution of the foreign tax credit problem. Certainly the difficulties of determining whether a tax is the "one" tax constituting "the principal source of tax revenue" to the foreign government from the particular trade or business, whether the tax is a sales, turnover, property or excise tax, and if so whether such tax is generally or selectively imposed, would seem to raise possibilities of prolonged controversy and litigation. The House Report states (page A251) that where a tax is widely applicable but its rates differ significantly from industry to industry, the tax on each industry would be considered selectively imposed. Under this language it would be difficult to determine whether many of the franchise taxes of the American states are generally or selectively imposed. It might be possible to avoid many of the difficulties of the foreign tax credit provisions if credit were allowed for any business taxes paid to a foreign government or subdivision thereof, subject, however, to the per country, and, perhaps, over-all limitations in the existing Code.

If the new tax concept is to be retained, our Committee recommends the following changes or clarification.

Under existing law credit is available for income taxes paid to both the national government of a foreign country and any political subdivision thereof. This is true whether the taxes are income taxes or "in lieu of" taxes. Under the bill no credit is allowable for principal taxes paid to a political subdivision of a foreign country. It would seem that taxpayers should be allowed to elect separately on each level, i.e., to elect between the income tax and the principal tax of the national government of the foreign country and between the income tax and the principal tax of a political subdivision of the foreign country.

There is some confusion as to the deductibility of the taxes in question. Under Section 164(b)(6) deduction is denied for any foreign income taxes if the taxpayer chooses to take "to any extent the benefits of Section 901" relating to foreign tax credit. This would mean that if the taxpayer chose the principal tax as the basis for credit, it would not be entitled to deduct the income tax. On the other hand, the taxpayer electing the income tax as the basis for credit would not, by reason of such election, be denied a deduction for the principal tax. Furthermore, it would appear that the taxpayer electing the principal tax as the basis for credit would be entitled to a deduction as well as a credit for the tax. It would seem that it might be appropriate to deny a deduction with respect to any tax to the extent that it was claimed as a credit, but to permit the deduction of the tax, including income taxes, to the extent that it was not claimed as a credit.

In any event it would seem that income taxes attributable to income other than income from the source with respect to which the principal tax was imposed, should be allowed as a credit, even though the principal tax is elected as the basis for the credit. Moreover, even if principal taxes paid to a political subdivision of a foreign government are not to be generally allowed as a basis for credit, it is believed consistent with the theory of the credit that such taxes should be allowed to the extent that the principal tax paid to the national government is reduced by a credit for similar taxes paid to the political subdivision.

In order to make it clear that no change in existing law is intended, it is recommended that Section 901(b)(1)(A) expressly provide that if the taxpayer elects a credit for income taxes, it will include income taxes of a political subdivision of the foreign country.

Section 901(b)(4), dealing with the treatment of tax credits to members of partnerships, refers to an "individual" member of a partnership. Since corporations may participate in joint ventures which may be treated as partnerships, it would seem preferable not to limit the provision to individuals.

D. Western Hemisphere Trade Corporations

Section 921 defines a Western Hemisphere trade corporation as a domestic corporation all of whose business is done in described areas of the Western Hemisphere and inserts after the word "business" the new phrase ("other than incidental purchases"). The insertion of this parenthetical phrase is a result of the Treasury's position that the purchase of goods outside the Western Hemisphere constitutes the transaction of business which might disqualify a corporation from the benefits of this section. It appears doubtful whether the phrase in question is sufficiently definite to settle the issue. If the words "incidental purchases" mean occasional purchases, the present uncertainty will continue. If the phrase means purchases incidental to the business, the question would be resolved against the Treasury's contention under present law. The House Report is silent as to the meaning of the phrase or the intended policy decision. It is believed that the language should be clarified to express the intended result.

PART SEVEN

PROCEDURE AND ADMINISTRATION

Subtitle F represents, in the main, a desirable rearrangement and consolidation of administrative provisions which are scattered among numerous chapters of the present Code. While time has not permitted analysis of many of the numerous administrative changes proposed to be made, our Committee has selected some of the more important changes for comment and, in addition, wishes to point to certain important problems in this field that have not been dealt with in the bill.

A. Declarations of Estimated Tax by Individuals (Sections 6015, 6073, 6153 and 6654)

Sections 6015, 6073 and 6153 make several changes in the provisions relating to declarations of estimated income tax by individuals. The requirements for filing declarations have been liberalized and for future years estimates will be due from calendar year taxpayers on or before April 15th of the taxable year. These sections are related to Section 6654 which provides for a single charge of 6% per annum on underestimates and unpaid installments of estimated tax, in substitution for the various complex penalties under present law for failure to comply with tax-estimation requirements.

Under present law an individual who substantially underestimates his tax may correct his estimate by January 15th of the following year without penalty. Under Section 6654 of the bill, the taxpayer is chargeable with a penalty equivalent to 6% per annum on the amount of an "underpayment" of any installment (the difference between 70% of the quarterly installment which should have been paid on the basis of the tax shown on the final return and the installment actually paid), and the penalty is charged for each "underpayment period," i. e., from the due date of the installment to April 15th of the following year (in the case of calendar year taxpayers) or the date the underpayment is paid, whichever is earlier. Since this change would apply to 1954 taxes (House Report, page A442), each taxpayer who underestimated his 1954 income tax in a declaration filed March 15th has already incurred, under the bill, a retroactively imposed penalty of 6% per annum on the "underpayment" (as defined in the bill) for the period from March 15th to the date of payment, or April 15, 1955, whichever is earlier. It seems to our Committee that the effective date of this substantial change should be deferred to taxable years commencing after December 31, 1954 to enable taxpayers to familiarize themselves with this change. This would also avoid retroactive interest charges in respect of 1954 taxes against taxpayers who underestimated their 1954 taxes in declarations filed last March 15th, before the provisions of the bill could have been known to more than a handful of taxpayers.

B. Extensions of Time for Payment of Estate Tax (Sections 6161 and 6601)

The provisions of Section 6161 for extensions of time for payment of estate tax should be considered in conjunction with the provisions of Section 6601 which impose interest thereon. Section 6601(b) provides for interest at 4% on estate taxes where extension for payment thereof has been granted or the value of a reversion or remainder interest is involved. Apparently the 4% interest privilege would be inapplicable to payment of estate tax deficiencies. Also, under Section 6161(b)(2), the extension for payment of an estate tax deficiency may not be for more than four years from the date otherwise fixed for the payment of the deficiency, although under Section 6161(a)(2) a ten-year extension may be granted for payment of the estate tax shown on the return. Our Committee recommends that by amendment of Section 6161, the Secretary should be authorized to grant an extension for payment of an estate tax deficiency for a reasonable period not in excess of ten years from the due date of the return, where the Secretary finds that payment on any prior date would result in undue hardship to the estate. In such event, interest would be imposed upon the amount of such deficiency at the rate of 4% from the date prescribed for payment to the date paid.

C. Assessment and Liens (Sections 6203, 6204, 6322 and 6323)

(1) Under Section 6203, the assessment shall be made by recording the liability, presumably by mechanical processes, in the office of the Secretary or his delegate in accordance with rules or regulations

to be prescribed therefor. This change is important in conjunction with the provisions of Sections 6322 and 6323 which provide in part that the lien in respect of an assessed tax arises "at the time the assessment is made," and that, without filing of public notice, a tax lien is valid against a mortgagee, pledgee, etc., who had notice or knowledge of the existence of the lien at the time the mortgage, pledge or purchase was made. It may be noted that these changes may result in uncertainty as to the kind or degree of notice or knowledge that would deprive a creditor of priority of lien.

(2) Section 6204 authorizes the Secretary or his delegate to make a "supplemental assessment" whenever "it is ascertained that any assessment is imperfect or incomplete in any material respect." Where a deficiency exists, the original assessment is obviously "incomplete" in a material respect, and, literally read, this section might permit the Secretary to dispense with the statutory notice for assessment of a deficiency. This ambiguity should be eliminated by adding to Section 6204 a provision to the effect that it is subject to compliance with the requirements respecting deficiency procedures prescribed under Subchapter B.

D. Right to Petition Tax Court After Advance Payment of Disputed Tax (Section 6213(b)(3))

Under present law there is some uncertainty whether a taxpayer may make voluntary payment of a threatened deficiency in advance of receiving formal notice of deficiency without forfeiting the right to a Tax Court hearing on the questions involved. This assumes that restrictions upon assessment have not been waived. Under Section 6213(b)(3), the Secretary would be authorized to assess any such payment and in that event would not be required to issue a deficiency notice. Without such notice, a taxpayer may not file a petition with the Tax Court. The House Report at page A405 states that this proposal represents a material change from existing law.

To deprive taxpayers of a right of review which they have enjoyed since the creation of the Board of Tax Appeals is an important policy decision. It is not uncommon for audit and settlement of a large or complex return to require a period ranging up to ten years from the filing date, and often the Treasury, not the taxpayer, is responsible for the delay. A taxpayer facing such delay is almost compelled to make an advance payment of a prospective deficiency in order to avoid continuing accrual of interest charges. Under Section 6213, the taxpayer making such payment will forfeit, or run serious risk of forfeiting, the right to have the questions reviewed in the Tax Court. Obviously, if this change is enacted, any taxpayer who desires to preserve his right to go to the Tax Court will have two alternatives: (1) to withhold payment of the tax and run the risk of incurring additional interest thereon, or (2) to forego further effort at administrative settlement, request issuance of the deficiency notice, file a petition with the Tax Court and then pay the tax. Many taxpayers would choose the second alternative, with the result that the Tax Court's work-load of cases, many of them capable of administrative settlement, would be unnecessarily increased.

It is hardly an answer to say that a taxpayer may avoid this dilemma by depositing an amount which approximates but is less than the prospective deficiency assessment. Not only would this be an obvious artifice which should not be encouraged, but in making such payment, a taxpayer assumes the risk that the amount deposited may be found to equal or exceed the deficiency; moreover, payment of interest accrued on such deficiency may not safely be made since the Secretary might apply a portion thereof against any unpaid balance of the deficiency, assess the amount thereof and thus deprive the taxpayer of a Tax Court hearing.

Our Committee believes that it is in the interests of the Treasury and taxpayers alike to permit a taxpayer to make a voluntary advance payment of a prospective deficiency without forfeiting his right to have the case considered by the Tax Court. We recommend, therefore, that Section 6213(b)(3) be omitted, and that the definition of deficiency in Section 6211 be appropriately amended to guarantee such privilege to the taxpayer.

E. Modification of Finality of Tax Court Decisions in Estate Tax Cases (Sections 6212 and 6512)

In the case of the estate tax, Section 6212(c)(1) provides an exception to the present rule which restricts the issuance of further deficiency letters where the taxpayer has filed a petition with the Tax Court in respect of a notice of deficiency. The restriction under the above section would apply only with respect to estate tax "on account of the same transfer of net estate." (The term "net" estate is abandoned in Chapter 11 in favor of the term "taxable" estate.) The phrase is also incorporated in Section 6512(a) and (b) relating, respectively, to the prohibition against a suit for refund where a petition respecting the tax has been filed with the Tax Court, and the limitation upon Tax Court jurisdiction to determine overpayment of a tax for which a deficiency has been asserted. Presumably these changes are designed to protect the Government in the situation where additional assets of the decedent are discovered after issuance of the notice of deficiency, filing of a petition in respect thereof and entry of decision thereon.

The phrasing of this new provision is ambiguous. It could be interpreted to permit a second deficiency notice respecting a transfer duly reported by the estate but not included therein when the first deficiency was adjudicated by the Tax Court. In any event, the provision represents a serious inroad upon the established principle that, absent fraud, a decision of the Tax Court, upon becoming final, is conclusive of the liability in question for all purposes. Under the section the Secretary would be permitted to reopen an estate tax liability determined by the Tax Court and tax newly discovered assets but, notwithstanding intervening legislation or decisions of a higher court, the estate would be unable to offset against the new deficiency any overpayment indicated to exist in respect of issues determined in the first proceeding. Our Committee believes that the finality of Tax Court decisions should not be whittled down by changes of the character proposed. It is recommended, therefore, that the phrase "on account of the same transfer of net estate" be deleted from Section 6212(c)(1) and also from Section 6512(a) and (b).

F. Limitations (Sections 6501 and 6511)

(1) Section 6501(c)(2) provides for assessment of tax at any time "in case of a willful attempt in any manner to defeat or evade tax imposed by this title." The House Report (page A413) states that this exception to the basic three years' limitation period exists under present law with respect to all taxes other than income, estate and gift taxes, and is being extended to them. Presumably, the change is in the interest of uniform procedure and administration,

and is suggested because of the consolidation of limitation periods affecting different taxes, an otherwise desirable provision. Our Committee believes, however, that no valid basis exists for engrafting a further unlimited exception upon the present limitation period. So far as appears, the provisions of present law for an unlimited assessment period in the case of a fraudulent return, or failure to file a return, have been adequate to protect the Government. The public policy which underlies the statute of limitations, i. e., to prevent resurrection and litigation of stale claims either by the Government or taxpayers, may be frustrated if other exceptions, unlimited in scope, are added thereto. It is submitted, therefore, that Section 6501(c)(2) should be deleted. If, contrary to this view, the provision is retained, we think that the burden of proving the application of the exception should be imposed upon the Secretary by appropriate amendment of Section 7454(a).

(2) Section 6511, relating to limitations on credits and refunds, substantially reenacts the provisions of existing law, but does not deal with a problem which will recur with increasing frequency in the future, viz., the situation where a payment of tax accompanies the filing of a "tentative return" which is not the return called for by statute in that it fails to provide information prescribed under the regulations.

To illustrate: A "tentative" corporate return is filed March 15, 1954, and under present law, a payment of 45% of the tax is made on that date. Pursuant to extension, the statutory return is filed on June 15, 1954. Under both existing and proposed law, a claim for refund may be filed up to June 15, 1957; however, unless the claim is filed prior to March 15, 1956, refund of the payment made on March 15, 1954 would be barred even if an otherwise timely claim filed on June 15, 1957, i. e., within three years from the filing of the return. This is because of the statutory provision that if a return is filed during the three years immediately preceding the filing of the refund claim, the amount of the refund cannot exceed the portion of the tax paid within such three year period. In such case, the taxpayer is remitted to the two year statute of limitations. This has been specifically held by the Tax Court with respect to payments accompanying a tentative return. *Southern Sportswear Co., Inc.*, 10 T. C. 402 (1948), *remanded* 175 F. 2d 779 (6th Cir. 1949).

In many cases, the audit is not begun and the overpayment issues are not developed until after the expiration of two years from the filing of the tentative return and initial payment of tax. This problem is bound to become more important than in the past under the present system of accelerated payment of corporate taxes. Where an extension beyond June 15th is obtained, the entire tax will have been paid prior to the filing of the return.

It is recommended, therefore, that a proviso be added to the first sentence of Section 6511(b)(2)(A) to the effect that any amount paid on or after the due date of the return (determined without regard to any extension) but prior to the filing of the return shall be deemed to have been paid on the date of the filing of such return.

G. Interest (Section 6601)

Under existing law no interest is chargeable on an assessed deficiency of income tax if the amount assessed is paid within ten days after notice and demand (Section 294(b) of existing law). No comparable provision is contained in the bill and Section 6601(d) thereof provides in effect that interest is chargeable from the date of notice and demand. As a practical matter, the assessment will rarely be paid on the date of notice and demand because the notice will ordinarily not be received by the taxpayer until a day or two thereafter. It is suggested that, in order to avoid small interest computations, Section 6601(a) be amended to provide that no interest shall be assessed from the date of notice and demand if the amount demanded is paid within ten days from that date.

H. Civil Actions (Sections 7403 and 7422)

(1) Section 7403(c), relating to adjudication and decree in an action by the United States to enforce a lien, changes the comparable provision of existing law by adding the following sentence: "For the purpose of such adjudication, the assessment of the tax upon which the lien of the United States is based shall be conclusively presumed to be valid." This change is inconsistent with present law under which the Government may bring suit for collection of taxes. 28 U. S. C. Section 1396. Under this provision, which replaced Section 3744 of the present Code, the United States is authorized to file a civil suit to recover taxes. Where such a suit is brought,

the defendant is permitted to show that the assessment, although *prima facie* valid, is erroneous, excessive or illegal. It seems illogical to deny such right to the taxpayer in a suit to enforce a tax lien. It is recommended that the sentence quoted be eliminated from Section 7403(c).

(2) Section 7422(c), incorporating the provisions of Section 3772(d) of existing law, includes inadvertently the following language derived from Section 3772(d): "* * * where the petition to the Tax Court was filed after such date." In Section 3772(d) of existing law, this is a reference to June 15, 1942, the effective date of the original amendment of that section. In Section 7422(c) the clause is surplusage.

I. Tax Court Procedure (Section 7459)

Section 7459 continues existing requirements that in every case the Tax Court make a written report of its findings of fact or opinion. These provisions have been interpreted by the Court to require the judge presiding at the hearing to prepare his own findings of fact, and in every case the practice of the Court has been to prepare a formal written opinion. In a report filed by our Committee with the Congressional Joint Committee on Internal Revenue Taxation in April, 1953, we expressed the view that many of the cases tried before the Tax Court do not justify the present procedures. In many instances, particularly in the simpler cases, it will be entirely clear to the judge by the end of the trial what the disposition of the case should be. In such cases, to delay the findings of fact and decision until the case has grown cold in the judge's mind and requires tedious review of the record, seems to us an inefficient procedure. It would be much more desirable, we think, to permit the judge in such situations to render his decision promptly based upon briefly stated conclusions of law. He would then direct counsel for the successful party to prepare appropriate findings of fact for submission to the Court. Such practice has proved efficient and satisfactory in the District Courts and there is no reason to suppose that it would be any less so in the Tax Court. It would, of course, be entirely discretionary with the trial judge whether he would exercise such authority in any particular case. It is therefore recommended that Section 7459 be revised to authorize such procedure.

PART EIGHT

CONSOLIDATED RETURNS

The provisions of Chapter 6 of Subtitle A dealing with consolidated returns are considered in this part of our Committee's report.

A. Statutory Enactment of Consolidated Return Regulations

In view of the legislative nature of the consolidated return regulations, which "have been generally accepted and have become stabilized," the House Report states (page 87) that such regulations have been included in the bill, changed "only to the extent necessary to reflect other changes your committee has made elsewhere in the code."

Because of the many changes that the bill would make in existing law and the far-reaching effects, now unforeseen, which many of the changes may have, it does not seem feasible in the time available to verify how accurately the consolidated return provisions have been revised to reflect the changes proposed to be made in existing law. Such examination as has been possible raises the question of whether the changes have been fully reflected in the consolidated return provisions.

For example, the present regulations provide (Reg. 129, Sec. 24.37(a)(1)) that gain or loss shall not be recognized upon a distribution during a consolidated return period by one member of an affiliated group to another in redemption of a portion of the stock of the distributing corporation and that (Reg. 129, Sec. 24.38(c)(3)) the distributee's basis for the property received on such a distribution shall be the same as its basis for the stock surrendered in exchange for such property (with adjustments for previous intercorporate transactions). Similarly, Section 334(c) of the bill provides that the distributee's basis for assets received on a distribution in partial liquidation on which no gain or loss was recognized shall be the adjusted basis of the stock with respect to which the distribution was made. Thus, at least in the case of a distribution in redemption of stock which constitutes a partial liquidation within the meaning of Section 336(a) of the bill, both the existing consolidated return regulations and the provisions of the bill applicable where no consolidated return is filed apply the same rule in determining the distributee's basis for the assets received.

Section 1707 of the bill, which is stated in the House Report (page A306) to be "similar" to Reg. 129, Sec. 24.38, provides an entirely different rule. Under Section 1707(c)(2) the distributee's basis for assets received on a distribution such as above described would be the same as the basis of the distributing corporation for such assets. Nothing is stated in the report to indicate why a rule is adopted which is both different from the rule contained in existing regulations and the rule provided in the bill generally for partial liquidations in which no consolidated return is filed.

B. Change in Membership Requirements of Affiliated Group

Section 1502(a) lowers the required percentage of stock ownership in an affiliate from 95% to 80% as the basic test of whether such corporation is includible in a consolidated return. This proposal intensifies certain problems which should be answered, including the problem as to the portion of the consolidated tax to be paid by each included corporation and the loss of separate benefit from carryovers and carrybacks.

(1) Allocation of Consolidated Tax Among Members of the Affiliated Group.

Under Regulations 129, Section 24.15, and under Section 1509 of the bill, the consolidated tax is the several liability of each included corporation with the parent corporation acting as agent for each of the corporations in the affiliated group. The method of allocating liability for the tax to the included corporations, at least for the purpose of determining the earnings and profits of the various members of a group, has been dealt with previously in rulings. (e. g., I. T. 3637 and I. T. 3692, 1944 C. B. 258, 261; I. T. 4085, 1952-1 C. B. 68) and is dealt with in Section 1732 of the bill.

The allocation rule contained in Section 1732 of the bill would permit making the allocation in any of several ways including the method required by the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935. It is recommended, however, that the statute provide expressly, if such is the intention, that the allocation made under Section 1732 shall be applicable not only to the computation of earnings and profits but for all purposes other than collection of the tax. (*Cf. Beneficial Corp.* v. *Comm'r,* 202 F. 2d 150 (3d Cir. 1953)). In this connection Section 1622(6) should be cross-referenced to Section 1732.

(2) LOSS OF SEPARATE BENEFIT FROM CARRYOVERS AND CARRYBACKS.

Lowering the consolidated return stock ownership requirement to 80% also may intensify the dangers to minority shareholders of being fortuitously or purposefully deprived of the benefit of net operating loss carryovers and carrybacks of an affiliate. The recent case of *Western Pacific R. R. Corp.* v. *Western Pacific R. R. Co.*, 197 F. 2d 994 (9th Cir. 1951), is suggestive of what could happen in this area. The difficulty may be illustrated by the following hypothetical case: In 1953, an affiliate in a consolidated return group suffers a net operating loss which is absorbed to the benefit of the other members of the group in 1953; in 1954 the group, pursuant to Section 1505, elects not to file a consolidated return; however, this year the affiliate has taxable income but has been deprived of the benefit of its net operating loss of 1953. Presumably, the availability of legal remedies for minority interests would prevent planned abuse of this kind where the affiliate has a substantial minority interest, but in any event purely fortuitous factors may occasion such losses.

C. New Election to File Separate Returns

Section 1505 of the bill requires an affiliated group, once it has elected to file a consolidated return, to continue to do so unless any one of certain stated events occurs. The stated event in Section 1505(a)(2), giving rise to a new election, is any amendment to Federal income tax law making a consolidated return "substantially less advantageous" to affiliated groups as a class. Regulations 129, Section 24.11(a), state "less advantageous" as the test. The word "substantially" has been added. Since the 2% charge for the right to file consolidated returns has been retained, it is recommended that the word "substantially" be deleted so that any change in the law making it *less* advantageous to file consolidated returns will give rise to a new election.

The policy stated in the House Report (page A298) with respect to the filing of consolidated returns is that "the election to file returns upon a consolidated basis is a long-term decision". The change in the law, and not the effective date of the change, is considered to be the significant fact. The House Report states in an example that if an affiliated group files a consolidated return for the calendar year 1953 on September 15, 1954, subsequent to the enactment of H. R. 8300, the group will be required to file a consolidated return for 1954 also, even though the enactment of H. R. 8300 would have entitled the group to file separate returns for 1954 if the consolidated return for 1953 had been filed prior to the enactment of the bill. This result is apparently not dependent on whether the bill makes any change with respect to 1953.

This policy is reflected in the retention in Section 1505(a)(2) of the condition in the regulations that "subsequent to the exercise of the election to make consolidated returns, [the income tax law applicable to corporations] has been amended * * * regardless of the effective date of such amendment." Such language was first used in the consolidated return regulations (Reg. 129, §24.11(a)(2)) in June 1951, effective with respect to taxable years ending after December 31, 1949. The comparable provisions of Regulations 104, Section 23.11(a)(2), theretofore in effect, did not contain the phrases "subsequent to the exercise of the election to make consolidated returns" and "regardless of the effective date of such amendment."

The bill, however, also reflects an entirely different and inconsistent policy by the inclusion in Section 1505(a) of the rule that "the expiration of a provision shall be considered an amendment". This would appear to apply to the coming into effect of the various provisions of the bill on their respective effective dates since this would of necessity result in "the expiration of a provision", i.e., provisions of existing law so far as not continued by the bill.

The rule that the expiration of a provision shall be considered the enactment of an amendment represents a partial return to the policy of Regulations 104, Section 23.11(a)(2). This seems inconsistent with the policy expressed for the retention of the phrases added by Regulations 129, which make the change in the law, rather than the effective date of the change, the controlling factor.

Our Committee recommends that the bill be changed to reflect clearly one or the other of these policies, rather than an inconsistent combination of both. There would appear to be no reason to allow an affiliated group with knowledge of the enactment of a change in the law to make a one-year election to file a consolidated return for a year prior to the effective date of the change where the change is prospective, but to require a long-term election where the change is retroactive. That is, when a "less advantageous" amendment to the tax laws is enacted, the binding effect of an election made after the enactment to file a consolidated return for a period not affected by the amendment should be the same whether the effective date of the amendment falls before or after the date of the election.

D. Effect of Erroneous Filing of Separate Returns on Statute of Limitations

Section 1505(b) provides for a total waiver of any statute of limitation if a group of corporations file separate returns when they should have filed a consolidated return. This provision is derived from Regulations 129, Section 24.11(b). It is an exception to the usual rule that if a return making full disclosure has been filed, the statute eventually runs so as to bar new litigation regarding years long past. There seems little warrant for this exception and it is recommended that it be removed. It would seem sufficient to require disclosure upon a separate return that a consolidated return was filed in the prior year.

E. Change in Definition of Taxable Income

Section 1621 of the bill, which corresponds to Regulations 129, Section 24.31(b)(1), omits provisions now in the regulations "for the computation of net income for consolidated returns purposes without disregarding intercompany gains and losses if the affiliated group so desired and the Commissioner approved." While the omission is intentional House Report, page A303, it appears not to have been made with any purpose of changing the applicable rule, for the House Report states: "It is assumed that although this rule is not continued, the Commissioner will not deny to those groups which used this basis of computing on consolidated returns the right to continue. * * * It is assumed that the Secretary or his delegate will continue to approve this practice in proper cases." Our Committee submits that, if affiliated groups are to be entitled to continue this practice (and it is important that they be permitted to do so), the authority for continuing the practice should be found in the statute and not in legislative reports.

F. Drafting Details

(1) Section 1502(e), though unchanged from Regulations 129, Section 24.2(c), is not stated clearly and should be revised.

(2) Section 1634 contains two references to carrybacks to "the" preceding taxable year. These references should be changed to "a" preceding taxable year in view of the two-year carryback provided in the bill.

(3) Section 1731 of the bill revives on a permanent basis the temporary provisions of Section 15(c) of existing law with respect to the disallowance of the corporate surtax exemption in the case of corporate multiplication having the securing of the exemption as a "major purpose" and extends such provisions to the accumulated earnings credit provided by Section 535(a). In a revision of existing law having the purpose of placing related provisions together, it is believed this section should appear, not in the consolidated return provisions, but near Section 11 or Section 269.

PART NINE

GAIN OR LOSS ON DISPOSITION OF PROPERTY AND CAPITAL GAINS AND LOSSES

Our Committee's comments on certain of the basis and capital gain and loss provisions are set forth in this part of the report.

A. Adjustments to Basis (Section 113(b)(1) of Existing Law)

Section 1016(a) of the bill sets forth the adjustments to basis and generally takes the place of Section 113(b)(1) of existing law.

(1) Section 1016(a)(15) provides that proper adjustment shall be made "for amounts allowed as deductions under section 174 (relating to research and experimental expenditures) and resulting in a reduction of the taxpayers' taxes under this subtitle, but not less than the amounts allowable". Under Section 174(a) the taxpayer may treat research or experimental expenditures in connection with its trade or business as expenses which are not chargeable to capital account and the expenditures so treated are allowed as a deduction. It would seem clear that expenses so treated and deducted should not be used as an adjustment to the basis of any property and that the reference in Section 1016(a)(15) should not be intended to cover such items.

Under Section 174(b) a taxpayer may elect under certain conditions to treat research or experimental expenditures not treated as expenses under Section 174(a) as deferred expenses. In this event, the deferred expenses are allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer. Research and experimental expenditures to be subject to these provisions must be of a nature chargeable to capital account but not chargeable to property of a character which is subject to the allowance for depreciation or to the allowance for depletion. Section 174(e) contains a cross-reference to paragraphs (1) and (15) of Section 1016(a). The reference to paragraph (15) may be attributed to the adjustments to the basis of depreciable property used in research in cases in which depreciation on such property is treated under Section 174(b) and (c) as a deferred expense. The reference to Section 1016(a)(1) as well, however, suggests that it may be intended to require that research and experimental expenditures treated as deferred expenses under Section 174(b) must be entered in an appropriate property account and added to basis under Section 1016(a)(1) and then adjusted under Section 1016(a)(15). Yet where this treatment was desired in the case of development expenditures of mines, Section 616(b) clearly so states. The language of Section 1016(a)(15) and the cross-references in Section 174(e) should be clarified.

(2) The provisions relating to adjustments for expenditures for soil and water conservation also require clarification. Section 175(a)

allows a taxpayer engaged in the business of farming to treat expenditures for the purpose of soil and water conservation and the prevention of erosion of land used in farming as expenses which are not chargeable to capital account and provides that the expenditures so treated shall be allowed as a deduction. Under Section 175(b)(1) the amount allowable is subject to the limitation that it may not exceed 25% of the gross income derived from farming, but the amount disallowed may be carried over for use in succeeding years. Section 175(b)(2) provides that the amount of expenditures treated under subsection (a) as expenses shall be taken into account, in computing the adjusted basis of the property in respect of which the expenditures were paid or incurred, as provided in Section 1016(a)(1) and (16), but fails to distinguish between conservation expenses currently deducted and those disallowed. To the extent that conservation expenses are disallowed as a current deduction under Section 175(b)(1) they should be added to the basis of the property and, if subsequently deductible, there should be an appropriate reduction of basis. To the extent that current expenses are currently deductible it would not seem that they should be added to basis and certainly if not added to basis the basis of the property should not be reduced by the amount of the expenses. The language of Sections 175 and 1016(a)(16) should be revised accordingly.

B. Foreclosures on Property Held as Security

Section 1035 represents an important change from existing law and provides for the nonrecognition of gain or loss as a result of the foreclosure on property held as security for the payment of debt. The provision appears broad enough to cover voluntary conveyances in lieu of foreclosures, repossessions under installment and deferred payment sales and foreclosure reorganizations. Gain or loss is to be realized as a result of a subsequent disposition of the property. Subsequent realizations on the original indebtedness or on a deficiency judgment are to reduce the basis of the foreclosed property and will not constitute income until after such basis has been recovered or until after the subsequent disposition of the property. Under Section 1035(b)(1) the property acquired on foreclosure shall be considered "for the purpose of this subsection and of Section 1221, as an asset having the same characteristics as the indebtedness on which it had previously been held as security". The basis of the property acquired on foreclosure is the same as the basis of the indebtedness secured by it.

Section 1035(b)(1) would appear to make the great majority of losses ultimately sustained on the foreclosure of property capital losses instead of ordinary losses. Under existing law, a loss on foreclosure will normally result in a bad debt deductible in full (except, of course, where it is a "nonbusiness bad debt"). However, since the property acquired in foreclosure is regarded as having "the same characteristics" as the indebtedness, the result would be that, except where the taxpayer is a dealer in mortgages or notes, the property would generally be considered a capital asset. This result is further assured by Section 1221(4) which, in excluding from capital assets accounts or notes receivable acquired for services or in the ordinary course of trade or business, excepts from the exclusion "obligations to which Section 1035, relating to foreclosures of property, applies". It would appear more in keeping with the principal purpose of Section 1035 to treat the obligations described in Section 1035 in the manner prescribed in Section 1221(4), since in most cases the loss realized on the ultimate disposition of the foreclosed property would seem entitled to treatment as an ordinary loss rather than as a capital loss.

Section 1035(b) also appears to be at cross-purposes with the treatment of installment obligations in Section 453(d) which corresponds to Section 44(d) of existing law. Section 453(d)(1) provides that gain or loss on the disposition of installment obligations shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received. The provision then expressly states that it shall not apply to a transaction subject to Section 1035. The result would appear to be that a note secured, for example, by stock in trade would produce an ordinary loss under Section 1221(4) or, in an appropriate case, under Section 453(d), if sold prior to foreclosure, but would produce a capital loss if the property were disposed of after foreclosure. It is recommended that Section 1035 be revised and clarified so as not to convert what would be a bad debt deduction or ordinary loss under existing law into a capital loss.

Since no new basis is acquired on foreclosure, gain on the subsequent disposition of the foreclosed property will probably be less frequent than loss. It would seem that the nature of the gain should depend upon the nature of the property and not upon the nature of the indebtedness since the gain would result from the appreciation in value of the property and not of the indebtedness.

C. Certain Exchanges of Insurance Policies

Section 1036 provides for the nonrecognition of gain or loss in the case of the exchange of insurance contracts for the same or a different type of insurance contract. Section 1036, on its face, applies to exchanges of the insurance contracts there mentioned between holders of insurance contracts. If it is intended only to apply to exchanges between the holder of the contract and the company issuing the contract, it is believed the statute should so state.

D. Holding Period of Property (Section 117(h) of Existing Law)

(1) Under Section 1223(1) the tacking of the holding period of property exchanged for other property in a transaction as a result of which the basis of the property received is the same as the basis of the property exchanged, is limited, in the case of exchanges after March 1, 1954, to situations where the property exchanged was a capital asset. This provision would seem to operate arbitrarily in the case of property which is entitled to capital gain treatment under Section 1231 (Section 117(j) of existing law). Assume, for example, that an individual has held for more than six months real property used in the trade or business. Upon the sale of this property he would be entitled to treat any gain as a gain from the sale or exchange of a capital asset. If, however, he transferred the property to a corporation in a tax-free exchange he would be required to start a new holding period for his stock. It would seem that in such a case tacking of the holding period of the property should be permitted.

(2) Section 1223(3), providing for tacking of the holding period in the case of stock received in a spin-off, expressly refers to the spin-off provisions of the bill and those of prior law with the exception of Section 112(b)(11) of existing law. If the omission is inadvertent, it should be corrected.

E. Sale or Exchange of Patents by An Inventor

Under Section 1235 an inventor may be entitled to capital gain treatment upon a sale of his patent or patent application under certain prescribed conditions. The conditions are that the entire proceeds of the sale be received within a period of five years from the date of the sale, and that the seller retain no interest in the property except to the extent that the purchase price may be related to the productivity, use or disposition of the property transferred within a period of five years from the date of sale.

It will probably be an unusual transaction under which an inventor will meet these requirements. With respect to amateur inventors the conditions will probably eliminate many transactions which would qualify for capital gain treatment under present case law.

It is believed that if it is the Congressional intent to favor inventors, Section 1235 should be materially changed.

F. Real Property Subdivided for Sale

Section 1238 provides that a tract of real property in the hands of a taxpayer other than a corporation shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because of the taxpayer having subdivided such tract for purposes of sale or because of any activity incident to such subdivision or sale, if certain carefully prescribed conditions are met. Even if these conditions are met capital gain treatment is not assured. Also, Section 1238 does not deal with losses on real property which may have met the tests of the section. It is believed that Section 1238 should be revised to prescribe the nature of the gain or loss resulting from the sale of the property in question under the conditions laid down by the statute.

G. Gains and Losses of Nonresident Alien Individuals and Foreign Corporations

Sections 871(a) and 881(a), imposing tax on nonresident alien individuals and nonresident foreign corporations, contain a provision not in existing law to include as income subject to the 30% tax "amounts which * * * are considered to be gains from the sale or exchange of capital assets but not including gains from the sale or exchange of capital assets specified in section 1221". The quoted language is far from clear and seems to present some problems. For example, in the case of the involuntary conversion of a capital asset, gain is considered to be gain from the sale of a capital asset under Section 1231(a). Similarly, gain on the retirement of bonds, debentures, etc., is considered to be gain from the sale of a capital asset under Section 1232(a)(1). Under the new law, such gains would be subject to the 30% tax, although there would be no tax if such capital assets had been sold by the nonresident alien (instead of having been involuntarily converted or redeemed). There is no apparent reason for such a distinction. Our Committee recommends that the statute specify more exactly the transactions which are intended to be taxed.

PART TEN

CERTAIN OTHER PROVISIONS

I.

DISCHARGE OF INDEBTEDNESS

The tax consequences of discharge of indebtedness are more fully treated in the bill than in existing law. The exclusions from gross income presently contained in Section 22(b)(9) and (10) appear in revised form as Section 108 of the bill, and the related basis adjustment provisions are contained in Section 1017 of the bill. For the first time, however, there appears, at Section 76 of the bill, a provision expressly including in gross income an amount with respect to discharge of indebtedness.

Section 76(a) provides that, with specified exceptions, gross income results "to the extent provided by this chapter" from the discharge of indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property. The section does not expressly deal with the question whether, except as provided in the National Bankruptcy Act, discharge of indebtedness results in income even to an insolvent debtor. The section does not distinguish between a taxpayer who is primarily liable on a debt and one who is only secondarily liable, the debt having been assumed by another. The section taxes to the holder of property, income from the discharge of indebtedness to which the property is subject but for which the taxpayer is not personally liable.

Section 76(a) enumerates several circumstances under which a discharge of indebtedness by means other than payment in money will not result in income. Section 76(b) indicates, however, that these exceptions will not be applicable if a tax deduction was allowed "on account of such indebtedness". In such event there is "included in gross income" the excess of the indebtedness discharged over the money paid and the adjusted basis of any property transferred by the taxpayer in connection with the discharge.

It is not believed to be the intent of this provision that the principal amount of a debt discharged as a gift is to be included in the income of the debtor solely because he had previously deducted interest paid on the debt. It is suggested, however, that the term "on account of such indebtedness" be clarified to eliminate any ambiguity in this respect. Furthermore, it is not entirely clear that the amount to be included in gross income may be treated as capital gain where a capital asset is transferred in discharge of the indebtedness. Clarification of this point is suggested. It is also noted that the absence of a definition of the term "discharge" may result in uncertainties, as in the case of a debt which becomes unenforceable by reason of the statute of limitations or other local law.

Correction of these defects, however, may not suffice. The problems which Section 76 seeks to solve are exceedingly complex, and the case law dealing with these problems is in a stage that is far from advanced. The nebulous catch-all exemption in Section 76(a)(5) reflects the difficulty encountered in developing a clearly defined set of rules to be applied in this area without inequity. Yet even with the specified exemptions, which are broad in some respects and narrow in others, the impact of this section on individuals at all income levels as well as on corporate taxpayers can be severe and unexpected.

In these circumstances we believe that it would be in the best interests of the Treasury and of taxpayers if the Congress defers enactment of definitive rules for inclusion of income from the discharge of indebtedness until a more satisfactory approach has been developed.

II.

NET OPERATING LOSS DEDUCTION

Section 172 of the bill amends the provisions of existing law relating to carryovers and carrybacks of net operating losses in several respects. Where different provisions of law are applicable in the year of the operating loss and in the year to which the loss is carried, Section 172(e) is intended to provide rules for determining which law is applicable. It provides in part as follows:

> "In determing the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year."

The House Report at page A57 indicates that the amount of the net operating loss shall be computed under the law for the loss year, conforming to the holding in *Reo Motors, Inc.* v. *Commissioner,* 338 U. S. 442 (1950). It also indicates that the adjustments to such loss in the year to which it is carried should be made under the law applicable to the year to which the loss is carried.

It is believed that Section 172(e) could be modified to give clearer expression to these rules, eliminating controversies which may otherwise arise, particularly during the transitional period from existing law to the new law.

III.

RESEARCH AND EXPERIMENTAL EXPENDITURES

(1) Section 174 provides alternative methods for treating research and experimental expenses. Subsection (b), which permits treatment of such expenses as deferred expenses, is expressly inapplicable to expenditures chargeable to property of a character which is sub-

ject to the allowance for depreciation. Research and experimental expenditures, where successful, frequently result in the acquisition of a patent, which is depreciable property. If the election to treat such expenditures as deferred expenses is to have general application, our Committee recommends that patents be excluded from the above limitation.

Section 174(b) further provides that the deferred expenses shall be amortized over a period beginning with the month in which "the taxpayer first realizes benefits from such expenditures". Our Committee considers this criterion too indefinite and too difficult to apply. It is recommended that the amortization period begin when the taxpayer elects, or, alternatively, when the taxpayer first realizes income attributable to such expenditures.

(2) Section 174(c) excludes from the operation of Section 174 expenditures for the acquisition or improvement of property to be used in connection with the research or experimentation and of a character which is subject to the allowance for depreciation. Initial experimental expenditures frequently result in the acquisition of patents utilized in the later development of a process. At the time such initial expenditures are incurred it may not be possible to determine whether they will result in the ultimate patent, and hence may be expensed under Section 174(a), or whether they will result in the acquisition of an intermediate patent to be used in connection with further experimentation, and are thus nondeductible under Section 174(c). Our Committee recommends that patents clearly be excluded from the operation of Section 174(c) as well.

IV.

AMORTIZATION OF ORGANIZATIONAL EXPENDITURES

Section 248 is a new provision designed to permit the amortization of corporate organizational expenditures over a period of not less than five years. Section 248(b) defines "organizational expenditures" as including any expenditure which is incident to the creation of the corporation, is chargeable to capital account and is of a "character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life." This last requirement creates uncertainty because it is not settled under present law that any of the organizational expenditures of a corporation having a limited life are amortizable. One Court of Appeals has held that expenses of incorporation, such as attorneys fees, charter fees and other expenses not related to the issuance of securities, are amortizable over the corporate life where that life is limited. *Hershey Manufacturing Co.* v. *Commissioner,* 43 F. 2d 298 (10th Cir. 1930). On the other hand, the Board of Tax Appeals, expressly disagreeing with the *Hershey Manufacturing Co.* case, held that no corporate organizational expenditures are amortizable, even in the case of a corporation having a limited life. *Surety Finance Co. of Tacoma,* 27 B. T. A. 616 (1933). This decision was affirmed on other grounds by the Court of Appeals for the Ninth Circuit (77 F. 2d 221 (9th Cir. 1935)).

In view of the uncertainty as to the amortization of the organizational expenditures of a corporation having limited life, our Committee recommends that the use of such a test be avoided, and that Section 248 be revised so as to specify, in general terms, the kinds of organizational expenditures which are amortizable.

With respect to the definition of organizational expenditures, the House Report at pages 31 and A64 states that Section 248 is not intended to permit amortization of expenditures connected with corporate reorganizations. The question may arise whether amortization will be permitted when a new corporation is formed by consolidation or otherwise in the course of a reorganization. In *Mills Estate Inc.* v. *Commissioner,* 206 F. 2d 244 (2d Cir. 1953), rev'g 17 T. C. 910 (1951), deduction of expenses of a partial liquidation was disallowed on the ground that the transaction was essentially a corporate reorganization. On the other hand, *United States* v. *Arcade Co.,* 203 F. 2d 230 (6th Cir. 1953), allowed a deduction for expenses of a complete liquidation though followed by a transfer of the assets to a newly organized corporation as part of the plan of the shareholders. These cases suggest that the problems in this area are sufficiently troublesome to warrant an attempt to foreclose litigation by appropriate amendment of Section 248.

V.

RENTAL PAYMENTS TO ISSUERS OF TAX-EXEMPT OBLIGATIONS

Section 274 denies all deductions for rental payments to a state, territory, United States possession, or any political subdivision of the foregoing, or the District of Columbia for the use or occupancy of property acquired or improved out of the proceeds of "any industrial development revenue bonds authorized after February 8, 1954."

The term "industrial development revenue bond" is defined to mean a bond issued to finance the acquisition or improvement of real property to be used "to any substantial extent by nonpublic lessees for manufacturing articles" and for which the "full faith and credit" of the issuing authority is not pledged.

The statutory language in Section 274(b)(1) is in need of redefinition. The term "to any substantial extent" invites controversy. And limitation of the rental disallowance to property used "for manufacturing articles" will not only prove difficult to interpret, but is hard to justify from a policy point of view, since it might exempt from rental disallowance properties used to process liquids or manufacture bulk chemicals, to cite two examples.

Moreover, the non-applicability of the provision to cases where the full faith and credit of the issuing authority is behind the obligation would, it is believed, render the provision in question ineffective, since it would appear comparatively easy to create "issuing authorities" for the bonds in question.

VI.

EMPLOYEES' STOCK OPTIONS

Section 421 of the bill reeenacts the provisions of Section 130A of existing law, with certain liberalizing and clarifying amendments.

A. Variable Price Options

Under existing law, the option price must be fixed or determinable in relation to market price at the date of grant. Uncertainties have arisen with respect to the qualification of so-called variable options, in which the option price is based upon a percentage of the market value of the stock at the date of the exercise of the option or on some other formula. Section 421(d) of the bill extends the definition of "restricted stock option" to include an option where at the time the option is granted "the purchase price of the stock under the option is not fixed or determinable, [but] the option price (computed as if the option had been exercised at such time) is at least 85 percent of the fair market value at such time of the stock subject to the option." The House Report at pages A153-54 uses as an example a case where an option is given to purchase stock at 85% of its market value at the time of exercise.

While the operation of the new provision may be considered satisfactory when the formula used to determine price is a direct percentage of market value, the results may be unreasonable when other factors are brought into the formula. For example, the option price might be fixed at the market value of the stock at the date of exercise less a percentage of net earnings of the employer during the period from the granting of the option to the date of its exercise. If the stock had a value of $100 on the date of the granting of the option and two years later when the option was exercised its market value was $200 but the applicable interim earnings amounted to $150, the option price would be $50. This would qualify under the statutory language, since the option price, computed as of the date of the granting of the option, would have been $100, the fair market value of the stock. It is not believed that this result was intended where the option price bears virtually no relation to market value, and corrective amendments are therefore recommended.

B. Corporate Succession

The bill contains provisions to meet the troublesome effect on restricted stock options of changes in the corporate structure. Section 421(a) provides that the employee, at the time he exercises the restricted stock option, must be an employee of the corporation, its parent or subsidiary, as under present law, and then adds "or a corporation which acquires property from such corporation in a transaction to which section 354 applies." Section 354 deals with corporate acquisitions and separations but not liquidations. The provision should be amplified to give the same results in the case of a corporation which has been liquidated into its parent, even though the parent-subsidiary relationship did not exist at the time of the granting of the option. The definition of "parent" and "subsidiary" in Section 421(d)(2) and (3) should be amended so that the date of grant of the option is not the exclusive date for applying the stock ownership test.

C. Modifications

The bill liberalizes the provisions relating to modification of options, but retains restrictive provisions if the option was granted before January 1, 1954, and is exercisable after the expiration of ten years from the date of grant (Section 421(e)). It is apparently intended to permit the period of time within which a restricted stock option issued prior to January 1, 1954 may be exercised to be shortened so that the option may qualify under the ten-year rule, House Report, page A155. There is some question as to whether the language employed achieves the result. Subsection (e) provides that a change in the terms of an option to permit it to qualify under subparagraph (d)(1)(D) shall not be considered a modification. Subparagraph (d)(1)(D) relates to options exercisable within ten years, but is restricted to options granted after December 31, 1953, and, therefore, a pre-1954 option could not meet its terms. The language of subsection (e) should be revised.

VII.

INSTALLMENT METHOD OF ACCOUNTING

In Section 453(c) an amendment to existing law is made which is stated in the House Report at page A160 to be designed to prevent the double taxation that exists under present law where an accrual basis taxpayer elects to change his method of reporting sales to the installment basis. Under present law a taxpayer who has accrued income from installment sales and subsequently changes to the installment method of reporting is required to include the previously accrued installments in income a second time when they are actually collected. The new provision permits the taxpayer to reduce the tax for the year in which the item is includible the second time by the amount of the tax paid in the prior year attributable to the item, but not in excess of the tax attributable to the item in the year in which it is includible for the second time. The tax attributable to an item is that percentage of the tax for the year involved which the gross profit from the sales for that year bears to gross income.

While in a number of cases this proposed provision would give some relief, the relief may be very limited in many cases. For example, if a taxpayer has commenced business and has reported income on the accrual basis in the first two or three years of operations, which are conducted on a low profit level, and thereafter changes to the installment method of accounting as business improves, he would get little relief under the bill.

In cases of change in accounting method other than the change from the accrual to the installment method, Section 481 of the bill permits a complete adjustment in order to insure that every item of gross income or deduction will be taken into account once and only once. It would seem that a similar rule might be applied to the change from the accrual to the installment method.

VIII.

REGULATED INVESTMENT COMPANIES

Subchapter M of the bill re-enacts Supplement Q of existing law, and accordingly continues to treat regulated investment companies, as defined in Section 851 of the bill (corresponding to Section 361 of existing law), as conduits for investment, provided 90% of the income is distributed to the shareholders. The mechanics of carrying out the conduit principle may be found in Section 852 and in Sections 561 and 562 of the bill, relating to the dividends paid deduction. These sections correspond to subdivisions (a) and (b) of Section 362 and Section 27 of existing law but are in more readily understandable form.

Two new sections, Sections 853 and 854, have been added and purport to put the shareholders of a regulated investment company more nearly in the shoes of a taxpayer directly owning a proportionate share of the investment trust portfolio.

A. Foreign Tax Credit

Section 853 provides for passing on the credit for foreign taxes to the shareholders of the regulated investment company. This section, in the words of the House Report (page A241), is "designed to permit a regulated investment company to elect to be treated as a conduit for the purposes of income, war profits, and excess profits taxes which it pays to foreign countries or possessions of the United States, so that its shareholders may apply their proportionate share of such foreign taxes either as a credit (under section 901) or as a deduction (under section 164(a)) as if they had paid such foreign taxes".

Section 853 provides that a regulated investment company "more than 50 percent of the value * * * of whose total assets at the close of the taxable year consists of stock or securities in foreign corporations" and which distributes 90% of its investment company taxable income, may "elect" to pass on the credit for foreign taxes to its shareholders "with respect to income, war profits, and excess profits taxes * * * which are paid by the investment company" to foreign countries and possessions of the United States. Among the various effects of such an election made by the company is a requirement that "each shareholder of such investment company shall * * * include in gross income and treat as paid by him his proportionate share of such taxes". It is, of course, required that the shareholders receive notice of the election.

(1) With respect to the restriction of the election solely to companies more than 50% of the value of whose total assets consists of stock or securities in foreign corporations, the House Report states at page 74 that "This restriction is added for administrative reasons to deny the passing on of the credit where only incidental holdings of foreign securities are involved". It would seem, however, that a company might have somewhat more than "incidental" holdings of foreign securities without necessarily having more than 50% of the value of its assets invested in foreign securities. Moreover, admin-

istrative difficulties would mainly be borne by the company making the election. It is suggested that the percentage limitation be substantially reduced or eliminated, leaving to the discretion of the regulated investment company the question whether an election should be made where only incidental holdings of foreign securities are involved.

(2) Since the election is limited to "income, war profits, and excess profits taxes", the election otherwise available under Section 901 to take, in the alternative, a credit for "principal tax" is not available to regulated investment companies for purposes of Section 853. No policy reason for this limitation is stated.

(3) The election with respect to income, war profits, and excess profits taxes relates to such taxes "which are paid by the investment company" to foreign countries and possessions. The word "paid" was probably intended to prevent a company from passing on any credit for taxes which the company is deemed to have paid pursuant to Section 902 of the bill. Since Section 853 was intended merely to place such shareholders in the same position for tax credit purposes as persons who directly own foreign securities, it seems proper to prevent the investment company from passing on credits which would not be normally available to a direct shareholder.

The credit for foreign taxes under Section 901 of the bill is a credit for certain taxes "paid or accrued" during the taxable year to a foreign country or possession. No reason appears for the omission of the words "or accrued" in Section 853 after "paid".

(4) In providing that if the election under Section 853(a) is made by the company, each shareholder of such company shall include in gross income and treat as paid by him his proportionate share of such taxes, the new provision seems to be carrying out the conduit principle. Under this provision, however, if such an election is made many small shareholders of investment trusts will be in a worse tax position than they are under present law, in that many such shareholders may find it to their advantage to take the standard deduction whether or not they are required to include their proportionate share of foreign taxes in gross income.

B. Credits, Deductions and Exclusions for Dividends Received

(1) Section 854 provides limitations applicable to dividends received from regulated investment companies. These limitations extend the conduit principle to make applicable the provisions of Section 34 (allowing credits to individual recipients of dividends from domestic corporations), Section 243 (allowing deductions to corporate recipients of dividends from domestic corporations) and Section 116 (providing limited exclusions of dividends from domestic corporations received by individuals). If all the income of an investment company is derived from interest, none of these benefits should be allowed if the shareholders of the investment company are viewed as the direct owners of the underlying securities. Accordingly, under Section 854, if the "aggregate dividends received" by such a company are less than 75% of its gross income, then in computing such credits, deductions and exclusions, "there shall be taken into account only that portion of the dividend which bears the same ratio to the amount of such dividend as the aggregate dividends received by such company during such taxable year bear to its gross income for such taxable year". Our Committee is not entirely clear that such proration should be limited to situations where the aggregate dividends received are less than 75% of the gross income.

(2) In referring to "dividends received by" a regulated investment company no distinction is made in Section 854 between dividends received from domestic corporations and dividends received from foreign corporations. It is entirely possible, therefore, that the shareholders of the regulated investment company may be entitled to the credit for dividends received under Section 34 and the limited exclusion for dividends under Section 116, or, in the case of a corporate shareholder, the 85% deduction under Section 243, even though a large portion or all of the dividend income of the regulated investment company is comprised of dividends from foreign corporations, as to which such credits and the exclusion would not be available to persons who directly own the foreign securities. This result would, of course, be inconsistent with the conduit principle, and it is suggested that an appropriate modification be made in Section 854 to avoid it.

(3) A defect in the operation of the conduit principle has appeared as a result of the technique adopted in Section 332(b)(1) of treating

as a dividend the gain realized by a corporate stockholder on a corporate liquidation. In the case of a regulated investment company, the offsetting deduction for dividends received which is normally supplied by Section 243(a) is disallowed by Section 852(b)(2)(C). Since the individual stockholders of the regulated investment company are not entitled to the 85% dividends received deduction, the regulated investment company's distributed gains on corporate liquidations are taxable to its shareholders as ordinary dividend income rather than as capital gain. A corrective amendment should be made.

IX.

SURVIVORS' ANNUITIES

Section 2039(c) excludes from a decedent's taxable estate the value of certain annuities payable to a beneficiary by an employees' trust or under an employees' retirement annuity contract. No correlative provision is found in the gift tax chapter. If such annuities are not subject to estate taxes, it would seem that an irrevocable election by an employee of an annuity for a surviving beneficiary, with a reduced annuity payable to him during his life, should not be subject to gift tax liability. Under present law, gift taxes may be obviated by providing in the retirement plan that the employee has the power to change the designation of the surviving annuitant, which power may be made subject to the consent of the insurance company or the trustee of the pension trust. This refinement would not be necessary if a provision similar to Section 2039(c) were added to the gift tax chapter. Our Committee recommends such an addition if Section 2039(c) is adopted. It is further recommended that the penultimate sentence of Section 2039(c) be amended to indicate more clearly that the exclusion from the gross estate is denied only to the extent that amounts payable after death are attributable to the decedent's contribution.

X.

FELLOWSHIPS AND SCHOLARSHIP GRANTS

Section 117 of the bill sets forth rules for exclusion of fellowships and scholarship grants from the gross income of the recipient. Section 117(b)(2) provides that in the case of an individual who is not a candidate for a degree, a grant is not excluded from income if it amounts to 75% or more of the recipient's earned income during the twelve-month period preceding the grant. This test seems unsatisfactory.

The question of candidacy for a degree has little relevance to a determination whether payments are made as compensation or as a gift to further an individual's education. Many fellowships for advanced study in fields such as medicine do not lead to degrees. Moreover, the income test is particularly unsatisfactory. A student whose studies have not been interrupted by employment will be unable to qualify under this test. The income test is also troublesome because its application is unrelated to the student's needs, which normally determine the amount of a fellowship award. In the opinion of our Committee, the method adopted by Section 117(b) for handling the problem of grants is unreasonable and should be revised.

Respectfully submitted,

THE COMMITTEE ON TAXATION,

THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

April 16, 1954.

Members of the Committee

JOHN H. ALEXANDER, *Chairman*
SAMUEL BRODSKY
DAVID BRET CARLSON
FREDERICK S. DANZIGER
ADRIAN W. DEWIND
JOHN WESTBROOK FAGER
FREDERICK GELBERG
EDWIN M. JONES
DAVID A. LINDSAY
CHARLES C. MACLEAN, JR.
PETER MILLER
WILLIAM EDWARDS MURRAY
CARBERY O'SHEA
CLIFFORD L. PORTER, *Secretary*
MARTIN A. ROEDER
EDWARD J. ROSS
HENRY CASSORTE SMITH
ROBERT STERLING
WILLIAM C. WARREN
WILLIAM R. WHITE
JOSIAH WILLARD
JOHN H. YOUNG

Associated

LAURENCE F. CASEY
ROBERT J. McDONALD
GEORGE STINSON

Senator BENNETT. Mr. Chairman——

The CHAIRMAN. Yes?

Senator BENNETT. I would like permission to ask a question of Mr. Tarleau, if he is still in the room. Apparently he is gone.

The CHAIRMAN. Any further questions?

Thank you very much.

That concludes the hearings for today. We will meet at 10 o'clock tomorrow morning.

(By direction of the chairman, the following is made a part of the record:)

AMERICAN LIBRARY ASSOCIATION,
Chicago 11, Ill., April 8, 1954.

Hon. EUGENE MILLIKIN,
Chairman, Finance Committee,
United States Senate, Washington 25, D. C.

DEAR SENATOR MILLIKIN: The American Library Association is a professional organization of approximately 20,000 members—librarians, library trustees, libraries, and friends of libraries. This association is interested not only in the development, extension, and strengthening of our Nation's library services but is also concerned with the welfare of library personnel, those currently employed and those who have retired.

The association is therefore vitally interested in section 38 of H. R. 8300 because of its attempt to equalize the tax exemptions on the retirement income of retired persons. Most retired library employees at present receive only the personal exemption allowed all individuals. Their small retirement incomes are derived primarily from benefits received under a public or private retirement plan. They therefore do not receive the additional tax exemption which is provided those having veterans' benefits or those beneficiaries of the Social Security and Railroad Retirement Acts.

While the association recognizes that section 38 will provide more equal treatment for retired individuals age 65 and over, it urges that modifications be made in this section of the bill so that all persons who retire under a public or private retirement plan providing a pension or annuity may be covered regardless of whether they have attained age 65. The exclusion of those under 65 places a particular hardship on such retired individuals as their personal exemption is only $600 per year whereas those 65 and over receive a personal exemption of $1,200. Furthermore, many of those who have retired prior to age 65 receive smaller retirement pensions because they accepted the lower age for retirement. As there seems to be a decided trend to encourage persons to retire before 65 and as many retirement plans are set up to allow retirement at age 55 or 60 on lower pensions, this exclusion of such persons from the exemptions provided in section 38 is particularly unfortunate. This exclusion tends to negate in our opinion the main purpose of this section of the bill which is an attempt to equalize the tax exemptions on the retirement income of all retired persons.

There are two modifications relating to the work clause which the association trusts will be incorporated in section 38. The association recommends that retired persons who are disabled and because of their disability do not have 10 consecutive years of work earning $600 per year be allowed this exemption. Many of these individuals receive very meager pensions or annuities since their work history has made it impossible for them to build up pension rights adequate financially and their disability has often taxed their resources so they could not save to provide otherwise for their old age. It is our belief, furthermore, that the work clause should not apply to individuals 75 years of age and older.

In the Mason bill, H. R. 5180, the exemption was originally $1,500. This amount has now been reduced to $1,200. We trust that section 38 may be revised to increase the amount to $1,500.

Although the association would not seek legislation providing special tax exemptions for retired library employees nor for any other special groups of retired workers, we heartily endorse legislation which will provide an equitable floor of protection against income taxation for retirement income for all retired persons who now lack this floor protection.

May we ask you, please, to incorporate this statement of the American Library Association in the record of the hearings on section 38 of H. R. 8300.

Very sincerely yours,

DAVID H. CLIFT,
Executive Secretary.

DENVER, COLO., *April 6, 1954.*

Hon. EUGENE D. MILLIKIN,
United States Senator, Colorado,
Chairman, Senate Finance Committee,
Senate Office Building, Washington 25, D. C.

DEAR MR. MILLIKIN: Your letter of March 31, with the information contained therein, is greatly appreciated by me.

I do not wish to overburden you with letters at this busy time, but when I wrote to some of the Representatives on the House Ways and Means Committee, and others, I did not explain the disability conditions in the United States civil service retirement system, because H. R. 5180 included all those who were drawing from a public or private retirement plan.

For your thoughtful consideration, now that the House passed a bill which will leave the disabilities under 65 out, I, being a disability, wish to explain:

First of all, a disability is forced to give up a good-paying position, due to conditions of health, to go on a disability annuity based on years of service. Disability may be drawn under the United States civil service system after 5 years of employment, but disability must be proven. It is not a careless setup. Medical examination is ordered and directed by the Medical Division of the Commission. The decision rests with the Medical Division of the Commission. Their word is final. In Denver the examinations are made at the Veterans' Administration or Fitzsimons Hospital. The examinations are detailed, thorough, exhaustive—3 to 5 doctors, laboratory work, X-rays, grilling and questioning to detect possible faking or fraudulent statements.

Thereafter, the Medical Division has the right, under the law, to order medical examinations annually, or whenever it chooses. Permanent disability is extended only where the disability is permanent in nature.

The payments are made regardless of age, so any age limit placed by the Congress in tax-exemption provisions will leave some disabilities out, which is most unfair to people trying to get along on a limited annuity, many of whom are not able to work even the couple of hours a day at pay which the Commission may not object to. Of the disabilities I know in our Denver organization none are able to work a few hours a day, including myself.

The January issue of the Annuitant, official publication of the National Association of Retired Civil Service Employees, states that 28 percent of the civil service annuitants are retired for disability; that their average age is less than 60; that their average length of service is less than 20 years; and that their annuities are proportionately lower than the average of annuitants retired for age.

Railroad retirement benefits are tax exempt, and in that system total disability may be drawn at any age. I believe it is not the practice of Congress to tax other disability payments.

The State of Colorado grants income-tax exemption to disability payments without regard to age, and I believe without regard to amount of disability. My disability annuity is $828 a year.

Representative William S. Hill, Second District of Colorado, sent news release to me under his name, citing some changes in the income-tax law in this tax-revision bill, 8300, but those changes will only now and then affect our retirees. The reduction in excise taxes will not help us except in a very small degree on the purchase of light bulbs and on our telephone bill. We cannot purchase furs, automatic clothes driers, plane rides, and cameras, etc.

It would be most discriminatory and unfair for Congress to pass a tax-exemption law without giving tax exemption to the disabilities, regardless of age, and I think it would be well to remove the 10-year earned-income provision, in view of the rigid medical examinations required in the civil-service law.

I would be most grateful to you if, when the Senate Finance Committee is discussing this matter, you read my letter to them, so they will have the facts regarding the disability annuitants under the United States Civil Service Retirement System.

Thanking you for all your good efforts and thoughtful consideration of our problems, I am

Very sincerely,

MRS. LUCILLE H. IMHERR.

MASSEYS VANILLAS, INC.,
Chicago, April 5, 1954.

In re H. R. 8300—Revised Internal Revenue Code of 1954, part II, sections 5131–5134.

Hon. EUGENE D. MILLIKIN,
Senate Office Building, Washington, D. C.

DEAR MR. MILLIKIN: With regard to the drawback on the tax on nonbeverage alcohol, which product we use in the manufacture of vanilla extracts, we understand that the proposed changes in the law might delay the payment of the drawback due to the rather ambiguous report made by the committee in regard to the drawback.

As users of nonbeverage alcohol used in making vanilla extracts for flavoring food products, we have been in a position for years of tying up a considerable amount of capital in taxes to which we are entitled a return by drawback, making it very difficult at times to properly conduct our business because of the large amount of money uselessly tied up. This drawback, by the way, is given to our customers immediately upon the sale of our vanilla because we do not consider the amount of tax that we draw back as part of the cost of our vanilla and it is, therefore, not figured in the selling price.

In the past we have put in a claim every 3 months and then we have had to wait about a month and a half after that to receive our money and this means that some of this money that we advanced as tax is tied up for 4½ months. Our claims run as high as $30,000 to $35,000, and it means that we must have that much excess working capital at all times plus the amount of tax we pay out in the ensuing month and a half following the filing of our claim.

We now have the choice of filing a claim each month but we must put up a bond and in our case we put up a $40,000 bond which costs us $400 a year simply for the privilege of receiving our money a little faster than we normally would get it. Now we file our claim on the 1st of each month and about 30 days later we receive our check.

The Alcohol Tax Unit here in Chicago has been very wonderful in promptly checking our claims and putting them through for payment but it seems that after it leaves their hands it must go through a certain ritual which takes anywhere from 3 to 4 weeks, even under the bonding arrangement.

Putting up this bond has helped us at a certain expense to us for which we receive nothing but a little faster payment of the money that is due us and, therefore, we sincerely hope that nothing is now going to happen that is going to cause a greater delay than in the past in receiving money which we should have paid back to us even more promptly than it has been in the past.

We, therefore, suggest that any relief granted to any industrial plant or bonded warehouse regarding payment of tax on distilled spirits intended for beverage purposes, be extended to include ethyl alcohol, which is subject to drawback claim when used for nonbeverage purposes in the manufacture and production of medicine, medical preparations, food-products flavor, and flavoring extracts.

If you will use your influence in at least retaining current system of filing and payment of monthly drawback claims enacted in November of 1953, we shall appreciate your kind cooperation.

Sincerely yours,

O. J. NIELSEN, *President.*

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D. C., April 8, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Committee on Finance, Washington, D. C.

DEAR MR. CHAIRMAN: Your committee is presently considering H. R. 8300, the tax revision bill as passed by the House of Representatives. I am particularly interested in bringing about a change in section 117 of the now existing Internal Revenue Code which contains the provisions for special tax treatment of capital gains and losses.

Capital gains are gains on sales of assets held for investment in contrast with gains on sales of assets resulting in a merchandising profit. Generally speaking, a merchant's stock in trade is turned several times a year and except in periods of rapidly rising prices does not include much price profit in his merchandising profit.

The point I am interested in, however, is the Treasury Department's liberal interpretation of real-estate-dealer classification. It is a technical problem and a number of factors are involved, but generally a person who subdivides acreage held as an investment is classed as a dealer if he has more than just a few sales, even though it is a liquidating operation not followed by the repurchase of additional land for development. A real estate developer has a problem which other merchants do not face in that he often times must hold his stock in trade for a considerable time before it is sold. Consequently a large part of his profit on sale is a gain resulting from a rise in the price level or the concentration of population in an area (a capital gain) yet his entire gain is taxed as ordinary income.

The last-in, first-out inventory method described by section 22 (d) of the code permits most businesses to eliminate from income substantially all of the profit resulting from sale of merchandise at an increased price level. However, because of technical requirements and the certain peculiarities of the real-estate business the use of its last-in first-out inventory method is apparently not available to a dealer in real estate.

If a taxpayer has owned land for 40 years and it was originally acquired for purposes other than subdivision, the cost or other basis is quite low in comparison with current inflated prices. For such property acquired before March 1, 1913 (date of enactment of income-tax law), the basis for computing gain on sale is the value on that date, if that value is higher than cost. It is possible then for a person to sell property as a "dealer" as defined by the Treasury Department and the courts, on which the gain has been accruing for 40 years. As it stands now, all of the profit on the sale is taxed as ordinary income whereas in fact the greater portion of the profit is attributable to the change in values over the last 40 years rather than being a merchandising profit. Thus the taxpayer classified as a real-estate dealer must treat as ordinary income all of the gain accrued over the 40-year period and is not receiving equitable treatment, especially in view of the fact that relief measures have been granted in other situations by law. (Amendment to sec. 117 (k) by the act of 1943 wherein certain timber growers may elect to treat the cutting of timber from a tract as a sale at the value as of the first day of the taxable year in which it is cut and this value then becomes the cost of timber in determining the ordinary income from the timber processing operation.) The result is that the increase in value of the timber to the beginning of the taxable year in which it is cut is treated as a capital gain and the gain from processing the timber is treated as ordinary income.

It is respectfully requested that your committee give consideration to an amendment which would permit the taxation as capital gain of that part of the profit on sale of real estate which has accrued over a long period of time.

Sincerely,

OLIN E. TEAGUE, *Congressman.*

R. J. REYNOLDS TOBACCO CO.,
Winston-Salem, N. C., April 8, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SIR: With reference to the hearings now being conducted by your committee on H. R. 8300, a bill to revise the internal revenue laws of the United States, we are submitting a statement herewith which, with your permission, we should like to file for the record in lieu of a personal appearance.

This statement, as you will see, is brief and states the problem confronting us under subtitle E, chapter 52—Tobacco, Cigars, Cigarettes, and Cigarette Papers and Tubes, as presently proposed in H. R. 8300. This language constitutes a substantial revision of the present tax laws relating to cigarettes and tobacco products, and, therefore, we earnestly request that your committee carefully consider our statement.

Respectfully submitted.

JOHN C. WHITAKER,
Chairman of the Board.

STATEMENT OF JOHN C. WHITAKER, CHAIRMAN OF THE BOARD OF R. J. REYNOLDS TOBACCO CO., SUBMITTED IN CONNECTION WITH THE HEARINGS ON H. R. 8300, A BILL TO REVISE THE INTERNAL REVENUE LAWS OF THE UNITED STATES

Subtitle E, chapter 52, Tobacco, Cigars, Cigarettes, and Cigarette Papers, and Tubes, of H. R. 8300, constitutes a substantial revision of present tax laws relating to cigarettes and tobacco products, and was drafted for the purpose of deleting many obsolete and unnecessary requirements of the present law.

The Treasury Department and members of the industry have agreed that a revision of the laws relating to cigarettes and tobacco products should be enacted and have worked together to draft such a revision. An unwillingness to postpone the collection of maximum revenues in any taxable month or year compelled the Treasury Department to insert certain provisions in its proposals to the Ways and Means Committee which we believe to be inequitable.

The controversial provisions of chapter 52 occur in subsections (a) and (b) of section 5703, Liability for Tax and Method of Payment. Subsection (a) provides that after January 1, 1955, the taxes imposed shall be paid by return and the Secretary shall by regulation prescribe the period for which the return shall be made, the information to be furnished on such return, the time for making such return, the time for payment of such taxes, and when (after January 1, 1955) the new system of paying such taxes by return shall be adopted. Subsection (b) provides that if the Secretary shall require the use of stamps to evidence the tax or indicate compliance with the chapter, he shall cause to be prepared suitable stamps to be issued for sale at a sum sufficient to defray the expense of preparing such stamps.

The report of the Committee on Ways and Means accompanying H. R. 8300 indicates that representatives of the Treasury Department told this committee that while no definite date had been set for instituting the return system, plans have been made to require a weekly return when the plan is first put into effect, with a subsequent extension of time for filing returns dependent on the fiscal situation and on the experience with the weekly returns.

Under present procedures employed by this company an average of about 28 days elapses between the date cigarette stamps are purchased and the date the product is paid for by our customers. The inevitable result of this is that the capital requirements of the company are much larger than would otherwise be the case, and the payment of interest on such requirements constitutes a hardship. Adoption of a system which would permit the payment of the required taxes by returns, rather than by the purchase of stamps, is a step in the right direction, but since the Secretary has indicated that he intends to institute a weekly return system with subsequent extensions of time for filing returns largely dependent on his judgment of the fiscal situation, we feel that the proposed revision does not afford adequate relief.

We respectfully suggest that payment of cigarette and tobacco taxes should not be required of the manufacturer or importer until the last day of the month succeeding the month of removal from bonded premises. Such a requirement would not give the manufacturer time to recover in full amounts due on all removals occurring within a month, but on an average basis would allow for such recovery in the case of a fairly rapid turnover. There would be no reduction of tax receipts to the Government under this proposal, but only a brief deferment when the system is first put into effect.

If the Secretary requires the use of stamps to evidence the tax, or to indicate compliance with the taxing statute, it would be unfair indeed to require the taxpayer to pay to the Government the cost of the stamps in addition to the tax imposed, and we suggest that this provision in the bill be removed.

MCAFEE, GROSSMAN, TAPLIN, HANNING, NEWCOMER & HAZLETT,
Cleveland, April 17, 1954.

Re section 421 of proposed Internal Revenue Code of 1954—employee stock options

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: I wish to call to your attention a situation in which proposed section 421 would occasion unnecessary hardship to existing employees stock-option plans, and to suggest a simple amendment by which the difficulty can be avoided.

One purpose of section 421 is to discourage the granting to employees of stock options which extend for such a long period that they are likely to result in benefits to the employee without regard to the effectiveness of his own efforts. To effectuate this result, the section disqualifies for treatment as a restricted stock option any option hereafter granted which is exercisable more than 10 years from the date of the grant. While the section does not disqualify an already existing option which may be exercised after the expiration of 10 years from the date of the grant, it denies to it the new benefits accorded to restricted stock options by the bill.

Comments on the proposed bill indicate that the choice of 10 years as the limiting period resulted partly from the fact that the New York Stock Exchange has required issuers whose securities were listed thereon to limit their stock options to a period of about 10 years. The period seems, in general, to be a reasonable one.

However, two of our clients, both of whose securities are listed on the New York Stock Exchange, are confronted with a serious problem as the result of the proposed provisions. Both of these corporations have in force employee stock option plans which permit exercise of the options over a period of 10 years, one-tenth each year. However, when the plans were adopted, it was felt that the employees should have a reasonable period after the expiration of the 10 years in which to decide whether to exercise their options, and the options were therefore made exercisable at any time within 3 months after the expiration of the 10th year. This brief extension of the 10-year period was in both cases approved by the New York Stock Exchange, which had originated the 10-year rule. It would be a cumbersome and expensive procedure to eliminate the provision for the extra 3-month period, since, under the plans, no modification in the option period can be made except on a vote of the stockholders—a significant burden in the case of a widely held corporation with listed stock.

It seems to us that a provision giving to employees at the end of their 10-year option period a period of 3 months in which to decide what to do, is a fair and desirable provision. Certainly, as attested by the New York Stock Exchange approval, such a provision does not deviate in spirit from the proposed 10-year rule. It may be that many other corporations have similar provisions in their stock option plans. In any event, we see no reason why a plan that provides for exercise within a reasonably short period after the expiration of the 10 years should not be entitled to the full benefits of treatment as a restricted stock option under the new law.

To effectuate this result, we suggest that in section 421 (d) (1) (D), line 2, there be added, after the words "10 years" the words "and 6 months". The same change should be made in section 421 (e) (1), line 2.

If by any chance the above change is not made, the least that should be done is to make it clear that options running more than 10 years which were granted under plans adopted before the date of enactment of the new law should be regarded as qualified under the old law and as entitled to the same treatment as other plans qualified under the old law, even if not entitled to additional benefits under the new law.

One of the corporations above referred to adopted a stock option plan after March 1, 1954, but before the provisions of section 421 were known. Some of the options under this plan have already been issued, and others have not. All of them run for 10 years and 3 months after the date of issuance. At the very least, these options should be regarded as options qualified under the old law, just as if they had been issued last year.

This result can be effectuated by deleting from section 421 (d) (1) (D), line 3, the words "after December 31, 1953" and inserting the words "pursuant to a plan adopted after the enactment of this act". Similarly, in section 421 (e) (1), line 1, there should be deleted the words "January 1, 1954" and inserted the words "pursuant to a plan adopted before the enactment of this act".

Of course, if the committee makes the change first suggested, the second change will not be necessary.

Sincerely,

RUFUS S. DAY, Jr.
(For McAfee, Grossman, Taplin, Hanning, Newcomer & Hazlett).

(Whereupon, at 11:40 a. m., the committee recessed, to reconvene at 10 a. m., Friday, April 9, 1954.)