Calendar No. 2029

85TH CONGRESS } SENATE { REPORT
2d Session } { No. 1983

TECHNICAL AMENDMENTS ACT OF 1958

REPORT

TOGETHER WITH

INDIVIDUAL VIEWS

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

TO ACCOMPANY

H. R. 8381

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO CORRECT UNINTENDED BENEFITS AND HARDSHIPS AND TO MAKE TECHNICAL AMENDMENTS, AND FOR OTHER PURPOSES

JULY 28, 1958.—Ordered to be printed

UNITED STATES
GOVERNMENT PRINTING OFFICE
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CONTINENTAL UNITED STATES—Continued

Oregon	$623, 000
Air Force: Kingsley Air Force Base, Klamath	229, 000
Air National Guard: Portland International Airport	233, 000
Army National Guard: Salem	161, 000
Pennsylvania	7, 418, 000
Army: Carlisle Barracks	374, 000
Air Force:	
Olmstead Air Force Base, Middletown	6, 169, 000
Marietta Air Force Station, Marietta	94, 000
Army National Guard:	
Bethlehem	45, 000
Carlisle	45, 000
Chester	206, 000
Ligonier	45, 000
Army Reserve:	
Johnstown	99, 000
St. Marys	149, 000
Naval and Marine Reserve: Naval Air Station, Willow Grove	99, 000
Air Force Reserve: Naval Air Station, Willow Grove	93, 000
Rhode Island	4, 405, 000
Navy:	
Naval Station, Newport	1, 709, 000
Naval Supply Depot, Newport	2, 210, 000
Naval War College, Newport	273, 000
Air National Guard: Theodore F. Green Airport, Providence	213, 000
South Carolina	8, 960, 000
Navy:	
Marine Corps Auxiliary Air Station, Beaufort	4, 352, 000
Marine Corps Recruit Depot, Parris Island	462, 000
Air Force:	
Donaldson Air Force Base, Greenville	78, 000
Myrtle Beach Air Force Base, Myrtle Beach	1, 650, 000
Shaw Air Force Base, Sumter	1, 339, 000
Army National Guard:	
Belton	122, 000
Whitmire	99, 000
Chesterfield	99, 000
Batesburg	99, 000
Clover	99, 000
Johnson	99, 000
Pacolet Mills	99, 000
St. George	99, 000
Lake City	99, 000
Columbia	80, 000
Army Reserve: Greenwood	85, 000
South Dakota	3, 081, 000
Air Force: Ellsworth Air Force Base, Rapid City	2, 931, 000
Army National Guard: Salem	150, 000

CONTINENTAL UNITED STATES—Continued

Tennessee	$4, 309, 000
Air Force:	
Memphis General Depot, Memphis	1, 464, 000
Sewart Air Force Base, Smyrna	591, 000
Army National Guard:	
Camden	91, 000
Crossville	91, 000
Dayton	91, 000
Franklin	91, 000
Harriman	91, 000
Kingsport	165, 000
Livingston	91, 000
New Bern	91, 000
Oak Ridge	142, 000
Persons	91, 000
South Pittsburg	91, 000
Waverly	91, 000
Waynesboro	91, 000
Nashville	493, 000
Naval and Marine Reserve: Marine Corps Reserve Training Center, Memphis	453, 000
Texas	55, 541, 000
Army:	
Fort Bliss	13, 734, 000
Fort Hood	4, 258, 000
Navy: Naval Auxiliary Air Station, Kingsville	1, 041, 000
Air Force:	
Amarillo Air Force Base, Amarillo	979, 000
Bergstrom Air Force Base, Austin	1, 584, 000
Biggs Air Force Base, El Paso	5, 080, 000
Brooks Air Force Base, San Antonio	13, 805, 000
Carswell Air Force Base, Fort Worth	2, 257, 000
Dyess Air Force Base, Abilene	1, 346, 000
James Connally Air Force Base, Waco	750, 000
Kelly Air Force Base, San Antonio	157, 000
Laughlin Air Force Base, Del Rio	897, 000
Perrin Air Force Base, Sherman	319, 000
Randolph Air Force Base, San Antonio	245, 000
Sheppard Air Force Base, Wichita Falls	2, 051, 000
Webb Air Force Base, Big Spring	3, 081, 000
Army National Guard:	
Amarillo	231, 000
Belton	86, 000
Cuero	93, 000
Dallas	154, 000
Edna	93, 000
El Campo	104, 000
Gainesville	111, 000
Honey Grove	90, 000
Houston No. 1	323, 000
Houston No. 2	264, 000
Texarkana	153, 000
Army Reserve: Sinton	134, 000
Naval and Marine Reserve: Naval Air Station, Dallas	259, 000
Air National Guard: Hensley Field, Grand Prairie	1, 862, 000
Utah	1, 981, 000
Air Force: Hill Air Force Base, Ogden	1, 746, 000
Army National Guard: Salt Lake City	235, 000

CONTINENTAL UNITED STATES—Continued

Vermont	$1,335,000
Air Force: Ethan Allen Air Force Base, Winooski	990,000
Army National Guard:	
Swanton	137,000
Burlington	208,000
Virginia	20,080,000
Army:	
Fort Lee	4,630,000
Fort Eustis	3,634,000
Navy:	
Naval Proving Ground, Dahlgren	44,000
Fleet Air Defense Training Center, Dam Neck, Virginia Beach	1,184,000
Naval Auxiliary Landing Field, Fentress	142,000
Armed Forces Staff College, Norfolk	4,643,000
Naval Base, Norfolk	2,546,000
Naval Supply Center, Norfolk	128,000
Marine Corps School, Quantico	168,000
Air Force: Langley Air Force Base, Hampton	1,371,000
Army National Guard:	
Berryville	135,000
Norfolk	441,000
Pulaski	135,000
Richmond	441,000
Naval and Marine Reserve: Marine Corps Reserve Training Center, Lynchburg	388,000
Air National Guard: Byrd Field, Richmond	50,000
Washington	11,479,000
Army: Fort Lewis	1,085,000
Navy: Naval Ammunition Depot, Bangor	86,000
Air Force:	
Fairchild Air Force Base, Spokane	4,094,000
Larson Air Force Base, Moses Lake	3,795,000
McChord Air Force Base, Tacoma	935,000
Naval and Marine Reserve:	
Naval Reserve Electronics Facility, Centralia	81,000
Naval Reserve Electronics Facility, Olympia (Tumwater)	47,000
Naval Reserve Electronics Facility, Yakima	48,000
Air National Guard: Geiger Field, Spokane	1,308,000
West Virginia	1,674,000
Army National Guard:	
Beckley	200,000
Clarksburg	189,000
Gassaway	189,000
Keyser	157,000
Logan	189,000
Weston	189,000
Army Reserve:	
Beckley	289,000
Weirton	149,000
Air National Guard: Martinsburg Municipal Airport, Martinsburg	123,000

CONTINENTAL UNITED STATES—Continued

Location	Amount
Wisconsin	$17,903,000
Air Force:	
Richard Bong Air Force Base, Kansasville	15,552,000
Truax Field, Madison	795,000
Army Reserve:	
Beloit	157,000
Kewaunee	157,000
Madison	490,000
Air Force Reserve: General Mitchell Field, Milwaukee	173,000
Air National Guard: Camp Williams, Camp Douglas	579,000
Wyoming	433,000
Army National Guard:	
Lovell	142,000
Cody	142,000
Army Reserve: Cheyenne	149,000
Various locations (Zone of Interior)	177,699,000
Army	6,584,000
Air Force	170,396,000
Air National Guard	300,000
Army Reserve	419,000
Classified (Zone of Interior)	484,495,000
Army	123,199,000
Navy	73,796,000
Air Force	287,500,000

OUTSIDE CONTINENTAL UNITED STATES

Location	Amount
Alaska	3,158,000
Army: Fairbanks	7,000
Air Force:	
Eielson Air Force Base	380,000
Elmendorf Air Force Base	710,000
King Salmon Airport	340,000
Army National Guard:	
Anchorage	192,000
Bethel	480,000
Fairbanks	277,000
Juneau	450,000
Ketchikan	277,000
Sitka	45,000
Bermuda	683,000
Navy: Naval station	683,000
Canal Zone	1,540,000
Air Force: Howard Air Force Base	1,540,000
Cuba	890,000
Navy: Public Works Center, Guantanamo Bay	890,000
Eritrea	1,180,000
Navy: Naval Communication Unit No. 3	1,180,000

OUTSIDE CONTINENTAL UNITED STATES—Continued

Hawaii	$5, 992, 000
Army:	
Kawaihae Harbor	240, 000
Schofield Barracks	593, 000
Fort Shafter	2, 925, 000
Navy:	
Naval Air Station, Ford Island	1, 271, 000
Naval Submarine Base, Pearl Harbor	159, 000
Air Force: Hickam Air Force Base, Honolulu	144, 000
Naval and Marine Reserve: Naval and Marine Reserve Training Center, Honolulu	515, 000
Army National Guard: Kealakekua	145, 000
Mariana Islands	8, 982, 000
Navy:	
Naval Air Station, Agana	4, 414, 000
Naval Supply Depot, Guam	3, 060, 000
Air Force: Andersen Air Force Base	1, 508, 000
Midway	839, 000
Air Force: Naval Station, Midway Island	839, 000
Morocco	519, 000
Navy: Naval Radio Facility, Port Lyautey	519, 000
North Ireland	219, 000
Navy: Naval Radio Facility, Londonderry	219, 000
Okinawa	165, 000
Navy: Naval Air Facility, Naha	165, 000
Puerto Rico	4, 735, 000
Navy: Naval Station, Roosevelt Roads	3, 324, 000
Air Force: Ramey Air Force Base	643, 000
Army National Guard:	
Juncos	38, 000
Mayaguez	160, 000
Air National Guard: San Juan International Airport, San Juan	70, 000
Various locations, overseas	122, 517, 000
Army	4, 967, 000
Air Force	117, 550, 000
Classified locations, overseas	79, 427, 000
Army	77, 922, 000
Navy	1, 505, 000
Locations not specified	80, 000, 000
Army	25, 000, 000
Navy	25, 000, 000
Air Force	25, 000, 000
Department of Defense	233, 401, 000

APPENDIX

Hon. RICHARD B. RUSSELL,
Chairman, Committee on Armed Services,
United States Senate.

DEAR MR. CHAIRMAN: Submitted herewith are lists of Reserve Forces facilities projects indicating the carryover authorization which would be provided under section 4 of S. 3863, presently under consideration by your committee. Consultation with your committee has previously been effected or is pending on all listed projects, in accordance with the provisions of chapter 133, title 10, United States Code.

The inclosures include a summary for each Reserve component involved, showing the total estimated dollar amount of the carryover authorization based on the obligations as estimated by the respective military departments for the entire fiscal year 1958. The actual amount of the carryover would, of course, be determined by the actual obligation level attained as of June 30, 1958.

Attention is invited to the fact that a reasonable amount of flexibility is provided for the Army Reserve and Army National Guard, as requested by the Department of the Army; while an additional number of projects are listed, the actual net carryover authorization would not exceed the June 30, 1958 unobligated balance of funds heretofore appropriated, as provided in section 4 of the proposed legislation.

Additional copies of the lists can be provided if desired by the committee.

Sincerely yours,

FLOYD S. BRYANT.

RESERVE FORCES FACILITIES SUMMARY SHEET

Fiscal year 1958 and carryover project authorization subject to provisions of H. R. 12369 and S. 3863

	Army National Guard	Army Reserve	Naval and Marine Corps Reserve	Air Force Reserve
Total estimated cost (Federal) of listed projects	$39,689,456	$62,553,679	$24,841,449	$22,675,356
Less program flexibility	7,208,288	11,858,546	0	0
Total available funding, fiscal year 1958	32,381,168	50,695,133	[1] 24,841,449	22,675,356
Estimated obligations as of June 30, 1958	14,645,456	19,707,679	13,000,000	7,601,356
Estimated carryover authorization	17,735,712	30,987,454	[1] 11,841,449	15,074,000

[1] Does not include $883,162 of unobligated prior year appropriations for which specific project authorization is contained in H. R. 12369 and S. 3863.

ARMY NATIONAL GUARD

KEY TO TYPE OF CONSTRUCTION

A—Addition
ANOL—Ancillary
BN—Battalion
CFMS—Combined field maintenance shop
CONV—Conversion
EXP—Expansion
MCAS—Marine Corps air station
MCRTC—Marine Corps Reserve training center
MVSB—Motor vehicle storage building
NAS—Naval air station
N&MCRTC—Naval and Marine Corps Reserve training center
NREF—Naval Reserve electronics facility
NRTC—Naval Reserve training center
N&ARTC—Naval and Army Reserve training center
OMS—Organizational maintenance shop
P—Plus
PLAT—Platoon
REH—Rehabilitation
SH—Shop hangar
TKSS—Tank storage shed
TNG—Training
U—Unit
USP&FO OFF—United States property and fiscal officer, office
UTIL—Utilities
WH—Warehouse

Fiscal year 1958 and carryover project authorization subject to provisions of H. R. 12869 and S. 3863

ARMORY

Location	Type	Obligations as of Apr. 30, 1958	Planned obligations, June 30, 1958	Carryover authorization
Alabama:				
Birmingham (Med)	1-U-P & MVSB			$160,000
New Brockton	1-U			70,000
Slocomb	1-U		$67,813	
Springville	1-U		68,313	
Vincent	1-U		67,000	
Alaska:				
Anchorage	1-U & MVSB			450,000
Alakanuk	Special		20,000	
Dillingham	Special		20,000	
Hoopers Bay	Special		20,000	
Kiana	Special		20,000	
Mount Village	Special		20,000	
Noatak	Special		20,000	
Norvik	Special		20,000	
Selawik	Special		20,000	
Shungnak	Special		20,000	
42 Scout armories	Special			840,000
Kodiak	1-U-(Plat)		154,864	
Nome	1-U-P & MVSB			480,000
Arizona:				
Casa Grande	1-U			120,000
Douglas	1-U & MVSB			75,000
Safford	1-U			120,000
Warren	1-U & MVSB			120,000
Winslow	1-U & MVSB			75,000
Arkansas:				
De Witt	1-U			45,000
Harrison	2-U-Exp			17,000
North Little Rock	5-U-P		300,000	
Ozark	1-U-P	$43,000		
Warren	1-U		43,500	
California:				
Anaheim-Fullerton	1-U			106,000
Petaluma	1-U			91,000
Riverside	2-U-P			129,000
Victorville	1-U		92,000	
Watsonville	1-U		91,000	
Colorado:				
Colorado Springs	1-U-Exp		45,000	
Fort Collins	2-U-P			132,000
Grand Junction	2-U-P		92,836	
Greeley	1-U-P & MVSB			132,000
La Junta	1-U-P			113,000
Connecticut: Naugatuck	1-U	123,012		
Florida:				
Lake City	1-U-P & MVSB		97,000	
Live Oak	1-U & MVSB		97,000	
Miami	4-U-Exp			60,000
St. Petersburg	3-U-P & MVSB	140,640		
Tampa	6-U-Exp & MVSB			36,000

Fiscal year 1958 and carryover project authorization subject to provisions of H. R. 12369 and S. 3863—Continued

ARMORY—Continued

Location	Type	Obligations as of Apr. 30, 1958	Planned obligations, June 30, 1958	Carryover authorization
Georgia:				
Canton	1-U		$90,000	
Gainesville	1-U			$90,000
Lyons	1-U		90,000	
Macon	1-U-P		147,000	
Do	3-U-P			221,000
Montezuma	1-U		67,369	
Savannah	8-U-P			600,000
Hawaii:				
Hilo	4-U-P			195,000
Do	5-U-Exp			48,000
Honolulu	4-U-P			275,000
Lihue	1-U-Exp			48,000
Idaho:				
Bonners Ferry	1-U-P & MVSB	$65,549		
Emmett	1-U-P		65,000	
Gooding	1-U & MVSB			65,000
Grangeville	1-U & MVSB	60,143		
Idaho Falls	2-U-P & MVSB			105,000
Lewiston	2-U-Exp			60,000
Indiana:				
Anderson	2-U-P		188,000	
Bloomington	2-U-P		232,000	
Iowa:				
Glenwood	1-U			115,000
Le Mars	1-U			115,000
Ottumwa	2-U		131,010	
Sheldon	1-U			115,000
Kansas:				
Colby	1-U & MVSB			80,000
Mankato	1-U	77,080		
Kentucky:				
Ashland	1-U-Conv			8,000
Barbourville	1-U-P-Conv			12,000
Bowling Green	1-U-P-Conv			12,000
Carrollton	1-U			102,000
Henderson	1-U-Conv			2,000
Jackson	1-U			97,000
Livermore	1-U-Conv			2,000
London	1-U-Conv			9,000
Olive Hill	1-U		102,000	
Paducah	1-U-Conv			18,000
Ravenna	1-U-Conv			1,000
Richmond	2-U-P-Conv			3,000
Russellville	1-U-Conv			11,000
Somerset	1-U-Conv			12,000
St. Matthews	2-U-P-Conv			10,000
Tompkinsville	1-U			132,000
Williamsburg	1-U-Conv			3,000
Maine:				
Bangor	2-U-Exp & MVSB			150,000
Bath	1-U-Exp & MVSB			75,000
Maryland: Cumberland	1-U-P		185,000	
Massachusetts:				
Bridgewater	1-U			200,000
Cambridge	3-U-P		259,671	
Framingham	2-U-P		216,595	
Leominster	1-U			200,000
Northbridge	1-U-P		173,408	
Southbridge	1-U			200,000
Michigan:				
Albion	1-U & MVSB		186,479	
Big Rapids	MVSB	6,710		
Sault St. Marie	1-U & MVSB			225,000
Minnesota:				
East St. Paul	1-U & MVSB		110,000	
Redwood Falls	1-U-Reh			5,000
St. Cloud	2-U-P & MVSB			255,000
West St. Paul	1-U & MVSB		110,000	
White Bear Lake	1-U-Reh			5,000
Mississippi:				
Bay St. Louis	1-U			54,000
Clarksdale	1-U	49,770		
Greenville	2-U-P-Exp			86,000
Hattiesburg	2-U-P	78,038		
Hazelhurst	1-U			54,000
Iuka	1-U			54,000

Fiscal year 1958 and carryover project authorization subject to provisions of H. R. 12369 and S. 3863—Continued

ARMORY—Continued

Location	Type	Obligations as of Apr. 30, 1958	Planned obligations, June 30, 1958	Carryover authorization
Mississippi—Continued				
Laurel	2-U-P	$86,158		
Lumberton	1-U	50,974		
Pascagoula	2-U			$76,000
Prentiss	1-U	52,033		
Quitman	1-U			54,000
Missouri:				
Farmington	1-U			115,000
Fulton	1-U			115,000
Lexington	1-U			115,000
Moberly	1-U		$115,000	
Montana:				
Chinook	1-U			64,000
Dillon	1-U			64,000
Hamilton	1-U			63,000
Whitefish	1-U			63,000
Nebraska: Omaha	5-U-P			450,000
Nevada:				
Ely	1-U			101,000
Yerington	1-U		103,735	
New Hampshire:				
Keene	2-U-P		213,000	
Nashua	2-U-P	171,121		
New Jersey:				
Cape May Court House	2-U-P			250,000
Delaware Township	1-U-P-Exp			74,000
Long Branch	2-U-P		212,000	
Woodbridge	3-U			338,000
New Mexico:				
Artesia	1-U			94,000
Clovis	1-U			94,000
Farmington	1-U		56,867	
Hobbs	1-U		56,995	
Las Cruces	2-U			130,000
Portales	1-U			94,000
Roswell	3-U-P			200,000
New York:				
Amsterdam	Conv			55,000
Corning	Conv			60,000
Dunkirk	Conv		71,000	
Freeport	3-U-P			400,000
Geneva	Conv		54,000	
Glens Falls	Conv		45,000	
Gloversville	Conv			39,000
Hornell	Conv		35,000	
Hudson	Conv		52,000	
Huntington	2-U & MVSB	342,520		
Jamestown	Conv		84,000	
Malone	Conv		56,000	
Medina	Conv		43,000	
Ogdensburg	Conv		45,000	
Olean	Conv			46,000
Oneonta	Conv		45,000	
Orangeburg (Nyack)	2-U-P			300,000
Oswego	Conv			52,000
Schenectady	Conv			96,000
Ticonderoga	Conv		45,000	
Troy	Conv			47,000
Whitehall	Conv			40,000
North Carolina:				
Benson	1-U			105,000
Durham	3-U-P	162,842		
Elizabeth City	1-U			105,000
Mooresville	1-U			105,000
Mount Olive	1-U			105,000
Roxboro	1-U			105,000
Siler City	1-U			105,000
Statesville	1-U		83,000	
Windsor	1-U			105,000
North Dakota:				
Bismarck	2-U-P			212,000
Fargo	1-U-P			142,000
Jamestown	1-U-P			153,000
Mandan	1-U-P-Reh			126,000
Mott	1-U			153,000

Fiscal year 1958 and carryover project authorization subject to provisions of H. R. 12369 and S. 3863—Continued

ARMORY—Continued

Location	Type	Obligations as of Apr. 30, 1958	Planned obligations, June 30, 1958	Carryover authorization
Ohio:				
Columbus (north end)	3-U-P		$225,908	
Logan	1-U & MVSB			$165,000
Massilon	1-U & MVSB		150,000	
Sandusky	1-U-P & MVSB			180,000
Oregon:				
Oswego	1-U			126,000
Salem	2-U			160,000
Pennsylvania:				
Allentown	2-U-P-Reh		150,000	
Hanover	1-U & MVSB	$153,400		
Kutztown	1-U			171,000
Lebanon	2-U			206,000
Sharon	1-U		150,000	
Tamaqua	2-U		206,800	
West Pittston	1-U	157,807		
Puerto Rico:				
Aibonito	1-U			75,000
Bayamon	3-U			150,000
Caguas	2-U	59,556		
Humacao	2-U			71,000
Ponce	2-U-P			150,000
Sabana Grande	1-U			75,000
San German	2-U			150,00
Yauco	1-U	36,774		
South Carolina:				
Allendale	1-U			99,000
Bamberg	1-U		99,000	
Conway	1-U			99,000
Inman	1-U			99,000
Jonesville	1-U			99,000
Manning	1-U		99,000	
McCormick	1-U			99,000
Ridgeland	1-U	90,360		
Saluda	1-U			99,000
Summerville	1-U	90,565		
South Dakota:				
Lead	1-U		137,000	
Madison	2-U-P & MVSB			205,000
Miller	1-U & MVSB		148,000	
Mitchell	2-U-P		172,000	
Sioux Falls	1-U-P		164,632	
Springfield	1-U & MVSB			188,000
Tennessee:				
Bristol	2-U		127,700	
Covington	1-U		81,000	
Knoxville	5-U-P		295,458	
Milan	1-U			91,000
Nashville	5-U-P			365,000
Smithville	1-U			91,000
Texas:				
Beaumont	1-U			117,000
Brownfield	1-U			113,000
Cameron	1-U			120,000
Clifton	1-U			113,000
Coleman	1-U			113,000
Corpus Christi	2-U-P		86,000	
Dallas, No. 4 (White Rock)	2-U-P			168,000
Decatur	1-U			84,000
Donna	1-U			99,000
Gonzales	1-U			153,000
Houston, No. 3	2-U		82,000	
Longview	1-U-P		74,000	
Mineral Wells	1-U-P	92,556		
New Braunfels	2-U-P			150,000
Orange	1-U-P			111,000
Raymondville	1-U	76,263		
Terrell	1-U-P			133,000
Victoria	1-U			113,000
Utah: Ogden	3-U-P & MVSB		185,384	
Vermont:				
Bradford	1-U		109,000	
Enosburg Falls	1-U			109,000
Williston	1-U	122,040		
Windsor	1-U		109,000	

Fiscal year 1958 and carryover project authorization subject to provisions of H. R. 12369 and S. 3863—Continued

ARMORY—Continued

Location	Type	Obligations as of Apr. 30, 1958	Planned obligations, June 30, 1958	Carryover authorization
Virginia:				
Bassett	1-U			$154,000
Big Stone Gap	1-U			154,000
Christiansburg	1-U-P			165,000
Gate City	1-U-P		$135,600	
Manassas	2-U-P		170,000	
Staunton	1-U-Exp			45,000
Washington:				
Camas	1-U-Exp		60,000	
Okanogan	1-U	$121,418		
Pasco	MVSB		40,000	
Poulsbo	1-U-Exp		60,000	
Shelton	MVSB		18,000	
Snohomish	MVSB		18,000	
Wenatchee	MVSB		5,000	
Yakima	MVSB		26,000	
West Virginia:				
Dunbar	1-U-P			200,000
Moundsville	1-U-P		184,480	
Parkersburg	2-U-P & MVSB			250,000
Princeton	Conv			60,000
Richwood	1-U & MVSB		174,745	
Ronceverte	Conv			54,000
Salem	1-U-P			180,000
Williamson	1-U & MVSB	149,019		
Wisconsin:				
La Crosse	1-U			160,000
Milwaukee	2-U-P			235,000
Mosinee	1-U		123,660	
Plymouth	1-U	132,365		
Wausau	1-U-P			160,000
Wyoming:				
Laramie	2-U-P & MVSB	187,745		
New Castle	1-U			135,000
Total		2,979,466	9,152,028	19,614,000

NONARMORY—Continued

Location	Type	Obligations as of Apr. 30, 1958	Planned obligations, June 30, 1958	Carryover authorization
Alabama: Dannelly Field (Montgomery)	SH		$95,420	
Alaska: Anchorage	USP&FO Off			$71,000
California:				
Los Angeles (Van Nuys)	SH			97,000
Stockton	SHA		49,000	
Colorado: Buckley Field	SH		64,000	
Florida: Camp Blanding	CFMS			167,000
Georgia: Fort Stewart	CFMS			221,000
Do	TNG			580,000
Hawaii: Fort Ruger (Oahu)	CFMS			63,000
Idaho: Gowen Field	SH	$61,169		
Indiana: Indianapolis (Stout Field)	OMS			72,000
Kentucky:				
Capitol City Airport (Frankfort)	SH			90,000
Frankfort	USP&FO Off		43,000	
Frankfort (Capitol City)	WH			270,000
Maine: Camp Keyes (Augusta)	CFMS	216,910		
Massachusetts:				
Boston (Dorchester)	OMS		48,000	
Fitchburg	SH			183,000
Fort Devens (Ayer)	CFMS			400,000
Natick	WHA		197,296	
New Bedford	OMS			39,000
Worcester	OMS		49,000	
Michigan:				
Camp Grayling	OMS			57,000
Do	TNG (1 Bn)			296,000
Lansing	SH			170,000
Mississippi: Camp Shelby	TNG (2 Bn)			580,000
Montana: Helena (municipal airport)	SH			90,000
Nebraska: Lincoln	WH&USP&FO Off		175,227	
Nevada:				
Carson City	CFMS		168,910	
Do	USP&FO Off			66,000
New Hampshire: Concord	SH		100,503	

Fiscal year 1958 and carryover project authorization subject to provisions of H. R. 12369 and S. 3863—Continued

NONARMORY—Continued

Location	Type	Obligations as of Apr. 30, 1958	Planned obligations, June 30, 1958	Carryover authorization
New Jersey:				
Camp Drum, N. Y., for New Jersey	TKSS (2)		$120,000	
Do	OFMS			$308,000
Jersey City	OMS			49,000
Morristown	SH			90,000
Orange	OMS			33,000
Trenton	USP&FO Off			40,000
West Orange	CFMS (Util)		75,000	
Do	CFMS (Ancl)		236,000	
New Mexico: Santa Fe	CFMS			249,000
North Carolina: Camp Butler	OFMS			427,000
North Dakota:				
Bismarck	USP&FO Off			43,000
Do	SH			57,000
Oklahoma:				
Norman	WH		38,704	
Oklahoma City	SH			86,000
Puerto Rico: San Juan	CFMS		148,000	
Rhode Island: Smithfield	CFMS		265,000	
South Carolina: Columbia	USP&FO Off			52,000
South Dakota: Rapid City	SH	$46,328		
Vermont: Burlington (Camp Johnson)	SH	42,217		
Virginia: Byrd Field (Richmond)	SH		75,149	
West Virginia:				
Buckhannon	USP&FO Off			48,000
Do	WH			158,000
Clarksburg	OMS			46,000
Parkersburg	SH		65,991	
Wisconsin:				
Eau Claire	OMS			40,000
Hayward	OMS			52,000
Milwaukee (West Bend)	SH		133,138	
Wausau	OMS			40,000
Total		366,624	2,147,338	5,330,000

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Calendar No. 2029

85TH CONGRESS 2d Session | SENATE | REPORT No. 1983

TECHNICAL AMENDMENTS ACT OF 1958

REPORT

TOGETHER WITH

INDIVIDUAL VIEWS

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

TO ACCOMPANY

H. R. 8381

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO CORRECT UNINTENDED BENEFITS AND HARDSHIPS AND TO MAKE TECHNICAL AMENDMENTS, AND FOR OTHER PURPOSES

JULY 28, 1958.—Ordered to be printed

UNITED STATES
GOVERNMENT PRINTING OFFICE
28508 WASHINGTON : 1958

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85TH CONGRESS 2d Session | SENATE | REPORT No. 1983

TECHNICAL AMENDMENTS ACT OF 1958

JULY 28, 1958.—Ordered to be printed

Mr. BYRD, from the Committee on Finance, submitted the following

REPORT

together with

INDIVIDUAL VIEWS

[To accompany H. R. 8381]

The Committee on Finance, to whom was referred the bill (H. R. 8381) to amend the Internal Revenue Code of 1954 to correct unintended benefits and hardships and to make technical amendments, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. GENERAL STATEMENT

As indicated in the report of the House, H. R. 8381 represents a major step in the elimination of substantive unintended benefits and hardships in the existing income, estate, and gift-tax provisions, and also removes many technical errors and ambiguities in the tax statutes.

In terms of the number of changes, most of the bill deals with the correction of inadvertent errors in the internal revenue laws. These include inconsistencies in the statute as well as instances in which the language in the statute does not carry out the intention of Congress as clearly expressed in committee reports.

The more significant changes in the bill, however, are those concerned with "unintended benefits" and "unintended hardships." These relate to problems of revenue significance or are problems of significance in the internal revenue laws.

The amendments made by your committee to the House bill fall into four broad categories: Minor technical, perfecting amendments; amendments changing effective dates; revisions or deletions of provisions in the House bill; and the addition of new substantive amendments dealing with unintended benefits and unintended hardships.

The effective date changes made by your committee almost entirely are concerned with advancing the effective date of the application of the various substantive House provisions from November 7, 1956 (or from a date close to that time) to December 31, 1957. The House had adopted the 1956 date because this was the time when a subcommittee of the House committee first indicated that it was studying many of the substantive problems. However, in view of the fact that this bill cannot now become law until more than a year and one-half after that date, your committee has generally advanced those effective dates to December 31, 1957.

The bill as passed by the House contained 81 sections. Your committee has added 33 new provisions although not all of these appear as separate sections. In addition, it has substantially revised or deleted about half as many provisions passed by the House. The substantive new provisions added by your committee, as well as the substantive revisions of the House provisions and the deletions of House provisions, are summarized below.

A. Substantive New Provisions

(These provisions are generally effective as of December 31, 1957, unless otherwise noted.)

(1) Dependency exemptions are to be allowed for a legally adopted child where the child is neither a citizen nor resident of the United States, if the child has as his principal place of abode the home of the taxpayer and is a member of his household (sec. 5 (b)).

(2) Bribes, kickbacks, or improper payments to foreign government officials and employees are not to be allowed as deductible expense items if the payment would be unlawful under United States laws (sec. 6).

(3) To carry out the intent of Congress last year, 5-year emergency amortization deductions are to be allowed for primary processing facilities for uranium ore or concentrate under a program of the Atomic Energy Commission for the development of new sources of this ore where existing facilities are unsuitable because of their location (sec. 10).

(4) The unlimited charitable deduction under present law is available where in the past 8 out of 10 years an individual has given 90 percent of his income either to charity, or to the Federal Government in the form of taxes. Those claiming this deduction are to be permitted to determine their taxes in the 10 prior years not only on the basis of those paid in any year but alternatively on the basis of the taxes imposed with respect to those years (sec. 11).

(5) Assessments levied by a soil or water conservation or drainage district, invested by the district in depreciable property, are to be deductible by the members of the district, by way of the district's depreciation for such items being passed through to the members (sec. 16).

(6) The maximum medical expense deduction under present law is $10,000 for a joint return and $5,000 for a separate return, except that the total cannot exceed $2,500 times the number of persons represented by the exemptions claimed. The bill raises the maximum medical expense deduction to $15,000 in the case of a taxpayer if he, or his spouse, is over 65 and is totally disabled. Where both the taxpayer

and his spouse are over 65 and disabled for a long period of time the maximum is increased to $30,000 (sec. 19).

(7) Where a parent corporation owns 80 percent or more of the stock of another corporation, the tax imposed on the minority shareholders, on a complete liquidation of the corporation (in sec. 337) is to be reduced with respect to assets of the corporation which are sold if the proceeds are distributed within 1 year (sec. 21).

(8) An exclusion from the "collapsible corporation" provision of present law is provided for the sale of stock where the appreciation in "ordinary income assets" of a corporation does not exceed 15 percent of the fair market value of all of the assets of the corporation (less liabilities). The effect of the exclusion is to tax any gain on the sale of this stock as capital gain, rather than as ordinary income. Similar rules are applicable in the case of a complete liquidation under section 333 and in the case of sales or exchanges of corporate assets in connection with the complete liquidation of the corporation within 1 year (code secs. 331 and 337) (sec. 22).

(9) The $5,000 exclusion for death benefits, the estate-tax exclusion for contributions to a pension by an employer and the gift-tax exclusion provided elsewhere by this bill for joint and survivor elections are to be made available to employees of tax exempt operating schools and colleges, publicly supported charities, and religious organizations, to the extent that the organizations pay no more than 20 percent of the compensation to an employee in the form of an annuity (sec. 24 (d), (e), and (f)).

(10) Publishers of newspapers, magazines, and other periodicals are to be permitted for tax purposes to spread their subscription income over the period of the subscription rather than reporting it as income in the year of receipt (sec. 29).

(11) Loans by an employee pension fund to the employer organization are not to be considered as prohibited transactions: (*a*) where the employer is prohibited by law from pledging as security for such a loan more than half of the value of its assets; (*b*) where the making or renewal of the loan must be approved in writing by an independent trustee (and other independent trustees have not previously refused); and (*c*) the amount loaned by the employee fund to the employer does not represent more than 25 percent of the value of all of the assets of the fund (sec. 31 (b)).

(12) A lease to a medical clinic by a medical research foundation of adjoining premises is to be considered as "related" if the clinic is used by the foundation for research purposes, by making use of the clinic's case histories and donated services of the clinic doctors. The effect of this is to exclude such rental income from "business leases" and, therefore, to exclude it from the base of any unrelated business income tax which might otherwise be imposed in the case of the tax-exempt organization involved (sec. 32).

(13) Percentage depletion for gold is increased from 15 percent to 23 percent where gold ore is the principal product of the taxpayer (sec. 38).

(14) Where regulated investment companies have the bulk of their assets invested in State and local government obligations, a "pass through" of the tax-exempt character of the interest income from the companies to the stockholders is to be allowed. This applies to taxable years beginning after the date of enactment of the bill (sec. 42).

(15) Real-estate investment companies whose funds are largely invested in real estate and real-estate mortgages (or to a limited extent in stocks and bonds) are to be eligible for regulated investment-company treatment. The effect of this is to tax the trusts only on their undistributed income if they distribute 90 percent or more of their income (sec. 44).

(16) The basis of gifts is to be increased by the gift tax attributable thereto, except that the basis is not to be increased above the fair market value of the property at the time of the gift. This is effective with respect to property which has not been sold or otherwise disposed of by the donee on the date of enactment of the bill (sec. 47).

(17) In the case of property which is involuntarily converted, no gain is to be realized in the case of real property which is replaced with property of a "like kind" whether or not that property is "similar or related in service or use." Thus, the more liberal replacement rule now applicable in the case of the exchange of business property will in the case of real property be available under the involuntary conversion provision (sec. 50).

(18) Casualty losses realized in connection with business property, where the taxpayer is not compensated for the loss by insurance, are always to result in ordinary losses and not to be offset against gains which might otherwise be taxed as capital gains (sec. 53).

(19) Small-business investment companies, established by the Small Business Investment Act of 1958, are to receive ordinary, rather than capital, loss treatment, on losses realized on convertible debentures acquired in supplying long-term equity capital for small-business concerns. Second, losses realized by stockholders with respect to investments in these small-business investment companies are to result in ordinary, rather than capital, loss treatment. Third, the intercorporate dividends-received deduction for these investment companies is to be 100 percent instead of 85 percent. These changes are effective for years beginning after the passage of this bill (sec. 61).

(20) Damages received as the result of awards or settlements for injuries under the antitrust laws are to be taxed at a rate no higher than if the award or settlement had been received ratably over the period the injury was sustained. This is effective for taxable years ending after the date of enactment of the bill for awards and settlements after that date (sec. 62).

(21) A provision is added to the sections dealing with the mitigation of the effect of limitations to provide that there is to be a retroactive allowance (or disallowance) of a deduction or credit involving a corporation where there also is a correlative deduction or credit which was disallowed (or allowed) to a related taxpayer. This is effective as of November 14, 1954, the effective date for these provisions under the 1954 Code (sec. 63).

(22) The provision relating to restorations of substantial amounts held under a claim of right is revised to take into account the World War II excess profits tax. This is effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954 (sec. 64 (a)).

(23) The provision relating to the restoration of substantial amounts held under a claim of right is broadened to provide for cases where regulated public utilities make refunds to customers under a court order or in settlement of litigation or under threat or imminence of

litigation (as well as where so ordered by a governmental agency as provided by present law) (sec. 64 (b)).

(24) The provision relating to the restoration of a substantial amount held under a claim of right is made applicable where under a contract subject to statutory renegotiation a second-tier subcontractor makes a repayment to an unrelated first-tier subcontractor, pursuant to a price redetermination. This provision is applicable to 1954 Code years for contracts entered into before 1958. Also, for contracts entered into in 1958 and subsequent years relief is accorded a second-tier subcontractor in such cases by a reduction in his taxes by the amount they would have been reduced had the income not been reported in the earlier year. However, in such cases the first tier subcontractor is required to take up the income and to make the reverse computation with respect to the prior year (sec. 64 (c) and sec. 66).

(25) Where small-business corporations meeting certain conditions so elect, no corporate income tax is to be imposed, and instead the shareholders of the corporation are to be taxed on the corporate earnings on a pro rata basis and also to take into account any corporate losses (sec. 68).

(26) The World War II excess profits tax is amended to provide that where there is a recapitalization of a railroad in a bankruptcy or receivership proceeding, the equity invested capital of the recapitalized corporation, at the election of the taxpayer, is to be the same as that of such corporation before the recapitalization. This applies to years beginning after December 31, 1941 (sec. 97).

(27) The marital deduction provision of the 1939 Code, under the estate tax, in general is to be available with respect to property (or a portion of the property) where it is left to the spouse in trust for life, or as a life estate, if she has the power to appoint the interest to herself or her estate (sec. 98).

(28) Claims for credits or refunds with respect to educational expenses paid in 1954 can be filed within 60 days after the date of enactment of this bill (sec. 101).

(29) The application of the "strict accrual" rules for vacation pay deductions are to be postponed from January 1, 1959, to January 1, 1961 (sec. 102).

(30) For the period from 1950 to date of enactment of this bill inclusive, reimbursements for moving expenses received by employees of certain corporations formed exclusively to operate laboratories for the Atomic Energy Commission are not to be subject to income tax unless the employees were advised at the time of employment that this reimbursement was taxable (sec. 103).

(31) Where there has been an overpayment of income tax because of the taxing of an amount received as sick pay, if an initial claim for credit or refund was filed after December 31, 1951, and before the statute of limitations expired, the time for commencing suits for refunds is to remain open for such amounts until 1 year after the enactment of this bill (sec. 104).

(32) Amounts received in settlement of a claim against the United States, arising from the taking of possession or control by the United States, pursuant to an executive order dated August 11, 1944, of a motor carrier transportation system, are, at the motor carrier's election, to be treated as income received in the taxable years the trans-

portation system was in the possession of the United States. The election as to this treatment must be made within 1 year after the date of the enactment of this bill (sec. 105).

(33) The penalties for failure to file a complete return for the period 1943 through 1948 are made inapplicable where the taxpayer had the same reasons to believe that no taxes were due, as he subsequently did with respect to a claim to which section 106 (relating to amounts received from the United States in the case of certain claims against the United States) of the 1939 Code was applicable (sec. 106)

B. SUBSTANTIVE AMENDMENTS TO HOUSE PROVISIONS

(Other than effective date changes which generally are advanced to December 31, 1957.)

(1) The retirement-income credit has been revised to treat earnings, pension, or annuity income attributable to work, and social security, railroad retirement, and other tax-exempt pensions received by a husband and wife as being attributable one-half to each for purposes of computing the retirement-income credit (sec. 2).

(2) Dealers in tax-exempt securities will not be required to amortize bond premiums in the case of bonds with a maturity, or call, date of more than 5 years where the bonds are sold at a gain. This is the same rule as the House bill provides for such bonds when held for less than 30 days (sec. 3).

(3) In the case of improvements on leased property, etc., the House bill provides that renewal periods are to be taken into account where it is more probable that a lease will be renewed than that it will not, in determining the period over which an improvement made by the lessee, or an acquisition cost, is to be written off. This has been amended to provide that the improvement can be written off over the initial leased period if this period accounts for 60 percent or more of the useful life of the improvement, or in the case of costs of acquiring a lease, the new provision is not to apply if 75 percent or more of this cost is attributable to the initial lease period. In any case, however, a renewal period will be taken into account, where the lease actually has been renewed or there is a "reasonable certainty" that it will be (sec. 17).

(4) Adjustments attributable to periods before 1954 where a taxpayer makes a change in method of accounting after that time, under the House bill generally are to be spread forward for a period of up to 10 years if the taxpayer was in business that long before 1954 and if the change is voluntary and results in an increase of more than $3,000 in income. Your committee has adopted the basic principle of the House bill, but has made several changes in it: (*a*) It provides that the 10-year spread-forward is to be available whether or not the taxpayer was in business 10 years prior to 1954; (*b*) it permits taxpayers, as alternatives to the 10-year spread-forward, to determine their tax in the year of change as if the income had been reported in the years before 1954 under the new method of accounting, or to make the adjustment one-third in the year of change and one-third in each of the prior 2 years; (*c*) taxpayers who have voluntarily changed over to a new method of accounting since 1953 without permission of the Treasury are to be permitted to go back to their prior method of accounting rather than make the adjustment required by the bill;

and (*d*) taxpayers who make changes in their methods of accounting for 1957, or a prior year to which the 1954 Code is applicable, may begin the 10-year spread-forward of any positive adjustment beginning in 1958 (sec. 30).

(5) A House provision would permit a pension fund to invest in debentures or other obligations of the employer corporation, where there was no security for the debentures, etc., but not have the transaction classified as a prohibited transaction if four conditions are met. Classifying the transaction as a prohibited transaction would deny the pension-fund exemption where such debentures, etc., were held. Your committee has stricken 1 of the 4 conditions required under the House provision; namely the requirement that the obligation acquired contain a clause indicating that it would be given a preference no less favorable than that afforded subsequent obligations. The other three requirements which are retained provide that the obligation be acquired on a basis no less favorable than the market price; that the pension trust own not more than 25 percent of any issue; and that not more than 25 percent of the total assets of the pension fund may be invested in the employer's obligations (sec. 31 (a)).

(6) The House bill provided that taxpayers for 1954 and subsequent years could follow either the 1954 Code definition of property or the rules applied under the 1939 Code, for purposes of determining percentage and cost depletion. Your committee retains the House provision in the case of gas and oil, but in the case of other mineral properties it substitutes a specific definition in lieu of both the 1939 Code rules and the 1954 Code definition. In general, the new rules permit an aggregation of all the interests in 1 mine and the aggregation of 2 or more mines within an operating unit. More than one aggregation is permitted. Your committee's amendments also permit the breakup of an interest into two or more properties where a mine is located on each portion. The election to aggregate under your committee's action need not be made until developmental or operational expenses are incurred, but exploration expenses incurred before the aggregation are to increase taxes after the aggregation, to the extent that there would have been an increase in taxes before that time had the properties then been aggregated. These rules are the exclusive rules for 1958 and subsequent years and are an alternative to the 1954 Code rules for the period from 1954 to 1958 (sec. 40).

(7) The House bill provided that any gain on the sale of an obligation containing an original-issue discount was to be considered as ordinary income to the extent of that discount. Your committee would continue to tax this amount in part as capital gain if there was no intention on the part of the issuer to call the obligation before maturity (sec. 54).

(8) The House bill starts a new holding period with respect to securities held in an investment account where the same type of security is sold short to customers, but only if the short sale is not closed for a period of more than 20 days. Your committee has amended this provision to apply it only in the case of stock (sec. 56).

(9) Before 1952, where a lessee contracted to pay a fixed rental and also agreed to pay the Federal income tax attributable thereto, the Internal Revenue Service provided that the first tax payment of this type should be included in the lessor's income tax base, but no tax on this tax should be so included. Since 1954 (in the case of con-

tracts entered into before that time), there is no tax on the tax, although the lessee is not allowed a deduction for this payment. In 1952 and 1953, however, the tax on a tax was pyramided without limit. The House bill applied the pre-1952 rule for 1953 and 1954. Your committee has extended this rule for the same years to similar contracts between corporations which, also, before 1952 were taxes under the same rule as the lessees and lessors (sec. 96).

(10) The House bill provided that where taxpayers acquired property in a receivership or bankruptcy proceeding where the prior taxpayer used the retirement method of depreciation and the acquiring taxpayer adopts another form of depreciation, then the depreciation base is to be reduced for pre-1913 depreciation. Your committee provides an exception for this rule for taxpayers if there was a determination by a court for any year where there was a changeover from a retirement to a straight-line method of computing depreciation if the decision became final after December 31, 1955, and the court decision established the right of the taxpayer to use the straight-line method of computing depreciation (sec. 100).

C. House Provisions Deleted by Your Committee

(1) The House bill would have denied the charitable contribution deduction in the case of a trust, where the income is irrevocably payable for a charitable purpose for a period of 2 years or more and the wife, children, grandchildren, or other closely related members of the grantor's family have a reversionary interest of more than 5 percent in the corpus or income of the trust (sec. 9 of House bill).

(2) The House bill would have provided that where loss is recognized with respect to a transaction which in part is classified as a tax-free exchange under section 358, there is to be a reduction in basis to the extent of the recognition of the loss (sec. 17 of the House bill).

(3) The House bill would have provided a 2-year carryback and 5-year carry-forward for foreign taxes which cannot be credited against the United States tax in the current year because of the country-by-country limitation (sec. 37 of the House bill).

(4) The House bill would have provided, in the case of the sale or exchange of patents by the inventor or certain other persons, that capital-gains treatment rather than ordinary income treatment, is to be available where a patent is sold to a corporation where the inventor or certain closely related persons own 25 percent or more of the stock. Present law, which is restored, denied capital-gains treatment only where such persons owned 50 percent or more of the stock (sec. 58).

(5) The House bill would have repealed the provision of present law permitting certain proprietorships and partnerships to be taxed as corporations. Your committee's action restores this provision (sec. 67).

II. REVENUE EFFECT

It is not possible to prepare any detailed revenue estimates for this bill. Statistical data are not available in case of most of the provisions. In addition, and probably more important, although there are many provisions in this bill which are expected to result in only relatively small increases in revenue currently, they are much more significant from the standpoint of preventing the growth of the use of avoidance devices which might in the future result in substantial revenue losses. On the other hand it is recognized that some of the provisions may eventually result in revenue losses. On balance, therefore, it appears doubtful whether this bill will have any significant effect on revenues.

III. GENERAL EXPLANATION

Section 1—Title, effective dates, etc.

As indicated in the title of H. R. 8381 this bill is intended "to correct unintended benefits and hardships and to make technical amendments, and for other purposes." For that reason, this bill is to be cited as the Technical Amendments Act of 1958.

Because many of the sections in this bill are concerned with technical errors and ambiguities, the bill provides that as a general rule the amendments made by this bill are to take effect as if originally enacted as a part of the Internal Revenue Code of 1954. However, under the bill, as passed by the House, the substantive provisions of the bill for the most part were made effective as of November 7, 1956, or with respect to the future only. November 7, 1956, had been selected as the effective date because this was the date of announcement of consideration of these provisions by a subcommittee of the Committee on Ways and Means of the House. However, this bill was not referred to the Committee on Finance until January 29, 1958. As a result, your committee concluded that the November 7, 1956, date was no longer appropriate for these substantive provisions. For that reason your committee generally substituted as the effective date, taxable years beginning after December 31, 1957.

Section 2—Retirement-income credit

Present law provides a retirement-income credit which in effect excludes from tax up to $1,200 of retirement income for those age 65 or over, and for those receiving governmental pensions also excludes a like amount from tax where they are below age 65. This credit was added by the Internal Revenue Code of 1954 to provide equality of tax treatment between those receiving tax exempt social-security and railroad-retirement pensions and those receiving other forms of retirement income.

Requirements specified in the law determine the eligibility of an individual for this credit and also the amount of the credit. In general, these conditions are patterned after conditions which must be met in the case of social-security benefits. First, in order to be eligible for the credit, an individual must have earned over $600 a year in 10 prior years. Second, the maximum credit is based upon a retirement income of $1,200. The retirement income of an individual if he is age 65 is the income he derives from pensions or annuities, interest, rents, and dividends. (For those under age 65 only pension or annuities from public retirement systems are taken into account.) Third, like social-security benefits, the amount of the retirement-income credit available is reduced for any earned income received by an individual in excess of $1,200 but this reduction is made only for those under age 72 (the maximum earned income for those under age 65 and receiving Government pensions is $900). Fourth, the retirement income taken into account is also reduced for any social security, railroad retirement, or other exempt income received by an in-

dividual since this credit is designed as a means of according those receiving these other forms of retirement income the same tax treatment as those receiving social-security and railroad-retirement income.

The House report points out that under present law the retirement income credit operates differently in community property and non-community-property States. It also indicates that this is a result which was not intended at the time of the adoption of this provision in 1954. On the basis of this, the House concluded that the benefits now made available in community-property States, which for the most part are the more liberal, should be changed so as to be in accord with the rules followed in computing the retirement-income credit in non-community-property States.

Your committee recognizes that the retirement-income credit is computed differently in community-property and non-community-property States and that a change should be made so as to equalize this treatment as between residents of these two groups of States. However, rather than adopt the rules now applicable in non-community-property States for the community-property States, it believes that it is more appropriate to extend what are generally the more liberal rules of the community-property States to the remaining States. This was the course taken in 1948 when the benefits of "income splitting" available in community-property States were extended to the other States.

One of the areas of inequality between community-property and non-community-property States pointed out by the House report was concerned with variations in community-property and non-community-property States in the manner in which it is determined whether an individual had earnings of more than $600 in 10 prior years. In a community-property State the earnings of each spouse are attributed one-half to each, while in other States the earnings are attributed only to the spouse performing the work. As a result, as the House report points out, if only the husband worked prior to retirement, in a community-property State this might qualify both the wife and the husband under the 10-year earnings test while in the non-community-property State such employment could qualify only the husband. The House bill amends the definition of "earned income" by providing that community-property income for the purpose of this 10-year earnings test is to be treated as the income only of the individual who renders the services. Your committee's bill substitutes for this a definition of "earned income," for purposes of this 10-year earnings test, which provides in the case of married individuals that earnings of an individual are to be treated as received one-half by him and one-half by his spouse.

Another area of inequality between community-property and non-community-property States pointed out by the House report also is concerned with this same definition of "earned income," but in this case in its application in the current year in reducing the retirement-income credit for earned income in excess of $1,200 (or $900 in the case of those under 65 receiving Government pensions). As pointed out in the House report, in community-property States earned income of the husband for this purpose is divided equally between the husband and wife, while in non-community-property States the earnings are attributed, in this case, only to the husband. This variation in State

law in some cases works to the detriment of couples in community-property States and in other cases to the detriment of those in non-community-property States. Present law, for example, generally is more advantageous to those in community-property States where one spouse has both the retirement income and the earned income. On the other hand, present law in some cases may work to the advantage of couples in non-community-property States where the retirement income is split but one spouse earns all of the income. Your committee's bill provides in all of these cases, in community-property and non-community-property States, that one-half of the earned income is to be attributed to each spouse.

A third area of inequality under existing law exists in the case of work-connected pension or annuity income. In community-property States the pension income of a husband, for example, is attributed one-half to the husband and one-half to the wife with the result that in the case of a $2,400 pension received both spouses may claim a credit based upon $1,200 of retirement income. In a non-community-property State the pension income is attributed only to the husband and in such a case can result in only one credit based upon $1,200 of retirement income. The House bill would correct this inequality by permitting work-connected pension or annuity income to be attributed only to the spouse who was actually employed. Thus, in the above example, it would have limited the retirement income on which a credit could be based in the community-property State to the $1,200 now available in the non-community-property State.

Your committee's bill would provide that any work-connected pension or annuity received by a married individual is to be attributed one-half to him and one-half to his spouse. Thus, under your committee's bill the retirement income on which a credit could be based in the above example would be $2,400 instead of $1,200.

The House report points out that still another area of inequality exists under present law in the variation in community-property and non-community-property States in the attribution of social security, railroad retirement, and other tax-exempt payments to the husband and wife. In a non-community-property State, this income (which reduces the retirement income) is attributed to the designated beneficiary, usually the person who was employed although the social-security program also provides half payments for wives not in covered work. In community-property States, on the other hand, all such benefits are attributed one-half to each spouse. The House bill in this respect provided that the amount of the reduction to be made in the income of an individual because of the receipt of such income was to be determined without regard to community-property laws. Your committee's bill, on the other hand, provides that this tax-exempt income, which reduces the retirement income, is to be treated in all States as being received one-half by each spouse.

The House bill would have made the changes in the retirement-income credit applicable with respect to taxable years beginning after December 31, 1956. Your committee makes the changes it proposes with respect to the retirement-income credit effective for taxable years beginning after December 31, 1957.

Section 3—Dealers in tax-exempt securities

Under present law where, because of a relatively high rate of interest, tax-exempt bonds of State or local governmental units are purchased at premium prices, the premiums generally must be amortized over the life of the bond. Under the general rule the investor must reduce his cost for the bond each year by a pro rata portion of the premium. He is given no tax reduction for this premium written off, however, since the premium reflects the receipt of tax-exempt interest income by the investor. As a result of this annual reduction in the basis of the bond, a sale of the bond will not indirectly result in a tax deduction for the premium.

An exception is made under existing law to the rule described above for dealers in municipal bonds. These dealers are not required to write off premiums on tax-exempt bonds which they hold for less than 30 days. Also under this section a dealer is not required to write off the premium on a tax-exempt bond where the maturity or earliest call date is more than 5 years beyond the date of acquisition of the bond. These 30-day and 5-year rules were provided as exceptions to the general rule by the Revenue Act of 1950 in order to prevent unduly complicating the accounting procedures of dealers.

It is understood that certain dealers in tax-exempt bonds have been taking advantage of the exceptions provided by these 30-day and 5-year rules. They have been making a regular practice of holding high-interest exempt bonds for slightly less than 30 days and then transferring them in a so-called daisy-chain procedure to other dealers who similarly hold them for slightly less than 30 days. The dealers engaging in these practices reduce their income by deducting the loss attributable to the reduction in the premium during the period they held the bond although collecting interest, attributable to the premium, which they did not include in their income because it was tax exempt. A similar procedure has been followed with respect to high-interest municipal bonds having a maturity date of more than 5 years. In such cases also, dealers are holding the bonds and deducting the artificial losses attributable to the premiums when the bonds are sold or mature.

The bill, as amended by the House, would eliminate this avoidance device by repealing the 5-year-maturity or call-date rule in present law and by requiring the writeoff of the premium by the dealer where the bond is held for less than 30 days if the bond is sold at a loss.

The House believed that it was necessary to require dealers to write off the premium only where the bonds are sold at a loss because as a general rule where the bonds are sold to other dealers, as is true under the "daisy chain" procedure, there is no dealers' profit resulting from transactions with customers. Thus, the House found it unnecessary to require dealers to amortize the premium on their tax-exempt bonds where the bonds were sold at a profit in their ordinary transactions with customers.

Thus, the House desired not to require the amortization of the premium where the bonds are held by dealers for less than 30 days except in those cases where it was believed there was likely to be tax avoidance. It was thought that to require the amortization in other cases represented an unnecessary bookkeeping requirement. Your

committee believes that the same reasoning should be applied in the case of bonds with a maturity or call date of more than 5 years where the bonds are held for more than 30 days. In such cases also it would appear that tax avoidance would be unlikely to occur where the bonds are sold by a dealer at a gain. For that reason your committee has restored the 5-year rule and provided that dealers need not amortize the premium on bonds having maturity or call dates of more than 5 years from date of acquisition, irrespective of how long such bonds are held, if they are sold by the dealer at a gain. Where these bonds are sold at a loss the amortization of the premium which is required, is to be made in the year of the sale.

The amendment made by the House bill would be effective with respect to taxable years ending after November 7, 1956, with respect to obligations acquired after that date. Your committee makes this provision as amended effective with respect to taxable years ending after December 31, 1957, with respect to bonds acquired after that date.

This provision is expected to result in an increase in revenue over the long run but is of such a nature that estimates of current revenue gain cannot be made.

Section 4—Statutory subsistence allowance of police

Present law (sec. 120) permits police officials of States and local governments to exclude subsistence allowances not in excess of $5 per day from their gross income. This provision was originally designed to cover subsistence allowances of police only because it was believed that the nature of their duties required them to incur considerable expense, in proportion to their compensation, on trips away from their posts of duty and that expenses of this type incurred by them were greater than was true in the case of most other types of occupations.

However, as the House report points out, since the adoption of this provision in 1954, a number of States have altered, or are in the process of altering, the form of payment of compensation to their police officials in order to maximize the utilization of this $5 subsistence allowance. Many localities have, or are also making, changes in their compensation systems for their police officials in order to provide tax exclusion of $5 for all policemen. Your committee agrees with the House that there is no reason to provide what in effect is likely eventually to amount to a $5 a day tax exclusion for police officials. Moreover, it believes that this exclusion is inequitable because there are many other individual taxpayers whose duties also require them to incur subsistence expenditures regardless of the tax effect. Subsistence expenses incurred by taxpayers generally in the performance of services as employees while away from home are deductible and as a result police officials, even without this special $5 exclusion in the law, can claim such expenses as deductions in the same manner as other taxpayers who are away from home.

To bring the tax treatment of subsistence allowances for police officials in line with the treatment of such allowances in the case of other taxpayers, your committee's bill, like the House bill, repeals the section of present law providing this $5 exclusion. The House bill however, would have repealed this exclusion with respect to taxable years beginning after December 31, 1956. Your committee's bill, in

order to be sure that the police officials have time to become acquainted with this provision, provides that this provision is to be repealed only with respect to taxable years ending after September 30, 1958, and only with respect to amounts received as a subsistence allowance for any day after that date.

The revenue effect of this provision is difficult to ascertain with certainty because a number of States and local governmental units apparently are in the process of changing their compensation systems with respect to their police officials in order to qualify for this $5 a day exclusion. Should all States and local governmental units change their pay classification systems for police so as to allow the maximum daily subsistence allowance, it is estimated that the revenue cost of the present provision would entail as much as $50 million a year.

Section 5—Definition of dependent

The House bill makes two changes with respect to the definition of a dependent for tax purposes. These amendments by the House have been approved by your committee without change. However, your committee has also added a new amendment to the definition of a dependent relating to certain nonresident alien children who are dependents of United States citizens.

Present law (in sec. 151 (b)) provides an exemption of $600 for the taxpayer and an additional exemption of $600 for the spouse of the taxpayer. Present law (in sec. 151 (e)) also provides certain additional exemptions for dependents (sec. 152). Among the prescribed dependents for which an exemption can be taken is an individual who for the taxable year of the taxpayer has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household. Some have argued that this made it possible to claim 2 deductions for a spouse, 1 as the spouse of the taxpayer and 1 as an individual who has as his principal place of abode the home of the taxpayer. To make it clear that this was not at any time intended, both the House and your committee's bill amend paragraph (9) of section 152 (a) to state specifically that the dependency exemption which can be claimed for an individual who has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household, does not include the spouse of the taxpayer.

The House and your committee's bill also amend section 152 (b), which contains the rules relating to the general definition of a dependent. On this point it is made clear that a person who is not a close relative but is living with the taxpayer may not be claimed as a dependent if the relationship between the taxpayer and the individual is an illegal one under the applicable local law. For example, this would make it clear that an individual who is a "common-law wife" where the applicable State law does not recognize common-law marriages would not qualify as a dependent of the taxpayer. This qualification applies only to the definition of a dependent under section 152 (a) (9).

These changes made in the definition of a dependent are effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of income taxes under the 1954 Code.

Your committee has also amended the definition of a dependent where the individual is neither a citizen of the United States nor a resi-

dent of the United States (or of a contiguous country, the Canal Zone, or the Republic of Panama). Generally, under present law, where the dependent is neither a citizen of the United States nor a resident of the United States, a dependency exemption cannot be claimed for him. Your committee believes that this discriminates against American citizens employed abroad either by the United States Government or by private industry who legally adopt children while they are abroad and who cannot obtain an exemption for these children while their employment keeps them out of the United States.

To remove the discrimination described above your committee's bill provides that dependency exemptions may be claimed for a child of the taxpayer, even though the child is neither a citizen nor resident of the United States, if the child is legally adopted by the taxpayer and for the taxable year the child has as his principal place of abode the home of the taxpayer, and is a member of the taxpayer's household. The exemption is to be available in such cases, however, only if the taxpayer involved is a citizen of the United States. This change applies to taxable years beginning after December 31, 1957.

Section 6—Improper payments to officials of foreign countries

For an expenditure to be deductible as a business expense under existing law, it must be ordinary and necessary and directly connected with the taxpayer's trade or business. It is not deductible if it is clear that the allowance is a device to avoid the consequences of violations of a law or otherwise contravenes the Federal policy expressed in a statute or regulation.

The position of the Service has been that when bribes or improper payments are made to officials of foreign countries, such expenditures usually are not considered to be "ordinary and necessary" business expenses. This is not the case, however, where the foreign government itself demands or acquiesces in the payment. In such cases the Service has indicated that because legal recourse is not available to the taxpayer in the operation of his business, it would find it difficult to sustain the position that the expenses in such a case were not ordinary and necessary to the taxpayer's business.

Your committee believes that bribes, kickbacks, or improper payments to foreign governmental officials should not be treated as properly deductible expense items irrespective of the position which the foreign government may take with respect to such payments. For that reason your committee has added a new provision (sec. 162 (c)) to existing law to provide that no business expense deduction is to be available for expenses paid directly or indirectly to an official or employee of a foreign country if the payment would be unlawful under United States laws if these laws were applicable to the payment and to the foreign official or employee.

This amendment is to apply with respect to expenses paid or incurred after the date of enactment of this bill. The question as to whether any expense relating to a date before the enactment of this bill is to be allowed as a deduction is to be made without inference drawn as a result of the enactment of this provision.

Section 7—Payments for municipal services in atomic energy communities

The attention of the House was directed to a problem relating to persons in Oak Ridge, Tenn., and Richland, Wash., who have acquired

real estate from the Atomic Energy Commission. In these communities persons acquiring or leasing real estate from the AEC are required to pay the Commission (or its agents) for services usually rendered by a municipality and usually paid for by taxes. These payments would be deductible if they were paid as taxes to a municipality but are not deductible when paid to the AEC (or its agent). Since as a result of legislation passed by Congress (Public Law 221, 84th Cong.) these communities are likely to become municipalities within a period of 5 years, your committee sees no reason, during the transition period, why the residents of these communities should not receive deductions for income-tax purposes for amounts which generally are deductible as taxes in other communities.

Therefore, the House bill amends section 164 of the code by adding a new subsection (f) permitting the deduction for income-tax purposes of amounts paid AEC for municipal-type services by owners of real property within a community qualifying under section 21b of the Atomic Energy Community Act of 1955. Your committee has accepted the House provision without change, except for the change in effective date noted below.

An owner, for purposes of this provision, is to include a person who holds property under a lease of 40 years or more from the AEC because prior to the passage of the Atomic Energy Community Act of 1955, AEC entered into long-term lease arrangements with some of the families in these communities, but required payments for municipal-type services from them at least equal to the payments required by those purchasing property. The term "owner" also is to include persons who have entered into contracts to purchase property under section 61 of the Atomic Energy Community Act of 1955.

In the House bill, this provision would apply to taxable years beginning on or after January 1, 1957. In view of the time which has passed since this provision was reported out by the House committee, your committee has advanced the effective date of this provision 1 year, so that it will apply to taxable years beginning on or after January 1, 1958.

This provision is expected to result in a negligible revenue loss.

Section 8—Worthless securities in affiliated corporations

This provision, which is the same in the House bill and bill as amended by your committee, corrects a grammatical error in section 165 (g) (3) (B) of the 1954 Code relating to worthless securities in affiliated corporations. In the definition of affiliated for this purpose it strikes out the words "rental from" and inserts "rental of."

Section 9—Nonbusiness bad debts

Present law provides that in the case of a taxpayer other than a corporation, a worthless nonbusiness debt is to be treated as a short-term capital loss. Such a loss is first offset against capital gains, and then, if any loss remains, against other income but only to the extent of $1,000 a year for a period of 6 years. On the other hand, a business bad debt can be offset in full against ordinary income.

Under the 1939 Code a business-created debt, which became worthless after the taxpayer left the business in which the debt arose, was considered a nonbusiness bad debt. The 1954 Code provided, however, that if either the creation of the debt or its becoming worthless was connected with a taxpayer's business, the loss would be character-

ized as a business bad debt, and consequently, was fully deductible against ordinary income.

It is possible to argue that a business-created debt would qualify as being fully deductible against ordinary income in the hands of a donee, executor, or transferee who was not, and never had been, engaged in the trade or business in which the debt arose. To preclude this possible result, the House bill changes the reference to "a taxpayer's trade or business" to "a trade or business of the taxpayer." Your committee has accepted this provision without change. Thus only if the debt was created or acquired in a trade or business of the particular taxpayer claiming the loss deduction, and subsequently became worthless, will it be treated as a business loss which is fully deductible against ordinary income.

This provision in both the House bill and under your committee's version, is effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

Section 10—Facilities for primary processing of uranium ore or uranium concentrate

In 1957 Congress enacted a provision severely restricting the authority of the Office of Defense Mobilization to issue certificates for rapid amortization of emergency facilities. Under this rapid amortization provision, a taxpayer who constructs a facility is permitted to charge off some portion of the cost of the facility over a period of 5 years, instead of over the useful life of the asset, if it is certified by the Office of Defense Mobilization that the investment is "necessary in the interest of national defense." Under the amendments made to this provision last year, certificates for 5-year amortization could be issued after August 22, 1957, only for (1) new or specialized defense facilities as defined in the bill and (2) for research and development facilities for national defense. In addition, the authority to issue rapid amortization certificates is to be terminated completely as of December 31, 1959.

A problem has arisen in connection with the definition of "new or specialized defense items" for which certifications may be made after August 22, 1957, and before December 31, 1959. The definition of this term in the bill indicates that it means only items which are produced for the Defense Department or for the Atomic Energy Commission for use in the national defense program, and then only if existing productive facilities are unsuitable because of the item's newness or its specialized defense features.

On the basis of the above definition it has been held that it is not possible to certify any part of a uranium processing facility as a "new or specialized defense item" eligible for the 5-year emergency amortization provision. Nevertheless, it was clearly intended that such facilities would be eligible for this certification as is indicated by the report of your committee last year with respect to the restrictions imposed on the issuance of certificates for rapid amortization of emergency facilities. In that report in connection with the discussion of the term "new or specialized defense item" it was stated as follows:

> It is also possible that the defense program may require that particular facilities be available in a place where they were not heretofore available and this could be a specialized

defense feature justifying rapid amortization. Thus, for example, if new sources of uranium ore are required to be developed by the Atomic Energy Program and these require primary ore processing facilities near the site of the ore, where they are not presently available, they may be certified for rapid amortization as involving a specialized defense feature.

To carry out the intent of Congress with respect to primary processing facilities for uranium ore or concentrate, your committee has amended the emergency amortization provision of present law (sec. 168 (e)). In this amendment it provides that certificates for emergency amortization after August 22, 1957, and before January 1, 1960, may be issued not only for the "new or specialized defense items" or "research development or experimental services" provided for by previous law, but also for primary processing facilities for uranium ore or concentrate under a program of the Atomic Energy Commission for the development of new sources of this ore or concentrate. However, no facilities for primary uranium ore or concentrate processing may be certified for emergency amortization unless existing facilities are unsuitable because of their location.

Where applications for certificates were filed before the passage of this bill and within 6 months after the beginning of construction, reconstruction, erection or installation, or the date of acquisition of the facility, your committee's bill provides that an emergency amortization deduction is to be available, where the facility is subsequently certified, even though the certification did not take place before the filing of the company's tax return for the year in question. Also, where the application for the certificate is filed at any time within 3 months after the date of enactment of this bill, the emergency amortization deduction is to be available for prior years even though the certificate was not issued before the filing of the tax return, and even though the application for the certificate was not filed within 6 months after the beginning of construction, reconstruction, erection or installation, or the date of acquisition of the facility.

Section 11—Unlimited deduction for charitable contributions by individuals

Under present law the charitable contribution deduction of an individual is generally limited to 20 percent of the taxpayer's adjusted gross income, although in the case of contributions to churches, schools, and colleges, and hospitals the limit is 30 percent instead of 20 percent. However, in addition to this the statute has long permitted a deduction for charitable contributions without limit where certain conditions are met. Before an individual is eligible for the unlimited charitable deduction, however, he must establish that he has for an extended period of time given the bulk of his income to charity or to the Government in the form of taxes. More specifically, to be eligible for the unlimited deduction he must in the current year and in 8 out of the 10 preceding years have given 90 percent of his taxable income to charity or to the Federal Government in the form of income taxes (for this purpose taxable income is computed without regard to the charitable deduction, personal exemptions, or any net operating loss carryback to the year in question).

Under present law in determining the amount of income tax for purposes of this 90 percent test, a taxpayer is to take into account those income taxes "paid during such year in respect of such year or preceding taxable years." Situations have come to the attention of your committee where individuals fail to meet the 90 percent test merely because the income taxes were paid in an earlier or later year than the year in question. For example, under the present rule deficiencies subsequently determined cannot be attributed back to the year with respect to which the income tax liability arose. Moreover, payments may occur other than in the year of liability because of payments with declarations of estimated tax made after the end of the year of liability or because of payments made at the time of filing the return which also occurs in the year after the year of liability

The rule in present law with respect to unlimited charitable deductions is restricted quite narrowly to those cases where the great bulk of an individual's income is spent for charitable purposes. Your committee believes that it is unfortunate to deny the benefits of the unlimited charitable deductions in those cases where an individual does not qualify under the present provisions merely on the grounds of the timing of the income-tax payments. As a result, your committee has amended the unlimited charitable deduction provisions of present law (sec. 170 (b) (1) (C)) to provide that instead of taking into account the income tax paid during any year in determining whether or not the 90 percent test is met, the individual can take into account the income tax paid "in respect of" any year, or in other words may take into account income taxes of the year of liability. For this purpose a taxpayer may take into account tax payments made in 1 year in determining whether that year qualifies as one of the 8 years, and liabilities in the case of another year in determining whether or not that year qualifies. However, where a specific tax payment is taken into account in the year of liability this same amount may not also be taken into account in the year of payment (where that year is different from the year of liability).

This amendment applies with respect to taxable years beginning after December 31, 1957. Thus, it will apply in determining whether or not an unlimited charitable deduction is available in 1958 and subsequent years.

Section 12—Charitable contribution carryover for corporations

Present law (in sec. 170 (b) (2)) provides a 2-year carryover of charitable contributions in excess of the 5-percent limitation for corporations. Present law (in sec. 172) also provides a net operating loss carryback of 2 years and a carryforward of 5 years. Under certain circumstances the interrelationship of this charitable contribution carryover and net operating loss carryover, may give rise to a double deduction, because of the different methods provided for the computation of these two carryovers.

This possible double allowance of the same amount can be illustrated, for example, by a corporation with a net operating loss of $100,000 in 1 year which is carried over to a second year in which it has a taxable income of $100,000 before taking account of a $5,000 charitable contribution and before the application of the net operating loss carryover. In this second year, the net operating loss is applied first and wipes out the $100,000 of taxable income. Thus, the $5,000

charitable contribution becomes a carryover to the third year. However, in determining whether any net operating loss from the first year is still available for application in the third year, present law may provide that the $5,000 charitable deduction was applied first in the second year and, therefore, that for this purpose only $95,000 of the net operating loss was considered to be absorbed in that year. As a result, $5,000 of the net operating loss from the first year may still be available in the third year as well as the $5,000 charitable contribution carryover from the second year.

This section, in both the House and your committee's bill, eliminates any possibility of a double allowance for the same amount in such situations by reducing the amount of the charitable contribution carryover to the extent that a charitable contribution deduction, which has been disallowed as a deduction for the year of contribution, in effect, operates to increase the net operating loss carryover to a succeeding year.

Both the House bill and your committee's action with respect to this provision, the following provision, and several other provisions in this bill make certain changes in the law to make it clear that specified double deductions are not allowable. Although there may be other areas in existing law where there is confusion as to whether or not certain situations might be considered as giving rise to double deductions, the clarifying amendments made in this bill are not intended to imply that in other areas where there may be confusion, double deductions are allowable under existing law.

This provision is effective with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

Section 13—Limitations on charitable contribution deduction

(*a*) *Prepaid interest and charitable contributions.*—Under present law a double deduction may be available to a taxpayer if interest on a loan secured by property is prepaid, and the property is donated to a charitable organization. In such a case, a cash-basis taxpayer generally may deduct the full amount of prepaid interest at the time of payment. Where property (such as real estate) which secures such a loan is contributed to a charitable organization subject to this encumbrance the value of the gift is increased by the amount of this interest which has been prepaid by the donor. Hence the donor becomes entitled to a charitable contribution deduction which includes not only the value of his equity in the property donated but also the amount of interest he has prepaid. Since he also is entitled to a separate deduction for the interest item, the amount of prepaid interest is deducted twice: once as prepaid interest and again as a part of the charitable contribution.

The bill, both as passed by the House and as reported by your committee, eliminates the possibility of this double deduction by adding a provision (largely in subpar. (A) of sec. 170 (b) (4)) to the effect that the amount of any charitable contribution is to be reduced by any deduction for interest which has been prepaid by the taxpayer (or is to be paid by him in the future), and which is attributable to a liability assumed by the charitable organization to the extent the interest paid is attributable to any period after the making of the contribution.

(*b*) *Interest and charitable deductions for bonds purchased with borrowed funds and donated to charity.*—It has been reported that a somewhat similar situation to that described above exists wherein taxpayers borrow money to purchase bonds (or other indebtedness), and then donate the bonds to a charitable organization subject to the loan just before a date on which they would receive interest income from the bonds. In this case the donor may have paid the interest on the loan before giving the bond (or other obligation) to charity. If so, he receives an interest deduction. Moreover, where interest income from the bond is not received until after the bond is given to charity, the amount of the charitable contribution also reflects the present value of the interest income shortly to be received by the charity. However, under present law it is not clear that in all circumstances this amount is necessarily reflected in the gross income of the donor. Thus, taxpayers may receive both an interest deduction and a charitable-contribution deduction for what in reality relates to the same amount.

The new paragraph (4), of section 170 (b), provided by both the House bill and your committee's version, deals with this problem by providing that in the case of a charitable contribution of a bond or other obligation, the amount of the charitable contribution is to be reduced by interest paid on a loan to carry the bond to the extent attributable to the period before making the gift and to the extent the interest income from the bond has not been included in the donor's gross income.

(*c*) *Effective date.*—Under the House bill both of the provisions described above apply to taxable years ending after November 7, 1956, but only with respect to charitable contributions after that date. Your committee's action will make these provisions applicable to taxable years ending after December 31, 1957, with respect to charitable contributions after that date.

(*d*) *Revenue effect.*—The two above provisions are expected to result in an increase in revenue over the long run but are of such a nature that estimates of current revenue gain cannot be made.

Section 14—Amortizable bond premium

Under the 1939 Code a premium on a taxable bond generally was amortized over the period from the date of acquisition of the bond to its maturity or, if it had a call date, to the earliest call date. The bond premium written off in this manner was deducted in computing ordinary income, but any gain on disposition of the bond was subject to capital-gains treatment.

Under these rules where a bond was callable prior to maturity, a taxpayer could deduct this premium ratably over the period from the date of acquisition to the earliest call date. If the bond was not actually called at that time, even though the premium had been deducted in full by the taxpayer against ordinary income, when he sold the bond any gain he received attributable to the premium was, nevertheless, taxable at capital-gains rates. In some cases bonds were issued with early call dates with the result that the purchasers were able to write off against ordinary income any premium over a short period of time. Then the bonds were sold and gains attributable to the premium were taxed at capital-gains rates. It was possible for this process to be repeated indefinitely, so long as the

premium price existed for the bonds, by groups buying and selling the bonds to each other.

The 1954 Code (sec. 171) attempted to prevent this tax avoidance by permitting the amortization of premiums on callable bonds to the earliest call date only if this call date was more than 3 years from the date the bonds were issued. However, taxpayers found they could accomplish much the same result as under the 1939 Code by using bonds with call dates slightly more than 3 years from the date of the issue of the bonds and by waiting until these bonds are 3 years old before buying and selling them.

To stop this tax avoidance, the House bill would amend the code (sec. 171 (b)) to require that the bond premium on any taxable bond acquired after November 7, 1956, may not be amortized to any date earlier than the maturity date of the bond (unless a smaller deduction results from amortizing the amount to an earlier call date). Your committee has accepted this provision with one substantive modification: the proposed new treatment has been made applicable to bonds acquired after December 31, 1957. Under both versions of the provision where a bond is called prior to maturity the unamortized bond premium may be taken as a deduction against ordinary income in the year the bond is redeemed.

This provision, as modified by your committee, applies to all taxable bonds without regard to date issued (and whether or not issued before January 22, 1951) which are acquired after December 31, 1957 (instead of after November 7, 1956, as provided in the House bill).

This provision is expected to result in an increase in revenue over the long run but is of such a nature that estimates of the current revenue gain cannot be made.

Section 15—Net operating loss deduction

The 1954 Code made a number of changes in the method of computing the net operating loss (sec. 172) and also, for purposes of this loss provision, in the method of computing income in the years to or through which losses are carried. In general, the 1954 Code provision more nearly follows the "statutory-income" concept rather than the "economic-income" concept; that is, it gives taxpayers with net operating losses, to the extent possible, the same deductions as taxpayers with more stable income rather than attempting to limit the benefit of the net operating loss carryover to what might be termed the economic loss. As a result, the 1954 Code rules are usually somewhat more generous than those provided by the 1939 Code.

A problem has arisen in connection with the transition from the 1939 Code rules with respect to the net operating loss provision to those under the 1954 Code. Present law (sec. 172 (f)) provides that in determining a net operating loss in the case of a taxable year which began in 1953 and ended in 1954, the loss is to be computed under the 1939 Code provisions and then under the 1954 Code provisions. The allowable loss consists of a portion of each of these losses, based upon the portion of the year falling in the calendar year 1953 and the portion falling in the calendar year 1954. However, a taxable year which begins in 1953 and ends in 1954 (and a short taxable year beginning in 1954 and ending before August 17, 1954) generally is a taxable year exclusively subject to the provisions of the 1939 Code.

As a result, when a net operating loss is carried to such a year or through it to a subsequent year, the 1939 Code rules are followed with respect to this year.

The provision in the House bill, which your committee has accepted, equates the method of computing net operating losses in these cases by providing that where a loss is carried to, or through, one of these years, the 1954 code concepts are to apply on a pro rata basis with respect to the portion of such year which falls in the calendar year 1954.

Your committee did amend the House provision, however, in one respect because 3 years have now elapsed since 1954 and many of the transitional years with which this provision is concerned are now closed years. To prevent relief from being denied in such cases, your committee amends this provision to provide that if a refund or credit with respect to this provision is prevented on the date of enactment of this bill or within 6 months after that time by the operation of any law or rule of law (except closing agreements or compromises) refund or credit, nevertheless, is to be allowed if the claim is filed within 6 months of the date of enactment of this bill. No interest is to be paid or allowed on any refunds or credits arising from this provision.

This provision is expected to result in a one-time revenue loss of approximately $1 million.

Section 16—Assessments levied by soil or water conservation or drainage districts for certain depreciable property

Under existing law (sec. 175) a taxpayer engaged in the business of farming may treat expenditures paid or incurred by him for the purpose of soil or water conservation for land used in farming or for the prevention of erosion of land used in farming as expenses which are not chargeable to a capital account. Expenditures so treated are allowed as a deduction. Expenditures qualifying for this treatment include amounts (not otherwise allowable as a deduction) paid or incurred by a taxpayer to satisfy any part of an assessment levied by a soil or water conservation or drainage district to defray expenditures made by such district which, if paid or incurred by the taxpayer, would be deductible under section 175.

Expenditures qualifying for this treatment do not include expenditures for the purchase, construction, installation, or improvement of structures, appliances, or facilities which are of a character which is subject to the allowance for depreciation provided in section 167 of the code. As a result assessments paid or incurred by a taxpayer which are levied by such districts to defray expenditures made by such districts for the purchase, construction, installation, or improvement of structures, appliances or facilities which are of a character subject to the allowance for depreciation are not eligible for a deduction under section 175.

Your committee has added an amendment to put such taxpayers in somewhat the same position they would have been in if they had made the expenditures for depreciable property directly instead of through the district. In effect this amendment passes through to the taxpayer his share of the district's depreciation deductions with respect to its depreciable property.

Your committee's amendment provides a deduction with respect to any assessment levied after December 31, 1957, by a soil or water

conservation or drainage district to defray expenditures for the purchase, construction, installation or improvement of such property to a taxpayer who is the owner of the land in respect to which such assessment was levied (whether or not the taxpayer was the owner of such land when the assessment was levied) to the extent of the taxpayer's share, as determined under regulations prescribed by the Secretary or his delegate, of the district's depreciation deduction for such property. This deduction can be available for any taxable year to a taxpayer with respect to such an assessment only if during the taxable year the taxpayer is engaged in the business of farming and uses the land in respect of which such assessment was levied in farming. The deduction for any taxable year (when added to the amount of similar deductions for prior taxable years) cannot exceed the amount of such assessments levied in respect to the land of the taxpayer before the close of the taxable year. For this purpose the soil or water conservation or drainage district's depreciation deduction for any such property for any taxable year is an amount (computed by the district) equal to the amount of the deduction which would be allowable to the district under section 167 for such property for such taxable year. Appropriate adjustments to basis are required for amounts allowed as deductions under this provision which result in a reduction of the taxpayer's taxes, but not less than the amounts allowable for the taxable year and prior taxable years.

Your committee's amendment shall apply with respect to taxable years beginning after December 31, 1957.

Section 17—Improvements on leased property

Under present law, where a lessee makes improvements on leased property, he generally is permitted depreciation or amortization with respect to this improvement based upon the life of the improvement or the length of the lease period, whichever is shorter.

Where the lease period is shorter than the useful life of the improvement, the present rule permits the lessee to recover his cost over a shorter period of time than would be true if he owned the property. This rule generally reaches the correct result, however, since the lessee usually has possession of the improvement only over the period of the lease and, therefore, should not be required to spread his cost over any longer period of time.

Similarly, there is a problem as to the period over which the cost of acquiring a lease should be written off. Examples of such costs are cases where a lessee subleases a property to a sublessee and requires an additional payment, over and above the specified rent, from the sublessee either for an improvement the lessee may have made with respect of the property or because the property had become more attractive for some particular use than was recognized at the time of the initial lease.

(*a*) *Options to renew*—.Problems are presented under the rules outlined above where there is an option on the part of the lessee to renew the lease. Court decisions in general have held that renewals of leases are not to be taken into account in determining the period over which a lessee's improvement is to be written off, unless the facts show with reasonable certainty that the lease will be renewed. The Treasury regulations in general reflect this rule for renewal of leases both in the case of improvements made by lessees and also in the case of specific costs incurred in acquiring a lease.

As indicated by the report of the Committee on Ways and Means, the House believes that the establishment of "reasonable certainty" that a lease will be renewed before the renewal period can be taken into account in determining the writeoff period for a lessee's improvement or a cost of acquiring a lease, makes it unlikely that these renewal periods will be taken into account in very many of these arrangements. As a result, the House bill provides in these cases that the term of the lease in determining the writeoff period for these improvement or acquisition costs is to include any renewal periods unless the lessee establishes that it is more probable that the lease will not be renewed than that it will. (See proposed code sec. 178 (a).)

Your committee in general agrees with the House that where there is an option to renew a lease these renewal periods should be taken into account where it is more likely that the lease will be renewed than that it will not. However, testimony presented before your committee has illustrated the difficulty in determining whether or not a lease will be renewed. Therefore, your committee amends this provision to provide more objective rules for the application of this new provision. Your committee's amendments provide that in the case of improvements made by a lessee the new provision is not to apply if the unexpired lease period (determined without regard to any unexercised option to renew) accounts for 60 percent or more of the useful life of the improvement. In the case of costs of acquiring a lease, your committee's amendments provide that the new provision is not to apply if 75 percent or more of this cost is attributable to the unexpired lease period. However, if because of these 60 percent or 75 percent rules the new provision is not applicable, but nevertheless the lease has been renewed or there is a "reasonable certainty" that the option to renew the lease will be exercised then the bill as amended by your committee provides that the renewal period still will be taken into account.

(*b*) *Closely related lessees and lessors.*—Another problem dealt with in the House bill is concerned with cases where the lessee and the lessor are closely related and improvements are made by the lessee where the life of the improvement is longer than the period of the lease. Where the lessee and lessor are strangers, writing the improvement off over the leased period, which is shorter than the improvement's life, presents no particular problem since the lessee in such cases is unlikely to be making gifts to the lessor. Thus, any improvement with a life longer than the lease period might well be reflected in lower lease payments. However, where the lessee and lessor are closely related and thus may be willing to permit value to be transferred from one to the other, permitting the cost of the improvement to be written off over the lease period alone may in effect be merely a way of obtaining rapid depreciation.

To deal with this problem the House bill provides that if the lessee and lessor are related persons, the cost of any improvement made by the lessee on the leased property may be recovered only over the useful life of the improvement. For this purpose, the House bill provided that the rules specified in section 267 (b) and (c) would be followed with two exceptions: the family of an individual is to include only his spouse, ancestors, and lineal descendants and that control for purposes of this section is to mean ownership of 80 percent or more rather than 50 percent or more.

Your committee has accepted the House provision concerning leases between closely related persons (proposed code sec. 178 (b)) except that it has expanded the definition of related persons to include a relationship which it is believed was unintentionally omitted from the House provision. Under your committee's bill related persons will also include lessors and lessees who are corporations and are members of an affiliated group which is eligible for filing a consolidated return (as defined in sec. 1504). Generally, this includes corporations where there is a common ownership of 80 percent or more.

(*c*) *Effective date.*—The House bill makes this provision effective with respect to improvements begun after December 31, 1956, except for improvements made on and after that date where the lessee is under a binding obligation to make the improvements before that date. Since this effective date refers only to "improvements" and not to "any cost of acquiring the lease," the House bill may make the change with respect to costs of acquiring a lease effective as of the effective date of the income taxes under the 1954 Code rather than with respect to costs incurred after December 31, 1956. Your committee believes that this was unintentional and, therefore, it is amending the effective date provision to make it clear that it applies to costs of acquiring a lease incurred after the specified date as well as in the case of improvements begun after that date. Your committee also is advancing the effective date to July 28, 1958, so that it will apply to costs incurred in acquiring a lease and with respect to improvements begun after July 28, 1958 (other than improvements which on that date and at all times thereafter the lessee was under a binding obligation to make).

(*d*) *Revenue effect.*—This provision is expected to result in an increase in revenue over the long run but is of such a nature that estimates of the current revenue gain cannot be made.

Section 18—Medical, dental, etc., expenses in case of decedents

Present law (sec. 213 (d)) of the code permits the deduction in the last year of a decedent of expenses for his medical care which are paid out of his estate during the 1-year period after his death. These expenses are treated as if they had been paid by the taxpayer at the time they were incurred. This deduction is not available unless a statement is filed that the amount has not been claimed or allowed as a deduction for estate-tax purposes and a waiver of the right to this amount as an estate-tax deduction has been filed. It is possible to take certain other deductions, also allowable under section 2053 or 2054, as deductions in computing the taxable income of the estate, but here they may not be allowed unless a statement has been filed that they have not been allowed as deductions for estate-tax purposes and a waiver of the right to claim these amounts as estate-tax deductions has been filed. In this case, however, the statement referred to need only indicate that the amounts have not been allowed as deductions for estate-tax purposes, while in the case of the statement required where the amounts are taken as deductions in the last year of the decedent, the statement must indicate that they have not been claimed or allowed as deductions for estate-tax purposes.

This provision, conforms the language in section 213 (d) (2) (A) of the code relating to the deduction of the expenses in the last year of the decedent with the language in section 642 (g) which allows other

expenses as deductions to the estate. The conforming amendment is merely to remove the requirement that the statement filed must indicate that the amount has not been "claimed" as an estate-tax deduction. The statement will still have to show, however, that the amount has not been allowed, and is waived, as a deduction for estate-tax purposes.

This change is effective with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

Section 19—Increase in limitation on medical deduction for a taxpayer or his spouse who has attained age 65 and is disabled

Under present law the maximum deduction allowed for expenses paid for medical care is $5,000 in the case of a taxpayer who is single or a taxpayer who is married but files a separate return. The maximum deduction allowed is $10,000 in the case of a taxpayer filing a joint return with his spouse, a taxpayer who is a head of a household or a taxpayer who is a surviving spouse. In no case, however, is the maximum more than $2,500 per tax exemption.

Your committee believes that these maximum amounts should be increased where a taxpayer or his spouse is disabled and has reached age 65 before the close of the taxable year. Accordingly your committee has amended the code (sec. 213) to increase the maximum deduction to $15,000 in the case of a taxpayer who is single and who has reached age 65 and is disabled, or a taxpayer who is married but files a separate return but who has reached age 65 and is disabled. In the case of a taxpayer filing a joint return with his spouse the maximum deduction is increased to $15,000 unless both the taxpayer and his spouse have reached age 65 and both are disabled. In this latter case the maximum allowance is increased to $30,000. However, in a situation in which this $30,000 maximum is applicable, no more than $15,000 of the expenses of the taxpayer may be taken into account and no more than $15,000 of the expenses of the taxpayer's spouse may be taken into account.

In the case of a head of a household who has reached age 65 and is disabled, and in the case of a surviving spouse who has reached age 65 and is disabled the maximum deduction is increased to $15,000.

Under your committee's amendment an individual is considered disabled if unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.

This change is made effective for taxable years beginning after December 31, 1957.

Section 20.—Deductions by corporations for dividends received

It is understood that at the present time some corporations are buying stock just before a dividend is payable with the intention of receiving dividend income and then immediately after the dividend is received, selling the stock. In such cases, the selling price of the stock, other things being equal, is less than the purchase price by approximately the amount of the dividend. Thus, the corporation receives: (1) dividend income against which it can take a deduction for 85 percent of the amount received, and (2) a loss, of approximately the same size, which can be deducted in full against ordinary income

in the case of dealers in securities or in other cases can be offset against capital gains. Since only 15 percent of the dividend received is taxed, the applicable rate on the income is reduced from a rate approaching 52 percent to one approaching 7.8 percent. On the other hand, the loss upon the sale of the stock, in the case of a dealer would be fully deductible against other income taxed at a rate as high as 52 percent or in the case of other corporations would be a short-term capital loss which is deductible against capital gains taxed at either 25 percent or at a rate as high as 52 percent.

A similar problem is presented where a corporation maintains both a "long" and a "short" position over the dividend payment date. In this case the corporation receives: (1) Dividend income against which it can take a deduction of 85 percent for the dividend received; and (2) an ordinary business expense deduction, which is fully deductible, for the amount of the dividend which the corporation has to pay the person from whom it borrowed the stock.

Your committee agrees with the House that the intercorporate dividend received deduction should be denied in the types of situations described above. To discourage this tax avoidance the House bill added a new provision (sec. 246 (c)) to the Code which denies any dividends received deduction for dividend income where the corporation has held the stock for 10 days or less. Your committee has accepted this provision except that to give greater assurance of blocking any tax avoidance it would apply this new rule if the stock was held for no more than 15 days before the sale of the stock.

Both the House and your committee's bill also deny the 85 percent dividends received deduction where the corporation is, on the dividend date, in both a "long" and "short" position with respect to substantially identical stock or securities (or otherwise under obligation to make corresponding payments with respect to these securities). A special rule is provided in the case of cumulative preferred dividends attributable to a period of more than 1 year. In such cases, the dividends received deductions are denied if the corporation has held the stock for 90 days or less instead of for 15 days or less (10 days or less under the House bill).

The House bill provides that this provision is to apply to taxable years ending after November 7, 1956, in the case of shares of stock acquired after that time. Your committee's action will make this provision applicable with respect to taxable years ending after December 31, 1957, in the case of stock acquired or short sales made after that date.

This provision is expected to result in an increase in revenue over the long run but is of such a nature that estimates of the current revenue gain cannot be made.

Section 21—Gain or loss on sales or exchanges in connection with certain liquidations

Section 21, as added by your committee, would amend section 337 of the Internal Revenue Code of 1954 (relating to gain or loss on sales or exchanges in connection with certain liquidations). The new provision would be applicable to certain sales of property by a corporation which is owned at least 80 percent by another corporation and which has, in addition, minority shareholders.

Section 337 was added by the 1954 Code in order to eliminate the uncertainties which arose under the 1939 Code where property was sold in connection with the complete liquidation of a corporation. Under the 1939 Code, if the corporation was considered to have sold the property and the proceeds were considered to have been distributed to the shareholders, there would be 2 taxes imposed with respect to the sale—1 at the corporate level and 1 at the shareholder level. On the other hand, if the corporation was considered to have distributed the property in liquidation and the property was considered to have then been sold by the shareholders, only a single tax—imposed at the shareholder level—would be due. Section 337 eliminated this trap for the unwary and made unimportant the formalities of the transaction. Section 337 provides that if a corporation adopts a plan of complete liquidation, no gain or loss shall be recognized to the corporation from sales of property by the corporation after the adoption of the plan provided the corporation is completely liquidated within 12 months.

Section 337 of the 1954 Code, however, was not made applicable to sales or exchanges of property by a corporation where the corporation is owned 80 percent by another corporation and where the liquidation is tax free to the majority shareholder with a carryover to the parent corporation of the subsidiary's basis for its assets (sec. 337 (c) (2) (A)). Section 337 was apparently made inapplicable to this situation because there is no tax imposed upon the majority shareholder on the liquidation so that, as to the majority shareholder, there is no possibility of the imposition of two taxes with respect to a sale of property by the liquidating corporation. However, if there are any minority shareholders in the case of the liquidation of such a subsidiary, those shareholders will be required to pay a tax if the amount received by them on liquidation exceeds their stock basis. Accordingly, if the subsidiary corporation sells its property before the liquidation, a corporate tax will be payable by the subsidiary, and, in addition, the minority shareholders will be taxed when their share of the proceeds of the sale are distributed to them in complete liquidation. Your committee believes that it is neither necessary nor desirable to deprive minority shareholders in this situation of the benefits of section 337.

The amendment made by section 21 would add a new rule to section 337 applicable only to minority shareholders. The general effect of this rule is to reduce the tax payable by the minority shareholders on the liquidation. This is accomplished by first increasing the amount they are considered to have received on the liquidation (this increase is an amount equal to their proportionate share of the amount by which the tax imposed upon the subsidiary would have been reduced if section 337 had applied to sales of property by it) and then by deeming the shareholders to have paid an amount of tax equal to the amount of the increase. The new rule does not affect the tax treatment of the subsidiary corporation, nor does it affect the tax treatment of the majority corporate shareholder. The new rule is for the sole purpose of insuring that the minority shareholders will be placed in the same position, after taxes, as if there had been no majority corporate shareholder and the subsidy corporation had been able to utilize section 337.

The new rule is applicable to corporations which have adopted a plan of complete liquidation on or after January 1, 1958, and with respect to

which section 337 does not apply solely by reason of the application of section 337 (c) (2) (A). Accordingly, this new rule is applicable only where the corporation is owned 80 percent or more by another corporation and there is a complete liquidation which is tax free to the majority corporate shareholder (under sec. 332), with the corporate shareholder taking as its basis for the property received by it the basis of such property in the hands of the liquidating corporation.

The application of the new rule may be illustrated by the following example: Assume that corporation S, having only common stock outstanding, is owned 90 percent by corporation P (which has owned the S stock for 3 years) and 10 percent by individual A (a calendar year taxpayer), and that the sole assets of corporation S are 2 buildings, each having a fair market value of $100,000 and a basis to the corporation of $50,000. Assume further that A's basis for his stock is $10,000. On August 1, 1958, corporation S adopts a plan of complete liquidation. On September 1, 1958, corporation S sells 1 of the buildings for $100,000 and distributes in complete liquidation during the following month the other building and the proceeds of the sale (less $12,500 retained to pay the tax imposed on such sale). Under the new rule, the amount realized by A on the distribution is increased by $1,250 (A's proportionate share of the amount by which the tax imposed upon corporation S on such sale or exchange would have been reduced—assuming a 25 percent rate of tax—if sec. 337 had been applicable). Thus, the tax imposed upon A with respect to the complete liquidation is computed as follows: the amount realized by A is $18,750 ($10,000 for A's one-tenth interest in the building not sold, plus $8,750 representing A's proportionate share of the $100,000 received by corporation S on the sale of the building less the tax imposed upon corporation S on such sale) plus $1,250 (the increase in the amount realized provided by the new rule), or $20,000. Since A's basis for his stock is $10,000, the capital gains tax imposed on A with respect to the complete liquidation (assuming a 25-percent tax rate) is $2,500. Under the new rule, A shall be deemed to have paid $1,250 in tax. Accordingly, after credit, A will be left with $17,500 in property and money. This is the same amount A would have had if the corporation had not sold any property, but rather had distributed all its property in complete liquidation and A had sold his interest in the property received by him, and also is the same amount A would have been left with, after taxes, if section 337 had applied to such sale.

Section 22—Collapsible corporations

Section 341 of the 1954 Code relates to collapsible corporations. The purpose of this provision, enacted originally in 1950, is to prevent income which would otherwise be taxed at ordinary income-tax rates from being converted into income taxable at capital-gain rates merely by use of the corporate entity. For example, the collapsible-corporation provisions are intended to prevent a taxpayer from transferring inventory items owned by him to a corporation and then selling the stock of the corporation at capital-gain rates to avoid the ordinary income tax which he would have been required to pay if he had sold the inventory directly.

The collapsible-corporation provisions of present law, however, both by their terms and as interpreted, are so broad that in a number of situations they may have exactly the opposite effect from that

intended—instead of preventing the conversion of ordinary income into capital gain, they may instead convert what would otherwise be capital gain into ordinary income. The applicability of the provisions of present law, moreover, depends upon the subjective intent of the parties, a matter which is obviously difficult to determine. Furthermore, if the collapsible-corporation provisions do apply, the entire gain of the shareholder is taxed at ordinary income rates, notwithstanding the fact that had the shareholder not employed the corporate entity a large part of his gain might have been taxed at capital-gain rates. For these reasons, the collapsible-corporation provisions present law frequently impede or prevent legitimate business transactions and in some cases even result in the imposition of ordinary income taxes which would not be imposed if the shareholders of such corporations had not employed the corporate method of doing business.

Under present law there are three limitations on the application of the collapsible corporation provisions. (In general, sec. 341 is not applicable in the case of shareholders owning 5 percent or less of the corporation's stock; where 70 percent or less of the shareholder's gain is attributable to the collapsible property; or where the shareholder's gain is realized more than 3 years after the completion of the manufacture, construction, production or purchase of the collapsible property.) However, these limitations, as interpreted, do not eliminate the problems described above. For example, in the case of corporations engaged in the development of natural resources, which have continued development activity, the shareholders of such corporations can never be certain that their stock interests in such corporations will not be regarded as stock interests in a collapsible corporation, notwithstanding the fact that their corporations have little or no inventories and that the properties of such corporations (if sold by the corporation or by the shareholders) would be regarded as properties the sale of which would result in capital gain. Similarly, real-estate corporations established by investors (as distinguished from dealers) holding rental property for investment only may be regarded as collapsible corporations under present law.

Section 22, as added by your committee, would amend section 341 by adding a new subsection providing 4 limited exceptions to the application of the collapsible corporation provisions. Your committee believes that this amendment is desirable in order to avoid determinations of subjective intent in the situations described in this amendment and also to avoid the possibility in this area of the conversion of capital gain income into ordinary income. Furthermore, it is believed that this amendment will have the effect of removing some of the impediments that presently exist in the case of legitimate business transactions without permitting the tax avoidance which the collapsible corporation provisions are intended to prevent.

The four exceptions to the existing rules applicable to collapsible corporations relate to: (1) sales or exchanges of stock (other than sales or exchanges of stock to the issuing corporation or to certain related persons); (2) certain distributions in complete liquidation taxed as capital gains under section 331; (3) certain complete liquidations for which nonrecognition treatment is provided under section 333; and (4) certain sales or exchanges of property by the corporation under section 337 (relating to nonrecognition of gain or loss on sales or exchanges in connection with certain liquidations). A transaction will

not come within any of these exceptions unless the net unrealized appreciation on the "ordinary income" assets of the corporation does not exceed 15 percent of the net worth of the corporation (in general, the excess of the fair market value of the corporation's assets over its liabilities). The "ordinary income" assets of a corporation, in general, are those assets of the corporation which, if sold at a gain, would result in the imposition of an ordinary income tax on the corporation. If any shareholder of the corporation owns more than 20 percent of the corporation's stock (5 percent in the case of liquidations under sec. 333), the "ordinary income" assets of the corporation include those additional assets of the corporation which, if sold at a gain by such shareholder, would result in the imposition of an ordinary income tax on such shareholder.

The definition of "ordinary income" assets is also applied on a shareholder-by-shareholder basis in two situations: (1) The first situation is where a shareholder owns more than 20 percent of the corporation's stock and also owns or owned more than 20 percent of another corporation's stock during the preceding 3-year period and more than 70 percent of such other corporation's assets are or were similar or related in service or use to more than 70 percent of the assets of the corporation. In this case, any sale or exchange of the stock of the other corporation during the preceding 3-year period will be deemed to have been a sale or exchange of the assets of such other corporation by the shareholder. Similarly, any sales or exchanges of assets by such other corporation which qualify under section 337 (a) will be considered sales or exchanges by the shareholder. These additional requirements will prevent an individual from avoiding dealer status, for example, merely by using a separate corporation for each venture. (2) The second situation where the definition of "ordinary income" assets is applied on a shareholder-by-shareholder basis is where the shareholder owns 20 percent or less of the corporation's stock, but more than 5 percent of the corporation's stock. In this situation, there is no reference to the shareholder's interests in other corporations (as under (1)), but there is taken into account, as to that shareholder, the net unrealized appreciation in assets of the corporation which would be "ordinary income" assets under the definition if the shareholder had owned more than 20 percent in value of the corporation's stock.

These tests are for the purpose of insuring that the amount of unrealized ordinary income in a corporation's assets is relatively small in comparison to the total assets of the corporation, taking into account the tax status of the shareholders of a corporation, so that they will not be able to change the character of their income merely by employing the corporate form of doing business. Thus, under these rules, opportunities will not be created for the conversion of ordinary income into capital gain. In the case of a complete liquidation of a corporation, your committee believes that additional requirements must be imposed in order to prevent the shareholders of a corporation from liquidating their corporation, paying a capital-gain tax on such liquidation, and thereby obtaining a stepped-up basis for depreciable, depletable, or amortizable assets, in order to reduce for the future the ordinary income produced by such assets. Accordingly, in addition to meeting the percentage tests described above, in order for distributions in complete liquidation under section 331 to qualify under this

exception, the following three conditions must be met: (1) within the 12-month period beginning on the date of the adoption of the plan of complete liquidation, substantially all of the properties held by the corporation must be sold; (2) following the adoption of such plan, no distribution of depreciable, depletable, or amortizable property can be made to the shareholders; and (3) section 337 must be applicable to sales or exchanges of property by the corporation within such period. Where all of these conditions are met, your committee believes that the transaction is substantially the same as a sale by the shareholders of their stock and so should qualify under the statutory exception.

The application of the provision added by your committee, in the case of sales or exchanges of stock, may be illustrated by the following examples: Assume that the sole asset of a corporation is appreciated land, and that the corporation is not a dealer in such property. If no shareholder of the corporation owning more than 20 percent of the corporation's stock is a dealer in such land (and if no more-than-20-percent shareholder owns, or has owned, within the preceding 3 years, more than 20 percent of the stock in a corporation more than 70 percent in value of whose assets are property similar or related in service or use to the assets of this corporation) then gain from sale of stock by any shareholder owning more than 20 percent of the corporation's stock will not come within the provisions of section 341 (a). If, on the other hand, a shareholder owning more than 20 percent in the value of the corporation's stock is a dealer in land, no sale of stock by any shareholder in the corporation will come within the statutory exception added by your committee. If no shareholder owning more than 20 percent of the corporation's stock is a dealer in land, but a 21-percent shareholder has owned and sold, within the past 3 years, similar stock interests in corporations having similar property, then such sales of stock shall be taken into account, as to that shareholder only, in ascertaining whether he is a dealer and therefore is prevented from coming under the exception. Similarly, if no shareholder owning more than 20 percent in value of the corporation's stock is a dealer in land, but a shareholder owning 6 percent of the corporation's stock is a dealer in such land, a sale of stock by the 6-percent shareholder will not qualify under the exception, notwithstanding the fact that sales of stock by other shareholders may qualify.

The amendments contained in section 22 to the collapsible corporation provisions are not for the purpose of causing any corporation to be regarded as a collapsible corporation. Your committee recognizes that there may be legitimate corporate enterprises that will be unable to meet the terms of the limited statutory exceptions contained in section 22. Your committee does not believe that any inference should be drawn from the failure of any corporation, or the failure of any corporation with respect to any of its shareholders, to meet the requirements for any or all of the new statutory exceptions to the application of the collapsible corporation provisions. Accordingly, it is expressly provided that in determining whether any corporation is a collapsible corporation within the meaning of section 341 (b) of the 1954 Code, the fact that such corporation, or such corporation with respect to any of its shareholders, does not meet the requirements of any of the new rules shall not be taken into account, and such determination shall be made as if such rules had not been enacted.

The new rules added by your committee are to apply to taxable years beginning after December 31, 1957, but only with respect to sales, exchanges, and distributions after the date of enactment of this bill.

Section 23—Certain acquisitions of stock

The 1954 Code rules relating to sales of stock to related corporations were effective as of June 22, 1954. Under existing court decisions where a sale of stock to a related corporation was made before June 22, 1954, on an installment basis and installment proceeds are received in a period coming under the 1954 Code, the tax treatment of these installment proceeds is governed by the rules provided by the 1954 Code, notwithstanding the fact that the sale was made prior to the change in the law, and that the parties to the sale relied upon the law in effect at the time they made the sale.

A somewhat similar problem exists in the case of sales of stock to related corporations where contracts to sell the stock were entered into before June 22, 1954, but the actual sales occurred after that date. The 1954 Code rules under present law clearly apply to such a sale, notwithstanding the fact that transactions of this type could not be altered on or after June 22, 1954.

The House concluded that in the case of transactions of the two types described above, where the terms of the contract were firmly established when only the 1939 Code tax rules could be relied upon, that it is only proper that the 1939 Code rules should continue to apply even though the transactions were not consummated until after June 22, 1954. Your committee agrees with that conclusion.

The House bill provides for the two problems described above by adding a sentence to section 391, the effective date provision in the case of distributions by corporations. This sentence makes it clear that the 1939 Code provisions are applicable in determining the extent to which property received on an acquisition of stock is to be treated as a dividend in the case of any acquisition of stock involving redemption through the use of related corporations (sec. 304) which occurred before June 22, 1954. The sentence added by the House bill also provides that the 1939 Code provisions are to apply to acquisitions of stock in this manner which occurred between June 22, 1954, and December 31, 1957, under a contract entered into before June 22, 1954. Your committee's action accepts the House provision with one modification. It makes the 1939 Code applicable to acquisitions of stock which occurred between June 22, 1954, and December 31, 1958 (rather than 1957), where they are pursuant to a contract entered into before June 22, 1954.

This provision is to be applicable as if included in the 1954 Code on the date of its enactment.

This provision is expected to result in a negligible revenue loss.

Section 24—Taxation of employee annuities

(*a*) *Income tax treatment of nonforfeitable annuity contracts purchased by tax-exempt educational, charitable, or religious organizations.*—Under present law (sec. 403) an annuity purchased by an employer for an employee, under a qualified nondiscriminatory type of plan, is taxable at the time the employee receives the annuity payment rather than in the year the payments are made for the annuity by the employer. However, where the employer is a tax-exempt educational, charitable,

or religious organization, described in section 501 (c) (3), this deferment of tax in the case of the employee is available with respect to annuities whether or not they are paid under a qualified nondiscriminatory type of plan.

It is understood that certain of these organizations are paying selected employees all, or almost all, of their compensation in the form of annuities. Usually these are part-time employees of the organization who derive their principal income from other employment, and desire to be compensated by the organization in the form of an annuity rather than money, as a means of deferring income taxes on funds they in any case intend to save.

Your committee agrees with the House that these organizations should not be permitted to trade on this tax-deferment privilege for their employees. Accordingly, your committee has accepted without change the new subsection the House bill adds to section 403. This new subsection provides that in the case of annuity contracts purchased for employees by educational, charitable, or religious organizations exempt under section 501 (c) (3), if the annuity contract does not come under a qualified nondiscriminatory plan and the employees rights to the contract are nonforfeitable, the amount contributed by the employer is to be excluded from the gross income of the employee in the taxable year of the contribution only to the extent the contribution does not exceed an "exclusion allowance" for the year. The "exclusion allowance" is 20 percent of the employees' compensation for the last 12-month period multiplied by the employees' years of service, reduced by the amounts contributed by the employer for annuity contracts which were excluded from the gross income of the employee in prior taxable years.

The regulations under present law (sec. 1.403 (a)–1 (3)) provide that an annuity contract purchased by an exempt organization qualifies provided the purchase of the annuity is "merely a supplement to past or current compensation." Among the factors mentioned as to whether an annuity contract is a "supplement to past or current compensation" is whether the annuity contract is purchased as a result of an agreement for a reduction of the employee's salary or whether it is purchased at his request instead of an increase in current compensation to which he otherwise might be entitled. In such cases the regulations state that the amount paid for the contract is to be considered current compensation. Your committee intends the objective 20 percent rule set forth above as a complete substitute for these rules in the regulations. An exception, however, would exist where with respect to an amount already earned an employee took a reduced amount and accepted an annuity instead. In such a case he would have already constructively received the compensation and then converted it into an annuity. Your committee believes that the deletion of these rules in the regulations is particularly important in view of the fact that they favor new employees at the expense of existing employees, who apparently cannot change their terms of employment to conform with those of the new employees.

(b) *Income tax treatment of forfeitable annuity contracts purchased by organizations exempt from tax under section 501 or 521.*—The House bill also is concerned with a problem closely related to that described above. This relates to the granting of a forfeitable type of annuity by a tax-exempt organization where the employee will at some later

time obtain a nonforfeitable or vested interest. For example, an annuity may be granted to an employee in 1 year, but the employee may be required to work for the organization for some specified number of years before his rights to the annuity become nonforfeitable. Under present law an employee is not taxed in the year the forfeitable annuity is purchased for him, nor is he taxed in the subsequent year when his right to the annuity becomes nonforfeitable with respect to amounts already set aside. This is true whether or not the employer is an exempt organization. However, under existing law a taxable organization is unlikely to enter into such an arrangement since it would receive no deduction for its payments for the annuity. In the case of a tax-exempt organization, however, this denial of a deduction is of no consequence since such an organization is free of tax.

The House report points out that tax-exempt organizations can achieve the same result through the use of these forfeitable annuities which vest after the income is earned as is presently possible for the educational, charitable, and religious organizations prior to the amendment described in (*a*) above. Moreover, this applies not only with respect to educational, charitable, and religious organizations exempt under section 501 (c) (3) but also with respect to all other organizations exempt under section 501 such as chambers of commerce, social clubs, labor unions, etc., and also farmers' cooperatives exempt under section 521.

To prevent any possible abuse in this area the House bill provides that the rule in new section 403 (c) (403 (b) of the present law) is not to apply to an annuity contract purchased by an employer exempt from tax under section 501 or 521. The amendment made by the House was intended to provide that if an employee of a tax-exempt organization received an annuity which was forfeitable at the time the contributions were made, the annuity was to become taxable in full at the time the employees' rights to it changed from forfeitable to nonforfeitable. Your committee agrees with the goal sought here by the House committee but makes a clarifying amendment. A new provision has been substituted (to be subsection (d) of section 403) providing that if the rights of an employee under an annuity contract purchased by a tax-exempt employer changed from forfeitable to nonforfeitable rights, the value of the contract on the date of the change is to be included in the gross income of the employee at that time. Your committee did make one modification, however, which does constitute a change in policy from the provision as provided by the House. It makes the new rule applicable only to the extent the value of an annuity which becomes nonforfeitable after December 31, 1957, is attributable to amounts contributed by the employer after that date. The House provision would have made the new rule applicable with respect to contracts which became nonforfeitable after a specific date, irrespective of when the contributions to such annuities were made by the employer.

It should be made clear that by making forfeitable annuities taxable in the case of exempt organizations at the time they become nonforfeitable, there is no intention of changing the time of imposing tax in the case of forfeitable annuities paid by other than these exempt organizations. Other forfeitable annuities will continue to be taxable at the time the payments are received by the annuitant. Nor is this intended to change the timing of the taxation of nonforfeitable annuities in any way.

Paragraph (6) of the new section 403 (b) in both the House bill and under your committee's action provides an exception to the forfeitable rule outlined above, in the case of tax-exempt educational, charitable, and religious organizations. It provides that at the time of the vesting of a forfeitable employee annuity paid by one of these organizations, the value of the annuity is to be treated as a payment subject to the 20-percent exclusion described above. Then, if the contributions do not exceed 20 percent of the total compensation with respect to both current and past service (or to the extent it does not exceed such amount), the value of the annuity will not be taxable to the employee.

(c) *Death benefit and estate and gift tax exclusions.*—Your committee has added three new closely related amendments to this provision of the House bill. At the present time an employee of an industrial concern covered by a qualified pension plan not only is able to defer the taxation of contributions made to such a plan by the employer until the amounts are received but also receives certain other tax benefits as well. Among these is an exclusion for up to $5,000 paid with respect to an employee's death within 1 taxable year, and an exclusion from the estate tax base of a decedent employee with respect to his employer's contributions. Also, an exclusion from the gift tax base with respect to an employer's contribution (as added by section 72 of this bill) is provided in the case of the exercise (or nonexercise) by an employee of an election as to survivor benefits.

The House, by providing the 20-percent rule described above, has in effect established a substitute for educational, charitable, and religious organizations for the "qualification" required of industrial plans. As indicated previously, your committee is in accord with the action taken to establish this 20-percent rule but in so doing believes that the other major benefits accorded in the case of industrial plans should also be made available to the educational, charitable, and religious organizations whose pension payments qualify under the 20-percent rule (or to the extent they qualify under the 20-percent rule). Therefore, it is extending to these organizations the three tax benefit provisions referred to above. However, in the case of the educational and charitable organizations, your committee is extending these additional tax benefits only to a limited group.

The educational organizations covered are those which maintain a faculty and curriculum and have a regularly enrolled body of pupils in attendance where its educational activities are carried on. The charitable organizations covered are those which receive a substantial part of their support from a governmental unit or from the general public.

The income-tax exclusion for nonforfeitable death benefits up to $5,000 for employees of the specified educational, charitable, and religious organizations is provided by an amendment to section 101 (b) (2) (B). This amendment in the new clause (iii) provides that the exclusion of up to $5,000 is to be available with respect to the portion of the distributions represented by the employer's contributions which come within the 20-percent rule.

The estate tax exclusion for annuity contracts purchased for employees by one of the specified tax-exempt organizations is provided by the addition of a new paragraph (3) to section 2039 (c). Also, in

the same subsection it is provided that contributions by one of these tax-exempt organizations for an employee's annuity is not to be considered as contributed by the employee (and, therefore, is to be free of estate tax) to the extent it qualifies under the 20 percent rule.

The gift tax exclusion for the exercise (or nonexercise) of an election to provide survivor benefits under annuity contracts purchased for an employee by one of the specified tax-exempt organizations is provided by an amendment to the proposed new section 2517, added by section 72 of this bill. The amendment provides that the gift tax exclusion is to be available to the extent of the tax-exempt organization's contribution which did not exceed the limitation imposed under the 20 percent rule.

(*d*) *Effective dates.*—The House bill would make the new 20 percent rule with respect to annuities purchased by educational, charitable, and religious organizations effective with respect to taxable years beginning after December 31, 1956. The House bill also applies the same effective date with respect to the change made in the tax treatment of forfeitable annuities purchased by tax-exempt organizations generally. Your committee has advanced the effective date in both of these cases to taxable years beginning after December 31, 1957. Also, as indicated previously, in the case of the revised tax treatment to be applied in the case of forfeitable annuities which become nonforfeitable, your committee makes the new rule applicable only to the extent attributable to the amount contributed by the employer after December 31, 1957. In the case of the new provisions added by your committee, the amendment relating to death benefits up to $5,000 in the case of certain educational, charitable, and religious organizations is to apply with respect to taxable years beginning after December 31, 1957; the amendment extending the estate tax exclusion in the case of annuities received by the estates of the deceased employees of these organizations is made effective with respect to estates of decedents dying after December 31, 1957; and the extension of the gift tax exclusion in the case of the exercise (or nonexercise) of survivor benefits in the case of employees of the same organizations is to apply with respect to calendar years after 1957. In the case of both the estate and gift tax effective dates, these are the customary type of effective dates for prospective amendments in the case of these taxes.

(*e*) *Revenue effect.*—The provisions adding the 20 percent limitation in the case of annuities paid to employees of educational, charitable, and religious organizations and the new treatment proposed with respect to forfeitable annuities which become nonforfeitable and which are paid by tax-exempt organizations, are expected to result in an increase in revenue over the long run but are of such a nature that estimates of current revenue gain cannot be made. On the other hand, the extension of the death benefit exclusion of up to $5,000, the estate tax exclusion, and the gift tax exclusion, in the case of the determination of survivor rights, which under your committee's amendments are to be applicable to certain types of educational, charitable, and religious organizations and their employees, are expected, in the long run, to result in a decrease in revenue but in this case also the nature of the data available makes it impossible to make estimates of current revenue loss.

Section 25—Contributions of employer to employees' trust or annuity plan

This section, which has not been changed by your committee, corrects an error in punctuation. It amends the section of the code relating to the deduction of employer contributions to certain employee trust and annuity plans, etc. (sec. 404 (a)), by inserting a semicolon and a comma.

Section 26—Employee stock options granted by parent or subsidiary corporation

Section 421 (d) of present law, for purposes of the restricted stock option provision, defines parent and subsidiary corporations in terms of specified relationships to the "employer" corporation. However, section 421 (a), in the so-called employment rule, provides that an individual is not entitled to "restricted stock option" treatment unless at the time he exercises the option he is (or was in the last 3 months) an employee of the corporation which granted the option, or a parent or subsidiary of such corporation, or (2) a corporation or a parent or subsidiary of a corporation issuing or assuming a stock option as result of a corporate reorganization, liquidation, etc. Since the corporation "granting" the option, or "issuing or assuming" it may be the parent or subsidiary corporation, rather than the employer corporation, the definitions of parent and subsidiary in section 421 (d) which are in terms of the latter technically do not cover this rule.

The House bill, which your committee has accepted without change, extends the definition of parent and subsidiary corporations, for purposes of the employment rule (in sec. 421 (a)), to cover cases where an individual is, or has been, an employee of a parent or subsidiary corporation of the corporation which granted the option (or which issued or assumed the option). This was done by providing that the term "employer corporation" as used in the definition of parent and subsidiary corporations is to be treated as if it were the "grantor corporation" (or the "corporation issuing or assuming a stock option under section 421 (g)").

This provision is effective with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the 1954 Code.

Section 27. Variable price restricted stock options

Under present law (sec. 421) the price of a restricted stock option to an employee, in order for him to qualify for deferred tax, cannot be less than 85 percent of the value of the stock when the option is granted except in the case of variable price options. A variable price option is an option in which one variable is permitted in determining the option price; as, for example, an option to purchase stock at a fixed percentage of the value of the stock when the option is exercised (or at a fixed date before or after the date of exercise). Whether such an option qualifies under the code is determined by assuming it is exercised on the date it is granted. The option price as so determined must be at least 85 percent of the value of the stock on the date the option is granted. By using one of these variable price options, it is possible, depending upon the condition of the market, for the employee to meet this 85 percent test when the option is granted and at the same time buy stock for substantially less than

85 percent of its value either at the time the option is granted or at the time the option is exercised.

For example, assume that the stock of the X corporation has fallen from $150 to $100 per share from January 1 to March 1. X corporation then gives an employee a variable price restricted stock option, as it may do under present law, to buy its stock at 56.7 percent of the value of the stock 2 months before the option is exercised. Since 56.7 percent of the January 1 value of the stock of $150 is $85.05, or in excess of 85 percent of the $100 value of the stock on March 1 when the option was granted, the option would meet the requirements for a variable price restricted stock option under present law. If the price of the stock remains at $100 for 2 more months or until May 1, under the terms of the option the employee can buy the stock for $56.70 per share or 56.7 percent of the value of the stock when the option was granted and 56.7 percent of the value of the stock when the option is exercised.

Your committee agrees with the House that cases like that described above represent an abuse of the restricted stock option provision. For that reason, the definition of a variable price option is modified by both the House bill and your committee's action to provide that this term is not to include any option where the option price is determined by the value of the stock at any time before the option is exercised, if this value may be greater than the average value of the stock during the calendar month in which the option is exercised.

The House bill would make this amendment effective with respect to options granted and taxable years ending after November 7, 1956. Your committee has advanced this date to September 30, 1958, so that companies which may have authorized variable price options dependent on price in a prior period will have an opportunity to revise their stock option plans.

This provision is expected to result in an increase in revenue over the long run but is of such a nature that estimates of current revenue gain cannot be made.

Section 28—Transfers of installment obligations to controlled life insurance companies

Under present law a taxpayer may elect to defer income from installment obligations until these obligations are collected. If the obligations are transferred to another person before the collection is completed, however, the transferor generally is taxed at the time of the transfer on any remaining income.

In some cases, however, installment obligations may be transferred without tax then being imposed. These cases include transfers of installment obligations to a controlled corporation in exchange for stock or securities, contributions of installment obligations to a partnership, distributions of installment obligations in certain types of corporate liquidations, distributions of installment obligations by a partnership to a partner, and certain exchanges of property for stock or securities involving corporate reorganizations.

Usually, unless income from installment obligations is realized at the time of the transfer, the transferee reports the profit as the remaining installments are collected. However, where the transferee is a life insurance company, the profit element in the uncollected installment obligation is not taxed because it is a type of income excluded from life insurance company gross income.

To prevent this tax avoidance, the House bill provides that income which is uncollected at the time of the transfer of an installment obligation to a life-insurance company is to be taxed to the transferor at the time of the transfer in all cases. Your committee has accepted this provision without change. The bill accomplishes this by amending section 453 (d), relating to gain or loss on disposition of installment obligations, to provide that, where an installment obligation is transferred directly or indirectly to a life-insurance company, gain is to be recognized for tax purposes despite other provisions of the code providing for nonrecognition. This rule also applies to transfers to partnerships of which a life-insurance company is a member.

In addition, if a life-insurance company was in the prior year other than a life-insurance company, both the House bill and your committee's action provide that this company is to be taxed with respect to installment obligations on hand at the end of that year. Similarly, a partnership of which a life-insurance company becomes a member will be taxed with respect to installment obligations it holds at the time the insurance company becomes a partner. These latter provisions are designed to prevent indirect transfers of these installment obligations to life-insurance companies.

Under the House bill, this amendment would apply to taxable years ending after November 7, 1956, but only in the case of dispositions of installment obligations after that date. Your committee's action makes this provision effective with respect to taxable years ending after December 31, 1957, but only in the case of dispositions after that date.

Section 29—Prepaid income from newspaper and periodical subscriptions

Publishers of newspapers, magazines and other periodicals customarily make significant portions of their sales on a subscription basis; that is, the purchaser pays for a series of periodicals in advance and the publisher undertakes the responsibility of supplying the periodical at the stated periods of time. In the case of the publishers representing the major portion of the subscription income, this income is reported for tax purposes in the year in which the publisher is required to issue the periodical to which the income relates. In 1940 the Treasury Department officially sanctioned (in I. T. 3369, C. B. 1940-1, 46) this method of reporting subscription income in the case of the publishers of periodicals on an accrual basis who had over a period of years consistently followed the practice of reporting periodical subscriptions as income for the year of the subscription period rather than as income for the year of receipt. The Treasury Department has indicated that it permitted publishers who had consistently reported on this basis to continue to do so because to do otherwise would have resulted in a distortion of income, or would have resulted in double reporting in the same year, in one case 1 year's subscription income based upon receipts and in the other case 1 year's subscription income based upon the liability to provide the periodical. However, the Treasury apparently concluded that without express statutory sanction, it could not permit new publishers to spread subscription income over the period of the subscription, nor could it permit existing publishers to change over to this method of reporting subscription income.

In this connection it should be noted that the Court of Appeals of the Tenth Circuit in its decision in the Beacon Publishing Co. case (January 3, 1955) did not agree with the position of the Treasury Department. In that decision the court held that the deferment of prepaid subscription income was a proper method of accounting for a taxpayer on the accrual basis. In that case the taxpayer, prior to 1943, had reported prepaid newspaper subscriptions as income for the year in which received. In 1944 the newspaper changed its method of reporting this income and instead reported its subscription income in the year to which the subscription related. The court held that the taxpayer's action was proper under the accrual method of accounting.

Moreover, your committee in 1955 in a report relating to this general subject matter stated:

> It has come to your committee's attention that the vast majority of publishing concerns having prepaid income are already deferring their income with Treasury approval. It is recommended to the Treasury Department that it modify its published ruling to the end that the remaining publishers may be entitled to defer prepaid subscription income so that they may be placed upon a fair and equitable basis.

As indicated in its statement in 1955, your committee believes that it is unfair and discriminatory to permit the majority of publishers to defer the reporting of subscription income until the year of the subscription yet deny this treatment to publishers accounting for a minority of the publishing business. This appears particularly unfortunate in that the more favorable treatment presently is denied new publishers, adding to their already difficult problem of competing with well-established companies. In view of this, your committee has added a section to the House bill permitting prepaid subscription income to be accounted for in the year of the issue of the periodical to which it relates rather than in the year of the receipt of the income.

The section added to the code by your committee's action (sec. 455) provides that prepaid subscription income is to be included in the income of the publisher in the year in which he is required to furnish or deliver the newspaper, magazine, or other periodical. Prepaid subscription income for this purpose means any amount (includible in gross income) which is received in connection with, and is directly attributable to, a liability to supply a periodical extending beyond the year in which the amount is received and which is income from the subscription to a newspaper, magazine, or other periodical.

This deferral of the income to the year of the subscription is to be available only if the publisher so elects. This election may be made separately with respect to each trade or business but it cannot be made for one where the cash receipts and disbursement method of accounting is used. The election applies to all prepaid subscription income arising in a trade or business except that the publisher need not defer income beyond the current year where the liability to supply a subscription does not extend beyond 12 months. A taxpayer can make this election at any time if he obtains the consent of the Treasury Department. However, without the consent of the Treasury he may make this election only in his first year beginning after December 31, 1957,

in which he receives prepaid subscription income in the trade or business involved. This election once made is effective not only for the current taxable year but also for all subsequent taxable years unless the consent of the Treasury Department is obtained to a revocation of this election.

The provision added by your committee provides that where for any reason the taxpayer's liability to supply the periodicals ends or where the taxpayer dies or, in the case of taxpayers other than individuals, where the taxpayer ceases to exist, any prepaid subscription income not previously reported at the time the liability ends or the taxpayer dies or ceases to exist, is to be reported in that last year.

The provision added by your committee also contains a subsection specifically providing that publishers who have in prior years reported prepaid subscription income under an established and consistent method or practice of accounting for this income may continue to report the income in the same manner in the future. It also should be made clear that this new section in no way effects the right of taxpayers to deduct circulation expenditures in the year in which these expenditures are paid or accrued, as provided in section 173 of the code. The expenses that account for most of the subscription income are generally incurred at approximately the time the subscriptions are fulfilled. These costs include printing, paper, maintenance of a subscription list, mailing, and postage. Circulation expenditures, on the other hand, generally are keyed into advertising income received at approximately the same time these expenditures are made. As a result, your committee believes it is proper to defer prepaid subscription income, since the expenses related to this income are largely incurred when the periodical is published, while deducting circulation expenditures currently, since these expenditures are related to the advertising rates which currently are being charged.

This provision is made effective with respect to taxable years beginning after December 31, 1957.

It is anticipated that this provision will result in a loss of revenue but it is believed that this amount will be relatively small due to the fact that this is a nonrecurring loss and also due to the fact that most prepaid subscription income already is deferred until the year of the subscription.

Section 30.—Adjustments required by changes in method of accounting

Generally, under the 1939 Code taxpayers who requested permission to change their method of accounting were required to make certain adjustments, in the year of change, to prevent income or expenses from being included or deducted more than once, or to prevent their omission entirely. However, where the Internal Revenue Service had required taxpayers to change their method of accounting, the courts usually did not require these adjustments to be made. Where such changes were voluntary and the adjustments were made, the "bunching" of income which occurred in the taxable year of change frequently resulted in an especially heavy tax burden.

Section 481 of the 1954 Code for the first time provided statutory rules with respect to these adjustments. This section requires these adjustments to be made in full to the extent that they are attributable to 1954 or a subsequent year. However, no adjustments are required which are attributable to years before the application of the 1954 Code.

Section 446 of the 1954 Code provides that taxable income is to be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. An exception to this rule provides that if the method used does not clearly reflect income, the computation of taxable income is to be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income. Subsection (e) of the same section provides that except as otherwise expressly provided in chapter 1 a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

The House report suggests that there is no reason why the pre-1954 Code year adjustments should not be made, when taxpayers, of their own volition, have changed their method of accounting. It points out that this was, in fact, generally the practice under the 1939 Code. However, the need to prevent the "bunching" of taxable income in these cases was recognized. In this connection, the House report also pointed out that under the 1939 Code the administrative practice was to permit the spreading of some adjustments over a long period of time.

Your committee agrees with the House that pre-1954 Code year adjustments should be made where taxpayers of their own accord changed their method of accounting. For that reason, it has accepted the basic features of the House provision. Because of problems presented in the case of taxpayers who have already changed their method of accounting, however, your committee has made several amendments designed to ease the transition from the 1954 Code provision to the new provision set forth in the House bill. In addition, it has made two relatively minor amendments of a more permanent nature to the House provision.

(*a*) *Permanent features.*—Neither the House bill nor your committee's amendments affect present law with respect to pre-1954 adjustments where the change in method of accounting is not initiated by the taxpayer. Where the change is initiated by the taxpayer, the adjustments, to the extent attributable to years before 1954, must be made in computing taxable income. Where the adjustment results in an increase in income of the taxpayer of more than $3,000, both versions of the bill provide that the adjustment is to be spread over a period of up to 10 years. However, where the adjustment arising from the change initiated by the taxpayer results in either a smaller increase in income or a decrease in income, the entire adjustment is to be taken into account in the year of the change in method of computing the income. Your committee does not expect that a taxpayer will be denied the right to make any such change merely on the grounds that the change will result in a negative adjustment.

Changes in methods of accounting initiated by the taxpayer include a change in method of accounting which he originates, by requesting permission of the Commissioner to change, and, also, cases where a taxpayer shifts from one method of accounting to another without the Commissioner's permission. A change in the taxpayer's method of accounting required by a revenue agent upon examination of the taxpayer's return would not, however, be considered as initiated by the taxpayer.

The amount which is to be eligible for the new spread provision under both the House bill and your committee's version is the extent of any net amount of adjustment which would have been required had the taxpayer changed his method of accounting in his first 1954 Code year, but only if it is of sufficient size so that it would increase taxable income by more than $3,000. The words "net amount of the adjustments" refer to a consolidation of adjustments (both plus and minus) arising with respect to balances in various accounts (such as inventory, accounts receivable, and accounts payable) at the beginning of the taxable year in question, whether or not the same accounts require adjustment, or whether the same items or class of items with respect to which adjustments would have to be made in 1954 continue to exist, at the time the actual change in method of accounting occurs; only the net dollar balance is to be examined for this purpose.

The House bill provided that the net amount of any adjustment resulting in an increase in income of more than $3,000 and attributable to pre-1954 Code years was to be taken into account ratably in the year of change and the 9 succeeding years only if the taxpayer was engaged in the same trade or business for 9 years prior to 1954. Under the House bill, where a taxpayer was engaged in the same trade or business for a shorter period of time prior to 1954, the spreading forward of the net adjustment was limited to the shorter period of time. Your committee has amended the bill, however, to provide that the 10-year spread for pre-1954 Code adjustments resulting in an increase in income of more than $3,000 is to be available whether or not the taxpayer had been in the same trade or business for 9 years prior to 1954. Your committee saw no reason of adding the complication of the House provision differentiating between taxpayers depending upon how long they had been in business before 1954.

In both the House bill and in your committee's version this 10-year spread for net adjustments resulting in an increase in income of more than $3,000 is cut off where the taxpayer's status changes. Thus, in the following cases the portion of any adjustment not previously taken into account under the new spread procedure is to be taken into account as follows: (1) By an individual in the year in which he dies or ceases to engage in a trade or business, (2) in the case of a partnership in the year the partnership terminates or the entire interest of the partner is transferred or liquidated, and (3) in the case of a corporation in the year in which it ceases to engage in a trade or business unless the assets of the corporation are acquired by another corporation in an acquisition to which section 381 applies. If section 381 applies, a new paragraph (21) in subsection (c) of that section provides that the acquiring corporation is to take these pre-1954 adjustments into account to the extent they have not been taken into account by the distributor or transferor corporation in the same manner as they would have been taken into account by that corporation.

The 10-year spreading of pre-1954 adjustments is to be available under the House and your committee's bill only in the case of changes in methods of accounting made in taxable years beginning before January 1, 1964. In the case of changes in methods of accounting made after that time, pre-1954 adjustments where the changes in method of accounting are initiated by the taxpayer, will be subject to the same rules as apply in the case of adjustments attributable to 1954 and subsequent years.

Your committee has also made a clarifying amendment to the House bill applicable to the situation where a taxpayer has initiated a change in method of accounting and the statute of limitations has expired with respect to the year of change or any subsequent year. For example, if the period has run as to the year of change, but not as to any subsequent year, the 10-year spread rule is applicable although the taxpayer will not be required to pay a tax with respect to the one-tenth of the adjustment attributable to the year of change. He will, however, be required to take into account the remaining nine-tenths of the adjustment which is spread to the 9 succeeding years. This is made clear by your committee by adding a sentence in the provision providing for the 10-year spread, indicating that the spread forward to the 9 succeeding taxable years is to be taken into account whether or not for the year of change or any of such 9 following taxable years assessment of tax is prevented by operation of any law or rule of law. This sentence is also applicable to the provision described below which in certain cases permits the spread forward to begin in 1958. The intent of this provision is to make it clear, especially in the case of past years which may be closed (such as 1954), that even though the period of limitations has expired with respect to that year, nevertheless the adjustment required to be taken into account in succeeding taxable years, attributable to a change in method of accounting made in the closed year, still is required to be taken into account. This will prevent taxpayers from avoiding the adjustments with respect to open years by the circumstance that the change in method of accounting occurred in what is now a closed year.

In addition to making the 10-year spread of pre-1954 Code adjustments a uniform 10 years for all taxpayers having positive adjustments of more than $3,000, your committee has also made another change which is of a permanent nature. The House bill would make this 10-year spread rule the exclusive rule for pre-1954 adjustments of more than $3,000. The effect of this with respect to this pre-1954 adjustment is to deny taxpayers the use of possible alternatives provided by present law. One alternative under existing law (sec. 481 (b) (1)) provides that the tax attributable to the adjustment is not to be greater than the total increase in taxes which would have resulted with respect to the adjustment if one-third of this increase had been included in the year of the change and in each of the 2 prior years. This is available if the method of accounting from which the taxpayer changed was the method used in these 2 prior years and if the adjustment results in an increase of income of more than $3,000. Another alternative under existing law (sec. 481 (b) (2)) provides that the tax attributable to the adjustment is not to be greater than the increase in taxes which would have resulted if the adjustment were spread back over one or more consecutive prior years to which the adjustment would be properly attributable if the taxpayer in those prior years had been on his new method of accounting. This alternative is available to a taxpayer to the extent that he can establish in prior consecutive years what his taxable income would have been under his new method of accounting. As under the other alternative, this is available only where there is an increase in income of more than $3,000. Your committee sees no reason why, in providing the 10-year spread rule, taxpayers changing their method of accounting should be deprived of these alternative rules under existing law. Therefore, it has amended the House bill

to make these alternatives available with respect to pre-1954 adjustments. It should be clear, however, that where these alternatives are used the adjustment, as limited under either of these alternatives, is fully includible in the taxable year of change; and therefore, that no spread forward to the 9 succeeding years is permitted where either of these alternatives is availed of. Your committee's amendment provides, however, that the election to use either of these alternatives in the case of the pre-1954 adjustments is to be available only if the taxpayer consents in writing to the assessment of any deficiency for the year of change to the extent attributable to the adjustment even though the period of limitations may have run (or the year of change is otherwise closed) with respect to this year. The period in which this assessment can be made is to be agreed upon with the Secretary or his delegate.

(*b*) *Transitional features.*—In general, the House provision is applicable with respect to changes in methods of accounting where the taxable year of the change is a year beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes of the 1954 Code. Your committee has accepted this general effective date.

The House bill, however, provided two exceptions to the general effective date referred to above. One exception is made where the taxpayer, before the date of enactment of this bill, has already applied for a change in method of accounting in the manner provided by regulations and the taxpayer and the Treasury Department have reached an agreement as to the terms and conditions for making the change. Your committee has accepted this transitional rule. It agrees with the House that if there are any changes in methods of accounting which have already been specifically allowed, these should not be upset by this new provision.

The House bill also provides another special transitional rule applicable to cases in which a change from the cash to the accrual method of accounting has been made in returns filed on behalf of decedents by executors or administrators of decedents' estates on or after the date of enactment of the 1954 Code and prior to November 7, 1956, if the change was made because the decedent's business involved the use of inventories. In such cases, the change of accounting method is to be recognized and a transitional adjustment in computing taxable income is to be required. However, the tax attributable to this adjustment is to be limited (if the net amount of the adjustment would increase the decedent's taxable income by more than $3,000) to the tax which would have been payable on the cash method of accounting for the years for which the executor or administrator filed returns on behalf of the decedent. Moreover, a special tax computation is to be applied to such adjustments. The tax is computed in such a manner that the applicable rates are those applicable to incomes of one-tenth of the income in the years in question. Your committee has retained this provision of the House bill but in accord with its general practice has advanced the November 7, 1956, date to January 1, 1958.

Testimony before your committee has suggested that the primary concern with the proposed revision of section 481 has been with its application to those cases where taxpayers have already changed their method of accounting in some year from 1954 up to 1958. In some

cases taxpayers have made these changes without obtaining the consent of the Treasury Department. Moreover, they have made these changes on the assumption that no adjustment need be made to the extent it is attributable to periods prior to 1954. Since this provision makes a change in this respect and does require an adjustment with respect to the period prior to 1954 in the case of changes in methods of accounting made in 1954 and subsequent years, your committee believes that taxpayers who made changes on the assumption that no such adjustment would have to be made should now have an opportunity to review this decision in light of the changed requirements provided by this bill. Therefore, your committee has added a provision to the House bill providing that taxpayers who, of their own choice, changed from one method to another method of accounting in computing their income for any taxable year to which the 1954 Code is applicable, if such year ended before the date of enactment of this provision, are to have an election to recompute their taxable income for this year (or these years) under their prior method of accounting. For purposes of this provision permitting taxpayers to revert to their former method of accounting, the statute of limitations is opened, or is kept open, by your committee's amendments for 1 year after the election is made. The election may be made at any time within 6 months after the date of enactment of this bill. The statute is opened, or is kept open, for this purpose both to permit assessment of any deficiency and to permit a refund or credit of any overpayment.

A second transitional rule provided by your committee's amendments would permit taxpayers who made changes in their method of accounting in 1957 or in a prior year to which the 1954 Code is applicable, to begin the 10-year spreadforward provided by both the House and your committee's version of the bill, to begin in 1958 and extend forward for the 9 succeeding taxable years. This will be available not only to those who may have changed their method of accounting without the consent of the Treasury Department during this period, but also to those who have a request to change methods of accounting in one of these prior years now pending before the Treasury Department, and such request is allowed. This amendment will provide relief in that, although it requires the adjustment to be made with respect to changes made or to be made in these prior years, it permits the tax consequences to be spread over the current and future years. Thus, these taxpayers will be given more time to adjust their financial affairs to take account of any additional tax liability involved in making the adjustment with respect to the pre-1954 Code years.

(c) *Revenue effect.*—This provision is expected to result in a substantial saving in revenue over the long run.

Section 31—Denial of exemption to organizations engaged in prohibited transactions

Section 503 (c) (1) of the 1954 Code provides that an exempt organization has engaged in a "prohibited transaction" when it "lends any part of its income or corpus, without the receipt of adequate security * * * to the creator of such organization." The effect of engaging in a prohibited transaction is to take away the tax-exempt status of the organization in the year following notification by the Secretary or his delegate. Although the prohibited transaction provisions were in

the 1939 Code, it was not until the adoption of the 1954 Code that these provisions were made applicable to pension trusts.

The regulations under section 503 (c) of the 1954 Code define the term "adequate security" as meaning something "in addition to" and "supporting" a promise to pay (regulations, sec. 1.503 (c)-1 (b)). This prevents investment in debentures of an employer corporation by its employees' pension or profit-sharing trust unless the bonds are secured by a mortgage or other collateral.

(*a*) *Purchases of debentures, etc., at fair market prices.*—Heretofore a traditional type of investment for pension funds has been the purchase of unsecured bonds of the employer corporation. The House report suggested that generally in such cases it is not necessary to require collateral as long as the price paid is at least equal to that which an independent party would pay. Where bonds are acquired at the same or more favorable prices than is true in the case of transactions between independent parties, the House saw no reason to distinguish between the bonds of the employer and bonds of other persons. It was suggested that such a distinction was particularly inappropriate in view of the fact that under present law nothing prevents the investment of the pension trust funds in common stocks of the employer. In addition, it was reported that certain companies follow a practice of offering debentures to their pension funds at prices which are more favorable than the prices offered to the public. In such cases the House saw no reason to deny the pension trusts this especially favorable form of investment. Your committee is in full accord with the reasoning of the House report on this point.

Accordingly, your committee concurs with the addition of a new subsection to section 503 providing that a pension trust can, where certain conditions are met, invest in the bonds (debentures, notes, certificates, or other evidences of indebtedness) of the employer corporation.

Your committee does not, however, agree with one of the conditions which under the House bill must be met in order for the purchase of indebtedness of the employer corporation by its employee pension trust to be considered as not a prohibited transaction. The condition referred to is the requirement in the House bill of the so-called negative pledge clause. The House provision provided that obligations would qualify under this provision (where they were acquired after November 8, 1956) only if they were issued under an agreement which provides that if the employer subsequently mortgages substantially all of its property, the obligations in question will be given a preference no less favorable than that afforded other obligations. Testimony before your committee indicated that due to either traditional or required mortgaging arrangements, a significant portion of industry would be unable to secure subordination of existing financing to comply with this qualification. In view of this, and the fact that the other three conditions required under the House bill guaranteed that the price at which the obligation is acquired will be no less favorable to the trust than to independent purchasers, your committee believed that this negative pledge clause represented an unnecessary complication. Therefore, it has eliminated this condition of the House bill.

The remaining three conditions set forth in the House bill are retained by your committee's action. First, one of the following

conditions must be met to show that the obligation was acquired in the equivalent of an arm's length transaction:

(1) The obligation must be acquired on the market at the price offered on a national securities exchange or on the over-the-counter market at terms not less favorable than the offering price for the obligation (as established by current bid and ask prices quoted by those independent of the employer);

(2) The obligation must be acquired from an underwriter at a price not in excess of the public offering price at which a substantial portion of the issue is acquired by persons independent of the employer; or

(3) The obligation must be acquired directly from the employer at a price not less favorable than the price paid currently for a substantial portion of the same issue by persons independent of the employer.

Second, following the purchase of the obligations, the pension trust may not own more than 25 percent of any one issue and at least 50 percent of the issue must be held by persons independent of the employer.

Third, not more than 25 percent of the total assets of the pension fund may be invested in bonds or other obligations of the creator of the trust (and certain other specified persons).

Under both the House bill and your committee's action this provision is effective for taxable years ending after March 15, 1956.

(*b*) *Rules with respect to employers prohibited from pledging certain assets.*—Your committee has added a new provision to the section of the House bill relating to prohibited transactions, due in part to the fact that the House version applies mainly to corporations. This provision relates to situations where the employer is prohibited by Federal law or regulation from pledging as security for a loan certain classes of his assets which represent more than half of the value of all of his assets. In such cases where certain other conditions are also met, the "adequate security" test of present law is to be inapplicable. The effect of this, as in the case of the provision described above, is to provide that a loan from a pension trust qualifying under this provision to its employer will not be classified as a prohibited transaction. As a result, such loans will not lead to the denial of income tax exemption to the exempt pension trust in such cases.

Except for minor technical changes, this provision is substantially the same as was provided in H. R. 9049, which was passed by the House last year and referred to your committee. Your committee delayed action on this bill, however, so that it would be possible to consider its relationship with the provision in this bill discussed above.

This provision is concerned with a problem presently faced by unincorporated stock brokerage firms. As a result of the adequate security test in the prohibited transaction provision of existing law, these firms are finding it difficult to borrow funds from their employees' pension, profit-sharing, and stock bonus trusts, even though this is advantageous to the employees' trusts. The stock brokerage firms are having difficulty in meeting the "adequate security" test because section 8 (a) of the Security Exchange Act of 1934 and section 5 (a) of the Federal Reserve Board regulation T prohibit brokerage firms from pledging any of their registered securities (or the balances owed them by their customers) as collateral for employee trust loans or

for any other loans, except bank loans or loans from other brokers. In many cases the assets of the brokerage firms consist almost entirely of assets falling within these categories which they cannot generally pledge.

The making of these loans is of primary benefit to the employee trusts since the loans are made on very favorable terms. Usually, they provide not only for some minimum rate of interest but also contain a profit-sharing feature. As a result the employee trusts have been receiving a higher rate of return on these loans than they received on their investments generally.

The present situation also discriminates against employee trusts of unincorporated brokerage firms. The prohibited transaction provisions do not prevent a brokerage firm operating as a corporation from issuing stock to its employee trust and as a result employee trusts created by these corporate brokerage firms, presently, are in a more advantageous position than the employee trusts of the unincorporated firms.

The Internal Revenue Service (Rev. Proc. 56–33, October 15, 1956) has indicated that the "adequate security" test can be met by obtaining a surety bond to cover the loan. However, the cost of such a bond has proved to be substantial and as a result brokerage firms meeting the "adequate security" test in this manner must incur sizable additional costs or the employee trusts will receive a much lower rate of return with respect to these investments.

For the reasons indicated above, your committee has added a new subsection to the House bill permitting loans to be made by employee pension trusts to the employer firms without having the loans classified as prohibited transactions on the grounds that they do not meet the adequate security test if the loan bears a reasonable rate of interest and the three conditions set forth below are met.

First, in order to qualify, under this exception the employer must be prohibited by law of the United States or by Federal regulation from directly or indirectly pledging as security for a loan from one of these employee trusts, classes of its assets which represent more than half the value of all of its assets.

Second, the making or renewal of the loan must be approved in writing by a trustee of the employee trust who is independent of the employer (or a majority of such trustees if there is more than one) as being a loan which is consistent with the exempt purposes of the trust. Also, no other such independent trustee (or a majority of such trustees where there is more than one) may previously have refused to approve the making or renewal of the loan.

Third, the amount loaned by the employee trust to the employer without the receipt of adequate security must not represent more than 25 percent of the value of all of the assets of the trust.

This provision is to apply with respect to taxable years ending after the date of enactment of this bill but only with respect to periods after that date. As a result, the fact that a loan qualified after the date of enactment of this bill would not qualify such a loan with respect to any earlier period.

(c) *Announcements of Internal Revenue Service prior to enactment of bill.*—Both the House bill and your committee's action provide that the changes made in section 31 (a) of this bill with respect to the prohibited transaction provision insofar as they relate to the adequate

security test are not to be construed as making any transaction a prohibited transaction which, as a result of announcements made by the Internal Revenue Service with respect to this provision before the enactment of this bill, would not constitute a prohibited transaction.

In an announcement made June 6, 1957, the Treasury Department stated that the definition of "adequate security" under section 503 (c) (1) in the proposed regulations would not be applied until June 30, 1958, for debentures purchased prior to November 9, 1956, unless legislation passed by Congress provides otherwise. On May 22, 1958, the Treasury announced that it was further postponing the application of this definition until March 15, 1959, or until the 90th day after enactment of legislation relating to the adequate security test, whichever is earlier.

Section 32—Certain leases by medical research organizations

Present law (sec. 514) provides that in the case of educational, charitable, and certain other tax-exempt organizations, the proceeds from certain so-called business leases are to be subject to tax although the receipt of rent, usually, is not taxed to these organizations. The exception to the general rule as to rental income received by one of these exempt organizations applies where there is indebtedness outstanding with respect to the leased property, or, in other words, where the tax-exempt organization is in effect purchasing the property with the rental income. In such cases, Congress has generally taxed the receipt of rental income because of the belief that in such cases the exempt organizations were in effect using their tax exemption to acquire the property. It has been recognized, however, that where the leased property (although subject to indebtedness) is used for a purpose which is related to the functions of the tax-exempt organization, the motive of obtaining special tax exemption is not likely to be present. As a result, Congress has provided that these business leases are to be taxable only where the operations of the lessee are unrelated to those of the exempt organization.

The attention of your committee has been called to situations where the Internal Revenue Service has defined "related" leases for purposes of this provision in what your committee believes is too narrow a manner. The specific problem presented to your committee was that of a medical research foundation which leases a substantial portion of the building which it owns, and in which it is located, to a clinic of doctors. In this case it is understood that the clinic's patients are vital to the foundation's research work in that they provide case histories and opportunities for testing and checking theories developed by the foundation. In fact, it is understood that many of the foundation's research projects could not be carried on without a readily available group of patients, and that several of these projects were first initiated as a result of the observation of the conditions of clinic patients. In addition, the clinic doctors provide a readily available reservoir of experience and information for use in the foundation's research and the clinic's doctors customarily donate their services in carrying out many of the foundation's research projects.

In view of your committee's comment in its report on this provision in the Revenue Act of 1950, when this provision was first adopted, your committee believes that the term "related," for purposes of this

business lease provision, should include the type of case referred to above. In that report your committee said:

> "Related" is defined in a similar fashion as in the case of a related trade or business and is, for example, intended to exclude from the application of this tax leases by tax-exempt hospitals of part of the hospitals to doctors' associations to use as clinics. It is believed that leases of this type are entered into primarily to further the purpose of the exempt organization rather than to make special benefits from tax exemptions.

Your committee believes that the case cited above is related in a similar manner to the example given of the hospitals and the doctors' clinics. Moreover, it believes that, usually, leases entered into by medical foundations with doctors' clinics are primarily to further the stated purpose of the exempt organization rather than to gain special benefits from tax exemption.

As a result, your committee has added a sentence to the special rules applicable in defining a business lease. This sentence provides that a lease to a medical clinic by a medical research foundation of premises adjoining those occupied by the scientific foundation, are to be considered as "related" if the clinic is used by the foundation for research purposes by those making use of the clinic's case histories and by using the donated services of the clinic doctors.

This change is made without any inferences intended as to the tax treatment accorded such leases prior to the effective date of this provision.

This provision is made applicable to taxable years beginning after December 31, 1957.

Section 33—Corporation improperly accumulating surplus

This section is a provision of the House bill relating to the tax on corporations improperly accumulating surplus. Your committee has accepted the provision without change.

Subsection (a) eliminates the possibility of any carryover of charitable contributions above the 5-percent limit for purposes of the tax on improperly accumulated surplus. Corporations, generally, are allowed a deduction each year for charitable contributions, limited to 5 percent of taxable income. A carryover to the 2 succeeding taxable years of any excess is permitted, but again, subject in the succeeding years to the 5-percent limitation. However, in the case of corporations improperly accumulating earnings, in determining accumulated taxable income for purposes of the additional penalty tax, the allowable deduction for charitable contributions is not limited to 5 percent.

The bill makes it clear that in determining the accumulated earnings, these corporations may not deduct any carryover of charitable contributions made in preceding years in excess of 5 percent of the preceding year's income.

Subsection (b) eliminates the possibility of an excessive deduction, with respect to capital gains and taxes on capital gains in computing the tax on improperly accumulated surplus.

In measuring the accumulated taxable income of corporations improperly accumulating earnings, a deduction is allowed for the excess of net long-term capital gain for the taxable year over the net short-term capital loss for such year. This is to avoid imposing an addi-

tional tax on the capital gain. In order to make the adjustment accurate, however, it is necessary to offset against this deduction the amount of tax attributable to the capital gain. This is necessary because in determining accumulated taxable income a deduction is permitted for all taxes paid.

The bill makes it clear that in computing the tax attributable to the capital gain--the tax effect of any capital loss carryover from a prior year is not to be excluded from consideration.

This section will apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

Section 34—Undistributed personal holding company income

Corporations generally may not deduct charitable contributions in excess of 5 percent of taxable income. In determining undistributed personal holding company income for purposes of the tax on personal holding companies, however, the 20- and 30-percent limitations applicable to individuals are substituted. The House bill makes it clear that because of the liberal charitable contribution rule permitted in determining undistributed personal holding company income for purposes of the personal holding company tax the carryover of charitable contributions from a preceding year is not available. This provision is made effective as of the general effective date of the income taxes under 1954 Code. Your committee has accepted this provision without change.

Subsection (b) of this provision relates to net operating losses and the determination of undistributed personal holding company income. In computing undistributed personal holding company income, the code (sec. 545 (b) (4)) provides for the allowance of a deduction for the net operating loss for the preceding taxable year. Also, under the code (sec. 545 (b) (3)), in computing undistributed personal holding company income certain special deductions, such as the intercorporate dividends received deduction, generally allowed corporations, are not permitted. Subsection (b) of the provision makes it clear that in computing net operating loss from a preceding year for purposes of undistributed personal holding company income, adjustment is also to be made to exclude the special deductions generally allowed corporations (secs. 241–247).

The House bill would make this change applicable to net operating loss deductions for years beginning after December 31, 1956. Your committee has accepted this provision except that it has advanced this date to December 31, 1957.

Section 35—Foreign personal holding companies

Subsection (a) of this provision makes it clear that because of the liberal charitable contributions rule permitted in determining undistributed foreign personal holding company income (the 20- or 30-percent charitable contributions rule applicable to individuals) foreign personal holding companies are not also to be entitled to a carryover of charitable contributions from the preceding year. This provision is applicable to taxable years beginning after December 31, 1953, and ending after August 16, 1954. Your committee has accepted this House provision without change.

Subsection (b) of this provision (under sec. 556 (b) (3)) disallows a deduction by a foreign personal holding company for partially tax-exempt interest, since (under sec. 551 (c)) a United States shareholder

is allowed a credit against tax for his share of partially tax-exempt interest. If the corporation were also allowed a deduction there would be a duplication of benefits. The House bill would make this change effective for taxable years ending after October 31, 1956. Your committee has accepted the House provision but advanced the effective date to taxable years ending after December 31, 1957.

In computing undistributed foreign personal holding company income, present law (sec. 556 (b) (4)) provides for the allowance of a deduction for the net operating loss for the preceding taxable year. Also, in computing undistributed foreign personal holding company income, present law (sec. 556 (b) (3)) provides that certain special deductions, such as the intercorporate dividends received deduction, generally allowed corporations (under secs. 241 to 247) are not to be permitted. Subsection (c) of this provision makes it clear that in computing the net operating loss for a preceding year, adjustment is also to be made to exclude these special deductions (provided by secs. 241 to 247, inclusive). The House provision would make this provision applicable to net operating loss deductions for taxable years ending after October 31, 1956. Your committee has accepted this provision but advanced the effective date to taxable years ending after December 31, 1957.

Section 36—Bond, etc., losses of banks

Present law (sec. 582) provides that in the case of a bank, if the losses from sales or exchanges of bonds, debentures, notes or certificates, etc., with interest coupons or in registered form, exceed the gains of the taxable year from such sales or exchanges, ordinary loss treatment rather than capital loss treatment is to be permitted. The House bill amends present law (sec. 582 (c)) to delete the reference to "with interest coupons or in registered form." This restores the treatment under the 1939 Code so banks may not be denied ordinary loss treatment with respect to retirements on mortgages and other evidences of indebtedness issued by corporations or governmental units without interest coupons and not in registered form. This section is effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code. Your committee has accepted this provision without change.

Section 37—Depletion allowance in the case of estates

This provision, which your committee has accepted without change, corrects the misspelling of the word "devisees" in section 611 (b) (4) of the code relating to depletion allowances in the case of estates. This provision is effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

Section 38—Rate of percentage depletion for certain gold mined in the United States

At the present time the rate of percentage depletion for gold is 15 percent. This section of the bill, which has been added by your committee, increases the rate of percentage depletion for gold to 23 percent if it is extracted from deposits in the United States. However, this higher rate of percentage depletion is limited to those cases in which gold ore is the principal product of the taxpayer. This latter

limitation is designed to prevent the benefit of this increase in percentage depletion for gold from going to those whose principal business is the extraction of some other mineral and who extract gold only as a byproduct.

Your committee believes that increasing the percentage depletion rate for gold, subject to the limitations described above, is desirable to place gold production on an equal basis with the large number of other minerals where the rate of percentage depletion is 23 percent. Currently receiving percentage depletion at a 23-percent rate when extracted from deposits in the United States are such metals as lead, zinc, tungsten, antimony, platinum, and many others.

Your committee believes that this higher rate of percentage depletion for gold is also desirable as an incentive to keep alive the mining in the United States of a metal of such importance as gold. Testimony before your committee has indicated, moreover, that the gold-mining industry today is operating under especially unfavorable conditions. The price of gold was fixed at $35 an ounce in 1934. As a result, most of the gold mines in the country have been closed. An incentive, therefore, is needed not only to encourage the mining of known deposits but also to stimulate exploration for new deposits as well.

Your committee limited the benefit of the higher percentage depletion rate for gold to those cases where gold is the principal product of the taxpayer because it was felt that where gold is a byproduct, a tax incentive would not result in increased production. Thus, to allow the increased percentage depletion for gold in such cases would constitute a windfall gain.

This increase in the percentage depletion rate for gold is made effective with respect to taxable years beginning after December 31, 1957.

This provision is not expected to have any significant result on revenues in the near future.

Section 39—Percentage depletion rates for certain taxable years ending in 1954

The 1954 Code percentage-depletion rates were made effective January 1, 1954, for calendar year taxpayers. In the case of fiscal year taxpayers, however, the 1954 Code percentage-depletion rates were made available only in case of fiscal years beginning after December 31, 1953, and ending after August 16, 1954.

The House bill amends the code (sec. 613) to allow a taxpayer on a fiscal year basis to elect to apply the percentage-depletion rates specified in the 1954 Code to that portion of a fiscal year 1953–54 after December 31, 1953. It also makes this treatment available in the case of short years beginning in 1954 and ending on or before August 16, 1954. Your committee has accepted the House provision with only a minor technical change.

The House provision, to which your committee has agreed, is desirable because it will equate the tax treatment of fiscal year and calendar year taxpayers with respect to this transition period. Moreover, it is consistent with the policy previously adopted by Congress in connection with the percentage-depletion rates established by the Revenue Act of 1951.

The provision will provide for the application of the 1939 Code percentage-depletion rates for the part of the fiscal year (computed on a daily basis) which falls in the calendar year 1953 and the 1954 Code rates for that part which falls in the calendar year 1954.

The section opens, or keeps open the statute of limitations for purposes of this amendment for 6 months after the enactment of the bill (but not if there has been a compromise, and under your committee's action, not if there has been a closing agreement). No interest is to be paid on overpayments resulting from this provision.

This provision is expected to result in a onetime revenue loss of approximately $1.5 million.

Section 40—Definition of property for purposes of the depletion allowance

The 1954 Code (sec. 614) defines property for purposes of computing the percentage and cost depletion allowances in the case of mineral resources. This section permits a taxpayer owning interests in mineral resources to make one aggregation of part or all of his operating mineral interests within an operating unit, and permits him to treat this aggregation as one property. It also allows the taxpayer owning nonoperating mineral interests in a single tract, or in contiguous tracts, in hardship cases to treat these nonoperating interests as one property. These combined interests are considered as one property for purposes of computing depletion, gain or loss on sale, etc.

The House report indicates that the rule provided by the 1954 Code was intended to liberalize the provisions of the 1939 Code with respect to the definition of property. Some taxpayers have contended, however, that the 1954 Code section has deprived them of rights they previously had under the 1939 law, regulations, court decisions, or practices. Since, under the 1954 Code, there was no intention to remove any rights which taxpayers had, the House bill restored such rights as taxpayers had under the 1939 Code. The House bill accomplished this by adding a new subsection to the section dealing with the definition of property to the effect that a taxpayer could elect to treat any property as if the present 1954 Code definition had not been enacted, and as if the 1939 Code rules still applied. Thus, with respect to 1954 and subsequent years, a taxpayer was given two choices: he could apply the 1954 Code rules in determining what constituted a property within an operating unit, or he could apply the 1939 Code rules.

Your committee is in agreement with the House that the action taken by Congress in 1954 was intended to liberalize, rather than restrict, the 1939 Code rules with respect to the definition of property. However, insofar as operating mineral interests are concerned the rules as to what constituted a property under the 1939 Code regulations, court decisions, and practice were not well established. Thus, your committee concluded that to give taxpayers the right to apply the 1939 Code rules in effect would simply assure extensive litigation. Moreover, it is not at all clear that this would have established any consistent set of rules for determining what constitutes the property. Therefore, your committee has substituted specific rules to be followed in determining what constitutes a property for 1958 and all subsequent years. These rules for 1958 and subsequent years will be a substitute not only for the 1939 Code rules, which the House bill would have made available for such years, but also for the 1954 Code rules which

are available under present law. In addition, for the period from 1954 up to 1958, taxpayers will have their choice as to whether they follow the rules set forth in the 1954 Code or the new 1958 rules.

The new rules referred to above are made available by your committee's action only in the case of mineral interests extracted through a mine (including sulfur extracted by the Frasch process) and do not include oil and gas extracted through a well. In the case of oil and gas, the rules followed under the 1939 Code were more explicit, and there therefore does not seem to be the need for immediate action in redefining the property for purposes of oil and gas depletion. As a result in the case of oil and gas your committee has accepted the House provision permitting taxpayers for 1954 and subsequent years to choose between the 1954 Code rules and the 1939 Code rules.

In the case of nonoperating mineral interests (including oil and gas as well as other minerals) your committee has also provided a specific rule. This rule, which is an exclusive rule, applies for 1958 and subsequent years or at the taxpayer's election for 1954 and subsequent years. In large part, however, this is the existing 1954 Code rule with certain amendments referred to in (e) below.

(*a*) *1958 aggregation rule for separate mineral interests.*—Your committee's amendments permit a taxpayer (in the case of mineral interests other than oil and gas wells) to aggregate all of the interests in a mine, or all of the interests in two or more mines within an operating unit for purposes of determining what constitutes a property. Those interests which are not aggregated in a mine, or in an aggregation consisting of two or more mines, remain as separate interests and each constitutes a property. In making these aggregations, interests can be aggregated whether or not they are in the same or contiguous tracts, and the taxpayer can make more than one aggregation in an operating unit. However, any aggregation must include all of the interests in a mine, including interests which subsequently become part of that mine. In defining what constitutes an operating unit, or a mine, your committee intends that the taxpayer's determination is to be accepted unless there is a clear and convincing basis for a change.

(*b*) *1958 rules permit breakup of single interest.*—The 1958 rules permit a taxpayer to break up a single interest, or tract containing 1 deposit into 2 or more properties so long as there is a mine on each segment. The separate property on which the new mine is located can then be aggregated with other properties according to the rules set forth above. However, where 1 of these interests is broken between 2 or more mines, the special application of exploration expenses referred to below is not to be made in limiting allowable depletion.

Once an aggregation has been made of 2 or more interests, a portion of 1 of the aggregated interests cannot be broken off and treated as a separate property without the consent of the Secretary or his delegate. Ordinarily separations will be permitted in cases such as the following: Assume that a mine has been developed toward one end of a property and that the taxpayer aggregates it with another tract which he also owns. Subsequently he develops another mine toward the other end of the first tract, and desires to treat that mine as a separate property. It is contemplated that permission will be granted to break off and treat the new mine as a separate property in

such cases unless under the particular circumstances tax avoidance is the principal purpose for the separation.

(c) *Election as to application of 1958 rule.*—As has already been indicated under your committee's action, taxpayers having mineral interests, other than oil or gas wells, are required to make an election under these new rules for 1958 and subsequent years. They also are permitted to apply these same rules back to the general effective date of the 1954 Code, namely, taxable years beginning after December 31, 1953, and ending after August 16, 1954. Alternatively, however, for the period from 1954 to 1958 taxpayers are permitted to follow the definition of property now in the 1954 Code.

In the case of the new aggregation rules, taxpayers who elect the new treatment only for 1958 and subsequent years must make an election as to how they will aggregate their property for their first taxable year beginning after December 31, 1957, or for the first year in which they incur expenditures for the development or operation of an interest after its acquisition, whichever is later. If the taxpayer elects to apply this new rule for 1954 and subsequent years the aggregation under the new rule must be applied for the first year which begins after December 31, 1953, and ends after August 16, 1954, or the first year in which the taxpayer makes development or operational expenditures with respect to an interest, whichever is later.

The election to break up a single interest or tract having 1 deposit into 2 or more properties must be made according to the same rules as those set forth above except that instead of applying when the first expenditures are incurred for development or operation of the first mine the second alternative as to the election must be made when developmental or operational expenditures are first made for 2 or more mines.

The election as to an aggregation of interests or the break up of a single interest, although made with respect to 1954 and subsequent years or with respect to 1958 and subsequent years, in no case needs to be made before the first of the month which begins more than 90 days after final regulations are issued on the definition of property. The election as between the 1954 Code rule and the 1958 rule for the period from 1954 to 1958 can be made separately by operating units. That is, a taxpayer may elect the 1958 rule with respect to one operating unit and for this period the 1954 Code rule with respect to another operating unit, but he cannot elect one of these rules with respect to one part of an operating unit and the other rule with respect to the remainder of the operating unit. Your committee's action opens or keeps open, the statute of limitations with respect to assessments of deficiencies or overpayments which may arise as a result of these elections as to the definition of property for the period from 1954 to 1958.

(d) *Exploration expenditures made prior to an aggregation of interests.*—A special problem is presented by exploration expenditures which are incurred prior to the aggregation of 2 or more interests where there already is a mine in operation on 1 of the tracts. Without any special rule the exploration expenditures made before the aggregation, on the interest where there is no mine although themselves deductible would not decrease the income from the property on which the mine is located. Thus they could not result in any decrease in the maximum percentage depletion allowable with respect to that

property. On the other hand, such a reduction would have occurred had the two interests been aggregated during the entire period in question. As a result, your committee has provided that where exploration expenditures are made prior to the aggregation of two or more interests they are to be taken into account in future years after the aggregation has been made. This will be true, however, only from January 1, 1958 on, unless the taxpayer elected to apply the new rule back through 1954.

These expenditures are taken into account for the future years by first recomputing the tax for the prior years, assuming that the interests subsequently aggregated were at that time aggregated. If after this recomputation is made it is found that there is an increase in tax liability, this excess is taken into account for years beginning with the time the aggregation is made. This increase then is spread forward evenly over the same number of years in which it would have been incurred had the interests been aggregated in the past. Provision is also made where a taxpayer dies or ceases to exist to take into account in this last year any of the increase not previously accounted for.

(*e*) *Nonoperating mineral interests.*—In the case of nonoperating mineral interests your committee's amendment provides that 1 aggregation may be made of 2 or more separate interests, or tracts, so long as these tracts are adjacent and a principal purpose of the aggregation is not tax avoidance. Thus, your committee's amendment has substituted a tax avoidance rule for the "hardship" test of existing law and also permits tracts to be aggregated where they are "adjacent" rather than "contiguous." By "adjacent" it is not meant that the tracts may be separated only by a body of water, a highway, etc. Instead, it is meant that the tracts must be in reasonably close proximity to each other.

Section 41—Investment companies furnishing capital to development corporations

This section makes two technical corrections in the section of the code (sec. 851 (e)) which is concerned with the qualifications which must be met by investment companies furnishing capital to development corporations in order to obtain regulated investment company treatment.

Under the 1939 Code a certification was required by the Securities and Exchange Commission "not more than 60 days" which in the 1954 Code was inadvertently changed to "not less than 60 days." The House provision, which your committee has accepted without change, restores the effect of the 1939 Code language.

The House provision, which your committee accepted, also corrects a typographical error by changing the word "issues" to "issuer."

This provision is effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

Section 42—Treatment of dividends of regulated investment companies whose assets consist mainly of State and local obligations

Mutual funds represent an opportunity for those whose investment funds are relatively limited to diversify their investments and obtain expert investment counsel in much the same manner as larger investors are able to do directly. So that persons who make their investments

through these mutual funds will not be burdened with heavier taxation than those investing directly, Congress in the past has provided that the mutual funds which qualify as "regulated investment companies" need not pay the corporate income tax on the income they receive if it in turn is distributed to their stockholders (where 90 percent or more of their income is distributed in this manner).

To a limited degree present law provides that income received from a regulated investment company is in the hands of the stockholder to retain the same character it had in the hands of the regulated investment company, or the same character it would have had in the hands of a person investing his own funds directly in an operating company. This "pass-through" of the character of income, or conduit principle, has already been accorded to regulated investment company income in the case of capital gains. Also, where interest income represents more than 25 percent of the income of a regulated investment company, a distinction is made between dividend income and interest (or other) income. Also, in the case of a regulated investment company more than half of whose stock or securities represent investments in foreign corporations, the foreign tax credit is passed through to the shareholders. The conduit principle is not presently applied, however, in the case of tax-exempt interest derived from State and local government bonds.

Your committee believes that it is desirable to permit investors to pool their funds to invest in State and local government bonds in the same manner as other forms of investment. Under present law, since the conduit principle is not applied in this case, tax-exempt bonds, however, represent a relatively unattractive investment for regulated investment companies. At present, although this interest from State and local government bonds is not taxable to the regulated investment company, it loses its tax-free character when it is passed through to the shareholder. As a result, individuals cannot today invest part of their funds through a regulated investment company in State and local government bonds and receive the same tax treatment as investors who purchase the bonds directly.

Application of the conduit principle in the case of interest income from State and local government bonds is desirable, not only to give assurance of equal treatment of small and large investors but also as a means of aiding State and local government financing. This was in fact the reason given by the President in his Economic Report for 1957 in favoring the application of conduit principle for regulated investment companies that hold their assets in State and local government securities. The statement made by the President in his Economic Report is as follows:

> The expenditures of State and local governments are now about half those of the Federal Government, and the recent rate of increase has been considerably higher. The principal objects of this increased spending are schools, highways, and the variety of community facilities required by population increase and the rapid growth of suburban areas. In view of the exceptionally high demands for the labor, materials, and equipment needed to carry out these projects, it is inevitable that not all of them can go forward as rapidly, or on as large a scale, as may be desired. Financial consider-

> ations also may require some rescheduling of proposed projects, since State and local governments with large borrowing requirements have already encountered heavy competing demands in the capital markets. Some improvement in the ability of these governmental units to finance their projects would result from an amendment of the Internal Revenue Code to extend the "conduit principle" to regulated investment companies that hold their assets in State and local securities. The amendment, which would involve no loss of revenue, would permit regulated investment companies of this type to pass through to their stockholders the tax-exempt status of the income received on State and local securities. The Congress is requested to enact legislation to accomplish this result.

Your committee has, therefore, amended the regulated investment company provisions of present law to provide that where certain conditions are met, State and local government bond interest is to retain its tax-exempt character when passed through to the stockholders of the regulated investment company. This treatment is to be available, however, only where 90 percent of the value of the assets of the regulated investment company represents cash and cash items and obligations of State and local governmental units (that is, obligations the interest on which is excludable from gross income under sec. 103 (a) (1)). Also, to qualify for this "pass-through" of the tax-exempt character of State and local government bond interest, this interest income must represent more than 95 percent of the company's gross income (excluding capital gains and treating this interest as if it were includible in gross income). Thus, a regulated investment company, in order to pass through to its stockholders the tax-exempt character of State and local government bond interest, must have virtually all of its funds invested in such obligations. In other respects, the requirements that must be met by one of these special regulated investment companies are essentially the same as are required of regulated investment companies generally. In this case, also, 90 percent of the investment company income must be distributed for the special treatment to be available (for this purpose, treating the tax-exempt interest as if it were included in gross income) and the shareholders must be informed in writing not later than 30 days after the close of their taxable year the amount of any tax-exempt interest they are deemed to have received.

This provision is to be effective with respect to taxable years beginning after the date of enactment of this bill.

Section 43—Transactions in regulated investment company shares around time of distributing capital gain dividends or tax-exempt dividends

Under present law a regulated investment company is not taxed on net long-term capital gains which it distributes. Instead, such a dividend is taxed as a long-term capital gain to the stockholder. Moreover, a regulated investment company which does not choose to distribute capital gains, nevertheless, may pay the tax and pass this on as a credit to its shareholders. In such cases, the shareholder is deemed to have received the capital-gain income (including the tax paid by the company) but in computing his tax is given a credit for

the tax paid by the regulated investment company. In both of these cases the gain taxed to the shareholder is considered to be a long-term capital gain, whether or not the regulated investment company stock has been held for 6 months.

It has been reported that on occasion dealers in securities have purchased regulated investment company stock just before a capital-gain dividend became payable, and then, immediately after the receipt of the dividend, sold the stock. In such cases the selling price of the stock is usually less than the purchase price by approximately the amount of the capital-gain dividend. If the dealer held such stock in an inventory account, his loss on the sale of the stock would be treated as an ordinary loss deductible against ordinary income. Taxpayers other than dealers (or dealers as purchasers for their own investment accounts) also can take advantage of this device. In these cases the capital-gain dividend is a long-term capital gain and the loss from the sale of the stock is a short-term capital loss which can be offset against short-term capital gains on which the taxpayer would otherwise be taxed as ordinary income.

The problem presented here is similar to that presented in the case of ordinary dividends where the recipient is a corporation eligible for the intercorporate dividends received deduction. As in the case of that problem (dealt with in sec. 20), the House concluded that taxpayers should not obtain such tax advantages merely by juggling income among different types of income tax categories. Your committee concurs in this conclusion.

The House bill dealt with this problem by providing (in sec. 852 (b)) that where a taxpayer has held a share of regulated investment company stock for no more than 30 days and either receives or is deemed to receive a long-term capital gain dividend in that period, any loss on the sale of the stock is to be treated as a long-term capital loss to the extent of the long-term capital gain dividend received or deemed to have been received.

Your committee has accepted the House provision, but expanded it to deal with a similar problem it believes would otherwise arise in connection with section 42 of the bill, which, in certain cases, permits tax-exempt State or municipal bond interest received by a regulated investment company to be passed through to its stockholders and still retain its tax-exempt character. If no amendment were made, it would be possible to buy regulated investment company stock of a company specializing in tax-exempt bond investments shortly before a tax-exempt interest dividend became payable by the regulated investment company. Then, after receipt of the interest dividend, which the stockholder would not need to include in his taxable income, he could immediately sell the stock, and could normally expect to incur a loss about equal to the exempt interest dividend. Although the income was not taxable, the loss for a dealer would be an ordinary loss and fully deductible, or for other taxpayers would be a short-term capital loss which would be offset against either short-term or long-term capital gain.

To prevent the pass-through of tax-exempt interest from being used as a tax-avoidance device of the type referred to above, your committee expanded this provision of the House bill so that, where regulated investment company stock is held for not over 30 days and in that period an exempt interest dividend becomes payable, then

any loss on the sale of the stock is not to be recognized to the extent of the exempt interest dividend.

The House bill would make this section applicable to taxable years ending after November 7, 1956, but only with respect to stock acquired after that date. Under your committee's action, this provision is made applicable to taxable years ending after December 31, 1957, with respect to stock acquired after that date.

This provision is expected to result in an increase in revenue over the long run but is of such a nature that estimates of the current revenue gain cannot be made.

Section 44—Special method of taxation for real estate investment trusts

Under present law individuals desiring to invest in stocks and bonds can secure the benefits of stock diversification, even though their funds are small, by buying shares of stock in investment companies which in turn invest in stocks and securities of operating companies. These companies which invest in stock and securities are known as regulated investment companies if they meet certain requirements as to asset diversification, capital structure and operations. Such companies if they distribute at least 90 percent of their ordinary income are taxed only on their undistributed income. Dividends paid by them generally are taxed in the usual manner to shareholders, except that dividends arising from capital gains realized by the company receive capital gains treatment in the hands of the recipient and dividends, which to an important degree are attributable to interest or other nondividend income, are, to the extent of that portion, not eligible for the dividends received credit, exclusion, or deduction.

The omission of the corporate income tax in the case of distributed earnings, which present law provides for regulated investment companies, secures for investors in these companies essentially the same tax treatment as they would have received if they had invested directly in the operating companies. Your committee has added a provision which extends this same type of tax treatment to real estate trusts specializing in investments in real estate equities and mortgages as distinct from the stock and security holdings of the regulated investment companies. Thus, this secures for the trust beneficiaries the same type of tax treatment they would receive if they held the real estate equities and mortgages directly and, therefore, equates their treatment with that accorded investors in ordinary regulated investment companies.

Your committee believes that the equality of tax treatment between the beneficiaries of real estate trusts and the shareholders of regulated investment companies is desirable since in both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources. These advantages include the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangements; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly.

In addition to providing equality of tax treatment between the trust beneficiaries and the investment company shareholders, your committee believes it is also desirable to remove taxation, to the extent

possible, as a factor in determining the relative size of investments in stocks and securities on one hand, and real estate equities and mortgages on the other. This is particularly important because it will increase the private capital and mortgage money available for individual homes, apartment houses, office buildings, factories, and hotels. At the present time the financing of these real estate equities and mortgages is dependent largely on Government-guaranteed money, and investments by special groups, such as insurance companies and pension trusts.

It has sometimes been argued that real estate investment trusts differ from regulated investment companies in that the income of the latter already has been subjected to income tax while the income of the former has not. This refers to the fact that the dividend income of the regulated investment company already has been taxed as a part of a corporation's income before it was received by the regulated investment company while the rental income received by the real estate trust has not.

This overlooks the fact that the interest income of regulated investment companies, as well as their capital gain income, has not previously been subjected to the corporate income tax. Moreover, this interest income is an important element in the portfolios of many of these regulated investment companies. This absence of a prior tax in the case of a significant portion of the income of regulated investment companies demonstrates that the concept of a regulated investment company is not to impose, or retain, any specified number of taxes with respect to income but rather to accord individuals of small means an opportunity to pool their investments in one of these companies, yet receive the same treatment as those of greater wealth can obtain by direct investments.

This provision will be available not only to the real-estate investment trusts which are in existence today but also in the case of many new real-estate investment trusts which it is anticipated will be formed as the discriminations against this type of investment are removed. Your committee believes that this will have the desirable economic effect of encouraging real estate investments generally.

This provision closely parallels a provision reported out favorably (H. R. 8102) last year by the Committee on Ways and Means of the House. Your committee's provision, like the provision previously reported by the House committee, to the full extent feasible makes the requirements and conditions now applicable to regulated investment companies also applicable to the real-estate investment trusts. Although in this provision your committee has used a different form than that used in the House bill in distinguishing between passive investments and the active operations of a business, it shares the views expressed in the House report that the regulated investment company type of tax treatment should be extended only to the passive investments of real-estate investment trusts. Your committee agrees that any real-estate investment trust engaged in active business operations should continue to be subject to the corporate tax in the same manner as is true in the case of similar operations carried on by comparable enterprises.

Under the provision added by your committee real estate investment trusts are defined as unincorporated trusts or associations meeting certain general requirements and, in addition, meeting a series of

requirements as to amounts of various types of gross income. The general requirements referred to include provisions that they be managed by trustees, have transferable shares or certificates of beneficial ownership, and that they must be a type of organization which in the absence of this provision would be taxed as an ordinary domestic corporation. These are the usual characteristics of real estate trusts.

The provision added by your committee also provides that qualifying real estate investment trusts must meet the following general requirements:

(1) The beneficial ownership must be held by 100 or more persons;

(2) No 5 individuals, taking account of related individuals, may hold more than 50 percent of the beneficial interests in the trust (your committee's provision achieves this effect by specifying that the trust must not be one which would be classified as a personal holding company if all of its gross income were personal holding company income);

(3) The trust must elect to be treated as a qualified real estate investment trust for the taxable and subsequent years; and

(4) The trust may not hold any property primarily for sale to customers in the ordinary course of its trade or business.

The requirements set out above are substantially similar to the conditions which must be met by qualifying regulated investment companies.

The income requirements, all of which must be met by a qualifying real estate investment trust, are divided into four categories. First, for the trust to qualify, at least 90 percent of its gross income must be from dividends, interest, rents from real property, gains from the sale of stock, securities and real property (including interests in real property and interests in mortgages on real property), and abatements or refund of taxes on real property. This is substantially the same as the 90 percent test provided for regulated investment companies except for the addition of the various types of income derived from real property.

The second income test provided for real estate investment trusts is new and is not required in the case of regulated investment companies. Under this test at least 60 percent of the trust's income must be derived from real property; that is, must be derived from rents from real property, interest on obligations secured by mortgages on real estate, gain from the sale of real property, dividends and other distributions from other qualifying real estate investment trusts and abatements or refunds of taxes on real property.

The effect of this 60 percent test, plus the prior 90 percent test, is to require that at least 60 percent of a trust's income be derived from real property. Another 30 percent must be derived either from real property or from sources from which a regulated investment company must derive most of its income.

The third and fourth income requirements are concerned with gains from the sale of property. The third test provides that not more than 30 percent of the trust's income may consist of short-term gains on security sales. The fourth test provides that gains from voluntary sales of real property (including interests in real estate mortgages) held for less than 5 years, may not account for more than 30 percent

of the trust's gross income. The third test is similar to one required in the case of regulated investment companies; the fourth test is new.

As indicated above, your committee has made sure that transactions which might be considered active business operations are not given the regulated investment company type of tax treatment. The principal limitation to achieve this result provides that rents from real property do not include amounts received with respect to real property if the trust furnishes or renders services to the tenants of the property or manages or operates the property, other than through an independent contractor from whom the trust itself does not derive or receive any income. If any services are performed for tenants or management fees are received therefor, these services must be performed and these fees received by an independent contractor rather than by the real estate investment trust. This provision is not intended to require the trustees to delegate or contract out their fiduciary duty to manage the trust, as distinguished from the servicing and operating of the building or buildings owned by the trust. Moreover, the requirement that the trust not receive any income from the independent contractor gives assurance that the relationship between the two is an arm's length relationship.

Rental income is also defined as excluding amounts derived from property if these amounts depend in whole or in part on the income or profits derived by any person from the property. This is provided to give assurance that no profit-sharing arrangement, provided for in the rental contract, will in effect make the trust an active participant in the operation of the property. Income from the operation of a store on a business property would, of course, be income derived from this property.

An exception to the general rule is provided for amounts based on a fixed percentage or percentages of receipts and sales since these are customary types of rental contracts and are not generally considered related to the profit or loss of the lessee. Generally speaking, therefore, rents received from real estate would not be disqualified solely by reason of the fact that the rent is based on a fixed percentage of total receipts or sales of the lessee (whether or not adjusted for such items as returned merchandise, or Federal, State, or local sales taxes). It is not intended to disqualify situations where the lease provides for differing percentages of receipts or sales from different departments or from separate floors of a retail store, for example, so long as each percentage is fixed at the time of entering into the lease. However, the fact that a lease is based upon a percentage of total receipts would not necessarily qualify the rent as "rent from real property." Thus, for example, rent would not qualify if the lease provides for a rental measured by varying percentages of receipts, unless the arrangement conforms with normal business practices where rental percentages are based on receipts, and is not in reality used as a means of basing the rent on income or profits.

Still a third restriction provided in the case of rents from real property excludes from the definition of rents amounts received from any person if the trust has an interest of 10 percent or more in the business, assets, or profits of that person. This prevents the avoidance of the restrictions described above with respect to rents from real estate through the device of setting up a related organization. It also forecloses the opportunity of any substantial relationship between the trust and the business of any tenant.

As has been previously indicated, this bill provides the regulated investment company type of tax treatment in the case of real estate investment trusts which distribute 90 percent or more of their ordinary taxable income (exclusive of net long-term and short-term capital gains). Any amount in excess of the 90 percent which the trust retains, however, is to be subject to the regular corporate income tax.

The beneficiaries of the trust in general will continue to be taxed in the same manner as ordinary dividend recipients. Capital gains of the trust, however, to the extent they are distributed, are to be free of tax at the trust level and at the beneficiary level are taxed as long-term capital gains rather than as an ordinary dividend. No provision is made, however, to extend to real estate investment trusts the procedure, presently available for regulated investment companies, whereby capital gains which are not distributed can be taxed to the beneficiaries rather than to the trust.

Where 25 percent or more of the income of the real estate investment trust is from rents, interest or other nondividend income the trust beneficiary is to treat as a dividend only that portion of the dividend payment he receives which corresponds to the percentage of the trust's income which was attributable to dividends. Any amount not treated as a dividend to the beneficiary is not to be eligible for the dividends received credit, exclusion or deduction, but is to be taxed as ordinary income to the recipient. If the interest and other nondividend income is less than 25 percent of the trust's total income, the entire distribution to the beneficiary (exclusive of capital gains dividends) is to be treated as if it were the receipt of an ordinary dividend and eligible for the dividends received credit and exclusion or deduction.

A restriction in this provision applies in the case of capital-gain dividends, the same treatment which this bill in section 43 applies to regulated investment companies generally. That is, where a share or interest in a real estate investment trust is held for not more than 30 days any loss on the sale or exchange of the share or interest, to the extent of any capital gain dividend received during that period, is to be treated as a long-term capital loss.

This provision is effective with respect to taxable years of real estate investment trusts beginning after December 31, 1957.

Section 45—Tax on nonresident aliens

Under present law, lump-sum distributions made under "trusteed" employee-pension, profit-sharing, and stock-bonus plans are subject to a 30-percent tax as provided by section 871 (a) when paid to a nonresident alien not engaged in a trade or business within the United States. In addition, such payments are subject to withholding at the source. However, lump-sum payments made to the same individual are not subject to either the 30-percent tax or withholding at source if they are made under an "insured" employee pension, etc., plan.

The House bill corrects these defects by subjecting (in sec. 871 (a) (1)) lump-sum distributions made under insured employee-pension, etc., plans to the 30-percent tax. The bill (code sec. 1441) also subjects these distributions to withholding at the source. Your committee has accepted this provision without change.

The 30-percent tax is made effective for taxable years ending after the date of enactment of this bill. The withholding becomes effective the day after the enactment of this bill.

Section 46—Credits for dividends received and for partially tax-exempt interest in the case of nonresident aliens

In lieu of the regular individual income tax, section 871 (a) imposes a tax of 30 percent on the gross amount of certain items of income received by nonresident aliens not engaged in trade or business in the United States. However, if the individual's income from these sources exceeds $15,400, section 871 (b) provides that the alien is to pay the regular income tax if this is more than 30 percent of the gross amount received from the specified income sources.

Although the 30-percent tax imposed by section 871 (a) is not reduced by the 4-percent dividends received credit or the $50 dividend exclusion, the credit and exclusion are available where a 30-percent tax is applicable under section 871 (b). Thus, this may result in a lower tax under this subsection than under subsection (a). To remove this inequality, the House bill provides that the 30-percent tax required by section 871 (b), where applicable, is to be the same tax as that provided under section 871 (a). This, in effect, denies the dividends-received credit and exclusion in the case of the present 30-percent tax provided under section 871 (b). Your committee has accepted this provision.

The House bill also amends section 35 of the code to provide that no 3-percent credit is to be available for partially tax-exempt interest in the case of the 30-percent tax under section 871 (a) or that presently applicable under section 871 (b). Your committee has concurred in this change.

The House bill would make the amendments made by this section apply to taxable years beginning after December 31, 1956. Your committee has advanced this date to December 31, 1957.

Section 47—Basis of property acquired by gift

Under present law where property is acquired by gift it is generally considered to have the same basis in the hands of the donee for purposes of computing gain, loss, depreciation, or amortization as it had in the hands of the person who made the gift. Where donated property is subsequently sold at a loss, however, the recognized loss is limited to the excess of the fair market value of the property at the time (when this value is below the basis at that time) it was given to the donee over the amount received.

In general, carrying over the basis of property in the case of gifts is in accord with the general principle followed in determining basis; namely, setting the basis of the property at its "cost". In this case the "cost" is the cost of the property to the donor, adjusted for any subsequent depreciation, etc. However, this ignores the fact that in reality there is another "cost" incurred in transferring the property from the donor to the donee; namely, the gift tax, which must be paid in order to make this transfer. As a result, your committee has concluded that to properly reflect total "costs" incurred with respect to donated property, it is necessary to increase the basis of the property by the amount of any gift tax paid with respect to it.

As a result, your committee has added a new subsection to the section of present law (sec. 1015) specifying the basis for property acquired by gift. In this new subsection it is provided that the basis of property acquired by gift, after the date of enactment of this bill, is to be increased by the amount of any gift tax paid with respect to

the donated property. However, the basis of the property as a result of this addition of the gift tax to the basis is not to be increased to more than the fair market value of the property at the time of the gift. A limitation of this type means that cash will be treated no less favorably than other property, and that there will be no incentive to convert cash into securities in order to obtain an increase in basis above the fair market value of the property. Moreover, this is similar to the rule which presently is in effect in the case of a subsequent sale at a loss.

The bill also provides an increase in basis for any gift tax paid with respect to gifts made before the date of enactment of this bill where the property has not as yet been sold, exchanged, or otherwise disposed of. In this case also, the basis of the property is to be increased by the amount of the gift tax, but not by more than any excess of the fair market value of the property at the time of the gift over its basis at that time.

The gift tax attributable to each gift is to be determined by assigning a pro rata portion of the gift tax paid for any calendar year to the taxable gifts made in that year. In determining the total amount of taxable gifts for purposes of this allocation, the $30,000 specific exemption is ignored and the total amount of the gifts made is reduced by any charitable deductions and any marital deduction. Also, where gifts are considered as being made one-half by a husband and one-half by his wife, both gift taxes are taken into account in determining the gift tax to be added to the basis of the property in the hands of the donee.

Section 48—Property acquired in tax-free exchange

Where, in connection with an exchange of property described in section 1031 (exchange of "property held for productive use in trade or business"), section 1035 (certain exchanges of insurance policies), or section 1036 (stock for stock of same corporation) a taxpayer transfers property of the type permitted to be exchanged tax free and, in addition, other property, having a tax cost in excess of its market value, the taxpayer may be able to claim a recognized loss. This loss should be reflected in determining the basis of the property received by the taxpayer on the transaction. However, present law does not make it clear (under sec. 1031 (d)) that there is a decrease in the basis of the property received in order to reflect this recognized loss.

Accordingly, the House amended the code (sec. 1031 (d)) to provide for a decrease in basis of the property received to the extent of the amount of any loss recognized to the taxpayer upon the transaction. Your committee has accepted this provision without change.

The provision is effective for taxable years beginning after December 31, 1953 and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

Section 49—Involuntary conversions

Under the present involuntary conversion provision (sec. 1033) no gain is recognized if within a specified length of time the taxpayer acquires other property similar in nature to the property converted, or purchases stock and thereby acquires control of a corporation holding similar property.

Under the 1939 Code "control" was defined as the ownership of 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 the corporation.

This definition of "control" of a corporation was inadvertently made inapplicable to involuntary conversions in the rearrangement of provisions made by the 1954 Code. Both the House bill and your committee's action make it clear that this definition of "control" is applicable in the case of involuntary conversions.

This provision is effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

Section 50—Condemnation of real property held for productive use in trade or business or for investment

Present law (sec. 1033) provides that where property is either wholly or partially destroyed, stolen, seized, requisitioned, condemned, or whether there is a threat or imminence of such, no gain is recognized where the property is compulsorily or involuntarily converted into "property similar or related in service or use to the property so converted." This same treatment is also accorded where the property is first converted into money or unrelated property and then, within a specified period of time, it is converted into property which is similar or related in service or use. The Internal Revenue Service and courts have held that section 1033 requires a relatively narrow construction of the words "property similar or related in service or use," with the result that the converted property must be substantially similar to that destroyed. It has been held not to include, for example, improved real estate which is converted into unimproved realty, nor a barge substituted for a tug. Similarly, it has been held not to include property used in the operation of a business which was substituted for rented property. Likewise, it has been held not to include city real estate exchanged for a farm or a ranch.

Present law also provides (sec. 1031) for the nonrecognition of gain where property held for productive use in trade or business or for investment (not including inventory, stock, bonds, or other securities) is exchanged for property of a "like kind to be held either for productive use in trade or business or for investment." The phrase "like kind to be held either for productive use in trade or business or for investment" has been given a broader interpretation than the similar or related phrase. "Like kind," for example, has been held to include unimproved real estate which is exchanged for improved real estate, so long as both properties are held either for productive use in trade or business or for investment. Thus, the "like kind" phrase has been held to include the exchange of city real estate (used in a trade or business) for a farm or ranch.

Both in the case of property involuntarily converted and in the case of the exchange of property held for productive use in trade or business or for investment, gain is not recognized because of the continuity of the investment. Your committee sees no reason why substantially similar rules should not be followed in determining what constitutes a continuity of investment in these two types of situations where there is a condemnation of real property. Moreover, it appears particularly unfortunate that present law requires a closer identity of the destroyed and converted property where the exchange is beyond

the control of the taxpayer than that which is applied in the case of the voluntary exchange of business property.

As a result your committee has added a new subsection to the involuntary conversion (sec. 1033) provision of present law. In this new subsection it has added the "like kind" test of the voluntary exchange of business property rule of present law as an alternative in the case of involuntary conversions for the rule requiring the substitution of property "similar or related in service or use." The "like kind" rule in this case applies, however, only in the case of real property, does not include inventory or property held primarily for sale, and is limited to seizures, requisitions, condemnations, or the threat or imminence thereof. Nor does it apply in the case of the purchase of stock in acquiring control of a corporation. This new rule is to be available only in the case of the disposition of converted property after December 31, 1957.

Under present law the involuntary conversion provision applies in the case of a personal residence which is involuntarily converted and replaced. Such replacements do not come under the provision relating to the sale or exchange of a residence (sec. 1034), which provides for the nonrecognition of gain where there is a voluntary exchange of one personal residence for another within a specified period of time. In most cases it makes no difference which of these two provisions is applied to an involuntary conversion of a personal residence. However, in some cases the voluntary sale or exchange provision may be more liberal than that relating to involuntary conversions. For that reason your committee has decided to give taxpayers an option in the case of the involuntary conversion of personal residences to come under the provision relating to the sale or exchange of residences (sec. 1034) or the involuntary conversion provision (sec. 1033).

Section 51—Property acquired before March 1, 1913

Present law (in sec. 1053) provides that property acquired before March 1, 1913, is to have a basis of cost, adjusted for depreciation for the period before March 1, 1913, or the fair market value as of March 1, 1913, whichever is greater, for purposes of determining gain. As a result of the rearrangement of various code provisions in 1954, the wording of this provision erroneously refers to only one part in the subtitle relating to income taxes. The House bill corrects this reference by making this provision refer to the entire income tax subtitle instead of merely the one part. Your committee concurs in this change.

This provision is effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

Section 52—Postponement of gain from sale or exchange to effectuate Federal Communications Commission policies

Where the sale of broadcasting property is certified by the Federal Communications Commission as being necessary or appropriate to carry out its policies, present law (sec. 1071 (a)) provides for the deferral of the recognition of any gain resulting from such a sale. This deferral of gain becomes effective if the proceeds from the sale are reinvested in "property similar or related in service or use," as in the case of sales coming under the involuntary conversion provisions, or if the taxpayer elects to reduce the basis of any remaining property

subject to depreciation, by the amount of the gain on the property disposed of.

It is understood that taxpayers have on occasion purchased additional facilities in excess of the maximum number of facilities permitted under then existing FCC rules, and then obtained a certification from the FCC that the disposition of the older facility was necessary or appropriate, thereby obtaining tax deferment on the gain from the sale. This is true even though the entire transaction in effect amounts to a voluntary undertaking by the taxpayer.

In September 1956, the FCC announced that commencing October 15, 1956, (21 Federal Register 7831) certificates would be granted only where the disposition is required because of a change in FCC policy or rules with respect to the ownership and control of broadcast facilities.

The House believed that the announced policy of the FCC is a desirable way of eliminating these voluntary transactions from the application of the involuntary conversion rules. The House bill, therefore, amends section 1071 to include as a statutory requirement a rule similar to that announced by the FCC. Under the bill this section will apply only to sales or exchanges of property certified by the FCC to be necessary or appropriate to effectuate "a change in the policy of, or the adoption of a new policy by, the Commission."

This provision of the House bill would be effective with respect to all sales or exchanges after December 31, 1957, and also to sales or exchanges between October 15, 1956, and January 1, 1958, but in this latter case only if they were made under a contract entered into after October 15, 1956.

Your committee does not believe that this provision should be made applicable to sales or exchanges which occurred before the beginning of this year. Accordingly, your committee has accepted the House provision without change except that instead of making the provision retroactive to October 15, 1956, it is making the provision effective only with respect to sales or exchanges occurring after December 31, 1957.

Section 53—Casualty losses sustained upon certain uninsured property

Under present law where there are uninsured losses on property as a result of its destruction, theft, seizure, requisition, or condemnation, such losses, in the case of property used in the trade or business or capital assets held for more than 6 months, are treated as section 1231 losses. These casualty losses coming under section 1231 of the code must be added together with other gains and losses from sales or exchanges of property used in a trade or business and with other gains or losses from involuntary conversions. If the resulting net amount is a gain, under section 1231 it is treated as a long-term capital gain and in effect taxed at a rate no higher than 25 percent. If, on the other hand the net amount is a loss, under section 1231 it is treated as an ordinary loss which can be offset against income taxed at the regular tax rates.

Where a taxpayer elects to be a self-insurer against casualty losses, there seldom is a conversion into money or other property, as there would be if the destroyed property were insured. If this casualty loss were the only loss incurred during the taxable year by the self-insured person, he would be entitled to the full benefit of an ordinary loss

deduction under section 1231, but where there are also 1231 gains, the casualty loss is partially or wholly offset against these gains which would otherwise be taxed as capital gains. As a result, the benefit of having casualty losses treated as ordinary, rather than capital, losses may be reduced or eliminated in the case of self-insurers, depending on the fortuitous circumstance as to what gains the taxpayer may have from trade or business assets or involuntary conversions. This is not a problem for those who are fully insured by others because they receive insurance payments in the case of destroyed property which offset the casualty losses which would otherwise be realized. Moreover, such persons may deduct currently the cost of their insurance for property used in a trade or business. Thus, in their case they obtain a deduction against ordinary income for any premiums paid and any gains from trade or business assets (or involuntary conversions) are taxed as capital gains and are not offset against losses (since these are covered by insurance) which would otherwise be treated as ordinary losses.

Your committee believes that this constitutes an unintended hardship and for that reason it has added a provision to the House bill amending section 1231 (a) of the code. The provision added makes section 1231 inapplicable in the case of losses where the taxpayer is not compensated for the loss by insurance, if the loss arises from fire, storm, shipwreck, or other casualty or from theft. This treatment is to apply, however, only in the case of property used in the trade or business and in the case of capital assets held for more than 6 months and held for the production of income. The effect of this provision will be to treat such losses always as ordinary losses and never to offset them against gains which might otherwise be treated as capital gains.

This amendment is to apply to taxable years beginning after December 31, 1957.

Section 54—Bonds issued at a discount

Under present law (sec. 1232) a taxpayer is required to treat as ordinary income a portion of any gain realized upon the sale or exchange of bonds or other evidences of indebtedness originally issued at a discount. This ordinary income treatment applies to that part of the gain which represents the portion of the "original issue discount" attributable to the time the taxpayer has held the bond. A practice has developed in some areas of issuing bonds with an artificially large discount and then redeeming them at par or at a special call price before their maturity date. Where such bonds are sold or retired before maturity at a price above the issue price plus the discount attributable to the period the bond has been held, a portion of the original issue discount receives capital gains treatment rather than ordinary income treatment. As a result, although the entire difference between the issue price and the redemption price is claimed by the corporation as a deduction against ordinary income, the bondholder obtains capital gains treatment with respect to his gain in excess of the discount attributable to the period up to redemption. To eliminate this abuse the House bill provided that *any* gain realized on the sale or exchange of a bond or other evidence of indebtedness containing an original issue discount is to be considered as ordinary income to the extent of the original issue discount. The House bill provides that this

section applies to taxable years ending after November 7, 1956, but only with respect to dispositions made after such date.

Your committee believes that the House bill should be restricted to provide that the rule of existing law should continue to apply if at the time of original issue there was no intention to call the bond or other evidence of indebtedness at a special price before maturity. In this connection your committee intends that the mere existence of a right to call the bond or other evidence of indebtedness before maturity is not to be regarded as an intention to call prior to maturity. Whether there is such an intention will depend upon all the facts and circumstances at the time of original issue. Your committee believes the new rule provided by the House bill will thus be confined to the areas of abuse. In addition, your committee has provided that this amendment shall apply to taxable years ending after December 31, 1957, but only with respect to dispositions made after such date.

Section 55—Bonds with coupons detached

Where a bond is sold with a number of interest coupons detached, a discount is created. This discount gradually decreases as the due dates for the interest payments represented by the detached coupons pass, and as a result the value of the bond gradually increases until, other things being equal, it is restored to its prior value. Before the enactment of the 1954 Code, it was contended that when a bond which had been purchased with coupons already detached was sold or redeemed, any gain realized on such a bond was to be treated as a capital gain. The gain in such a case, however, was at least partially attributable to the passing of the interest dates with respect to the detached interest coupons which, had they not been detached, would have resulted in ordinary interest income.

Under the 1954 Code (sec. 1232 (c)) where the detached coupons are payable on a date more than 12 months in the future, any gain, on sale or redemption, to the purchaser of the bond with the coupons detached is treated as ordinary income to the extent of the difference between the purchase price and the fair market value the bond would have had with the coupons attached at the time of the purchase. An exception was provided under the 1954 Code for interest coupons payable within 12 months from the date of purchase, in order to avoid the necessity of applying this provision in those cases where only 1 or 2 interest coupons had been detached. It was believed that such cases would not develop into tax-avoidance devices.

However, since the adoption of the 1954 Code provision some taxpayers have been creating artificial capital gains by buying bonds with detached interest coupons which are payable within 12 months from the date of purchase, and in this manner avoiding the application of the provision.

Both the House bill and your committee's action (in sec. 1232 (c)) prevent this avoidance by providing ordinary income treatment for discounts arising from the detachment of interest coupons whether or not the coupons are due within a period of 12 months or less from the date of purchase.

The House bill would delete this exception for detached interest coupons payable in the 12-month period immediately following purchase only for bonds purchased after November 7, 1956. Your committee deletes this exception only for purchases made after December 31, 1957.

This provision is expected to result in an increase in revenue over the long run, but is of such a nature that estimates of the current revenue gain from this provision cannot be made.

Section 56—Short sales

Under the 1939 Code any gain or loss from a short sale was a capital gain or loss. Under the 1954 Code (sec. 1233 (a)), however, a short sale results in a capital gain or loss only if the property used to close the short sale is a capital asset in the taxpayer's hands. Moreover, the rules (subsec. (b) of sec. 1233) which relate to the postponement of the beginning of the holding period, apply only if the short sale results in a capital gain or loss.

As a result, a dealer in stock may now be able to avoid the postponement of the beginning of his holding period under section 1233 (b) (2) by closing a short sale with stock held for sale to customers in the ordinary course of his trade or business rather than by closing it with stock from his own investment account. The House bill makes it clear that a dealer in securities may not avoid this holding period rule by closing a short sale by using property held for sale to customers instead of property held in his investment account. Because those who handle the inventory accounts for the dealer may be entirely separate from those who handle his investment accounts, the House thought that it was best to apply this new rule only where the short sale is not closed for a period of time in excess of that normally required in usual business operations; namely, where the short sale is not closed for a period of more than 20 days. It is believed that this will prevent any significant tax avoidance by covering inventory account short sales with investment account property since the maximum period of time during which such a situation may exist will be only 20 days. It is believed that it is necessary to provide a period of this type to give assurance that the short sales provision as modified by this bill will not unduly interfere with normal business practices.

Your committee has adopted the House provision described above except that it has limited its application to stock. It has limited the provision in this manner because in the case of the sale of certain types of bonds, particularly Government bonds, it is understood that short sales normally are kept open for periods in excess of 20 days. Moreover, in the past it has also been understood that the tax avoidance has occurred in the case of stocks rather than bonds.

This section of the House bill also rearranges the position of the provision with respect to hedging transactions in commodity futures.

The amendment made to section 1233 by the House bill with respect to the holding period would be effective with respect to short sales made after October 24, 1956. Your committee has amended this House provision to make it effective only with respect to short sales made after December 31, 1957. Making the short sale provision entirely nonapplicable in the case of hedging operations is made effective under both the House bill and under your Committee's action with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

This provision is expected to result in an increase in revenue over the long run but is of such a nature that estimates of current revenue gain cannot be made.

Section 57—Options to buy or sell

This section of the House bill rearranges and clarifies the existing tax treatment with respect to options to buy or sell. Present law (under sec. 1234) provides that a gain or loss attributable to the sale or failure to exercise an option to buy or sell property is to be considered gain or loss from the sale or exchange of a capital asset where the property, if it were in the hands of the taxpayer, would constitute a capital asset. This does not specifically provide that gain or loss attributable to an option to buy or sell property which would not be a capital asset in the hands of the taxpayer would result in ordinary income or loss rather than capital gain or loss. This, however, was the intent of the 1954 changes as is clearly reflected by the committee reports with respect to the 1954 Code. To carry out this intent, both the House bill and your committee's action provide (in a new subsection (a)) that the gain or loss arising from an option to buy or sell property is to be considered gain or loss arising from property which has the same character as the property underlying the option.

In addition, the House bill clarifies certain exceptions to the general rule with respect to options. The clarifications are as follows:

(1) It is made clear that capital-gain treatment will not apply to dealers in options where the options in question are a part of their inventory or stock in trade.

(2) It is made clear that the section does not apply to gains on the sale of an option in any case in which income derived in connection with the option would be treated, without regard to this section, as ordinary income. As a result, the section will not apply to gain from the sale of an employee stock option which is in the nature of compensation to the employee. It also will not apply to gain on the sale or exchange of an option involving "section 306 stock" resulting in ordinary income and it will not apply where a gain is a distribution of earnings and profits taxable as a dividend.

(3) It is made clear that the section does not apply to gain attributable to the sale of options acquired before March 1, 1954.

Your committee has accepted these clarifications without change.

This provision is effective for the taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

Section 58—Sale or exchange of patents

Present law (sec. 1235) provides that the sale of a patent by the inventor, or certain other persons, generally is to receive capital gains treatment rather than ordinary income treatment. This capital gains treatment is not available, however, when the patent is sold to certain specified related persons. The rules provided in section 267 (b) are generally followed in determining what constitutes a related person for purposes of this provision. These rules use a 50-percent test in determining relationship where a corporation is involved.

The House bill amended this patent provision to provide that capital gains treatment on the sale by an inventor of his rights in a patent would not be available in any case where he owns 25 percent or more of the stock of the corporation, instead of where he owns more than 50 percent as is provided by present law.

Your committee has restored the 50-percent test of existing law in determining whether or not capital-gains treatment is to be available where an inventor sells his rights to a patent to a corporation in which he owns stock. Your committee has restored this 50-percent test because this is the usual test of relationship used in the Internal Revenue Code and because there appears to be no reason to adopt a broader definition of relationship for purposes of the patent provision than in the case of many other provisions in the code. Moreover, the 50-percent test appears appropriate because the inventor who sells his patent to a corporation in which he does not own more than 50 percent of the stock, although he will indirectly receive part of the income derived by the corporation from the patent, is losing management and control of the patent itself.

The House bill also removes what may be interpreted as an inconsistency in the present rules under the patent provision. Present law provides that in such cases the relationship rules in section 267 (b) are to apply except that brothers and sisters are not to be considered as related persons. However, some take the position that a sale is considered a sale to a related person if a sale is made to a corporation which is controlled by a brother or sister of the taxpayer. Thus, under this interpretation although a patent may be sold directly to a brother or sister and still qualify for capital-gains treatment under section 1235, it cannot be sold to a corporation controlled by a brother or sister and qualify for capital-gains treatment. This possible interpretation is removed by an amendment (to sec. 1235 (d)) under the House bill which provides that in determining whether the seller of the patent constructively owns 25 percent of the stock of the purchasing corporation, the holding of brothers or sisters will be disregarded. Your committee has concurred in this amendment.

Under the House bill this provision would have applied with respect to taxable years ending after the date of enactment of the bill with respect to transfers after that date. Under your committee's action this provision is effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

Section 59—Real property subdivided for sale

Present law (sec. 1237) provides that under certain conditions real property which has been subdivided in order to be sold in separate tracts will not be considered property held primarily for sale to customers in the ordinary course of trade or business and, therefore, gains from such sales will be eligible for capital gains treatment. It was not intended that this treatment would be available in the case of property which had previously been held for sale to customers by the taxpayer, nor was it intended to apply in the case of property sold in the same year in which the taxpayer is a dealer in real estate, whether or not the particular property in question was held for sale to customers. A change made by the House bill, to which your committee has agreed, carries out this intention.

Section 60.—Gain from sale of certain property between spouses, etc.

Under the 1939 Code, the provision (now sec. 1239) relating to gains from sales of certain property between spouses or between an individual and a controlled corporation, did not apply to sales or exchanges made on or before May 3, 1951. This date, which was

unintentionally omitted from the 1954 Code, is restored by the House bill. Your committee concurs in the restoration of this date.

This provision is effective for taxable years beginning after December 31, 1953 and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

Section 61—Small-business investment companies

Recently the Senate passed a bill entitled the "Small Business Investment Act of 1958" (S. 3651). This bill was designed to make equity capital and long-term credit more readily available for small-business concerns. To carry out this purpose, the bill provided for the formation of small-business investment companies. These companies are to be authorized to provide equity capital to small-business concerns through the purchase of convertible debentures. The small-business investment companies are to be private companies with a paid-in capital and surplus of at least $300,000. Also, the Small Business Administration will be authorized to make loans to these companies of up to $150,000 through the purchase of subordinated debentures. The small-business investment bill of 1958 initially contained certain tax provisions relating to the tax treatment of these proposed investment companies and their stockholders. These tax provisions were withdrawn, however, for consideration in connection with this bill. Your committee, after considering these provisions, is convinced that they will substantially increase the effectiveness of these small-business investment companies. Therefore, it has amended the House bill to include these tax provisions formerly in the small-business investment bill of 1958.

The amendment to the House bill made by your committee contains three specific tax features. First, it adds a provision to the House bill providing that these proposed investment companies are to be allowed an ordinary loss deduction, rather than a capital loss deduction, on losses realized on the convertible debentures (including stock received pursuant to the conversion privilege) acquired in connection with the supplying of long-term equity-type capital for various small-business concerns. This loss deduction includes losses due to worthlessness, as well as those arising from the sale or exchange of the security. Second, taxpayers investing in the stock of the proposed investment companies also are to be allowed an ordinary loss deduction, rather than a capital loss allowance, on losses arising from the worthlessness, or from the sale, of such stock. The third tax feature of this amendment provides that these proposed investment companies are to be allowed a deduction for 100 percent of the dividends received from a taxable domestic corporation rather than the 85 percent deduction generally allowed corporate taxpayers.

Section 62—Amounts received as damages for injuries under the antitrust laws

In the absence of any specific statutory provision to the contrary an amount received (or accrued) during a year which represents an award or settlement of a civil action brought under section 4 of the Clayton Act for injuries sustained by the taxpayer in his business or property because of anything forbidden in the antitrust laws, is included in gross income as a lump sum in the year received (or accrued). Because of the progressive rate structure of the individual income tax, including this entire amount in income of a single year, although attributable

to injuries occurring over a period of years, is likely to result in a substantially higher tax being paid than if the amount had been received over the period in which the injury was sustained. Your committee believes that this discriminates against those who have been injured by violations of the antitrust laws and also tends to discourage suits for damage being brought under the Clayton Act.

For the reasons outlined above, your committee added a provision (a new sec. 1306) to the House bill providing a limitation with respect to the tax imposed on amounts representing damages received as awards or settlements in a civil action brought under section 4 of the Clayton Act for injuries sustained in the taxpayer's business or property because of violations of the antitrust law. In such cases the tax attributable to the award or settlement is not to be greater than the increases in taxes which would have resulted if the award or settlement had been included in the taxpayer's income, on a pro rata basis, over the period in which the taxpayer was injured. This provision covers settlements, as well as awards, both because equity appears to require the same treatment in these two types of cases and also because your committee did not want to discourage settlements.

This provision is to be effective for taxable years ending after the date of enactment of this bill but only in the case of amounts received after that date for awards or settlements made after that date.

Section 63—Mitigation of effect of limitations

Present law (secs. 1311–1315) contains a series of sections designed to mitigate the effect of the statute of limitations and other similar provisions where an item or transaction is treated differently from the way it was treated with respect to the same taxpayer in another year, or with respect to a related taxpayer. Thus, where there has been a court decree, closing agreement, final disposition on a claim for refund, or agreement with the Treasury, but because of the ststute of limitations or other similar provisions the erronous treatment cannot be corrected, so that there is a double inclusion of an item in gross income, double allowance of a deduction or credit, double exclusion, double disallowance of a deduction or credit, etc., a correcting adjustment may nevertheless by made to correct the inequity. The purpose of these provisions is to prevent either the Government or the taxpayer from obtaining a double benefit because of the statute of limitations or other similar provisions.

An example of where the Government may obtain a dual benefit at the taxpayers' expense which is not covered by these provisions, has been called to the attention of your committee. The example presented was that of a parent and subsidiary corporation. The subsidiary, in this case, claimed an interest deduction for an amount paid to the parent and the parent included this amount in its tax return as interest. However, the interest deduction claimed by the subsidiary was subsequently disallowed on the grounds that the amount paid to the parent was a dividend rather than an interest payment. As a result, the subsidiary paid a deficiency tax but because the parent corporation's tax year was closed, it could not claim what was at that time an intercorporate dividends received credit which would otherwise have been allowed.

One of the paragraphs under section 1312 was designed to cover a case in which the disallowed deduction or credit relates to the same

item for which a deduction or credit should have been allowed for another taxable year or should have been allowed to a related taxpayer. The typical situation there involves a payment for which the taxpayer claimed a deduction for the wrong year or for which the wrong taxpayer claimed the deduction; and the Internal Revenue Service does not regard that provision as being applicable to a case such as the example posed, which involves the treatment of a payment by one taxpayer and the treatment of its receipt by another taxpayer.

Your committee has added a provision to this section of the House bill designed to remove the inequity described in the example. It does this by adding to the list of types of adjustments under sections 1311 through 1315 where errors may be corrected, cases involving the allowance or disallowance of a deduction or credit to a corporation where a correlative deduction or credit should have been allowed or disallowed to a related taxpayer. For this purpose a related taxpayer is defined as one who is a member of the same affiliated group; that is, one where there is an 80 percent common ownership.

Your committee has also accepted the change made by the House bill in these provisions relating to the mitigation of effect of limitations.

The House provision makes it clear that in computing a refund or deficiency with respect to an adjustment in a barred year, where the same item has been adjusted by agreement between the Government and the taxpayer in an open year, neither the Government nor the taxpayer may raise unrelated adjustments in the barred year.

The amendments made in this section apply to determinations made after November 14, 1954 (90 days after the enactment of the 1954 Code, or the effective date of sec. 1314).

Section 64—Computation of tax where taxpayer restores substantial amount held under claim of right

Present law (in sec. 1341) deals with the situations where a taxpayer has included an amount in gross income in one year because it appeared that he had an unrestricted right to it, and in a subsequent year takes a deduction for the amount because it had subsequently become clear that he did not have an unrestricted right to the amount and restored it. In such a case the tax in the year in which the taxpayer must restore the amount is computed under present law in 1 of 2 ways: the tax in that year is to be computed by taking the deduction into account, or, instead, by reducing the tax in that year by the amount of the decrease in tax which would have occurred in the prior year if the amount had not initially been included in gross income.

(*a*) *Where World War II excess-profits tax is paid.*—Present law generally covers cases where a taxpayer is required to refund in a current year an amount he reported as income in an earlier year under the 1954 Code or under corresponding provisions of "prior revenue laws." However, through an oversight in the code, the definition of the term "prior revenue laws" includes only taxes imposed by chapter 1 of the 1939 Code and not those imposed by chapter 2 of that code. Since chapter 2 of the 1939 Code imposed the World War II excess-profits tax, this tax presently cannot be taken into account in determining the decrease in tax for a prior taxable year which would result from the exclusion of the item from income of that prior year. This is true despite the fact that the Korean excess-profits tax, as well as World War I excess-profits tax are covered by section 1341.

Cases have been called to your committee's attention where railroads have included amounts in income during World War II which they received from military shipments. This income was taxed under the excess-profits tax at rates as high as 85 percent. Now the railroads are being required to repay part of these receipts to the Government because a lower freight rate should have been applicable. Because of security restrictions during World War II, however, the railroads were unable in many cases to determine that these lower rates were applicable.

To correct this inequity, your committee has amended present law (sec. 1341) so that the term "prior revenue laws" includes taxes imposed by chapter 2 of the 1939 Code, or the World War II excess-profits tax. Your committee has made this amendment applicable to taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

(b) *Refunds by regulated public utilities.*—Certain exceptions to the general rule for the tax treatment of restoration of income held under a claim of right are provided in subsection (b) of section 1341. One of these special rules provides that the recomputation of tax for restorations of income is not to be available where the gross income in question arose as a result of the sale of inventory or stock in trade. However, the recomputation of tax for restoration of income is available in the case of regulated public utilities even where the income arose as a result of sales of inventory if the refunds are required to be made by a governmental unit.

Problems have arisen under this latter exception to the inventory rule where the restoration of income is made by the regulated public utility as a result of an order of a court or is made in settlement of litigation or under the threat or imminence of litigation. In these cases, the benefits of section 1341 are denied the public utilities although the benefits of the provision are available where the refunds are made by order of regulatory agency. Your committee sees no reason for distinguishing unfavorably against refunds made to the customers of a regulated public utility where the refund arose as a result of a court order or in settlement of litigation or the threat or imminence of litigation, yet making available benefits of section 1341 where the refunds are required by a regulatory agency of the Government. For that reason it has amended present law (sec. 1341 (b) (2)) to make the exception available in the case of regulated public utilities not only where the refunds or repayments are required by a governmental agency but also where they are required by an order of a court or made in settlement of litigation or under threat or imminence of litigation. This exception for regulated public utilities, however, is restricted to refunds or repayments arising with respect to rates of regulated public utilities.

This amendment is made applicable to taxable years beginning after December 31, 1957.

(c) *Payment or repayments pursuant to price redetermination.*—Your committee has also added another exception to the rule which excludes income arising from the sale of inventory items from the tax benefits accorded by this provision where there is a restoration of income held under a claim of right. Elsewhere in present law (sec. 1481) a reduction in tax for a prior year is permitted where there has been a price

redetermination under a provision in a contract. However, the offset of the prior year's tax in such cases has been held to be available only where the refund of the price is paid directly or indirectly to the United States or a United States agency. Thus, in the past this has discriminated against companies taking a subcontract from a "first tier" subcontractor since in such cases the refund resulting from the redetermination of price does not go to a governmental agency.

Your committee concluded that such cases deserve relief for past periods because of the compulsory nature of their contract arrangement where such arrangements have been initially instigated by a governmental unit. Thus, for past periods your committee has added an exception to the limitation with respect to inventories applicable in the case of section 1341 to provide that the tax benefits of this section are to be available where (1) a refund has been made pursuant to a price redetermination provision in a subcontract; (2) the parties to the subcontract are not related (within the meaning of sec. 267 (b)); and (3) although the subcontract is subject to statutory renegotiation, there is no mitigation of the effect of the redetermination of price (under sec. 1481) because the payment or repayment is not made to a governmental agency.

Because your committee is uncertain as to what arrangements might be worked out in the future between a first-tier and second-tier subcontractor under this provision, it has made it applicable only to subcontracts entered into prior to January 1, 1958, with respect to years to which the income taxes under the 1954 Code apply (namely, those beginning after December 31, 1953, and ending after August 16, 1954). However, it has added another provision (sec. 66 of the bill) which for the future gives relief to the second-tier subcontractor in the type of case described here, but requires the first-tier subcontractor to report this income in the year to which it was properly attributable.

(*d*) *Technical amendment.*—Existing law does not make it clear that where the tax for the year of restoration is computed by reducing it by the tax attributable to the item in a prior year, the deduction, which is not taken into account, is not to have any effect at all. For example, it can be argued that the deduction, although not taken into account with respect to the current year, should be taken into account for purposes of a net operating-loss carryback or carryover from this year. To make it clear that this is not the intention, the House bill provides that in such a case the deduction is not to be taken into account in computing income apart from computations under section 1341 itself. Your committee concurs in this amendment.

This provision is effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954, the general effective date of the income taxes under the 1954 Code.

Section 65—Claims against United States involving acquisitions of property

Present law (in sec. 1347) provides a special rule in the case of taxpayers who have received amounts from the United States with respect to claims against the Government which involve acquisitions of property by the Government and which claims remain unpaid for more than 15 years. In this case, the tax imposed is not to exceed 30 percent of the amount (other than interest) received. This provision was primarily designed for hardship cases arising from acquisitions of property by the Government during World War I.

The House does not believe that it is desirable to permit a provision of this type, providing special tax treatment, to remain as a permanent part of the law. For that reason the House bill makes this provision inapplicable to claims filed with the United States on or after January 1, 1957. Your committee has accepted this provision but advanced the effective date to January 1, 1958. The provision will have application in those cases where a claim was filed before January 1, 1958, but an amount was not received from the Government until after that date.

The House bill also amends this provision to provide that the 30-percent limitation is to be applicable only with respect to the surtax. Thus, the 3 percent normal tax will also be imposed with respect to amounts received under this section in addition to the 30-percent tax. The normal tax was in addition to the 30-percent tax under the 1939 Code and its omission in the 1954 Code was inadvertent. The House bill makes this amendment applicable with respect to taxable years beginning after December 31, 1956. Your committee has accepted this amendment but made it applicable to taxable years beginning after December 31, 1957.

This provision is expected to result in an increase in revenue over the long run but is of such a nature that estimates of current revenue gain cannot be made.

Section 66—Mitigation of effect of price redeterminations of subcontracts subject to renogotiation

Where a price charged by a prime contractor is subject to price redetermination or where the prime contract, or a subcontract thereunder, is subject to renegotiation and there is a repayment to the United States, present law (in sec. 1481) provides that the repayment is to be excluded from the contractor's or subcontractor's income for the prior year or years in which it previously was reported for tax purposes. This treatment is available, however, only where there is a repayment to the United States or one of its agencies. It does not apply in the case of a repayment required of a second-tier subcontractor to a first-tier subcontractor.

Elsewhere in this bill (see par. (c) in the discussion on sec. 64) your committee for subcontracts entered into before January 1, 1958, made provision for the type of case described above. In those cases it permitted the second-tier subcontractor to compute his income for the current year, either by taking the repayment as a deduction in that year or by reducing his tax for that year by the amount of tax paid in earlier years with respect to the amount now being repaid. From the standpoint of the second-tier subcontractor, this is, of course, appropriate tax treatment, although it does not require the first-tier subcontractor, who received the repayment from the second-tier subcontractor, to report this repayment as income in the same year as it is deducted by the second-tier subcontractor. While it appears inappropriate to impose an additional tax in such a case upon the first-tier subcontractor on a retroactive basis, your committee believes that, as a prospective rule, this obtains the correct result.

Therefore, your committee has added a new section to the chapter dealing with the recovery of excessive profits on Government contracts (ch. 4, in which sec. 1482 is added). In this provision, your committee

provides that, where there is a repayment from one party to another under a subcontract subject to statutory renegotiation, the tax of the party making the repayment is to be reduced and the tax of the party receiving the repayment is to be increased for the year with respect to which the payment was originally made. The amount of the decrease and increase in tax in these two cases is to be determined by making a recomputation of tax for the prior year or years. However, for purposes of determining when the statute of limitations expires with respect to this repayment (and also with respect to other provisions of the internal-revenue laws), this amount is to be considered an overpayment or underpayment in the year in which the repayment is made. This provision does not apply in cases where the repayment is made to the United States, since this type of case is already covered by present law (sec. 1481).

This provision is made effective with respect to subcontracts entered into after December 31, 1957.

Section 67—Revocation of election permitting certain proprietorships and partnerships to be taxed as corporations

Present law (sec. 1361) permits certain proprietorships and partnerships with 50 or less members to elect to be treated for tax purposes as corporations. This privilege is limited to those businesses where capital is a material income-producing factor or where 50 percent or more of the gross income consists of gains, profits, or income derived from trading as a principal or from certain types of brokerage commissions.

(*a*) *Deletion of House provision repealing section.*—The House bill repeals section 1361 effective with respect to taxable years beginning after December 31, 1957. The reasons given were that this provision had proved difficult to apply in actual practice because of the complexities which can arise in such problems as how to treat undistributed earnings and profits after a proprietorship or partnership has been taxed under this provision for a period of time and then subsequently becomes taxable as a proprietorship or partnership again. It was also pointed out that it had not been possible as yet to prepare either final or tentative regulations on this section.

Your committee believes that many of the problems with this provision will be resolved with the preparation of regulations on this section indicating in more detail how the provision will be applied. It recognizes, however, that problems may still exist and that as a consequence further legislative action may subsequently be required with respect to this provision. Your committee believes, however, that this provision is important to small business and is likely to be extensively used when taxpayers can be sure of the tax consequences of making this election. For that reason your committee has reinstated this provision.

(*b*) *Elections to apply provision in prior years.*—This provision provides that an election to come under the corporate treatment must be made in accordance with regulations prescribed by the Secretary or his delegate not later than 60 days after the close of any taxable year. However, the Treasury Department was not able to issue regulations under section 1361 before the last day (March 1, 1955) on which this election could be made for 1954. As a result, it issued Treasury Decision 6124 on February 24, 1955, which permitted tax-

payers to make a binding election within a 60-day period after the close of the taxable year. It was provided, however, that this election would not be valid unless perfected by the filing of an amended return on or before the last day of the third month following the month in which the final regulations are published.

To make certain that an election under this section will not be binding on the taxpayer before the final regulations under this section are published, the House bill provides a specific statutory substitute for Treasury Decision 6124. First, it provides that an election to be taxed as a corporation under section 1361, which is filed in accordance with regulations prescribed by the Secretary or his delegate, is to be treated as a valid election. However, it further provides that a valid election may be subsequently revoked at any time after the enactment of this bill and a period ending 3 months after final regulations are published on section 1361. Such a revocation, if made, would be effective for all years to which the election applied. Your committee has accepted without substantive change this House provision relating to the election.

Section 68—Election of certain small-business corporations

In 1954, Congress enacted legislation permitting proprietorships and partnerships to elect to be taxed like corporations (sec. 1361). At the same time, the Senate passed, but the Congress did not enact, a provision which would, at the election of the stockholders, permit corporations to forego the payment of any tax and require their shareholders to report the corporate income (whether or not distributed) as their own for tax purposes.

Your committee believes that the enactment of a provision of this type is desirable because it permits businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence. In this respect, a provision to tax the income at the shareholder, rather than the corporate, level will complement the provision enacted in 1954 permitting proprietorships and partnerships to be taxed like corporations. Also, permitting shareholders to report their proportionate share of the corporate income, in lieu of a corporate tax, will be a substantial aid to small business. It will be primarily beneficial to those individuals who have marginal tax rates below the 52-percent corporate rate (or 30-percent rate in the case of the smaller corporations) where the earnings are left in the business. Where the earnings are distributed (and are in excess of what may properly be classified as salary payments), the benefit will extend to individuals with somewhat higher rates since in this case a "double" tax is removed. The provision will also be of substantial benefit to small corporations realizing losses for a period of years where there is no way of offsetting these losses against taxable income at the corporate level, but the shareholders involved have other income which can be offset against these losses. In this connection it should be noted that the President's Cabinet Committee on Small Business and the President in his budget message this last January recommended a general provision of this type for the benefit of small business.

To permit shareholders in small-business corporations, in lieu of payment of the corporate tax, to elect to be taxed directly on the corporation's earnings, your committee has added a new subchapter

(subch. S, secs. 1371–1377) to the code. Where the tax treatment provided by this subchapter is elected, the shareholders include in their own income for tax purposes the current taxable income of the corporation, both the portion which is distributed and that which is not. Neither type of income in this case is eligible for a dividend received credit or exclusion, since it has been subject to no tax at the corporate level. Generally, this income is treated as ordinary income to the shareholder without the retention of any special characteristics it might have had in the hands of the corporation. This rule has been adopted so that this provision can operate in as simple a manner as possible. Long-term capital gains, however, are an exception to this general rule. In the case of these long-term capital gains the character carries over to the shareholder level.

Where a shareholder has been taxed on corporate earnings which were not at that time distributed, and then the corporation in a subsequent year distributes these earnings to such shareholders no further tax is required from the shareholder at that time, since these earnings have already been taxed to him in a prior year. Once all such earnings have been distributed, if further distributions are then made, and the corporation had earnings and profits before it elected this special tax treatment, then such distributions are to be taxed to the shareholders in the same manner as ordinary dividends from corporations.

Under this provision the net operating losses of the corporation currently also are passed through to the shareholder. Thus, at the corporate level where this special treatment is elected, there is no carryover or carryback of operating losses to or from a year with respect to which this special treatment has been elected. At the individual level these "distributed" corporate losses are to be treated in the same manner as any loss which the individual might have from a proprietorship; that is, they first offset income of the individual, in that year (whether or not derived from another business) and then any excess of these losses may be carried back and offset against the individual's income in prior years and, if any losses still remain, they may be carried forward and offset against his income in subsequent years.

Where this special treatment has been elected the basis of a shareholder's stock is increased for any of the corporate earnings taxed to him which are not then distributed, although this basis is subsequently reduced if these taxpaid corporate earnings are distributed. The basis of the stock of a shareholder is also reduced for any corporate losses which are passed through to him. The losses that he may take, however, are limited to the basis he has for the stock. Thus, his basis for the stock cannot be reduced below zero.

The right to elect the treatment provided under this new subchapter is limited to what are defined as small business corporations. These corporations must be domestic corporations which are not eligible to file a consolidated return with any other corporation. Also, they must not have more than 10 shareholders, their shareholders must all be individuals (or an estate), no nonresident aliens may be shareholders, and the corporation may not have more than one class of stock.

An election may be made to apply the tax treatment provided by this new subchapter only if all of the shareholders consent to this

election. For this purpose the shareholders are those of record as of the first day of the taxable year in question, or if the election is made after that time, shareholders of record when the election is made. An election to come under this provision must be made in a two months interval, either in the first month before the beginning of the taxable year for which the election is to be made or in the first month of that year. (A longer period of time, up to 90 days after the date of enactment of this bill, is allowed for the first taxable year beginning after December 31, 1957.) Once this provision is elected it is effective not only for the taxable year but also for all subsequent years although this election may be terminated.

The election to the tax treatment provided by this subchapter can be terminated in any one of several ways. First, the election is terminated if a new person becomes a shareholder of the corporation and he does not consent to the election. Second, the election can be terminated if all of the shareholders consent to its revocation. A revocation, however, is effective only with respect to subsequent years unless it is made in the first month of the taxable year. Third, the election as to the treatment under this new subchapter is to be terminated if the corporation ceases to qualify as a small-business corporation; that is, if the corporation no longer meets the requirements of a small business corporation, such as having not more than 10 shareholders or having no nonresident alien as a shareholder. Fourth, the election to be taxed under this new subchapter terminates if the corporation derives more than 80 percent of its gross receipts from sources outside the United States and, fifth, the election terminates if more than 20 percent of the corporation's gross receipts are derived from interest, dividends, rents, royalties, or other forms of passive income.

In order to prevent a corporation from electing in and out of the application of the provisions of this new subchapter, a limitation has been added providing that if a corporation has made an election under this subchapter, and if this election has been terminated or revoked, the corporation (or any successor) is not to be eligible to elect this treatment until its fifth year after the beginning of the year in which the termination or revocation is effective. However, the Secretary or his delegate is given the authority to make exceptions to this limitation.

This provision is to be effective with respect to taxable years beginning after December 31, 1957.

Section 69—Period of limitation for filing claim for credit for State death taxes

Under present law a credit is allowed against a portion of the tentative Federal estate tax for State death taxes. These State death taxes generally must be paid within 4 years after the estate tax return is filed to be eligibile for this credit. However, if an extension of time is granted to pay the Federal estate tax, the State death taxes need not be paid until after this period of extension. Similarly, if a petition for redetermination of a deficiency is filed with the Tax Court within 90 days after notice of a deficiency is mailed, the State death taxes need not be paid until 60 days after the Tax Court's decision becomes final in order to be eligible for credit against the estate tax. However, if the Federal estate tax is paid and then a refund claim is

subsequently filed, no extension of time is available under existing law for the payment of State death taxes.

Your committee agrees with the House that this discriminates against those who initially pay a disputed amount and then file claim for refund. As a result, both the House bill and your committee's action provide that where timely claims for refund have been filed with respect to Federal estate taxes, credits for State death taxes can still be claimed if these taxes are paid within the 4-year period provided by law or before the expiration of 60 days after the Treasury Department has notified the taxpayer of the disallowance of part or all of his claim, or are paid within the 4-year period or before the expiration of 60 days after a final decision of a court acting upon this claim, whichever is later. This amendment is made both to the 1954 Code (sec. 2011 (c)) and to the 1939 Code (sec. 813 (b)).

The amendment to the 1939 Code is applicable to estates of decedents dying after February 10, 1939, and on or before August 16, 1954. The amendment made to the 1954 Code is applicable with respect to estates of decedents dying after August 16, 1954.

This provision is expected to result in a negligible revenue loss.

Section 70—Estate tax in case of reversionary or remainder interest in property

Under present law an executor may, by posting an appropriate bond, postpone the payment of Federal estate tax on reversionary or remainder interests until 6 months after the termination of any preceding interests in the property. Where this election is made, State or foreign death taxes which are attributable to the reversionary or remainder interest are allowed as a credit against the Federal estate tax if they are paid and credit is claimed for them within 60 days after the termination of the preceding interests in the property.

The report accompanying the House bill points out that in some cases these 6-month and 60-day periods are too short a time to make the required payments of Federal and State taxes. For example, the settlement of accounts of a substantial and complicated trust may be required upon its termination before the executor obtains possession of the reversionary or remainder interest. In such cases, the payment of the State or foreign death taxes within the 60-day period may be impossible or result in undue hardship.

The House bill amends both the 1954 Code and the 1939 Code to extend, in the above types of cases, the time for payment of Federal estate taxes, and the time for paying and crediting State and foreign death taxes. Your committee has accepted these amendments without change.

The 1954 Code (sec. 6163) is amended to permit the Treasury Department, where payment at the end of the present period of postponement will result in undue hardship, to extend the time for payment for additional periods not to exceed 2 years. A corresponding amendment to the 1939 Code (sec. 925) extends a similar benefit to the estates of decedents who died during the period covered by the 1939 Code. The extensions authorized by these amendments are applicable only if the present period of postponement has not expired prior to the date of enactment of this bill.

In cases where the above hardship extension for the payment of the Federal estate tax has been granted, the bill (in sec. 2015 of the

1954 Code and sec. 927 of the 1939 Code) extends to the expiration of the period covered by the hardship extension, the time within which State and foreign death taxes attributable to the reversionary or remainder interest can be paid and credit for them claimed against the Federal estate tax.

Other technical or conforming amendments include—

(1) an amendment to the 1939 Code (sec. 926) to insure the Government the right to require surety bond for the payment of the tax at the end of the hardship extension; and

(2) an amendment to the 1954 Code (sec. 6601 (b)) to insure that the 4-percent interest rate, effective during the present period of postponement, will continue during the period of hardship extension.

The amendments (sec. 6163 of the 1954 Code and secs. 925 and 926 of the 1939 Code), which extend the time in hardship cases for paying Federal estate tax, apply only if the prior interests in the property did not terminate before the beginning of the 6-month period which ends on the date of the enactment of this bill. The amendments (sec. 2015 of the 1954 Code and sec. 927 of the 1939 Code), which extend the time for claiming credit for State and foreign death taxes, apply only if the prior interests in the property did not terminate before the beginning of the 60-day period which ends on the date of enactment of this bill. The amendment to the 1954 Code (sec. 6601 (b)) which relates to the continuation of the 4-percent interest charge in the case of hardship extensions of time is effective with respect to estates of decedents dying after August 16, 1954, the general rule of the 1954 Code applicable to the estate tax.

This provision is expected to result in a negligible revenue loss.

Section 71—Retirement annuities excluded from gross estate

Present law (in sec. 2039 (c)), to the extent attributable to contributions of the employer, excludes from the estate-tax base the value of an annuity or other payment receivable by a beneficiary under an employee's trust which is part of a plan meeting the requirements of "section 401 (a)" or under a retirement annuity contract purchased by an employer under a plan meeting the requirements of "section 401 (a) (3)."

Thus, in the case of an employee's trust this exclusion is available only if that trust meets *all* of the requirements imposed for income tax purposes with respect to a "qualified plan," that is, requirements intended to prevent discrimination in favor of employees who are officers, shareholders, supervisory or highly compensated employees. In the case of retirement annuity contracts, however, the present statute literally requires only that the annuity contract be purchased under a plan meeting one of these requirements to qualify for this exclusion from the estate-tax base, that is, the requirement of section 401 (a) (3).

The House bill makes it clear that the exclusion from the estate-tax base is to be available in case of an annuity contract only if it is purchased under a plan meeting *all* of the requirements of section 401 (a) required of an annuity plan which is a "qualified plan" for income tax purposes, that is, the requirements of section 401 (a) (3), (4), (5), and (6). Your committee concurs in this change.

This section applies to decedents dying after December 31, 1953.

Section 72—Gift tax not to apply to election of survivor benefits under certain qualified plans

By the enactment of section 2039 of the 1954 Code, Congress added a new section to the internal revenue laws generally providing that the value at the decedent's death of a joint and survivor annuity purchased by the decedent's employer (or one to which both the decedent and the employer made contributions) was includible in the decedent's gross estate and, therefore, subject to estate tax. Subsection (c) of section 2039, however, provided an exception to this general rule. This subsection provided that the portion of the survivor benefits payable under certain qualified pension, stock bonus, or profit-sharing plans which is attributable to the employer's contributions is excluded from the employee's gross estate for estate tax purposes.

Your committee agrees with the House that similar treatment to that outlined above should be made available in the case of the gift tax. Thus, your committee believes that the mere designation of a survivor beneficiary under a qualified plan should not result in the imposition of a gift tax when the survivor benefits are of such a nature that they would not be includible in the employee's gross estate for estate tax purposes.

The House bill adds a new section 2517 to the code which provides that the exercise or nonexercise, by an employee of an election as to survivor benefits is not to give rise to a gift tax where the annuity or pension rights are under an employee's trust or annuity contract which is qualified under section 401 (a). This exclusion is not to apply to the extent the annuity or pension is attributable to contributions made by the employee. Thus, this exclusion is comparable to the exclusion under the estate tax law provided by section 2039 (c).

The House provision applies to the calendar year 1955 and to all subsequent calendar years, the general gift tax effective date for the 1954 Code.

Your committee has accepted the House provision and the effective date provided therefor. However, because many believe that it was not clear prior to the enactment of the 1954 Code whether the designation of a survivor annuitant under a qualified annuity was subject to either the estate tax or to the gift tax, your committee has added a proviso to the effective date. This provides that, for calendar years before 1955, the determination of whether the exercise (or nonexercise) of an election to designate a survivor annuitant under a qualified annuity as being subject to the gift tax is to be made as if the new section 2517 had not been enacted and without inferences drawn from the fact that this section is not made applicable to calendar years before 1955.

This provision is expected to result in a negligible revenue loss.

Section 73—OASI coverage for employees of foreign subsidiaries

This section of the House bill, which your committee has accepted without change, amends the heading of section 3121 (l) (3) of the code relating to agreements entered into by domestic corporations for the purpose of extending old-age and survivors insurance coverage to service performed by certain employees of foreign subsidiaries. The section corrects a typographical error in the heading by changing the word "BE" to "BY."

Section 74—Federal service

This section of the House bill, which your committee has accepted without change, amends the last sentence of section 3122 relating to the collection and payment of employment taxes with respect to Coast Guard exchanges. It strikes out erroneous references to "this subsection" and inserts the words "this section."

Section 75—Acts to be performed by agents

This section of the House bill amends the first sentence of section 3504, relating to acts to be performed by agents in the case of employment taxes. It strikes out an erroneous reference to "this subtitle" and inserts in place of this a reference to "this title." Your committee has accepted this provision without change.

This provision is effective with respect to remuneration paid after December 31, 1954.

Section 76—Persons required to make returns with respect to income earned abroad

Present law (sec. 911 (a) (1)) provides an unlimited exclusion from gross income for compensation for personal services earned outside of the United States by a United States citizen who is a bona fide resident of a foreign country. Present law (sec. 911 (a) (2)) also provides an exclusion of up to $20,000 a year for personal-service income earned abroad by a United States citizen who is present in a foreign country at least 510 days out of 18 months. Taxpayers have not been required to report these excludable amounts in either income-tax returns or in information returns.

Apparently, the scope of these earned-income exclusions provided for citizens abroad has been misunderstood. Some citizens have assumed that the exclusions apply to income earned abroad, whether or not they qualify as bona fide residents of foreign countries or are present in foreign countries 17 out of 18 months. In other instances, citizens have mistakenly assumed that the exclusions apply to all items of income derived from sources outside of the United States. Types of income which are subject to United States tax, but which taxpayers frequently assume are not, include investment income, income from a taxpayer's business to the extent it is attributable to capital and not to personal efforts, and earned income in excess of the $20,000 excludable where an individual is in a foreign country 17 out of 18 months but is not a bona fide resident of that country. In addition, in the case of those who are abroad much of the time, some have the mistaken notion that, in their cases, income from personal services rendered in the United States is not subject to United States tax.

Because of this confusion as to the tax status of these various types of income, the Internal Revenue Service has found it difficult to administer the exemptions provided by section 911. The possibility that honest errors will occur is, of course, increased by the fact that citizens residing abroad necessarily have less readily accessible sources of information for determining the tax liability. Moreover, surveys made suggest that income of those residing abroad is escaping taxation and that remedial action is needed. It is believed that much of the difficulty stems from the fact that where taxpayers believe the exclusions to be applicable, they are at present reporting no information relative to the income, which means that the Internal Revenue Service

has little or no information available to it for determining whether the exclusions are properly allowable.

Your committee concurs in the House view that citizens residing abroad should be required to make returns in which they report their income in the same manner as other taxpayers whether or not they believe this income to be excludable from taxation under section 911. To provide for this the House amends the code (sec. 6012) to provide that in determining whether a taxpayer has $600 or more of gross income and, therefore, has to file a return, gross income is to include earned income excludable by reason of having been earned outside of the United States in the manner provided by section 911. Your committee has accepted this provision without change.

Under the bill income excludable under section 911 will be required to be treated as gross income only for purposes of determining whether a tax return must be filed. This will not deprive a United States citizen of any exclusion to which he is entitled and will have no effect apart from the requirement for filing returns and the administrative provisions relating to the filing of returns. It is expected, however, that the Treasury Department will exercise existing authority to require all taxpayers who have income excludable under section 911 to report this income on tax returns in sufficient detail, and with sufficient information to support their claim for an exclusion.

Under the House bill this provision is effective with respect to taxable years beginning after December 31, 1956. Your committee has advanced this date 1 year. Therefore, in the case of calendar year returns the new provision will first apply to those filed for the calendar year 1958.

This provision is expected to result in an increase in revenue over the long run but is of such a nature that estimates of current revenue gain cannot be made.

Section 77—Election to make joint return after filing separate return

The House bill amends the code (sec. 6013 (b)), which relates to the right of taxpayers to file joint returns within a certain time after having previously filed separate returns. In subparagraph (C) of paragraph (2) of that subsection a reference is made to a petition filed with the Tax Court within the time prescribed in "such section," which technically is section 6212, whereas it should be section 6213. The House bill corrects this reference and your committee has accepted the House provision.

Section 78—Returns treated as declarations of estimated tax by individuals

The bill corrects a technical omission in section 6015 (f) of the 1954 Code. That subsection now provides that a tax return filed by January 31 (or February 15 in the case of a farmer) will be a substitute for, or an amendment of, a declaration of estimated tax for the preceding year. However, if the taxpayer has a taxable year ending at any time other than December 31 these are not the appropriate dates. The bill substitutes dates having the same relation to any fiscal year as January 31 or February 15 has to the calendar year. Your committee has accepted this amendment.

Section 79—Publicity of exempt organization information

Congress in the Revenue Act of 1950 required certain tax-exempt educational and charitable organizations to file additional annual

information to be made available to the public. For the most part, the organizations required to supply this public information are what are commonly referred to as educational and charitable foundations. The type of information made available to the public under this provision includes the organization's gross income, expenses attributable to this gross income, disbursements out of income for its exempt purpose, accumulations of income, aggregate accumulations as of the beginning of the year, disbursements out of principal, and a balance sheet. In addition to the annual information returns which must be filed by some of the tax-exempt organizations, applications are required of most organizations claiming exemption in order that the Internal Revenue Service may determine whether or not they are exempt. These applications which are filed only at the time the organization applies for a ruling as to its exempt status, are not presently available to the public.

(a) *Publicity of applications.*—The House in this bill provides that the applications for exemption of these organizations, as well as other organizations described in section 501 (c) and (d), are to be made available to the public when the exemption has been granted. Your committee agrees with the House that making these applications available to the public will provide substantial additional aid to the Internal Revenue Service in determining whether organizations are actually operating in the manner in which they have stated in their applications for exemptions. It therefore has accepted this provision of the House bill.

The organizations, the applications of which will be made available to the public, include the following: so-called investment income holding companies for other exempt organizations; educational, charitable, religious, etc., organizations; civic leagues, social welfare organizations, and local welfare employee associations; labor, agricultural, and horticultural organizations; business leagues, chambers of commerce, etc.; social clubs; fraternal beneficiary societies; certain voluntary employees' life, sickness, accident, and other benefit associations (including Government employee associations); local teachers' retirement fund associations; local benevolent life-insurance associations and mutual or cooperative irrigation, electric, telephone, and like companies; nonprofit cemetery companies; nonprofit credit unions; mutual insurance companies, other than life or marine, whose gross receipts are not in excess of $75,000; corporations organized by exempt farm cooperatives to finance crop operations of members; communal-type religious or apostolic organizations; and United States Government instrumentalities.

The House provision to which your committee has agreed provides (sec. 6104 (a)) for public inspection of the applications for exemption of organizations described in section 501 (c) or (d) which are exempt under section 501 (a). The applications for exemption filed by these organizations (including not only those filed in the future but also those which have been filed in the past), together with any papers submitted by the organization in support of the application, are to be made available for public inspection at the national office of the Internal Revenue Service. In addition, in the case of applications filed after the date of enactment of this bill, copies of these applications (but not necessarily attachments, such as bylaws, charters, etc.) are to be open for public inspection at the field offices where the appli-

cations are filed or in the district where the organizations are located. It is your committee's understanding that this provision will not require any change in the current practice of the Internal Revenue Service in granting blanket exemptions to certain associations of religious organizations.

In addition, the new provision specifies that, after these applications have been made available to the public, the Treasury Department is, upon request, to indicate the subsection and paragraph of section 501 under which any organization is exempt.

The bill, however, makes provision for the withholding from the public of certain information the public disclosure of which might be harmful to the organization or to the national defense. Under this paragraph it is provided that, upon request by an organization, the Secretary shall withhold from public inspection any information contained in supporting papers submitted by the organization which he determines relates to trade secrets, patents, processes, styles of work, or apparatus of the organizations if he also determines that the public disclosure of this information would be detrimental to the organization. The Secretary or his delegate is also required to withhold from public inspection any information contained in supporting papers filed with exemption applications the public disclosure of which he determines will adversely affect the national defense.

(*b*) *Inspection by committees of Congress.*—In the past, committees of Congress in their investigations of tax-exempt organizations have found that the sections of the law authorizing them to inspect tax returns did not also authorize them to inspect the exemption applications of organizations qualifying under section 501 (c) or (d).

Therefore, the House bill (by amendment to sec. 6104 (a)) provides that the applications for exemption of organizations described in section 501 (c) or (d), together with any other papers in the possession of the Treasury Department which relate to these applications, are to be treated as if they were returns for the purposes of section 6103 (d) of the code. Your committee has accepted this provision.

Section 6103 (d) authorizes the Treasury Department to furnish certain committees of Congress, sitting in executive session, any information contained in, or shown on, any returns. The committees, either directly or through examiners or agents, are also authorized to inspect any and all returns. The committees referred to are the Committee on Ways and Means of the House, the Committee on Finance of the Senate, the Joint Committee on Internal Revenue Taxation, and also select committees of the Senate or House which are authorized to investigate returns by a resolution of the Senate or House (or joint committees so authorized by concurrent resolution).

(*c*) *Annual information returns.*—The House bill also makes one amendment relating to the annual information returns available to the public which are filed by certain educational and charitable organizations. In addition to the type of information already required to be submitted on these returns and made available to the public (see listing above), these organizations will also be required to make available to the public on their annual information returns the total of the contributions and gifts they have received during the year. Your committee also has accepted this requirement. This is added by the

House bill because information as to the total contributions and gifts received is essential to any proper analysis of these organizations.

It should be noted that this refers merely to the total contributions and gifts received. Thus, it will not be necessary to submit lists of contributions made by individual contributors.

In its hearings the attention of your committee was called to the fact that in the case of some tax-exempt charitable organizations, contributions are made to the organization in the form of used clothing, second-hand household furnishings, etc. These articles are then repaired by handicapped persons and resold. It was pointed out that it would be difficult, if not impossible, to value such articles as received. Your committee suggests that in such cases the total gifts and contributions may be estimated, however, by reducing total sales of such articles, by selling costs, repair costs, etc.

(*d*) *Effective date.*—Both the House bill and your committee's action provide that the amendment made with respect to publicizing the applications for exemption and also making these applications and other related material available to committees of Congress are to take effect on the 60th day after this bill is enacted. The amendments made with respect to the additional information to be required on annual information returns of certain educational and charitable organizations under the House bill would apply to taxable years ending on or after December 31, 1957, but under your committee's action are to apply to taxable years ending on or after December 31, 1958.

Section 80—Address for notice of deficiency

Section 6212 (a) of the code authorizes notices of deficiency "in respect of any tax imposed by subtitle A" (which includes chs. 1 to 6). However, subsection (b) of that section refers to the addresses of notices "in respect of a tax imposed by chapter 1." The House provision, which your committee has accepted, changes "chapter 1" to "subtitle A" in subsection (b).

Section 81—Release of lien or partial discharge of property

Present law (sec. 6325 (b)) provides that any part of property subject to a tax lien may be discharged if the value of the property remaining subject to the lien is at least twice the amount of the tax lien and any prior liens. Special estate-tax and gift-tax liens, however, are indefinite in amount, applying not only to the tax now known to be due, but, also, to amounts which are determined later. Therefore, the 1939 Code did not require retention of property equal to twice the amount of the lien in these cases, but provided that any or all of the property subject to one of these liens could be discharged if the Secretary or his delegate found that the tax liability had been "fully discharged or provided for." This rule was inadvertently eliminated in the rearrangement under the 1954 Code.

The House bill restores this rule of the 1939 Code (in a new subsec. (c) in sec. 6325), and your committee has agreed to this change.

Section 82—Correction of references to United States attorneys

This provision of the House bill, which your committee has accepted, corrects certain provisions of the code by changing references to "United States district attorney" to "United States attorney" to conform with presently established nomenclature.

Section 83—Conveyance of title

This provision of the House bill, which your committee has accepted, amends section 6339 (b) (2) of the code, relating to conveyance of title, to correct a grammatical error in the heading by changing the word "OF" to "AS."

Section 84—Request for prompt assessment

(*a*) *Corporations which are dissolved, or in process of dissolution.*—Present law (in sec. 6501 (d)) provides that an executor may request prompt assessment of any taxes (other than estate taxes) owed by the decedent or by the estate during the period of administration, and that a corporation which expects to be dissolved within 18 months may request a prompt assessment of taxes owed by it. The House bill provides that such a request can also be made by a corporation which is in process of dissolution, or has been dissolved, at the time the request is made. Your committee has accepted this amendment.

(*b*) *Six-year statute.*—Present law (sec. 6501 (d)) also provides, in general, that, if proper requests for prompt assessment have been made, the tax must be assessed within 18 months after the request was filed, rather than within the usual 3 years. However, the usual 3-year period for assessment is extended to 6 years, where there has been an omission of 25 percent of gross income (or 25 percent of the value of gifts) or where a personal holding company has not filed the required information schedule. Under present law, the 18-month period after a request for prompt assessment is not, however, expressly extended. The House provision, to which your committee agrees, specifically provides a 6-year period for assessment in such cases, notwithstanding the filing of a request for prompt assessment.

Section 85—Limitations on assessment and collection

(*a*) *Trusts filing information returns.*—Present law provides that if an organization believed to be exempt is found to be taxable as a corporation, the period of limitation for assessment is to begin to run from the date an information return required of exempt organizations was filed by that organization. Such an organization may be taxable as a trust, however, instead of as a corporation. The House bill (sec. 6501 (g) (2)) starts the period of limitation on the date the information return was filed whether the organization is a corporation or a trust. Your committee concurs in this amendment.

(*b*) *Years to which carrybacks are applied.*—A rule in the 1939 Code provided that where a net operating loss was carried back to reduce the income of an earlier year, any deficiency for that earlier year attributable to the carryback could be assessed at any time a deficiency for the subsequent year of the loss could be assessed. This rule, which was inadvertently omitted from the 1954 Code, was restored by the House bill. Thus, for example, if a 1956 loss is carried back to offset the income of 1954, a deficiency for 1954 could, in general, be assessed within 3 years after the return for 1956 was filed. Your committee has accepted this provision.

Section 86—Limitations on credit or refund

(*a*) *Period for filing claim.*—Under present law a claim, to be valid, must in general be filed within 3 years from the due date of the return, without regard to any period of extension granted for the filing of the return (or within 2 years from the time of tax payment, whichever is

later). However, the rule with respect to assessments is that the period of limitation is 3 years from the date the return was actually filed, whether or not filed when it was due. To correlate these rules the House bill (by amending sec. 6511 (a)) provides that a claim for refund or credit of any tax may be filed within 3 years from the time the return was actually filed (or, as under present law, within 2 years from the time of payment, whichever is later). Your committee has accepted this change.

(*b*) *Limit on credit or refund.*—Present law as one alternative provides that the amount of any credit or refund allowed cannot exceed the portion of the tax paid within a period of 3 years immediately preceding the filing of the claim. To correspond with the amendment described above, the House bill provides that in such cases the amount to be refunded or credited is not to exceed that portion of the tax which was paid within a period of 3 years preceding the filing of the claim plus the period of any extension of time for filing the return. Your committee has accepted this change.

(*c*) *Period for net operating loss carryback.*—The House bill (by amending sec. 6511 (d) (2) (A)) also changes an erroneous date with respect to periods of limitation for credit or refund in the case of net operating loss carrybacks. Present law provides that a valid claim for the refund of a tax for a year to which a net operating loss is carried back may be made on or before the "15th day of the 39th month" after the end of the taxable year of the net operating loss. Thus, if a net operating loss for the calendar year 1956 is carried back to 1954, under present law a valid claim may be filed within the period ending March 15, 1960. In the case of individual returns, however, the filing date is not March 15 but April 15. The House bill therefore changes the reference from the "15th day of the 39th month" to the "15th day of the 40th month" for individuals and your committee has accepted the change.

Section 87—Correlation of interest where overpayment of tax is credited against underpayment of tax

(*a*) *General correlation of interest.*—Under present law situations can arise where, even though underpayments and overpayments offset each other, the Internal Revenue Service collects more interest than it pays or the taxpayer is entitled to more interest than he owes the Government. Section 6611 (b) (1) of the code provides, for example, that interest on an overpayment which is credited against an additional assessment is to be allowed from the date of the overpayment to the date of the assessment. However, interest on an additional assessment which is offset against an overpayment runs from the due date of the return until the credit is scheduled, which may be long after the date the interest on the overpayment is cut off by the assessment of the additional amount. In such cases, although the underpayment and overpayment offset each other, the Internal Revenue Service collects more interest than it pays. On the other hand, where a taxpayer agrees to a determination and signs a waiver of the restrictions on an assessment, interest on an overpayment may run during the period between the 30th day after the waiver and the issuance of notice and demand while interest on an offsetting deficiency may be suspended. In such a case it is the taxpayer who is entitled to more interest than he owes—even though the overpayment and underpayment offset each other.

The House bill eliminates these erratic differences of present law by terminating the interest both as to the overpayment and underpayment during any period of time to the extent they offset each other, except that interest on a deficiency will be charged for any period during which interest on the overpayment would not have been allowed if the overpayment had not been credited against the deficiency. This change is made both in the 1954 Code and in the 1939 Code. Your committee has accepted this change. The House bill makes the amendments to both the 1954 and 1939 Codes effective with respect to overpayments credited after the date of enactment of this bill. However, your committee's action makes these amendments effective with respect to overpayments credited after December 31, 1957.

(*b*) *Interest attributable to net operating loss carryback in transition years affected by the 1954 Code.*—Prior to the adoption of the 1954 Code a net operating loss could be carried back only to the year immediately before the loss year. The 1954 Code, however, provided a 2-year carryback. Thus, situations arose where under the 1939 Code law a loss was carried back 1 year and offset against income, whereas after the adoption of the 1954 Code the loss should have been carried back 2 years. As a result, a deficiency arose in the first prior year, which bore interest, but by specific statutory provision no interest was payable on the overpayment in the second prior year. The House bill stops interest on deficiencies in cases of this type for periods where there are corresponding overpayments for which no interest is payable. Your committee has accepted this amendment.

This amendment is to apply to deficiencies in the first taxable year before a year ending after December 31, 1953, and before August 17, 1954, and overpayments in the second prior year.

Section 88—Interest on underpayments

It has been contended that interest to be collectible must be assessed within the limitation period for the assessment of the tax on which the interest has accrued. The House bill makes it clear (by providing an exception to the general rule of section 6601 (f) (1)) that interest may be assessed and collected at any time during the time when the tax involved may be collected. Your committee has accepted this clarification.

Section 89—Failure to file certain information returns

The bill amends section 6652 of the code, relating to additional amounts assessed for failure to file certain information returns. It makes it clear that the additional amount will apply if the required returns are not filed within the time prescribed, and the taxpayer can show no reasonable cause for failure to file on time. The language of existing law can be interpreted as applying only to failure ever to file such returns for a particular year rather than failure to file the returns on time. The House bill makes it clear that this interpretation of present law is not correct. Your committee concurs. The application of this section has been limited to information returns for which a fixed due date is prescribed by regulation.

Section 90—Definition of underpayment

Present law (sec. 6653 (c) (1)) provides that for purposes of measuring a deficiency in income, estate, or gift tax, the tax shown on the

return is to be taken into account if the return was filed before the last day prescribed for filing. The House bill makes it clear that the tax shown on the return also is to be taken into account if the return is filed on the last day prescribed for filing. Your committee has accepted this clarification.

Section 91—Termination of taxable year in case of departing aliens

Existing law provides that no alien may leave the United States until he has procured a certificate that he has complied with all of the obligations imposed upon him by the income-tax laws. Present law also requires a departing alien either to pay any income tax due, up to the time of departure, or to file a bond or other security to insure payment of the tax before a certificate of compliance may be issued to him. In practice the Internal Revenue Service makes exceptions to these rules in the case of foreign diplomats and aliens in transit through the United States without stopover privileges.

Your committee agrees with the House that the Secretary of the Treasury should be provided with some flexibility in administering these requirements. Therefore, it has concurred in the House amendment (to sec. 6851 (d)) to provide that the Secretary or his delegate may by regulations provide exceptions to the rule that all aliens departing the United States must obtain certificates that they have complied with all obligations imposed upon them by the income-tax law. In addition, this provision, which your committee has accepted, provides that payment of taxes not otherwise due, or the furnishing of bond for payment of these taxes, will not be required if the Secretary or his delegate determines that the collection of the tax will not be jeopardized by the departure of the alien. In this case, also, the Secretary or his delegate may prescribe exceptions by regulations.

Section 92—Bankruptcy and receivership proceedings

(*a*) *Immediate assessment.*—Present law (sec. 6871 (a)) provides for the immediate assessment of any deficiency upon (1) the adjudication of bankruptcy of any taxpayer in any liquidation proceeding, or (2) the appointment of a receiver in any receivership proceeding, or (3) the approval of a petition of, or against, any taxpayer in any other bankruptcy proceeding. However, the statute does not specify whether an immediate assessment may be made in those cases where approval of a petition in bankruptcy is not required. Such cases include, for example, proceedings under the Bankruptcy Act relating to arrangements with unsecured creditors.

The House bill makes it clear that the Government may make an immediate assessment where the Bankruptcy Act does not require approval of the petition. Your committee has accepted this provision.

(*b*) *No Tax Court proceeding to be instituted where unapproved petition in bankruptcy has been filed.*—Present law (sec. 6871 (b)) provides that claims for deficiency, interest, etc., may be presented to the court before which a bankruptcy petition is pending despite the fact that a petition for redetermination of the same deficiency is pending in the Tax Court. However, it specifically provides that no petition for redetermination of a deficiency may be filed with the Tax Court after adjudication of bankruptcy, appointment of a receiver, or approval of the petition in any other bankruptcy proceeding.

The House bill makes it clear that no petition for redetermination of a deficiency may be filed with the Tax Court after the filing of a petition in bankruptcy, where the Bankruptcy Act does not require approval of the petition. Your committee has accepted the clarification.

Section 93—Use of certified mail

Several provisions of the Internal Revenue Code now provide for the use of registered mail, both by the Internal Revenue Service and by taxpayers. For example, the Service is required to use registered mail in issuing notices of deficiency and notices relating to the disallowance of claims. Further, the use of registered mail with respect to any pleading, notice, or process in respect of a proceeding before the Tax Court is held by present law to be sufficient service of such pleading, notice, or process. The Post Office Department in 1955, however, established a new type of mail service known as certified mail. Apart from the fact that only matter of no intrinsic value is acceptable for certified mail, registered mail and certified mail provide much the same services. Moreover, certified mail is much less expensive than registered mail.

Accordingly, the House bill amends the code to provide that wherever the use of registered mail is presently required, either certified or registered mail may be used. In addition, the Secretary or his delegate is authorized to prescribe by regulations the extent to which section 7502 of the code regarding prima facie evidence of delivery and regarding postmark date, now applicable to registered mail, are also to apply in the case of certified mail. It has been indicated that the Treasury Department will exercise this authority, if granted, only if the Post Office Department prescribes regulations requiring that the postal employee who postmarks a sender's receipt for certified mail actually mails the letter. Your committee has accepted this amendment.

This change is effective with respect to mailings which occur after the date of enactment of this bill.

Section 94—Reproduction of returns and other documents

Representatives of the Treasury Department have stated that faster and more accurate processing of information contained on tax returns, cards, and other records can be obtained through the use of microphotographic and other reproduction processes. It has also been pointed out that microfilming provides more durable and lasting records and permits a great reduction in storage space, thus reducing the cost of retaining records. This is particularly true with respect to corporate returns and various statistical and accounting records which must be kept for a long period. The purchase and operation of equipment for processing film and for making reproductions, however, would be expensive and, accordingly, has not been undertaken.

The House bill (code section 7513 under your committee's action) grants the Secretary of the Treasury or his delegate authority to utilize the services of Federal agencies and commercial organizations for the processing of microfilm and other reproducing materials. It is understood, however, that the actual photographing of returns and other records would be performed only by Government employees. To protect the confidential character of information contained in returns and

other documents, the Secretary is required to issue regulations providing safeguards against unauthorized use of microfilm or other reproductions and unauthorized disclosure of information contained in these films or reproductions. In addition, a penalty of not more than $1,000 or imprisonment for not more than 1 year, or both, is provided for any person who without authority uses the film or photographic impression or reproduction or discloses any information taken from this material.

This provision further provides that microfilm and other reproductions are to have the same legal status as the original documents and that these reproductions if properly authenticated, are to be admissible in evidence in any judicial or administrative proceeding as if they were the originals, whether or not the originals are in existence.

Your committee has accepted this House provision.

Section 95—Seals for offices of Treasury Department

The Judicial Code provides that documents of a Government agency are to be admissible in court as evidence of the act, transaction, or occurrence involved. It further provides that properly authenticated copies of these documents are to be admitted in evidence equally with the originals.

In supplying the Justice Department with copies of Internal Revenue Service records certified under seal (usually assessment records) for presentation in court, it is now necessary that the copies be sent from the field offices, where the records are kept, to the national office in order to have the Treasury seal affixed. The copies are then sent back to be filed in a court, usually located in the district where the records are kept. This procedure for the authentication of records kept in the field is unsatisfactory in that it requires additional paperwork in the national office, necessitates constant exchange of documents between the field and national offices, and results in delay of the presentation of evidence in situations where expeditious action is essential.

To meet this problem the House bill (in sec. 7514 under your committee's amendments) authorizes the Secretary to prescribe individual seals for district directors of internal revenue and other officers and employees of the Department to whom functions of the Secretary are delegated. It also provides that judicial notice is to be taken of seals prescribed under this authority if facsimiles thereof are published in the Federal Register. Your committee has accepted this provision.

Section 96—Income taxes paid under contract

In some cases lessees contract to pay a fixed rental to a lessor without reduction for Federal income taxes, or agree to pay an annual rental plus any Federal income taxes of the lessor attributable to this rental income. On occasion, contracts of this type are also entered into by other than lessees and lessors.

For taxable years prior to 1952, it was the consistent practice of the Internal Revenue Service, for more than 30 years, to include in the lessor's income only the amount of the fixed rental plus the initial or original tax on the annual rental paid to the lessor. Any additional tax of the lessor paid by the lessee under the lease agreement was not included in the lessor's income. This same rule also was followed in the case of contracts between corporations. This rule can be

illustrated by assuming a $100 rental payment and a flat 52 percent tax rate:

Rental payment	$100.00
Tax on $100 rental payment	52.00
Tax on 1st tax	27.04
Total payment by lessee	179.04

The tax base in this case is $152 on which the tax, at a 52 percent rate, is $79.04.

The above rule was changed in 1952 (Mimeograph 6779, C. B. 1952-1, p. 8), as modified by Internal Revenue Service Mimeograph 51 (C. B. 1952-2, p. 65), with the result that for taxable years beginning after December 31, 1951, the Internal Revenue Service held that the lessor is deemed not only to have received as income the stipulated rental payment, but also all Federal income taxes paid by the lessee on behalf of the lessor. Since the lessee is obligated to pay all Federal income taxes, this additional tax, in turn, gives rise to additional income to the lessor which, in turn, gives rise to additional tax and additional income, and so forth. In this manner the tax on a tax is pyramided to a point where the income tax liability paid by the lessee may be greatly in excess of the initial tax on the rental income, except in those cases where the lease agreement contains a ceiling on the liability of the lessee to pay the lessor's taxes. This "pyramiding" rule was also applied in the case of contracts other than leases. This rule can be illustrated by the same example as that given above, namely, a $100 rental payment and a flat 52 percent tax rate:

Rental payment	$100.00
Tax on $100 rental payment	52.00
Tax on 1st tax	27.04
Tax on 2d tax	14.0608
Tax on 3d tax	7.3116
Tax on 4th tax	3.8020
Tax on 5th tax	1.9770
Tax on 6th tax	1.0280
Tax on 7th tax	.5346
Tax on 8th tax	.2780
Tax on 9th tax	.1446
Tax on 10th tax	.0752
Tax on 11th tax	.0391
Tax on 12th tax	.0203
Tax on 13th tax	.0106
Tax on 14th tax	.0055
Tax on 15th tax	.0029
Tax on 16th tax	.0015
Tax on 17th tax	.0008
Tax on 18th tax	.0004
Tax on 19th tax	.0002
Tax on 20th tax	.0001
Total payment by lessee	208.3332

The tax base in this case is $208.33 on which the tax is $108.33.

Section 110 of the 1954 Code changed this rule for subsequent taxable years in the case of leases entered into before 1954 where both the lessee and lessor are corporations. Under this section the lessor is required to include in income only the amount of the rental payment, and only this amount is allowed as a deduction to the lessee. The lessee is not allowed to deduct any income taxes paid on behalf of the lessor. The "pyramiding" rule continues to apply, however,

in the case of contracts other than leases. The 1954 Code rule for leases can also be illustrated by the example of the $100 rental payment and a flat 52-percent tax rate:

Rental payment	$100
Tax on $100 rental payment	52
Total payment by lessee	152

In this case, however, the lessee can deduct only the $100 rental payment paid to the lessor and may not deduct the $52 payment of taxes he made for the lessor. Thus, he foregoes a tax benefit of $27.04 (assuming the 52-percent tax rate on $52 of income which otherwise would be deductible).

Although the tax payments are divided differently between the lessee and lessor, as indicated in the examples presented above, the pre-1952 and post-1954 rules applying to leases are likely to result in substantially the same total tax payments. Thus, the hardship in this case exists only with respect to the taxable years 1952 and 1953 where a much heavier tax burden is imposed.

In view of the consistent practice for more than 30 years of the Internal Revenue Service, the House concluded that it is appropriate to make the pre-1952 rule applicable to all taxable years coming under the 1939 Code. It therefore amends the 1939 Code (sec. 22) to accomplish this result. This amendment provided that if a lease was entered into before January 1, 1952, both the lessee and lessor are corporations, and under the terms of the lease the lessee is obligated to pay or reimburse the lessor for any part of his income taxes with respect to the rentals he derives from the lease, then the new provision was to be applicable.

Your committee agrees with the reasoning of the House as to the treatment which should be accorded in the case of leases for the period 1952 and 1953. However, in its hearings the attention of your committee was called to the fact that a similar problem existed for the years 1952 and 1953 for contracts between corporations even though no lease was involved. As indicated above, before 1952 such contracts were accorded the same treatment as leases and then for 1952 and 1953 they also were subjected to the "pyramiding" rule. To provide equality of treatment in these 2 cases for the 2 years under consideration in the House provision, your committee believes that for the years 1952 and 1953 "pyramiding" should also be wiped out in case of corporate contracts. Therefore, it has revised the House provision to extend it to such cases. No change, however, is made in its application to leases.

Both the House and your committee's versions of this provision are effective for taxable years beginning after December 31, 1951, to which the 1939 Code applies. If any of these years are closed years, the statute of limitations is opened for a period of 6 months after the date of enactment of this bill for the claiming of credit or refunds. No interest is to be paid on any overpayment resulting from this provision.

This provision is expected to result in a negligible revenue loss.

Section 97—Certain recapitalizations of railroad corporations

One of the two alternative methods on which the World War II excess-profits credit could be computed was the invested capital

method. An element of invested capital was "equity invested capital." In general terms this was the money and property paid in, plus the earnings and profits of the corporation and less any distributions made by it. Where a corporation was reorganized and property was transferred from the old corporation to a new corporation and the exchange was a tax-free exchange, section 760 of the 1939 Code in general provided that the equity invested capital of the old corporation was carried over to the new corporation for purposes of determining its excess-profits credit. Thus, where the assets of a railroad were transferred from one corporation to another in a proceeding in receivership or bankruptcy, this section provided that the equity invested capital of the new corporation would reflect the basis of the assets transferred in the hands of the transferor corporation. It has been held, however, that where a railroad corporation was reorganized by means of a recapitalization with the result that the old corporation's charter is retained, the equity invested capital of the corporation may be reduced, for example, where bonds of the corporation are exchanged for new bonds and stock.

Your committee sees no reason why the equity invested capital of a railroad should be reduced where it goes into receivership or bankruptcy merely on the grounds that the reorganization takes the form of a recapitalization and as a result there is no new corporation. Substantially the same factual situation may exist where there is a transfer of the assets to a new corporation but in this case there is no reduction in the equity invested capital. As a result excess profits taxes in this latter case may be smaller than in the former. Moreover, your committee does not believe that this result was intended at the time of the adoption of the World War II excess profits tax. In providing a specific carryover of the equity invested capital only where there was a transfer of the assets from one corporation to another it was thought unnecessary to provide for the bankruptcy or receivership case where the same corporate charter was retained; in such a case it was assumed that there would be no reduction of the equity invested capital.

To provide equality of treatment for railroad corporations going through a bankruptcy or receivership proceeding between those which are recapitalized and those whose assets are transferred from one corporation to another, your committee has made an amendment to section 723 of the Internal Revenue Code of 1939. In this amendment it has provided that where a recapitalization of a railroad occurred after December 31, 1938, in a bankruptcy or receivership proceeding, the equity invested capital of the corporation, at the election of the taxpayer, is to be the same as if the assets had been exchanged in a tax-free reorganization to which section 760 of the 1939 Code applied.

This amendment is to apply to years beginning after December 31, 1941.

Section 98—Bequests, etc., to a surviving spouse

Under both the Internal Revenue Code of 1939 (sec. 812 (e)) and the Internal Revenue Code of 1954 (sec. 2056) a marital deduction is allowed in computing the taxable estate if the surviving spouse has a right to the income from property for life, coupled with a general power of appointment over it. However, the 1939 Code (sec. 812 (e) (1) (F)) requires in such cases that the property be placed in trust,

and because of doubt under the laws of various States as to what constitutes a trust, it is not clear when a life estate will qualify as a trust. Nor, is it clear under the 1939 Code whether property qualifies for the marital deduction, when the interest given the surviving spouse is placed in trust and the surviving spouse has an income interest in, and power of appointment over, only part of the property.

On the other hand, the 1954 Code (sec. 2056 (b) (5)) provides that property in a life estate, as well as property in trust, qualifies for the marital deduction and that a right to income, plus a general power of appointment, over only an undivided part of the property, will qualify that part of the property for the marital deduction.

Your committee, therefore, has amended the House bill to add a provision to conform the marital deduction provisions of the 1939 Code with the more realistic rules of the 1954 Code. Thus, if an interest in property passes from the decedent to his surviving spouse (whether or not in trust) and the spouse is entitled to all of the income from the entire interest, or all of the income from a specific portion of the entire interest with the power in her to appoint the entire interest or a specific portion, the interest which passes to her qualifies as a marital deduction in computing the taxable estate of the decedent if it generally satisfies the following five conditions:

(1) The surviving spouse must be entitled for life to all of the income of the entire interest, or a specific portion of all of the income from the entire interest.

(2) The income passing to the surviving spouse must be payable annually or at more frequent intervals.

(3) The surviving spouse must have the power to appoint the entire interest or the specific portion to either herself or to her estate.

(4) The power in the surviving spouse must be exercisable by her alone and (whether exercisable by will or during life) must be exercisable in all events.

(5) The entire interest, or the specific portion, must not be subject to a power in any other person to appoint any part to any person other than the surviving spouse.

The provision is to apply to estates of decedents dying after April 1, 1948, and before August 17, 1954. This was generally the period under the 1939 Code in which the marital deduction was available.

The provision also opens the statute of limitation for purposes of refund or credit of overpayments (where the statute was not closed by a closing agreement or compromise). For this purpose the statute is open for 1 year after the date of enactment of the bill. No interest is to be paid with respect to any refunds under this provision.

Section 99—Change from retirement to straight-line method of computing depreciation in certain cases

Prior to 1942, class I railroads for many years employed the retirement method of computing depreciation on roadway assets for income-tax purposes, as well as reporting to the Interstate Commerce Commission on this basis. These roadway assets include buildings, bridges, tunnels, water towers, etc., but not the rolling stock, roadbed, or the track. Instead of taking depreciation as the asset is used, under the retirement method, the original cost of an asset (less salvage value) is charged off against income at the time of the retirement of

the asset from use. In 1942, the Interstate Commerce Commission ordered class I railroads to change, not later than January 1, 1943, from the retirement method of computing depreciation on roadway assets to the straight-line method. Under the straight-line method of computing depreciation, the original cost of an asset (less salvage value) is charged against income by means of annual deductions over its useful life.

Because of the Interstate Commerce Commission's order, and because during World War II these assets were needed and, therefore, were not retired and charged off against income, the railroads asked the Commissioner of Internal Revenue to permit them to change over, for income-tax purposes, to the straight-line method of computing depreciation. Permission was granted, but only on the condition that the railroads establish a reserve generally of 30 percent of the cost of the roadway assets. The effect of this reserve was to limit the remaining amount which could be recovered by depreciation to the cost of these assets reduced by the 30-percent reserve. Although the railroads objected to this condition, many of them finally agreed to the establishment of this reserve imposed by the so-called terms letters. The changeovers to the new method of computing depreciation occurred, generally, in 1942 and 1943. A number of court decisions have dealt with the tax effects of the retirement method of computing depreciation and with the tax effects in changing from this method of depreciation to another. These decisions relate to a number of different issues and involve widely varying factual situations. They have, however, thrown some doubt upon the validity of the 30-percent reserve requirement imposed upon the railroads under the terms letters. As a result, the railroads and the Internal Revenue Service have been engaged in a continuing controversy over the tax effects of this change in method of computing depreciation. The amendment made by the House bill is, in essence, a settlement of this controversy.

In the House debate on this bill, it was pointed out that, if the Internal Revenue Service failed to sustain its position in court with respect to the legality of these reserves, it has been estimated that there might be a revenue loss of as much as $273 million for the years 1943 through 1955 and that, for the period 1956 to 1995, there might be a total additional reduction in income taxes of approximately $50 million more than under the provision adopted by the House.

The form of the settlement provided by the House bill relates to taxpayers who changed from the retirement to the straight-line method of computing depreciation for any taxable year beginning after December 31, 1940, and before January 1, 1956. The treatment provided is elective. If the election is made, a series of adjustments are required, the general effect of which is outlined below.

First, for taxable years beginning after December 31, 1955, the taxpayer's reserve for depreciation for the affected assets is to be computed by including only (1) depreciation sustained before March 1, 1913, (2) depreciation computed taking into account the 30-percent reserve requirement imposed by the terms letters for the years from the date of the changeover to the taxpayer's first year beginning after December 31, 1955, and (3) the portion of the 30-percent reserve applicable to certain dispositions of property occurring on or after the changeover date and before the 1956 adjustment date. Thus, in effect, this substitutes for the 30-percent reserve requirement the

requirement that, for 1956 and subsequent years, the basis of the assets involved is to be reduced for the actual depreciation which occurred before the imposition of the income tax in 1913, plus the depreciation which was actually charged off in the period from the changeover through 1955, taking into account only for this one period the 30-percent reserve required by the terms letters plus the part of the 30-percent reserve applicable to the dispositions referred to.

The effect of this adjustment is to permit for the future a larger depreciation deduction than that permitted under the terms letters. The reduction in the basis of the assets for pre-1913 depreciation is equivalent to about one-third of the 30-percent reserve.

Second, for the period between the changeover date and the taxpayer's first taxable year beginning after December 31, 1955, the depreciation reserve is to be computed by including the 30-percent reserve and the depreciation allowable for prior years under this reserve. As a result, if a taxpayer elects to come under this section, he cannot contest the 30-percent reserve requirement imposed by the terms letters and, therefore, with one exception, noted below, he cannot file claims or suits for refunds for this period.

The exception referred to above relates to a readjustment which is permitted under the bill for purposes of determining the equity invested capital base under the World War II and Korean war Excess Profits Tax Acts. For this purpose, the basis of the assets is to be reduced only for depreciation sustained before March 1, 1913 on property held on the changeover date. The effect of this adjustment will be to increase the excess-profits credit and decrease the income subject to the excess-profits tax in the case of some of the railroads.

Because of the possibility that the Service might fail to sustain its present position in the courts, and because the provision adopted by the House appears to be a fair and equitable settlement of the controversy, your committee has accepted the House provision with only a minor technical change.

In considering this provision, the attention of your committee was called to a railroad which was not a party to the terms letters and which is still on the retirement method of accounting for tax purposes. This provision will have no application to such a railroad since it is following a retirement method of accounting.

Section 100—Amendments to 1954 Code with respect to property acquired from retirement method corporation

This section of the House bill is closely related to section 99. It also deals with a changeover from the retirement method of taking depreciation to another method of taking depreciation. The section, however, applies to taxpayers who acquired property in a receivership or bankruptcy proceeding where the prior corporation which transferred the property to the taxpayer used the retirement method of depreciation and the taxpayer acquiring the property adopts another method of depreciation. In such cases, the acquiring taxpayer is required generally to make the type of adjustments referred to in section 99. Since taxpayers coming under this provision are required to make this change, this provision differs from section 99, which is elective.

The principal respect in which the adjustments under this section differ from those referred to in section 99 is that the 30 percent reserve

provided under the terms letters (rather than the depreciation sustained before March 1, 1913) is to be taken into account in computing equity invested capital for purposes of the World War II and Korean war excess profits taxes.

Your committee in general agrees with the House action on the grounds that such a provision is necessary to make sure that railroads going through bankruptcy or receivership proceedings may not as a result of these proceedings change from the retirement method of accounting to the straight line depreciation method without any adjustment for pre-1913 depreciation, merely on the grounds that the reorganized railroad represents a new taxpayer.

However, the attention of your committee has been directed to a litigated case to which this section would apply if not modified. This case is *The Akron, Canton & Youngstown Railroad Company* v. *Commissioner* (22 T. C. 648 (1954)), remanded to the Tax Court by the United States Court of Appeals for the Sixth Circuit pursuant to stipulation, order by the Tax Court modifying its decision entered January 12, 1956. In this case, there was a determination of the adjusted basis of retirement-straight-line property of the type described in this provision, and the right of the taxpayer to use the straight-line depreciation method was established. Your committee believes it is inappropriate to compel a taxpayer in this situation, who has already litigated this matter, to make adjustments not required by the court order. This appears especially inappropriate in view of the fact that section 99, which has application to the bulk of the national railroads in the United States, is elective rather than mandatory.

In view of this, your committee has provided that section 100 is not to apply to taxpayers if, before the date of enactment of this bill, there has been a determination by the Tax Court or other court of competent jurisdiction (in any proceeding in which the court decision became final after December 31, 1955), for any taxable year, of the adjusted basis of property of the type described by this section, provided that the decision established the right of the taxpayer to use the straight-line depreciation method.

Section 101—Extension of time for filing claims for refunds of overpayments of income tax based upon education expenses paid or incurred in 1954

The Internal Revenue Service long held that relatively few educational expenses were deductible as business expenses, or as expenses incurred in the production of income. Generally, the Service had held that for such expenses to be deductible they must be required as a condition to the retention, by the taxpayer, of his present employment. On April 4, 1958, however, the Treasury Department in a news release announced that it was issuing final regulations which were more liberal than the regulations previously in force, in that the expenses incurred by a teacher for education could be deducted even though they were incurred voluntarily and even though the courses taken carried academic credit or resulted in an increase in salary or in a promotion. The news release also indicated that this change was made in order to remove the distinction previously drawn between self-employed persons and employees, such as teachers. The final regulations issued on April 5, 1958, provided that expenditures made by a taxpayer for his education are deductible if they are for educa-

tion (including research activities) undertaken to maintain or improve skills required by the taxpayer in his employment or in his trade or business. These new, and more liberal, regulations were made effective for years to which the 1954 Code is applicable, or generally back to January 1, 1954, but credits or refunds can be made only if the years involved are still open.

Your committee is pleased with the more liberal interpretation by the Internal Revenue Service of what constitutes deductible educational expenses. A problem has arisen, however, as a result of the date of the news release and the date the new regulations were issued. For most calendar year taxpayers the period of limitations expired with respect to their 1954 tax returns on April 15, 1958. This was only 10 or 11 days after the date the new regulations and news release were issued. Your committee believes that this is too short a time to have given teachers and others generally throughout the country an opportunity to reexamine their 1954 returns and file claims for refunds with respect to any expenses incurred then which they then, for the first time, found were properly deductible under the regulations.

Therefore, your committee has added a section to the bill which provides that refunds or credits relating to the deduction of educational expenses may be made for any taxable years beginning after December 31, 1953, and ending after August 16, 1954, even though on the date this bill is enacted, or at any time within 60 days thereafter, the statute of limitations has expired for any of these years (except in the case of closing agreements and compromises). For a claim to qualify for one of these closed years, however, it must be filed within 60 days after the date of enactment of this bill.

Section 102—Deductibility of accrued vacation pay

Under the 1939 Code (sec. 43) the period for taking deductions was stated to be the taxable year in which the expenses were "paid or accrued" or "paid or incurred," depending upon the method of accounting, "unless in order to clearly reflect the income the deductions or credits should be taken as of a different period." In this connection, published rulings (GCM 25261, C. B. 1947-2, 44; I. T. 3956, C. B. 1949-1, 78), in general held that vacation pay for the next year could be accrued as of the close of the taxable year in which the qualifying services were rendered if under the employment contract all of the events necessary to fix the liability of the taxpayer for the vacation pay had occurred by the close of the taxable year. In determining whether the events necessary to fix the liability of the taxpayer for vacation pay had occurred, the fact that the employees' right to a vacation (or payment in lieu of vacation) in the following year might be terminated if his employment ceased prior to the scheduled vacation period was not regarded as making the liability a contingent one rather than a fixed one. It was held that the liability was not contingent since the employer could expect the employees as a group to receive the vacation pay and, therefore, that only the ultimate amount of the liability to the group remained uncertain at the close of the year.

In Revenue Ruling 54-608 (C. B. 1954-2, 8) the Internal Revenue Service reconsidered its previous rulings on vacation pay. This ruling held that no accrual of vacation pay could occur until the fate of liability with respect to specific employees was clearly established

and the amount of the liability to each individual employee was capable of computation with reasonable accuracy. This ruling was initially made applicable to taxable years ending on or after June 30, 1955. It was then thought that taxpayers accruing vacation pay under plans which did not meet the requirements of the strict accrual rules set forth in this ruling would utilize section 462 of the 1954 Code. This section of the code, however, has been repealed and the Treasury Department in a series of actions has continued to postpone the effective date of Revenue Ruling 54-608 until January 1, 1959 (the last postponement was made in Rev. Rul. 57-325, IRB 1957-27, 11, July 8, 1957). The Treasury Department recently announced in Revenue Ruling 58-340, Internal Revenue Bulletin 1958-28, page 19, that the postponement of the effective date of Revenue Ruling 54-608 applies only to those taxpayers who were properly accruing vacation pay under I. T. 3956. In the latest ruling postponing the effective date, Revenue Ruling 54-608 was made inapplicable to taxable years ending before January 1, 1959, except in cases involving an agreement with a labor union which was in effect on June 30, 1957, and which expires after December 31, 1958. In such cases Revenue Ruling 54-608 is to be applicable for the first time to taxable years ending on or after the 90th day after the date such agreement expires. This latest ruling states that there will be no further extension of the period of inapplicability of Revenue Ruling 54-608.

Your committee has concluded that more time is required for study before Revenue Ruling 54-608 is made applicable to those taxpayers who were properly accruing vacation pay under I. T. 3956. Therefore, your committee has extended for 2 more years the period in which Revenue Ruling 54-608 is to be inapplicable with respect to such taxpayers. Thus, in section 102 the bill provides that in respect of such taxpayers deductions for accrued vacation pay are not to be denied for any taxable year ending before January 1, 1961, solely by reason of the fact that the liability for the vacation pay to a specific person has not been clearly established or that the amount of the liability to each individual is not capable of computation with reasonable accuracy.

Section 103—Reimbursement for moving expenses received by employees of certain corporations formed exclusively to operate laboratories for the Atomic Energy Commission

A situation has been called to the attention of your committee involving moving expenses received by employees of a corporation formed to perform research development and production tasks for the Atomic Energy Commission on the ordnance aspect of atomic weapons. The corporation concerned engages only in activities assigned to it by the Atomic Energy Commission, and it operates under a contract which specifically provides that all costs and expenses of operation will be reimbursed by the Atomic Energy Commission from appropriations by Congress. Also, under the contract the services of the corporation involved are to be rendered without profit of any kind.

In hiring the professional and skilled employees required for the type of work in which the corporation is involved, the corporation paid the traveling and moving expenses incurred by the new employees in moving to accept employment. Until Revenue Ruling 55-140

(C. B. 1955-1, 317) was issued in March of 1955, the officials of the corporation had assumed that such expense reimbursement was not taxable income. This was based on the fact that an Internal Revenue Service ruling issued in 1949 to a laboratory, which was an Atomic Energy Commission installation, initially had held that reimbursed travel expense to a new employee from a person under contract to the Atomic Energy Commission was taxable income, was modified by the Commissioner in 1951. In the 1951 ruling it was held that reimbursement for travel expense on transfers between different nonprofit contractors in the Atomic Energy Commission complex was not considered to be taxable income.

In view of all of the circumstances involved in this case, your committee believes that it would be unfortunate to impose income tax with respect to the reimbursement of moving expenses for the employees of this corporation. It has, therefore, added a new section to the bill relating to amounts received by an individual, after December 31, 1949, and before the date of enactment of this bill from a corporation meeting certain qualifications, as reimbursement for moving himself and his immediate family, household goods, and personal effects to a new place of residence in order to accept employment with the qualifying corporation. This section provides that moving expenses of the type referred to above are to be excluded from the gross income of the individual to the extent that the reimbursement did not exceed the actual expenses paid or incurred for these purposes.

This provision is not, however, to apply in any case where the individual involved was advised at the time of his employment by an authorized official of the corporation that the amount of the reimbursement would be includible in gross income. In the case in question it is understood that new employees on or about September 1, 1955, were advised specifically that the amounts reimbursed to them for moving and travel expenses were taxable income and thus many, if not all, of the new employees hired after that date will not receive the treatment accorded by this provision.

The conditions which must be met by a corporation to qualify under this provision are (1) it must be formed exclusively for the purpose of, and be exclusively engaged in, operating without profit a scientific laboratory for the Atomic Energy Commission, and (2) it must be operated solely on funds appropriated to the Atomic Energy Commission by Congress.

Section 104—Extension of time for making refund of overpayments of income tax resulting from erroneous inclusion of certain compensation for injuries or sickness

Section 22 (b) (5) of the Internal Revenue Code of 1939 provided in general that amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injuries or sickness were excludable from gross income. However, in the past the Internal Revenue Service has held that sick pay received from a self-insured employer's plan did not qualify for this exclusion. Early in 1952, in *Arnold W. Epmeier* v. *United States* (C. A. 7, 1952, 199 F. 2d 508) the court rejected this position and held that sick pay received under one of these self-insured company plans was properly excludable from gross income under section 22 (b) (5). On March 26,

1953, however, the Internal Revenue Service issued news release I. R.-047, stating that it did not follow the Epmeier case. On April 1, 1957, the Supreme Court in *Gordon P. Haynes and Essie M. Haynes* v. *United States* (1957, 353 U. S. 81) sustained the position of the Seventh Circuit in the Epmeier case and held that sick payments made under a self-insured company plan qualified for the exclusion under the 1939 Code.

As a result of the decision in the Haynes case, refunds are now being paid on claims relating to self-insured sick plan payments where such claims are not barred by the statute of limitations. However, under present law a substantial number of such claims are barred. During the period from March 26, 1953, when the Service indicated that it would not follow the Epmeier decision, until December 9, 1954, the Internal Revenue Service followed the policy of disallowing these claims for refunds. Claims during this period are not generally eligible for refund because, in reliance on the announced policy of the Internal Revenue Service that the Epmeier case would not be followed, many of the claimants did not file protective suits upon receipt of notice of disallowance of their claim, and the 2-year period of limitation for filing suit for refund has expired. However, claims handled by the Internal Revenue Service after December 9, 1954, were held in suspense by the Internal Revenue Service with the result that these claims for refund generally are still valid. As a result, the eligibility of taxpayers to obtain refunds with respect to self-insured sick pay claims now depends in large part on whether the claims happened to be filed before or after December 9, 1954. Moreover, there apparently is some difference in this respect in the various local Internal Revenue offices, depending upon variations in promptness in handling refund claims. In some cases taxpayers who filed claims before December 9, 1954, are now entitled to refunds because the local offices involved were not able to act upon the claims until after December 9, 1954, while taxpayers where the local offices were able to act more promptly find that they are now unable to claim refunds.

To remove this inequitable situation your committee has added a new section to the House bill. This section provides that where there has been an overpayment of income tax because of the inclusion in gross income of an amount received as compensation for injuries or sickness, if claim for credit or refund of this overpayment was filed after December 31, 1951 (just before the Epmeier decision), and before the statute of limitations for filing the claim had expired, the time for commencing suits for refund (sec. 3772 (a) (2) of the 1939 Code) is to remain open until 1 year after the date of enactment of this bill.

Section 105—Amounts received by certain motor carriers in settlement of claims against the United States

The attention of your committee has been called to a problem presented by several trucking lines. During World War II there was a strike of the employees of several trucking lines which was not settled. Because of the war emergency the Government seized several of these trucking lines and operated them from August 11, 1944, until the fall of 1945. After the return of these lines to their owners claims for compensation were made by the trucking lines to the Government. These were settled in 1952 on the basis of a payment by the Government of compensation for the use of the trucking business, measured

by the rental value of the equipment, plus the amount of any operating loss or minus the amount of any operating profit for the period involved.

The tax problem presented is whether the amount received from the Government should be reported as income in the year of receipt or whether it should be treated as if it were income of the prior period with respect to which the compensation was paid; namely, part of 1944 and 1945. Section 107 (d) of the 1939 Code, relating to back pay, in general, provides that where qualifying tests are met, the tax attributable to the inclusion of the back pay in gross income for the taxable year is not to be greater than the increase in taxes which would have resulted from the inclusion of the back pay in gross income for the taxable years to which it is attributable. It has held, however, that this compensation paid by the United States Government was not compensation received by the employee for services performed for his employer and therefore that the back pay provision was not available.

Your committee believes that compensation received from the United States in the type of case described above is properly attributable to the years in which the motor carrier systems were in the possession or control of the United States. Thus, your committee has concluded that taxpayers in such cases should be taxed as if this compensation had been received in the years with respect to which the compensation was paid. As a result, your committee has added a new section to the House bill providing that amounts received in settlement of a claim against the United States, arising from the fact that United States through possession or control of a motor carrier transportation system, owned by the taxpayer, at the taxpayer's election, is to be deemed income which was received in the taxable years during which the motor carrier system was in the possession or control of the United States. The taxpayer may make this election within 1 year after the date of enactment of this bill. Also, the period for assessment of any defficiency attributable to the inclusion of the compensation in a prior taxable year of the taxpayer is not to expire until 1 year after the date the taxpayer makes the election.

Section 106—Reasonable cause for failure to file return

Section 106 of the 1939 Code provides that in the case of amounts received by a taxpayer from the United States in the case of certain claims against the United States, the surtax imposed with respect to such an amount is not to exceed 30 percent, or if the normal tax also is taken into account, the total tax is not to exceed 33 percent. In 1956 Congress added a new type of claim to which this provision was made applicable. The claim was one arising under a contract for the construction or installation of facilities for a branch of the armed services where the claim remained unpaid for more than 5 years from the date the claim first accrued, if the claim was paid prior to January 1, 1950. In addition, Congress in 1956 provided that in determining whether or not additions to tax were to be imposed for failure to file a return (under sec. 291 (a) of the 1939 Code) in the type of cases referred to above, the term "reasonable cause" is to be interpreted as including the filing of a timely incomplete return under circumstances where the taxpayer believed that no return was due on amounts received under a settlement from the United States.

This amendment was made applicable with respect to taxable years ending after December 31, 1948, whether or not the statute of limitations had expired (except in the case of closing agreements or compromises).

A situation has been called to the attention of your committee where amounts were received during the period 1943 through 1948 inclusive, in settlement of a claim arising under the same contract as one to which section 106 of the 1939 Code applies for years after 1948. In the period from 1943 through 1948 the taxpayer also received the amounts under conditions which led him to believe that the amounts were not includible in his income for tax purposes. For periods since 1948 Congress has already provided in this case that the tax with respect to the claim is to be limited to a maximum tax of 33 percent and that there are to be no penalties for failure to file a return where a timely incomplete return was filed. Your committee's bill extends the latter of these two features to cover the period from 1943 through 1948, but provides for no modification of the tax with respect to amounts received in this earlier period. Thus, the provision added by your committee prevents the application of penalties for failure to file a complete return for the period 1943 through 1948 where the taxpayer had the same reasons to believe no taxes due as he subsequently did with respect to a claim to which section 106 of the 1939 Code was applicable.

HOUSE SECTIONS DELETED

Section 9 of House bill which is omitted by your committee—Remainders to related persons in the case of certain charitable trusts

The 1954 Code (sec. 673) provides that the income of an irrevocable charitable trust for a period of 2 years or more is not to be taxed to the grantor of the trust. However, where the grantor has a reversionary interest of 5 percent or more in the corpus or income of the trust no charitable deduction is allowed to the grantor for the gift to charity of the income for the 2-year period. The House bill also denies the charitable deduction in the case of these charitable trusts where the corpus reverts to the grantor's children, spouse, grandchildren or other closely related persons. The types of exempt charitable organizations which qualify for exemption under the 2-year provision are: churches, hospitals, and educational organizations which normally maintain a regular faculty and curriculum and have a regularly enrolled body of students in attendance at the place where its educational activities are carried on.

Your committee is of the opinion that if the House provision were to be enacted it would severely limit the creation of short-term charitable trusts. This is true because grantors would hesitate to set up such trusts where the corpus did not revert to members of their family. In fact, the creation of such a trust for charity under the House bill would not result in any benefit to the grantor which he could not obtain by giving the property directly to members of his family without the income being set aside for an intervening period, for one of the specified charitable purposes. This is the result of eliminating a charitable contribution deduction in such cases since the property given to members of his family would in any case be excludable from his income whether this was accomplished by setting

up an irrevocable trust or by giving the property directly to members of his family. Your committee believes that the situation where the corpus of a charitable trust reverts to a member of the family of the grantor is substantially different from the case where the grantor himself has not irrevocably parted with all the interest in the property.

As a result, your committee has amended the House bill to strike section 9, relating to remainders to related persons in the case of charitable trusts. Thus, a charitable contribution deduction will not be denied with respect to an amount set up in trust where the remainder eventually is to go to relatives of the taxpayer.

Section 17 of House bill which is omitted by your committee—Property received in certain corporate reorganizations

The House report suggests that under present law it may be possible for loss to be recognized to a taxpayer in connection with transactions which in part come under section 358 dealing with tax-free exchanges. However, to the extent loss is recognized in connection with such a transaction the basis of the property received by the taxpayer should be adjusted downward but the basis provision (sec. 358) does not specifically provide for a reduction in basis in such cases. Accordingly, the House amended the code (sec. 358 (a) (1) (A)) to provide for a reduction in basis of the property received to the extent of the amount of any loss recognized to the taxpayer upon the exchange.

Your committee agrees with the House as to the result which should be obtained in the situation described above. However, further study of this situation has indicated that the transaction described above under present law would be considered as 2 transactions, 1 of them being tax free and resulting in no basis adjustment and the other resulting in a recognized loss which would result in a downward basis adjustment. As a result, your committee has deleted section 17 of the House bill.

Section 37 of the House bill which is omitted by your committee—Carryback and carryover of foreign tax credit

Under present law citizens and alien residents of the United States and also domestic corporations are subject to United States tax on income from sources within and sources without the United States. Since income from without the United States generally is subject to income tax in the foreign country or possession, a credit is allowed against the United States tax for those foreign taxes (or taxes of a possession). The foreign tax credit is restricted by the so-called country-by-country limitation in section 904. As a result of this limitation the foreign tax which can be claimed as a credit cannot exceed an amount which is the same proportion of the taxpayer's total United States tax liability before credit as the taxable income from the foreign country is of the total taxable income of the taxpayer.

The House bill would provide a carryback and carryforward of the portion of the foreign tax credit which cannot be used by reason of the limitation. Under this provision, the excess amount can be carried back for 2 years or forward for 5 succeeding years and can be used in those years to the extent that the taxes paid to the foreign country in any of those years is less than the limitation on the foreign tax credit. The House report indicates that it would add this carryback and carryover of the unused foreign tax credit to present law to prevent double

taxation which otherwise might occur because of differences in the time of reporting income in the United States and in various foreign countries. Illustrations in the House report of the factors which might result in differences in the timing of the reporting of income and allowance of deductions were:

(1) Reporting of taxable income from sales on the installment basis in the United States without being permitted to report in a similar manner in a foreign country;

(2) Differences under the laws of the United States and those of the foreign country in the pricing of inventories;

(3) Differences in reporting foreign exchange profit or loss;

(4) Differences in depreciation methods in the United States and in the foreign country;

(5) The requirement of some countries that income taxes be determined only on a fiscal year basis; and

(6) The use of an averaging device in the computation of taxable income in certain foreign countries covering more than 1 taxable year.

Your committee's investigation of this provision has indicated that while there is the problem of the difference in the time of reporting income under the country-by-country limitation of existing law, the effects of the foreign tax credit carryover is not limited to such cases. For example, where the effective rates of tax imposed by the foreign country vary from year to year, a foreign tax credit carryover in effect permits the circumvention of the country-by-country limitation. For example, if in 1 year the rate of tax in the foreign country is 60 percent and in the next year the rate is 30 percent, a credit carryover will permit the portion of the tax not credited in the first year to be credited in the next year. Thus, in reality the limitation will be exceeded with respect to taxes of the first year.

Also, where the taxpayer has losses in the United States, a foreign tax credit carryover may be available even though there are no variations in the time of reporting income in the United States and the foreign country. For example, suppose that the taxpayer has a $100 loss in the United States and $100 of income in a foreign country in the same year, and that the taxpayer pays a foreign tax of $30 with respect to his foreign income. The taxpayer would have no United States tax to pay under existing law. Under the House bill he would have an excess foreign tax credit carryover of $30, and would be entitled to carry over this credit to another year when it probably could be offset against the tax on domestically earned income.

Since the effect of the foreign tax credit carryover of the House bill is not limited to cases where there is a difference in the time of reporting income, your committee decided that it should not act favorably on this provision without further study. Therefore, it has deleted this provision from the bill.

IV. TECHNICAL EXPLANATION

SECTION 1. SHORT TITLE, ETC.

This section of the bill, which is identical with section 1 of the House bill, provides a short title for the bill, a provision to the effect that references in the bill are generally to the 1954 Code, and a general effective-date provision.

Short title

Subsection (a) of section 1 provides a short title for the bill: "Technical Amendments Act of 1958."

Amendment of 1954 Code

Subsection (b) of section 1 contains a provision eliminating the necessity of referring to the Internal Revenue Code of 1954 each time a change is made in that code by the bill. Except as otherwise expressly provided, whenever in the bill an amendment or repeal is expressed in terms of an amendment to, or a repeal of, a section or other provision, the reference is to a provision of the Internal Revenue Code of 1954.

Effective date

Subsection (c) of section 1 provides effective dates for the amendments made by the bill for which there are no separate special effective dates. Unless otherwise expressly provided, (1) the amendments to subtitle A of the 1954 Code apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954 (the general effective date for income-tax provisions of the 1954 Code), and (2) the amendments to subtitle F of the 1954 Code take effect as of August 17, 1954 (the day after the date of enactment of the 1954 Code), and apply as provided in section 7851 of the 1954 Code.

SECTION 2. RETIREMENT INCOME CREDIT

This section of the bill, which corresponds to section 2 of the House bill, amends section 37 of the 1954 Code (relating to the retirement income credit).

The House bill made three changes in section 37 to remove certain differences between the application of section 37 to married individuals residing in community-property States and those residing in common-law States. Subsection (a) (1) of the House bill provided that, in the case of individuals who are married, any pension or annuity received by either spouse and attributable to services rendered by either spouse shall be considered as the retirement income of the individual who rendered the services. Subsection (a) (2) of the House bill provided that, in determining the amount of any benefits under social security, railroad retirement, or other excludable pensions received during the taxable year, community-property law shall not be taken into account. Subsection (a) (3) of the House

bill amended section 37 (g) to provide that for purposes of the definition of earned income any such income which is community income shall be treated as the income of the individual who rendered the services.

These provisions of the House bill equated the treatment of individuals residing in community-property States to individuals residing in common-law States by overriding, insofar as the application of section 37 is concerned, certain community-property-law principles which would otherwise be applicable.

Your committee bill eliminates the House provision and provides instead rules which effectively equate the application of section 37 to all married individuals regardless of the law of the State in which they reside by applying, in general, to all married individuals the rule which would be applicable to residents of community-property States.

Definition of earned income

The new subsection (h) (1), which is added by subsection (a) of section 2 of your committee bill, relates to the determination of whether an individual has received earned income in excess of $600 for purposes of determining if he is eligible for the retirement income credit and to the determination of earned income received during the taxable year for purposes of computing the reduction, if any, in the maximum allowable amount of retirement income. Section 37 (b) of the 1954 Code provides, in general, that an individual may be eligible for the retirement income credit if he has received in each of 10 prior calendar years in excess of $600 of earned income, and section 37 (d) (2) of the code requires a reduction in the maximum allowable amount of retirement income on which the credit is based to the extent that an individual receives during the taxable year earned income in excess of specified amounts. Under the new subsection (h) (1), income received by a married individual in a particular year attributable to services rendered by him is treated, for purposes of subsections (b) and (d) (2) of section 37, as if it were received one-half by that individual and one-half by the individual who is his spouse in such year.

Thus, for purposes of determining under section 37 (b) whether a taxpayer has received over $600 of earned income in each of 10 calendar years prior to the taxable year in which he claims the retirement income credit, income received in a prior year by an individual who was the taxpayer's spouse in such prior year attributable to the services of such spouse is treated as having been received one-half by the spouse and one-half by the taxpayer. Conversely, one-half of the income received by the taxpayer in prior years attributable to his services is considered to have been received by the individual who was his spouse in those years. The attribution of income between individuals is not affected by any change in marital status after the year in which the income in question was received. For example, a widowed or divorced individual is considered for purposes of section 37 (b) to have received only one-half of the income actually received by him (for his services) in years prior to his divorce or his spouse's death. The former spouse is, of course, considered to have received the other half of such income. Also, for purposes of determining under section 37 (d) (2) whether a taxpayer has received earned income in excess of the amounts specified in such section, earned income received by such taxpayer during the taxable year is treated as having been received

one-half by him and one-half by the individual who is his spouse in that year. The converse is also true, in that the spouse's earned income will be attributed one-half to the spouse and one-half to the taxpayer.

Determination of amount of pensions and annuities received

Under section 37 (c), the term "retirement income" is defined to include pensions and annuities, and under section 37 (d) (1), the maximum allowable amount of retirement income upon which the retirement income credit is computed is reduced by the amount of pensions and annuities received under social security and railroad retirement and by the amount of certain other excludable pensions and annuities.

Subsection (a) of section 2 of your committee bill adds a new subsection (h) (2) to section 37, pursuant to which any pension or annuity received by an individual in a particular taxable year which is attributable to services performed by him or by the individual who is his spouse in such taxable year is treated, for purposes of subsections (c) and (d) (1) of section 37, as having been received one-half by him and one-half by such spouse. Thus, in determining whether an individual has received any retirement income during the year, the amount of any compensatory pensions, including a pension received from a public retirement system and a pension received from a private plan, attributable to services performed by him or his spouse, will be treated as having been received one-half by him and one-half by such spouse. No part of a pension received by an individual attributable to services performed by a former spouse is allocated to his present spouse. Thus, if a surviving spouse receives a pension on account of the services rendered by her deceased husband, she will be treated as having received the entire amount thereof.

The special treatment of pensions and annuities under the new subsection (h) (2) is only for purposes of computing the amount of retirement income upon which the retirement income credit is based and does not affect the amount of pensions and annuities includible in the income of the spouses. Accordingly, an individual resident of a common-law State who receives a taxable pension or annuity must still report on his return the entire amount thereof, even though his spouse is entitled to a retirement income credit based upon the treatment of one-half of such pension or annuity as received by her.

Determination of marital status

Under the new subsection (h) (3), as added by subsection (a) of section 2 of your committee bill, the rules of section 143 of the 1954 Code are to be applied in determining whether individuals are married during any taxable year, including taxable years not subject to the 1954 Code. Accordingly, no part of the earned income or pensions received by a taxpayer during a taxable year in which he becomes divorced from his spouse is treated under the new subsection as having been received by such spouse.

Community-property law applicable

The provisions of the new subsection (h) of section 37 of the 1954 Code are not intended by your committee to override community-property-law concepts as to the ownership of income by married persons. If under the law of a community-property State, certain income is considered to be owned one-half by each spouse, such

income will be treated under section 37 as having been received one-half by each spouse. For example in determining the amount of retirement income received in a taxable year by an individual residing in a community-property State, dividend and interest income received by one spouse will be treated as having been received one-half by each spouse if under the State law such income is considered to be owned jointly.

Effective date

The amendments to section 37 made by section 2 of the bill are applicable to retirement income credits for taxable years beginning after December 31, 1957. Therefore, the new rule with respect to the determination of earned income is applicable in determining the eligibility of an individual and the amount of the allowable credit for any such taxable year. In determining an individual's eligibility under section 37 (b) of the code for the credit for such a taxable year, it is immaterial when the earned income was received.

SECTION 3. DEALERS IN TAX-EXEMPT SECURITIES

This section, which corresponds to section 3 of the House bill, amends section 75 of the 1954 Code, which in effect provides for the amortization of the premium on short-term municipal bonds by dealers in tax-exempt securities. Generally, the premium must be amortized over the life of the bond by an adjustment either to the cost of securities sold or to the basis of such bonds so as to offset, in effect, the tax-exempt interest income. However, the term "short-term municipal bond," as defined in section 75 (b) of the 1954 Code, does not include any bond disposed of within 30 days after the date of acquisition by the dealer or any bond with the earliest maturity or call date more than 5 years from the date acquired by the dealer. Therefore, a dealer is not required under existing law to amortize the premium on any such bond. Any loss realized upon sale or redemption of such bonds constitutes an ordinary loss which may be applied against other income even though the interest that may be collected on the bond in the same period is tax-exempt.

The House bill amends section 75 (b) (1) by deleting altogether the exception to amortization for bonds with earliest maturity or call date more than 5 years after acquisition, and by providing that the exception for bonds which are disposed of within 30 days after acquisition shall be applicable only where the amount realized on the sale of the bond (or the fair market value of the bond at the time of its disposition in some other manner) is greater than the adjusted basis of the bond, computed without regard to any amortization of premium in the hands of the dealer under section 75.

Your committee has restored the exception to amortization for bonds maturing more than 5 years after acquisition, but has made the availability of such exception subject to the requirement that the bond be disposed of at a gain, just as in the case of a bond disposed of within 30 days. Your committee has also added a sentence to subsection (a) with respect to bonds maturing more than 5 years after acquisition. This sentence provides that in the case of such bonds, the reduction of "cost of securities sold," which is required under subsection (a) (1) to be made by those taxpayers valuing inventories on any basis other

than cost, shall not be made annually, notwithstanding subsection (a) (1), but instead shall be made in the aggregate for the year in which the bond is disposed of and in an amount equal to the adjustment to basis described in subsection (a) (2). Since the adjustment upon disposition is made applicable only to "municipal bonds" as defined in subsection (b) (1), it does not apply to bonds disposed of at a gain (or at a time when their fair market value is in excess of the basis of the bond). The sentence thus eliminates the technical problem of whether or not to amortize the premium on a bond which is still held at the close of the taxable year, at which time it is impossible to determine whether or not it will be disposed of at a gain. In the case of the later sale or exchange of a bond at a loss (or disposition of such a bond at a time when its fair market value is less than its basis), the sentence provides a method for reducing the "cost of securities sold" by the amount of the amortizable bond premium attributable to the period during which the bond was held by the dealer.

As in the House bill, a conforming amendment is made to section 1016 (a) (6), relating to adjustments to basis, consistent with the elimination of the words "short-term" in the proposed amendment with respect to both subsections of section 75.

The amendment is applicable only to obligations acquired after, and in taxable years ending after, December 31, 1957.

SECTION 4. STATUTORY SUBSISTENCE ALLOWANCE RECEIVED BY POLICE

With the exception of a change in the effective date provisions, this section is the same as section 4 of the House bill. The section repeals section 120 of the 1954 Code. Section 120 provides for the exclusion from gross income, not to exceed $5 per day, of a statutory subsistence allowance received by police officials of any State, Territory, or possession, or any subdivision thereof, or the District of Columbia.

The repeal applies to taxable years ending after September 30, 1958, but only with respect to amounts received as a statutory subsistence allowance for any day after September 30, 1958.

SECTION 5. DEFINITION OF DEPENDENT

This section which corresponds to section 5 of the House bill amends section 152 of the 1954 Code, relating to the definition of a dependent. Your committee has redesignated subsection (b) of the House bill as subsection (c) and has inserted a new subsection (b), which would amend the last sentence of section 152 (b) (3) of the 1954 Code to provide that certain adopted children may be claimed as dependents.

Spouse

Section 152 of the 1954 Code provides the definition of a dependent and corresponds to section 25 (b) (3) of the 1939 Code. Subsection (a) of section 152 defines the term "dependent" as any one of the individuals listed in paragraphs (1) through (10) of that subsection who, during the calendar year in which the taxable year of the taxpayer begins, received over half of his support from the taxpayer (or was treated under section 152 (c), relating to multiple-support agreements, as having received over half of his support from the taxpayer). Those individuals listed in paragraphs (1) through (8) of

subsection (a) are identical with those who may qualify as dependents under section 25 (b) (3) of the 1939 Code. The individuals described in paragraphs (9) and (10) are individuals who did not formerly qualify as dependents for income-tax purposes.

Subsection (a) of this section, which is identical with subsection (a) of the House bill, amends section 152 (a) (9) in order to clarify the definition of a dependent. For purposes of the personal exemption, a spouse of the taxpayer was not considered under the 1939 Code as a dependent of such taxpayer, and no substantive change was made by the enactment of the 1954 Code. However, the 1954 Code added a new class of dependents consisting of an individual who, although not falling within any of the specified relationships, has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household. The amendment made by section 5 (a) of the bill makes it clear that an individual who at any time during the taxable year was the spouse of the taxpayer cannot in any case be classed as a dependent of the taxpayer.

Adopted child

Subsection (b), for which there is no corresponding provision in the House bill, amends section 152 (b) (3) of the 1954 Code, relating to the definition of a dependent. Section 152 (b) (3) of the code excludes from the term "dependent" any individual who is not a citizen of the United States unless such individual is a resident of the United States, of a country contiguous to the United States, of the Canal Zone, of the Republic of Panama or, under certain circumstances, of the Philippine Islands.

Subparagraph (B) of section 152 (b) (3) of the code, as added by your committee, includes within the term "dependent" any child of the taxpayer legally adopted by him, if, for the entire taxable year of the taxpayer, the child has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household, and if the taxpayer is a citizen of the United States.

Member of household

Subsection (c), which is identical with subsection (b) of the House bill, amends section 152 (b) (relating to definition of dependent) of the 1954 Code so as to provide (for purposes of determining whether an individual is a dependent) that an individual is not a member of the taxpayer's household if at any time during the taxable year the relationship between such individual and the taxpayer is in violation of local law.

Effective date

Under section 1 (c) of the bill, the amendments made by subsections (a) and (c) of section 5 of the bill are to apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954. The amendment made by subsection (b) of section 5 of the bill is to apply to taxable years beginning after December 31, 1957.

SECTION 6. IMPROPER PAYMENTS TO OFFICIALS OF FOREIGN COUNTRIES

This section, for which there is no corresponding provision in the House bill, amends section 162 by adding a new subsection (c) which bars a deduction for improper payments to an official or employee of a

foreign country. Subsection (c) of existing law is redesignated as subsection (d).

This provision would deny the deduction, whether the payment to the foreign official or employee is direct or indirect, if, had a similar payment been made to a Federal (United States) official or employee, it would have been unlawful under the laws of the United States. In this regard the laws of the United States comprehend only Federal laws. Some such payments to foreign officials have been held deductible under existing law, as ordinary and necessary business expenses. But this section would deny the deduction of kickbacks and bribes for example, which may be a necessary concomitant of doing business in some foreign countries, whether the kickbacks or bribes are paid to officials of the central government of the foreign state, or a political subdivision thereof, because the payment of similar kickbacks or bribes to a Federal official or employee would be unlawful. Lawfulness or unlawfulness of the payment in the foreign country is immaterial, as is the place of payment.

The provision is to apply only with respect to expenses paid or incurred after the date of enactment of the bill. But it is specifically provided that no inference is to be drawn from enactment of this provision, where payments prior to its effective date are involved. As to such payments, therefore, existing rules as laid down, for example in *Commissioner* v. *Heininger* (320 U. S. 467 (1943)); *Lilly* v. *Commissioner* (343 U. S. 90 (1952)); and, more recently, *Commissioner* v. *Sullivan* (356 U. S. 27 (1958)), would continue to apply.

SECTION 7. PAYMENTS FOR MUNICIPAL SERVICES IN ATOMIC ENERGY COMMUNITIES

This section of the bill, except for a clerical change and a change in the effective date, is the same as section 6 of the House bill.

Persons acquiring or leasing real estate from the Atomic Energy Commission at Oak Ridge, Tenn., and Richland, Wash., are required to compensate the Commission, or its agents, for municipal-type services rendered to such persons. This section of the bill amends section 164 of the 1954 Code (relating to deductions for taxes) to provide that amounts paid or accrued, to compensate the Atomic Energy Commission for municipal-type services, by any owner of real property within any community (as defined in sec. 21 b of the Atomic Energy Community Act of 1955) shall be treated as real property taxes paid or accrued. For purposes of this provision, an owner includes a person who holds such property under a leasehold from the Commission, or its agents, of 40 years or more, and a person who has entered into a contract to purchase property under section 61 of the 1955 act. Generally, an assignee of the original lessee will qualify for the same treatment as such lessee under this provision. Although section 21 b of the act now refers only to Oak Ridge, Tenn., and Richland, Wash., the provisions of this amendment would apply to any similar Atomic Energy community subsequently included under the provisions of section 21 b.

The municipal-type services provided by the Atomic Energy Commission include police and fire protection, public recreational facilities, public libraries, public schools, public health, public welfare, and the maintenance of roads and streets. Although it may include

sewage and refuse disposal which are maintained out of revenues derived from the general charge made by the Commission, it would not include these services if a separate charge was made. The taxes for municipal-type services would not include charges assessed against local benefits of a kind tending to increase the value of the property assessed, as described in section 164 (b) (5) of the 1954 Code.

Subsection (d) of section 164 of the 1954 Code (relating to the apportionment of taxes on real property between the seller and purchaser) will not apply to a sale by the Commission or other agent of the United States Government.

This section will apply to taxable years beginning after December 31, 1957.

SECTION 8. WORTHLESS SECURITIES IN AFFILIATED CORPORATIONS

This section, which is identical with section 7 of the House bill, corrects a grammatical error in section 165 (g) (3) (B) of the 1954 Code, relating to the allowance of losses of securities in affiliated corporations, by striking out "rental from" and inserting in lieu thereof "rental of."

SECTION 9. NONBUSINESS BAD DEBTS

This section, which is identical with section 8 of the House bill, amends section 166 (d) (2) (A) of the 1954 Code, relating to nonbusiness bad debts, by striking out "a taxpayer's trade or business" and inserting in lieu thereof "a trade or business of the taxpayer." The amendment makes it clear that section 166 (d) (2) (A) excludes from the category of nonbusiness bad debts only debts created or acquired in connection with a trade or business of the taxpayer claiming the deduction.

SECTION 10. FACILITIES FOR PRIMARY PROCESSING OF URANIUM ORE OR URANIUM CONCENTRATE

This section, for which there is no corresponding provision in the House bill, amends section 168 (e) (2) of the 1954 Code, relating to certifications of emergency facilities after August 22, 1957.

Section 168 (e) (2) of the code contains the authorization for the certifying authority, designated by the President, to issue certificates entitling certain persons to a deduction with respect to the amortization of the adjusted basis (for determining gain) of certain emergency facilities based on a period of 60 months. Under the provisions of present law the authority to certify defense facilities for 60-month amortization after August 22, 1957, is limited to 2 categories, namely, facilities to be used—

(A) to produce new or specialized defense items or components of new or specialized defense items during the emergency period, or

(B) to provide research, development, or experimental services during the emergency period for the Department of Defense (or one of the component departments of such Department), or for

the Atomic Energy Commission, as a part of the national defense program,

and only such portion of such amount as such authority has certified is attributable to the national defense program.

Uranium ore or concentrate processing facilities

Subsection (a) of your committee's bill amends section 168 (e) (2) of the code by adding a new subparagraph (C) to provide a third category with respect to which certifications for rapid amortization may be made, namely, a facility that is to be used to provide primary processing for uranium ore or concentrate under a program of the Atomic Energy Commission for the development of new sources of uranium ore or concentrate.

Limitation with respect to uranium ore or concentrate processing facilities

Subsection (b) of your committee's bill amends section 168 (e) of the code, relating to determination of adjusted basis of emergency facilities, by adding a new paragraph (5) to provide that no certificate shall be made under new paragraph (2) (C) with respect to any facility unless existing facilities for processing the uranium ore or concentrate are unsuitable because of their location.

Applications heretofore filed

The next to the last sentence of section 168 (e) (2) of the code provides that an application for a certificate must be filed at such time and in such manner as may be prescribed by the certifying authority under regulations but in no event shall such certificate have any effect unless an application therefor is filed before the expiration of 6 months after the beginning of construction, reconstruction, erection, or installation, or the date of acquisition of the facility. The second sentence of section 168 (d) (1) of the code provides that in no event shall an amortization deduction be allowed in respect of any emergency facility for any taxable year unless a certificate in respect thereof shall have been made before the filing of the taxpayer's return for such taxable year.

Subsection (c) of your committee's bill provides that:

(1) In the case of any certificate which is made under section 168 (e) of the 1954 Code for any facility to which the amendment made by subsection (a) applies, if application for such certificate was filed before the date of the enactment of this act and within the time prescribed by the next to the last sentence of section 168 (e) (2) of such code, the second sentence of section 168 (d) (1) of such code shall not apply with respect to any taxable year of the taxpayer which ends prior to the date on which such certificate is made; and

(2) In the case of any certificate which is made under such section for any facility to which the amendment made by subsection (a) applies, if application for such certificate is filed at any time within 3 months after the date of the enactment of this act, the next to the last sentence of section 168 (e) (2) shall not apply and the second sentence of section 168 (d) (1) shall not apply with respect to any taxable year of the taxpayer which ends prior to the date on which such certificate is made.

SECTION 11. UNLIMITED DEDUCTION FOR CHARITABLE CONTRIBUTIONS BY INDIVIDUALS

This section, for which there is no corresponding provision in the House bill, amends section 170 (b) (1) (C) of the 1954 Code (relating to the unlimited deduction for charitable contributions by individuals). Under existing law, if in the taxable year and 8 of the 10 preceding taxable years the sum of an individual's income-tax payments and charitable contributions exceeds 90 percent of his taxable income (computed with certain modifications), the 10- and 20-percent limitations on charitable contributions do not apply.

Since to determine whether an individual comes within the provisions of present section 170 (b) (1) (C), reference must in all cases be made to actual payment in the 9 taxable years involved, inequities may result, for example, as a result of payments of estimated tax or deficiencies. Payments in 1 year in respect of another may distort the results for both years. Accordingly, this provision gives the taxpayer an election to examine a taxable year either on the basis of the amounts of income tax actually paid *in* that year or on the basis of the amounts of income tax actually paid *for* that year. Necessarily it is also provided that if a particular payment is taken into account on the latter basis, it must not also be utilized in making a determination for another taxable year on the former basis. Duplication of amounts is thus avoided.

The amendment applies with respect to taxable years beginning after December 31, 1957.

SECTION 12. CHARITABLE CONTRIBUTION CARRYOVER FOR CORPORATIONS

This section of the bill, which is the same as section 10 of the House bill, amends section 170 (b) of the 1954 Code, relating to limitations on deductions for charitable contributions.

Section 170 (b) (2) of the 1954 Code relates to the deduction allowed corporations for charitable contributions and provides for a 2-year carryover of contributions in excess of the amount allowable for the taxable year. The interrelationship of this provision and the net operating loss carryover provided by section 172 of such code in certain circumstances makes it possible to argue that a charitable contribution may be taken into account twice—once in the computation of the net operating loss carryover, and again in the computation of the charitable contribution carryover. This argument is possible by virtue of the differences in the methods provided for the computation of such carryovers. This section of the bill amends section 170 (b) of the 1954 Code to provide that in these circumstances the charitable contribution will reduce taxable income only once. (The problem does not arise with respect to a net operating loss carryback, because section 170 (b) (2) (C) specifically provides that the deduction for a charitable contribution shall be computed without taking into account any net operating loss carryback.)

The following example illustrates the problem. Assume that a corporation has a net operating loss of $100,000 in 1954 which is a carryover to 1955. Assume further that in 1955 the corporation has taxable income of $100,000 before allowance of a $5,000 charitable contribution made in 1955 and before application of the net operating

loss carryover from 1954. Under section 170 (b) (2) the net operating loss will first be applied to eliminate the $100,000 of taxable income for 1955, and the $5,000 charitable contribution therefore will become a carryover to 1956. However, in determining under section 172 (b) (2) the amount of the net operating loss of 1954 which is absorbed in 1955, the deduction for the charitable contribution is taken into account before application of the net operating loss carryover (reducing taxable income to $95,000) so that only $95,000 of the 1954 loss is deemed to be used in 1955 and the remaining $5,000 of the 1954 loss is available as a carryover to 1956. Accordingly, there is available by way of the two carryovers $10,000 of deduction in 1956. Although the corporation was entitled to only $105,000 of deduction, it may be argued that existing law provides a benefit of $110,000. Under section 12 of the bill, the charitable contribution carryover of $5,000 would be eliminated.

Under section 1 (c) of the bill, the amendment made by this section applies to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SECTION 13. LIMITATIONS ON CHARITABLE CONTRIBUTION DEDUCTION

Deduction for certain interest

This section, which corresponds to section 11 of the House bill, amends section 170 (b) of the 1954 Code (relating to limitations on deduction for charitable contributions) to eliminate the possibility of taking interest into account both for purposes of computing the interest deduction and for purposes of computing the deduction for charitable contributions. Under the amendment if, in connection with any charitable contribution, a liability is assumed by the recipient or by any other person, or if a charitable contribution is of property which is subject to a liability, then, to the extent necessary to avoid the duplication of amounts, the amount taken into account for purposes of section 170 of the code as the amount of the charitable contribution—

(1) is to be reduced for interest (A) which has been paid (or is to be paid) by the taxpayer, (B) which is attributable to the liability, and (C) which is attributable to any period after the making of the contribution; and

(2) in the case of a bond, is to be further reduced for interest (A) which has been paid (or is to be paid) by the taxpayer on indebtedness incurred or continued to purchase or carry such bond, and (B) which is attributable to any period before the making of the contribution.

The amendment further provides that the reduction referred to in paragraph (2) above is not to exceed the interest (or interest equivalent) on the donated bond which is attributable to any period before the making of the contribution and which is not, under the taxpayer's method of accounting, includible in the taxpayer's gross income for any taxable year. The term "interest equivalent" includes a situation where bonds are acquired at a discount and where the difference (or a portion thereof) between the discount and par value of the bonds is a substitute for periodic interest payments. The term "bond" for purposes of the amendment means any bond, debenture, note, or certificate or other evidence of indebtedness.

Effective date

The amendment made by this section of the bill is to apply to taxable years ending after December 31, 1957, but only with respect to charitable contributions made after such date.

SECTION 14. AMORTIZABLE BOND PREMIUM

This section, except for a change in the effective date and a change in the dates subsequent to which the acquisition of a bond will result in the applicability of clauses (ii) or (iii) of section 171 (b) (1) (B), is substantially identical with section 12 of the House bill.

Before the 1954 Code, premiums on wholly taxable bonds generally were amortized over the period from the date of acquisition to maturity or to an earlier call date. The bond premium thus written off was applied against ordinary income, but gain on disposition was generally subject to capital gains treatment. Section 171 of the 1954 Code allows amortization of bond premiums on wholly taxable bonds to an earlier call date, but only if the call date is more than 3 years from the date of issue of the bonds. This change made by the 1954 Code does not apply to (1) bonds issued on or before January 22, 1951, and (2) bonds acquired on or before January 22, 1954.

Section 12 of the House bill amends section 171 (b) (1) (B) of the 1954 Code to provide that in the case of a wholly taxable bond, regardless of date of issue, acquired after November 7, 1956 (changed by your committee to December 31, 1957), the amount of the bond premium is to be determined with reference to (1) the amount payable on maturity, or (2) if the bond premium determined with reference to the amount payable on earlier call date results in a smaller amortizable bond premium attributable to the period to earlier call date, with reference to the amount payable on earlier call date.

The following example illustrates the application of this new rule:

On January 1, 1958, the taxpayer (who is on a calendar-year basis) pays $1,200 for a $1,000 wholly taxable bond which matures on December 31, 1977. The bond is callable on January 1, 1963, at $1,165. The premium computed with reference to the maturity date of the bond is $200. The premium computed with reference to earlier call date is $35. Although the premium amortized ratably to maturity would yield a deduction of $10 for each year ($200 divided by 20 years), under the amendment the deduction for each taxable year for the period before January 1, 1963, will be $7 ($35 divided by 5 years). If the bond is not called, the deduction for each taxable year in the period from 1963 through 1977 will be $11 ($165 divided by 15 years). If the earliest call date in this example had been January 1, 1961, instead of January 1, 1963, the premium amortized ratably to maturity would be used to obtain a deduction of $10 per year since this would be less than the premium amortized ratably to earlier call date of $11.67 ($35 divided by 3, the number of years to the earliest call date).

A conforming technical change is made by inserting a reference to section 171 (b) (1) (B) (ii) and (iii) in subsection (b) (2) of the section in lieu of the previous reference to subsection (c) (1) (B).

The amendments apply with respect to taxable years ending after December 31, 1957.

SECTION 15. NET OPERATING LOSS DEDUCTION

This section is the same as section 13 of the House bill except that your committee has added a new subsection (c), relating to the refund or credit of overpayments which are barred by the statute of limitations and to the payment of interest on overpayments resulting from the application of this section.

Section 15 of the bill amends section 172 of the 1954 Code (relating to the net operating loss deduction) to provide certain rules with respect to taxable years beginning in 1953 and ending in 1954 and with respect to short taxable years beginning in 1954 and ending before August 17, 1954.

Section 172 (f) of the code now provides that the computation of a net operating loss arising in a taxable year beginning in 1953 and ending in 1954 is to be made by determining the loss for such year entirely under the 1939 Code provisions and then entirely under the 1954 Code provisions, and then by taking the sum of a prorated part of each such loss (based on the number of days in the taxable year falling in the calendar years 1953 and 1954, respectively).

Subsection (a) of section 15 of the bill provides similar pro rata computations (1) for the net operating loss deduction (as distinguished from the net operating loss itself) for a taxable year beginning in 1953 and ending in 1954 and (2) with respect to the reduction, in the amount of any net operating loss carried through such a taxable year, by reason of the income of such taxable year.

Subsection (a) of section 15 adds a new paragraph (3) to section 172 (f) of the 1954 Code pursuant to which, in the case of a taxable year beginning in 1953 and ending in 1954, the net operating loss deduction will consist of the sum of the respective prorated parts of a net operating loss deduction computed separately for such year under section 122 (c) of the 1939 Code and under section 172 (a) of the 1954 Code. These prorated parts will be based upon the number of days in the taxable year falling in the calendar years 1953 and 1954, respectively.

Subsection (a) of section 15 also adds a new paragraph (4) to section 172 (f) of the 1954 Code. Under subparagraph (A) of this new paragraph, the net income for a taxable year beginning in 1953 and ending in 1954 will first be determined under the applicable principles of section 122 (b) of the 1939 Code; then a prorated portion of the net income so determined will be taken into account in determining net income for purposes of section 172 (b) (2) of the 1954 Code. This prorated portion will be based upon the number of days in the taxable year which fall within the calendar year 1953. To the amount so determined there will be added, under subparagraph (B) of the new paragraph (4), a prorated portion (based upon the number of days falling in the calendar year 1954) of the net income for the taxable year determined under the applicable principles of section 122 (b) of the 1939 Code by taking into account the applicable modifications other than the modifications set forth in section 122 (d) (1) and (2) of the 1939 Code, and by taking into account as a deduction from gross income an amount which is equal to the sum of the credits otherwise allowable under section 26 (b) (relating to the credit for dividends received) and section 26 (h) (relating to the credit for dividends paid on the preferred stock of a public utility) of the 1939 Code in computing normal-tax net income.

In determining the net income of a taxable year which begins in 1953 and ends in 1954 under proposed section 172 (f) (4), the net operating loss deduction, if any, will be computed in accordance with proposed section 172 (f) (3).

Subsection (b) of section 15 of the bill amends section 172 (g) of the 1954 Code to provide the same rules for short taxable years beginning in 1954 and ending before August 17, 1954, as are applied under the amendments made by subsection (a) of the bill to the 1954 portion of a fiscal year beginning in 1953 and ending in 1954.

Subsection (c) of section 15 of the bill, as added by your committee, provides that the refund or credit of certain overpayments resulting from the application of this section which is barred, on the date of enactment of the bill (or within 6 months thereafter), by the statute of limitations may be made or allowed if claim for the refund or credit is filed within 6 months from the date of the enactment of the bill. This subsection of the bill also provides that no interest shall be paid or allowed on any overpayment resulting from the application of the amendments made by subsection (a) and subsection (b) of section 15

SECTION 16. ASSESSMENTS LEVIED BY SOIL OR WATER CONSERVATION OR DRAINAGE DISTRICTS FOR CERTAIN DEPRECIABLE PROPERTY

Allowance of deduction

Section 16 of the bill, for which there is no corresponding provision of the House bill, amends section 175 of the 1954 Code. Section 175 of existing law permits a taxpayer to adopt a method of deducting certain expenditures for soil or water conservation which are not otherwise deductible and which are not subject to an allowance for depreciation. Assessments by a soil or water conservation or drainage district to defray expenditures which the taxpayer could deduct under section 175 had he himself made the expenditures are also deductible under the method. Subsection (a) of section 16 of the bill amends section 175 by adding a new subsection (f) that, in general, allows deductions with respect to assessments which, while otherwise qualifying under section 175, are denied deduction under existing law solely by reason of the fact that the expenditures defrayed by the assessments were made for structures, appliances, or facilities of a character subject to the allowance for depreciation provided by section 167.

Paragraph (1) of the new subsection (f) allows deductions with respect to assessments levied after December 31, 1957, by a soil or water conservation or drainage district to defray expenditures for property described in paragraph (3). The property described in paragraph (3) is only a structure, appliance, or facility which meets three conditions. First, the property must be of the character which is subject to a depreciation allowance under section 167. Second, the cost of this property must be defrayed by assessments levied after December 31, 1957. Third, expenditures for the acquisition of the property must be of the type which, if made by the taxpayer, would constitute expenditures which would be deductible under section 175 (a) except for the second sentence of section 175 (c) (1). In addition, the deduction does not apply to assessments which are deductible apart from the amendment. For example, the deduction does not apply to an assessment deductible under section 164 as a tax, or to an assessment deductible under section 175 of existing law.

The amount of the deduction under paragraph (1) is the taxpayer's share of the depreciation that would be allowable to the district on the property described in paragraph (3) if the district were subject to Federal income taxes. The taxable year of the district and the method for determining the taxpayer's share of the district's depreciation deduction shall be prescribed by regulations.

The owner of the land with respect to which the assessment is levied is entitled to the deduction. Generally a purchaser of such land (whether or not the owner at the time of the assessments) who meets the conditions for the deduction may obtain the same deduction as his transferor could have obtained under paragraph (1) if he had retained the land. On the transfer of a part of the land the transferee obtains the deduction to the extent that the assessments relate to the land transferred. Of course, if no part of the assessments relate to that part of the land transferred, then the transferee obtains no deduction under the amendment. Where land is transferred during a taxable year, paragraph (4) authorizes the Secretary or his delegate to prescribe regulations for allocating the deduction between the transferor and the transferee.

The deduction provided by paragraph (1) is not limited to 25 percent of the gross income from farming, but paragraph (2) does impose certain requirements if the deduction is to be made available for assessments by the district to defray the cost of acquiring depreciable property.

Paragraph (2) provides for a ceiling on the amount of the annual deduction allowable under paragraph (1). The amount of the deduction for the taxable year (when added to the aggregate deductions under paragraph (1) for prior taxable years) may not exceed the aggregate assessments levied before the end of the taxable year (and after December 31, 1957), in respect of the taxpayer's land to defray such expenditures. To obtain this deduction the taxpayer need not adopt the method of deduction provided under section 175 (a).

Corresponding to a similar requirement in section 175 of present law, paragraph (2) limits the availability of the deduction to a taxpayer who is engaged in the business of farming and who uses the land in respect of which such assessment is levied in farming. During any period of noncompliance with this requirement, the taxpayer cannot obtain the deduction provided under paragraph (1).

Paragraph (5) makes clear that the deduction under paragraph (1) will not be prevented by section 263.

Basis

Paragraph (6) adds a cross reference to section 1016 (a). No change is made in the requirement under existing law that assessments of the kind to which the amendment applies must be charged to capital. Subsection (b) of section 16 of the bill adds to section 1016 (a) a new paragraph (17) to assure a proper adjustment to basis for the deductions under the new subsection (f) (1) of section 175. Where the land to which the assessments relate is disposed of, the transferee may obtain such deductions under subsection (f) (1) (limited as described above) as the transferor could have obtained and he must make corresponding adjustments under the new section 1016 (a) (17). Further assessments paid or incurred by the transferee are also charged to capital and his basis is likewise adjusted for

the deductions on account of such assessments under the new subsection (f) (1) of section 175.

Example

The operation of the amendment may be illustrated by the following example: In 1960, X, a drainage district, constructs a tile drainage ditch of a character subject to an allowance for depreciation at a cost of $20,000. The improvement is property described in paragraph (3) of the new subsection (f). To finance the construction, X issues 10-year bonds payable in equal yearly installments during the 10-year period, 1960 through 1969. The district levies an assessment of $2,000 for each calendar year against all of the land benefited by the improvement to defray the cost of this improvement. A, engaged in the business of farming, owns a tract of land benefited by the improvements and uses it in farming. Each year during the 10-year period an assessment of $200 is levied with respect to such tract. For the purpose of the new subsection (f) the district uses the straight-line method of depreciation. The improvement has no salvage value. Since it has a useful life of 20 years, the district's depreciation deduction each year is $1,000. A, a calendar year taxpayer, is entitled to a deduction under the new subsection (f) for each taxable year of $100 $\left(\frac{\$200}{\$2{,}000}\times\$1{,}000\right)$. On January 1, 1965, A sells his tract for $50,000 to B, a calendar year taxpayer, who during the entire period of 1965 through 1979 engages in the business of farming, and owns and uses the land in farming. At the close of the taxable year 1965 B's adjusted basis for the tract (before an adjustment is made for the deduction under the new subsection (f) (1) for the taxable year) is $50,200 (B's cost plus the assessment of $200 for 1965). Since $1,200, the aggregate assessments at the close of the taxable year with respect to the tract for the improvement, exceeds $600, the aggregate deductions by the end of 1965 with respect to the land and the improvement, by more than $100 (the current year's depreciation deduction), B is allowed a deduction under the new subsection (f) in the amount of $100 for the taxable year 1965. The adjusted basis of the tract, as adjusted for the $100 deduction for 1965, is $50,100. A cannot obtain a deduction under the new subsection (f) (1) after he disposes of the tract.

Effective date

Subsection (c) of section 16 of the bill provides that the amendments made by subsections (a) and (b) shall apply to taxable years beginning after December 31, 1957.

SECTION 17. IMPROVEMENTS ON LEASED PROPERTY

Deduction by lessee for depreciation, etc.

This section corresponds to section 14 of the House bill with changes as hereinafter mentioned. Section 17 of the bill adds a new section 178 to the 1954 Code (relating to depreciation or amortization of improvements made by lessee on lessor's property).

Subsection (a) of the new section 178 added by the House bill provided that where a lessee makes improvements on leased property (or where he incurs costs in acquiring the lease) renewal periods, as well

as the term of the initial lease, are to be taken into account in determining the length of the period over which the improvements (or costs) are to be written off (where this is shorter than the life of the improvement) unless the taxpayer can show that it is more probable that he will not renew the lease than that he will.

Subsection (b) of the new section 178 added by the House bill provided that if the lessee and lessor are related persons at any time during the taxable year, then, in determining the amount allowable to the lessee as a deduction for such taxable year for exhaustion, wear and tear, obsolescence, or amortization in respect of any building erected (or other improvement made) on the leased property, the lease shall be treated as including a period of not less duration than the remaining useful life of such improvement. Subsection (b) also provided that in determining whether a lessee and lessor are related persons, the rules of subsections (b) and (c) of section 267 of the 1954 Code are to apply, except that, (1) the family of an individual is to include only his spouse, ancestors, and lineal descendants, and (2) the phrase "80 percent or more" which appears in paragraphs (2) and (3) of section 267 (b), and relates to the requirements for stock ownership in determining whether certain corporations are related persons, is to be substituted for the phrase "more than 50 percent" each place it appears therein.

Your committee has amended subsection (a) of section 178 to provide that (except as provided in subsection (b), explained below) in determining the amount allowable to a lessee as a deduction for any taxable year for exhaustion, wear and tear, obsolescence, or amortization—

> (1) in respect of any building erected (or other improvement made) on the leased property, if the portion of the term of the lease (excluding any period for which the lease may subsequently be renewed, extended, or continued pursuant to an option exercisable by the lessee) remaining upon the completion of such building or other improvement is less than 60 percent of the useful life of such building or other improvement, or
>
> (2) in respect of any cost of acquiring the lease, if less than 75 percent of such cost is attributable to the portion of the term of the lease (excluding any period for which the lease may subsequently be renewed, extended, or continued pursuant to an option exercisable by the lessee) remaining on the date of its acquisition,

the term of the lease shall be treated as including any period for which the lease may be renewed, extended, or continued pursuant to an option (whether or not specifically provided for in the lease) exercisable by the lessee, unless the lessee establishes that (as of the close of the taxable year) it is more probable that the lease will not be renewed, extended, or continued for such period than that the lease will be so renewed, extended, or continued. Thus subsection (a) (1), as amended, would be applicable, in the case of unrelated taxpayers where the period of the lease remaining, without regard to any renewals, is less than 60 percent of the estimated useful life of the building or other improvement, and subsection (a) (2) as amended, would be applicable in respect of any cost of acquiring the lease in the case of unrelated taxpayers, if less than 75 percent of such cost is attributable to the portion of the term of the lease remaining on

the date of its acquisition without regard to any renewals. This subsection, as amended by your committee, may be illustrated by the following examples:

Example (1): Upon the completion of an improvement constructed by the lessee upon the lessor's property, the lessee has 15 years remaining on his lease with an option to renew for 20 years. The improvement has an estimated useful life of 30 years. Since the portion of the term of the lease (without regard to any renewals) remaining upon the completion of the improvement is less than 60 percent of the estimated useful life of the improvement, the term of the lease will include the total of the original lease period and the renewal period, or 35 years. Since the estimated useful life of the improvement (30 years) is less than 35 years, the improvement may be depreciated under the provisions of section 167 of the 1954 Code over the 30-year period. However, if the taxpayer is to amortize the cost of the improvement over the period remaining of the present lease (15 years) he will have to prove that (as of the close of the current taxable year) it is more probable that the lease will not be renewed, extended, or continued than that the lease will be renewed, extended, or continued.

Example (2): Upon the completion of a building constructed by the lessee upon the lessor's property, the lessee has 21 years remaining on his lease with an option to renew for 10 years. If the building has a useful life of 35 years, then the rule under this section would not apply because the term of the lease remaining after the completion of the building is for a period not less than 60 percent of the estimated useful life of the building. Since subsection (a) of section 178 is not applicable, the taxpayer is allowed to amortize the cost of the building over the remaining term of the lease (21 years) unless under the provisions of subsection (c) of section 178 there is a reasonable certainty that the renewal option will be exercised.

Example (3): If a lessee pays $10,000 to acquire a lease for 20 years with two options to renew for periods of 5 years each and $7,000 of his costs of acquiring the lease were paid for the initial 20-year lease period, the new rule of section 178 would be applicable since $7,000 is less than 75 percent of the cost of the lease (75 percent times $10,000, or $7,500). Thus, the cost of acquiring the lease ($10,000) will be amortized over the aggregate of the original term of the lease and the 2 renewal periods, or 30 years. If the taxpayer establishes that (as of the close of the current taxable year) it is more probable that the lease will not be renewed, extended, or continued than that the lease will be renewed, extended, or continued, he may amortize the cost of acquiring the lease ($10,000) over the initial term of the lease (20 years).

Example (4): If in example (3) $8,000 of the lessee's costs of acquiring the lease were for the initial 20-year lease period, section 178 (a) (2) would not apply and the taxpayer would be allowed to amortize the total cost of acquiring the lease ($10,000) over the 20-year period, unless, under the provisions of subsection (c) of section 178, that there is a reasonable certainty that the renewal option or options will be exercised.

Your committee intends that in a case where the lessee has given notice to the lessor of his intention to extend, renew, or continue a lease, the lessee shall take into account, in applying the percentage requirements of this section, such extension or renewal in determining

the portion of the term of the lease remaining upon the completion of the improvement or on the date of the acquisition of the lease. Therefore, in applying the percentage requirements under this section in a case where the lessee has given notice to the lessor of his intention to extend, renew, or continue a lease, that portion of the term of the lease remaining upon the completion of the improvement or on the date of the acquisition of the lease shall include the aggregate of the period remaining of the unexpired term of the present lease and the renewal period or periods if the notice includes such periods. The foregoing may be illustrated by the following examples:

Example (5): Upon the completion of a building constructed by the lessee upon the lessor's property (the lessee and lessor are not related), the lessee has 3 years remaining on a lease for 20 years with 2 options to renew for periods of 20 years each. The estimated useful life of the building is 50 years. Prior to completion of the building the lessee gives notice to the lessor of his intention to accept the first 20-year option. Section 178 is applicable since the term of the lease remaining upon completion of the building (23 years) is less than 60 percent of the estimated useful life of such building (60 percent times 50, or 30 years).

Example (6): If in example (5) the estimated useful life of the building is 30 years, section 178 would not apply since the period of the lease remaining (23 years) is not less than 60 percent of 30 years, or 18 years.

If the lessee fails to give notice of his intention to accept the renewal option, the renewal period would not be taken into account in computing the percentage requirements. Thus, in the above example, section 178 would apply in either case whether the estimated useful life of the building is 30 years or 50 years since the lease remaining upon completion of the building (3 years) is less than 60 percent of either of the estimated useful lives (18 or 30 years).

Related persons defined

Subsection (b) of section 178, as contained in the House bill, has been amended by your committee to provide that a lessor and lessee shall be considered to be related persons if—

(1) the lessor and lessee are members of an affiliated group (as defined in section 1504), or

(2) the relationship between the lessor and lessee is one described in subsection (b) of section 267, except that, for purposes of this subparagraph the phrase "80 percent or more" shall be substituted for the phrase "more than 50 percent" each place it appears in such subsection. For purposes of determining the ownership of stock in applying section 267 (b), the rules of subsection (c) of section 267 shall apply, except that the family of an individual includes only his spouse, ancestors, and lineal descendants.

Reasonable certainty test

Subsection (c) of section 178, for which there is no corresponding provision in the House bill, provides that in any case in which neither subsection (a) nor subsection (b) apply, the determination as to the amount allowable to a lessee as a deduction for any taxable year for exhaustion, wear and tear, obsolescence, or amortization—

(1) in respect of any building erected (or other improvement made) on the leased property, or

(2) in respect of any cost of acquiring the lease, shall be made with reference to the term of the lease (excluding any period for which the lease may subsequently be renewed, extended, or continued pursuant to an option exercisable by the lessee), unless the lease has been renewed, extended, or continued or the facts show with reasonable certainty that the lease will be renewed, extended, or continued.

Effective date

Subsection (c) of the House bill has been amended to provide that the amendments made by this section shall apply with respect to costs of acquiring a lease incurred, and improvements begun, after July 28, 1958 (other than improvements which, on July 28, 1958, and at all times thereafter, the lessee was under a binding legal obligation to make).

SECTION 18. MEDICAL, DENTAL, ETC., EXPENSES IN CASE OF DECEDENTS

Section 213 (d) (1) of the 1954 Code provides that expenses for the medical care of the taxpayer which are paid out of his estate within 1 year after his death are to be treated, for income-tax purposes, as paid by the taxpayer at the time incurred. Section 213 (d) (2) (A) of the 1954 Code provides that this rule will not apply unless there is filed a statement that the amount has not been "claimed or allowed" as a deduction for estate-tax purposes.

This section of the bill, which is identical with section 15 of the House bill, strikes out the phrase "claimed or" from section 213 (d) (2) (A) to conform the language of this provision with similar language in section 642 (g) of the 1954 Code.

SECTION 19. INCREASE IN LIMITATION ON MEDICAL DEDUCTION FOR A TAXPAYER OR HIS SPOUSE WHO HAS ATTAINED AGE 65 AND IS DISABLED

This section, which has been added by your committee, increases the maximum limitation on the medical deduction allowable to a taxpayer who has attained the age of 65 and is disabled, or whose spouse has attained the age of 65 and is disabled. Under your committee's amendment, the limitation would be $15,000 for a taxpayer if he is 65 or over and disabled, or if his spouse is 65 or over and disabled and if his spouse does not make a separate return for the taxable year. If both spouses are disabled and 65 or over, the limitation on a joint return is $30,000.

The increased amount allowable as a deduction, however, over the limitations of existing law as set forth in section 213 (c) of the 1954 Code is available only with respect to amounts paid during the taxable year for the taxpayer, if he has reached the age of 65 before the close of the taxable year and is disabled, or for his spouse, if she has reached the age of 65 before the close of the taxpayer's taxable year and is disabled. Other amounts paid during the taxable year, such as for the medical care of a dependent, shall be taken into account only to the extent such payments do not exceed the maximum limitation, contained in section 213 (c), which would apply but for this amendment. Thus, assume the case of a taxpayer over 65 and disabled, with one dependent and filing a joint return, with medical expenses deductible

under section 213 (a) of $8,500 for the dependent and $6,500 for himself. The deductible expenditures in respect of the dependent would be limited to $7,500, and the taxpayer would be entitled under this section to deduct the $6,500 paid for himself, a total of $14,000 out of the $15,000 paid. Because of the application of the section 213 (c) limitation to payments for the dependent, $1,000 of the amount deductible under section 213 (a) would be disallowed. In addition, the amendment limits to $15,000 the amount which can be taken into account with respect to amounts paid for the medical care of any one individual taxpayer or spouse. This limitation will operate where both spouses are 65 or over and disabled and file a joint return.

Your committee's amendment contains a definition of the term "disabled" for purposes of this section. A person shall be considered disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or be of long-continued and indefinite duration. Ordinarily, a terminal illness because of disease or injury would result in disability. Inability to engage in normal activities because of a broken bone would not generally be considered a disability, since inactivity from such an injury would not generally be either long-continued within the meaning of this section or of indefinite duration, both of which conditions must be met. In general, the gainful activity to which the section refers is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability. It is further provided that proof of the existence of disability must be furnished to the Secretary or his delegate, in such form and manner as may be required.

The determination of whether the taxpayer or his spouse is disabled shall be made as of the close of the taxable year of the taxpayer, except that if his spouse dies during the taxable year the determination as to whether disability of the spouse existed shall be made as of the date of death.

It is further provided that the amendment made by this section will apply only to taxable years beginning after December 31, 1957.

SECTION 20. DEDUCTIONS BY CORPORATIONS FOR DIVIDENDS RECEIVED

This section, with the exception of a change in the holding period and effective date, is identical with section 16 of the House bill.

Section 20 of the bill adds a new subsection (c) to section 246 (relating to rules applicable to the intercorporate dividends-received deduction) of the 1954 Code. Under the House bill, this new subsection denied the allowance of the deductions provided in section 243, 244, or 245 in respect of any dividend on any share of stock which was sold or otherwise disposed of in any case in which the taxpayer had held such share for 10 days or less or to the extent that the taxpayer was under an obligation (whether pursuant to a short sale or otherwise) to make corresponding payments with respect to substantially identical stock or securities. Your committee has amended this provision so that the 10-day holding period of new subsection (c) is extended to 15 days. The term "otherwise disposed of" is intended to include disposal by gift or other disposition.

Subsection (c) (of both your committee's bill and the House bill) also provides the rule to be followed in the case of any stock having preference in dividends. In such case the holding period is to be 90 days (in lieu of 15 days) if the taxpayer receives dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days.

The denial of the dividends-received deduction applies in any case in which the taxpayer is in both a "long" and "short" position over the dividend date without regard to the length of time during which the shareholder was in the long position. That is, in any case where a taxpayer is receiving dividends on stock and is under an obligation to make corresponding payments on substantially identical stock or securities, the dividends-received deduction would be denied. The term "substantially identical stock or securities" is intended generally to have the same meaning as used in sections 1091 and 1233.

Special rules are provided in paragraph (3) of the new subsection (c) to be used in determining (for purposes of applying the rules of the subsection) the period for which the taxpayer has held any share of stock. In computing such period, the day of disposition, but not the day of acquisition, shall be taken into account. There shall not be included in the computation any day which is more than 15 days after the date on which such share becomes ex-dividend. Thus, if a corporation buys stock immediately before the ex-dividend date and sells short with respect to the same stock immediately afterward, it will not be possible to obtain the dividends-received deduction by holding the straddle position for an indefinite period, closing the short position with newly acquired stock, and then holding the original stock for 15 days. Where paragraph (2) applies to stock having a preference in dividends, in lieu of the 15-day rule a 90-day rule applies. The special rules of section 1223 (4) (relating to holding periods in cases of wash sales) are not to apply. Paragraph (3) further provides that the holding periods (as determined above) shall be reduced for any period (during such holding periods) in which the taxpayer is in both a "long" and "short" position. Specifically, it is provided that the holding period shall be appropriately reduced (in a manner provided in regulations prescribed by the Secretary or his delegate) for any period in which the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of substantially identical stock or securities.

The House bill provided that the amendment made by section 16 of that bill was to apply with respect to taxable years ending after November 7, 1956, but only with respect to shares of stock acquired after November 7, 1956. Your committee has changed the effective date to December 31, 1957, and has provided that the denial of the deduction under this amendment shall apply not only to dividends received on shares of stock acquired after December 31, 1957, but also with respect to shares of stock acquired before that date where the taxpayer has made a short sale of substantially identical stock or securities after that date.

SECTION 21. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS

Section 21 of the bill, for which there is no corresponding provision in the House bill, amends section 337 of the 1954 Code (relating to gain or loss on sales or exchanges in connection with certain liquidations) to add at the end thereof a new subsection (d). The new subsection provides a special rule for minority shareholders in the case of sales or exchanges by a corporation following the adoption of a plan of complete liquidation, but only if the plan is adopted after December 31, 1957, if section 332 applies to such liquidation and if section 334 (b) (1) applies to property received by a corporation described in section 332 (b) (1). The new subsection does not apply unless subsection (a) is inapplicable to such sales or exchanges solely by reason of the application of subsection (c) (2) (A). Thus, if subsection (a) would not apply to any sale or exchange without regard to subsection (c) (2) (A), the new subsection will not apply with respect to such sale or exchange.

The special rule of the new subsection consists of two steps. First, the amount realized by a minority shareholder (that is, any shareholder except the corporation which meets the 80-percent stockownership requirement of sec. 332 (b) (1)) during the first taxable year in which he receives a distribution in complete liquidation is increased by his proportionate share of the amount by which the tax imposed by subtitle A on the liquidating corporation would have been reduced if subsection (c) (2) (A) had not been applicable to sales or exchanges of property by such corporation. In determining whether or not there would have been a reduction, and if so, the amount thereof, the provisions of subsections (a), (b), and (c) must be taken into account. Thus if subsection (a) would not apply to a sale because the property sold is described in subsection (b) (1) (A), or because the property is sold after the expiration of the 12-month period prescribed in subsection (a), such sale shall not be taken into account in determining the amount by which the tax imposed on the corporation would have been reduced if subsection (c) (2) (A) had not applied.

The entire increase provided for in subsection (d) (1) is treated as an addition to the amount realized by a minority shareholder on the liquidating distribution received by him during the first taxable year in which he receives a liquidating distribution. Thus, even though a minority shareholder receives distributions in complete liquidation in more than one taxable year, the entire increase takes place in the first taxable year in which he receives such a distribution.

Second, the shareholder is deemed to have paid, with respect to his taxable year in which he receives his first liquidating distribution, an amount of tax equal to the amount of the increase provided for in subsection (d) (1). Such payment is deemed to have been made on the last day prescribed by law for the payment of the tax imposed by subtitle A on the shareholder for such taxable year. Since the tax on the amount of the increase will always be less than the increase

itself, application of the new subsection may give rise to an overpayment of tax. Any such overpayment will be credited or refunded in accordance with the provisions of the code relating to the allowance of credits or refunds.

The amendment made by section 21 applies with respect to plans of complete liquidation adopted after December 31, 1957.

SECTION 22. COLLAPSIBLE CORPORATIONS

Section 22 of the bill, for which there is no corresponding provision in the House bill, amends section 341 of the 1954 Code (relating to collapsible corporations) to add at the end thereof a new subsection (e). The new subsection sets forth circumstances under which a corporation will be considered not to be a collapsible corporation with respect to (1) certain sales or exchanges of its stock by a shareholder, (2) certain distributions in complete liquidation under section 331, (3) certain distributions in complete liquidation under section 333, and (4) certain sales or exchanges of property by the corporation following the adoption of a plan of complete liquidation. If the proper circumstances exist, then the corporation will be considered not to be a collapsible corporation solely for purposes of the transactions mentioned in the preceding sentence. Thus, the new subsection merely provides rules under which a corporation may avoid being classified as collapsible; it will never result in causing a corporation to be classified as collapsible.

Paragraph (1) of the new subsection applies to certain sales or exchanges of stock by a shareholder. The paragraph does not apply unless the shareholder making a sale or exchange is able to satisfy a test based on the relationship between the net unrealized appreciation in so-called subsection (e) assets and corporate net worth. The test has three aspects. First, under subparagraph (A), it is necessary to compute the net unrealized appreciation in subsection (e) assets held by the corporation. Generally speaking, these are assets which, if sold by the corporation or any shareholder owning more than 20 percent in value of the corporation's outstanding stock, would give rise to ordinary income or to an ordinary loss (the term "subsection (e) asset" is described more fully in a subsequent portion of this report). Second, under subparagraph (B), if the shareholder owns more than 5 percent in value of the corporation's outstanding stock, it is necessary to compute the net unrealized appreciation in assets of the corporation which would be subsection (e) assets if the particular shareholder owned more than 20 percent in value of the corporation's outstanding stock. Finally, under subparagraph (C), if the shareholder owns more than 20 percent in value of the corporation's outstanding stock, it is necessary to compute the net unrealized appreciation in assets of the corporation which would be subsection (e) assets if the shareholder's ownership of stock in certain other corporations were taken into account.

Under clause (i) of subparagraph (C), any sale or exchange by the shareholder of stock in any other corporation is treated as a sale or exchange by the shareholder of his proportionate share of such other corporation's assets, provided (1) the shareholder owns, or at any time during the 3-year period preceding such sale or exchange owned, more than 20 percent in value of such other corporation's

outstanding stock, (2) at the time of such sale or exchange the shareholder owned more than 20 percent in value of such other corporation's outstanding stock, and (3) more than 70 percent in value of the assets of such other corporation are, or were at any time during which such shareholder owned (during the 3-year period) more than 20 percent in value of the outstanding stock, assets similar or related in service or use to assets of the corporation comprising more than 70 percent in value of such assets. Moreover, under clause (ii) of subparagraph (C), any sale or exchange of property by such other corporation within such 3-year period (provided at the time of such sale or exchange the stockholder owned more than 20 percent in value of such other corporation's outstanding stock) is treated as a sale or exchange by the shareholder of his proportionate share of the property sold or exchanged, if gain or loss on such sale or exchange was not recognized to the other corporation under section 337 (a). As a result of subparagraph (C), a particular shareholder's relationship to other corporations in which he owns or owned a significant interest and which hold or held assets similar to those held by the corporation whose stock is being sold or exchanged is taken into account, under the circumstances described above, in determining whether the shareholder is a dealer in assets of the latter corporation. However, such relationship is not taken into account in determining whether other shareholders qualify under the exception contained in paragraph (1).

Paragraph (1) of the new subsection does not apply if the sum of the amounts determined under subparagraphs (A), (B), and (C) exceeds an amount equal to 15 percent of corporate net worth. The test is applied as of the time of any sale or exchange.

A sale or exchange of stock to the issuing corporation cannot qualify under paragraph (1). Thus, stock redemptions (including distributions in complete or partial liquidation) cannot qualify under paragraph (1). Moreover, in the case of a shareholder who owns more than 20 percent in value of a corporation's outstanding stock, the paragraph does not apply to any sale or exchange of stock to a related person as defined in paragraph (8).

Paragraph (2) of the new subsection applies to certain distributions pursuant to a plan of complete liquidation in cases where, by reason of paragraph (4), section 337 (a) applies to sales or exchanges of property by the liquidating corporation. Paragraph (2) applies regardless of whether, by reason of paragraph (4), section 337 (a) applies to all or merely to some of such sales or exchanges. Paragraph (2) applies only if the shareholder receiving a liquidating distribution is able to satisfy the same tests (based on the relationship between net unrealized appreciation in subsection (e) assets and net worth) which a shareholder must meet who sells or exchanges stock under paragraph (1). These tests must be satisfied at all times after the adoption of the plan of complete liquidation.

Paragraph (3) of the new subsection applies to distributions in complete liquidation under section 333 and provides that a corporation will not be considered a collapsible corporation for purposes of section 333 (notwithstanding the parenthetical clause in the first sentence of sec. 333 (a)) if, at all times after the adoption of the plan of liquidation, the net unrealized appreciation in subsection (e) assets of the corporation does not exceed 15 percent of corporate net worth. Un-

like the test in paragraphs (1) and (2), the test in paragraph (3) is never made on a shareholder-by-shareholder basis. That is, either all of the shareholders can qualify under paragraph (3) for section 333 treatment or none of them can qualify.

Paragraph (4) of the new subsection provides that under certain circumstances a corporation will not be considered a collapsible corporation for purposes of section 337 (despite the provisions of sec. 337 (c) (1) (A)) with respect to sales or exchanges of property within the 12-month period beginning on the date of the adoption of a plan of complete liquidation. The paragraph applies only if the following conditions are satisfied: (1) At all times after the adoption of such plan, the net unrealized appreciation in subsection (e) assets does not exceed 15 percent of corporate net worth; (2) within the 12-month period following adoption of the plan the corporation sells substantially all of the properties held by it on the date of such adoption; and (3) no distribution is made of any property which in the hands of the corporation or in the hands of the distributee is property in respect of which a deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion is allowable. Thus, if following the adoption of a plan of complete liquidation a corporation distributes any property in respect of which a deduction of the type mentioned in the preceding sentence is allowable, none of the sales or exchanges of property during the 12-month period following adoption of the plan can qualify for nonrecognition treatment under section 337 (a).

Paragraph (4) does not apply to eliminate the corporate tax on any sale or exchange of property by a corporation to any shareholder who owns more than 20 percent in value of the corporation's outstanding stock or to any person related to such a shareholder within the meaning of paragraph (8), if such property in the hands of the corporation or in the hands of the purchaser is property in respect of which a deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion is allowable.

Paragraph (5) contains the definition of a subsection (e) asset. Subparagraph (A) defines the term for purposes of paragraph (1) (relating to sales or exchanges of stock), paragraph (2) (relating to distributions in complete liquidation), and paragraph (4) (relating to sales or exchanges of property by a corporation within the 12-month period following the adoption of a plan of complete liquidation). Clause (i) of subparagraph (A) includes property of the corporation (except property used in the trade or business as defined in paragraph (9)), which, in the hands of the corporation, is property gain from the sale or exchange of which would be considered in whole or in part as gain from the sale or exchange of property which is not a capital asset, or, which in the hands of any shareholder who owns more than 20 percent in value of the corporation's outstanding stock, would be property gain from the sale or exchange of which would be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (b). For example, if a corporation holds securities for investment and if a 21-percent shareholder is a dealer in securities, the securities would be considered subsection (e) assets under subparagraph (A) (i).

Clause (ii) of subparagraph (A) includes property used in the trade or business if there is net unrealized depreciation on all such

property considered in the aggregate. As a result of clause (ii) the net unrealized depreciation on property used in the trade or business will offset any appreciation on other subsection (e) assets for the purpose of determining whether net unrealized appreciation on all subsection (e) assets exceeds 15 percent of net worth.

Clause (iii) of subparagraph (A) includes property used in the trade or business only if there is net unrealized appreciation on all such property considered in the aggregate and only to the extent that any such property in the hands of a shareholder who owns more than 20 percent in value of the corporation's outstanding stock would be property gain from the sale or exchange of which would be considered in whole or in part as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (b). For example, if the only section 1231 (b) assets of the corporation are houses held for rental purposes upon which there is net unrealized appreciation and if a 21-percent shareholder is a dealer in houses, the houses would be considered subsection (e) assets under subparagraph (A) (iii).

Clause (iv) of subparagraph (A) includes property (if not included under clauses (i), (ii), or (iii)) which consists of a copyright, a literary, musical or artistic composition, or similar property, or any interest in any such property, if the property was created in whole or in part by the personal efforts of any shareholder who owns more than 5 percent in value of the corporation's outstanding stock. For example, the rendering of services with respect to a motion-picture production would be included within the term "personal efforts."

Subparagraph (B) of paragraph (5) defines the term "subsection (e) asset" for purposes of paragraph (3) (relating to recognition of gain in liquidations under section 333). The definition of "subsection (e) asset" under subparagraph (B) is identical to the definition of the term under subparagraph (A), except that clauses (i) and (iii) of subparagraph (A) apply to any shareholder who owns more than 5 percent in value of the outstanding stock.

The determination under paragraph (5) (A) as to whether property in the hands of the corporation is, or in the hands of a shareholder would be, property gain from the sale or exchange of which would be considered in whole or in part as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (b), is made as if all property of the corporation had been sold or exchanged to 1 person in 1 transaction. For example, if a corporation owns interests in oil or gas wells and has entered into a long-term contract for the future delivery of gas, the ownership of which will pass to the buyer only after extraction or severance, then the determination whether such contract is a subsection (e) asset shall be made as if the contract were sold or exchanged to 1 person in 1 transaction together with the corporation's interests in the wells. Thus, where the corporation's interests in the oil or gas wells are not subsection (e) assets, the contract will also not be a subsection (e) asset.

Paragraph (6) defines certain terms used elsewhere in the new subsection. Subparagraph (A) defines "net unrealized appreciation"; subparagraph (B) defines "unrealized appreciation"; and subparagraph (C) defines "unrealized depreciation." Subparagraph (D)

provides a special rule for any asset on the sale or exchange of which only a portion of the gain would be taxed as ordinary income and the remainder would be taxed as capital gain. In the case of such an asset, there is taken into account for purposes of paragraph (6) (but not for purposes of par. (5) (A)) only an amount of the unrealized appreciation in such asset which is equal to the portion of the gain which would be taxed as ordinary income on a sale or exchange of the asset.

Paragraph (7) defines "net worth." For the purpose of computing the net worth of a corporation as of any day, the amount of all prior distributions (at fair market value on the date of any distribution) in complete liquidation is taken into account. This means that prior distributions in complete liquidation will not cause a failure to meet the 15-percent test. Under paragraph (7) the net worth as of any day will not take into account any amount received during the preceding 1-year period for stock of the corporation, as a contribution to capital, or as paid-in surplus, if it appears that there was not a bona fide business purpose for the transaction in which the amount was received. For example, if a corporation, in anticipation of adopting a plan of complete liquidation, sells its stock or receives a contribution from its shareholders within such 1-year period to enable the corporation to meet the 15-percent test, the amount received on the sale or contribution will not be taken into account in determining net worth for a 1-year period after such sale or contribution.

Paragraph (8) describes those persons considered to be related to a shareholder to whom sales of stock or property will not qualify under paragraphs (1) and (4), respectively. The rules of paragraph (8) apply only in the case of a shareholder who owns, or is considered as owning, more than 20 percent in value of the corporation's outstanding stock. Related persons include an individual's spouse, ancestors, and lineal descendants, and any corporation which is controlled by such individual. If the shareholder is a corporation, related persons include a corporation which controls or is controlled by the shareholder, and, in cases where more than 50 percent in value of the shareholder's outstanding stock is owned by 1 person, any other corporation more than 50 percent in value of the outstanding stock of which is owned by the same person. "Control" means ownership of stock possessing either at least 50 percent of the outstanding voting power or at least 50 percent of the total value of all outstanding stock.

Paragraph (9) contains the definition of "property used in the trade or business." For purposes of the new subsection, the term means property described in section 1231 (b) without regard to any holding period.

Paragraph (10) provides rules for determining the ownership of stock. These rules are applicable in determining whether a person owns more than 20 percent in value of a corporation's outstanding stock for purposes of paragraphs (1) (C) and (2) (C) and clauses (i) and (iii) of paragraph (5) (A), for purposes of the last sentence of paragraph (1), and for purposes of the last sentence of paragraph (4). The rules are also applicable in determining whether a person owns more than 5 percent in value of a corporation's outstanding stock for purposes of paragraphs (1) (B), (2) (B), (5) (A) (iv), and (5) (B).

The amendment made by section 22 applies to taxable years beginning after December 31, 1957, but only to sales, exchanges, and distributions after the date of enactment of the bill.

SECTION 23. CERTAIN ACQUISITIONS OF STOCK

Section 23 of the bill, except for a date change, is identical with section 18 of the House bill. This section adds a new sentence to section 391 (relating to effective date of certain provisions of the 1954 Code with respect to distributions by corporations) to make the provisions of the 1939 Code applicable to property received on acquisitions of stock described in section 304 (relating to redemption through use of related corporations) of the 1954 Code which occurred either before June 22, 1954, or on or before December 31, 1958, if pursuant to a contract entered into before June 22, 1954. The amendment provides that the extent to which property received in return for such acquisition shall be treated as a dividend shall be determined as if the 1939 Code continued to apply in respect of such acquisition and as if the 1954 Code had not been enacted. The amendment is made applicable as if included in section 391 on the date of enactment of the 1954 Code.

SECTION 24. TAXATION OF EMPLOYEE ANNUITIES

This section of the bill, which corresponds to section 19 of the House bill, amends sections 403, relating to employee annuities; 101 (b), relating to employee death benefits; and 2039 (c), relating to exemption of annuities under certain trusts and plans, of the 1954 Code. This section also amends section 2517 of the 1954 Code (relating to the gift-tax treatment of certain annuities under qualified plans) which is added to the code by section 72 of the bill.

Employee annuities

Section 403 (a) (1) of the 1954 Code, which provides tax deferment in the case of certain employee annuities, is amended (by subsec. (b) of sec. 24 of the bill) in two respects. First, there is eliminated the former provision which extended deferred-tax treatment to annuities purchased for employees by employers described in section 501 (c) (3) of the 1954 Code (relating to charitable, educational, etc., organizations) and exempt under section 501 (a), when such contracts are not purchased under a qualified plan. This provision is eliminated from section 403 (a) (1) for the reason that annuities purchased by such employers are dealt with in a new section 403 (b). Secondly, the deferred-tax treatment is made applicable to plans which meet the requirements of section 404 (a) (2), instead of to plans with respect to which the contributions are deductible under section 404 (a) (2). Existing law has been administratively interpreted to hold that, if a tax-exempt employer establishes a qualified plan, his employees are entitled to the deferred-tax treatment, and this change merely makes clear that such rule will continue to be applied, notwithstanding the other changes made in section 403.

Subsection (a) of section 24 of the bill reletters subsection (b) of section 403 as subsection (c), and a new subsection (b) is added to set forth the new rules to be applied to annuities purchased for

employees of organizations described in section 501 (c) (3) of the 1954 Code and exempt under section 501 (a). This subsection does not apply if the annuity contract is subject to subsection (a). Thus, if an employer has established a plan which meets the requirements of subsection (a), any annuity purchased pursuant to such a plan is not subject to the new subsection (b) and its limitations. An annuity contract purchased by an employer, described in section 501 (c) (3) and exempt under section 501 (a), for an employee will be subject to the new section 403 (b) either where the employer does not have a plan meeting the requirements of section 403 (a), or where the annuity is purchased in addition to any annuities purchased under such a plan.

The exclusion provided by the new section 403 (b) becomes applicable only when the employee would otherwise be taxable on the employer's contributions. If the employee's rights under the contract are forfeitable at the time the contributions are made, he is not taxable on the contributions at such time, so that this exclusion is not then applicable. Paragraph (1) of the new section 403 (b) applies when the employee's rights under the contract are nonforfeitable except for failure to pay future premiums, and it provides that in such case any contributions to purchase such an annuity are excludable from the employee's gross income to the extent that they do not exceed the exclusion allowance.

By virtue of paragraph (6) of the new section 403 (b) and of new subsection (d) of section 403 (which is a committee amendment made by subsection (c) of section 24 of the bill), the exclusion also becomes applicable when an employee's rights change from forfeitable to nonforfeitable. Existing law provides that if an annuity contract which is not subject to section 403 (a) is purchased for an employee and his rights under the contract are nonforfeitable except for failure to pay future premiums, the employee is taxable on the contributions to purchase such contract. This provision has been interpreted to mean that if the employee's rights under the contract are forfeitable at the time the contributions are made, he is not taxable until he receives payments under the annuity contract. The House bill would have amended section 403 (c), as relettered, by adding to it a sentence providing that the section was not to apply in respect of annuity contracts purchased by an employer which is exempt from tax under section 501 or 521. This amendment was intended to tax the employee of such an employer, if the employee's rights were forfeitable when contributions were made, at the time his rights changed from forfeitable to nonforfeitable on the value of the annuity contract at such time, less any contributions that the employee had made.

The committee bill strikes the sentence added in the House bill to section 403 (c), as relettered, and in subsection (c) of section 24 adds a new subsection (d) to section 403. Except for relettering, section 403 (b) of present law is not changed under the committee bill. Therefore, under section 403 (c), as relettered, as under existing section 403 (b), employer's contributions for nonforfeitable annuity contracts which are not subject to section 403 (a) or (b) will be includible in the employee's gross income when the employer's contributions are made. Similarly, as under existing law, if an employee's rights under a contract purchased by an employer which is not exempt under section 501 (a) or 521 (a) are forfeitable at the time the contributions

are made, the employee will not be taxable on such contributions until he receives payments under the contract.

New subsection (d) has substantially the same effect that the stricken House amendment to section 403 (c) would have had. Subsection (d) provides that if rights of an employee under an annuity contract purchased by an employer which is exempt from tax under section 501 (a) or 521 (a) change from forfeitable to nonforfeitable rights, the value of such contract on the date of such change (to the extent attributable to amounts contributed by the employer after December 31, 1957) shall be included in the gross income of the employee in the year of the change except as provided in new section 403 (b). Amounts contributed by the employer until December 31, 1957, for forfeitable contracts which become nonforfeitable during taxable years beginning after December 31, 1957, are not taxed under new subsection (d). The House bill would have had retroactive effect in this respect and any amounts contributed by an employer would have been taxable when the employee's rights under a contract changed from forfeitable to nonforfeitable. With this exception, new subsection (d) of section 403 has the same effect as did the House amendment to section 403 (c). Paragraph (6) of the new section 403 (b) provides that, for purposes of such section and section 72 (f), if an employee's rights under an annuity contract change from forfeitable to nonforfeitable and the contract becomes subject to new section 403 (b) as a result of such change, then the amount determined without regard to the exclusion provided by subsection 403 (b) that is includible in the employee's gross income as a result of such change shall be treated as a contribution by the employer to purchase such contract.

Thus, if the rights of an employee under an annuity contract purchased by an employer exempt under section 501 (a) or 521 (a) change from forfeitable to nonforfeitable, and the employer is not described in section 501 (c) (3) when the employee's rights change, then under new section 403 (d) the employee includes in gross income in the year of such change the value of the contract on the date of the change to the extent such value is attributable to employer contributions made after December 31, 1957. However, if at the time the employee's rights change the employer is described in section 501 (c) (3) and is exempt under section 501 (a), and if the annuity contract is not subject to section 403 (a), then the exclusion provided in section 403 (b) applies to the amount includible under section 403 (d) in the employee's gross income as a result of the change. Under section 403 (b) (6) the amount includible in the employee's gross income under section 403 (d) (determined without regard to the section 403 (b) exclusion) is considered as an amount contributed by the employer for such contract as of the time the employee's rights change (and the exclusion is computed on that amount).

The availability of the exclusion provided by the new section 403 (b) depends upon whether, at the time the contributions are made or the employee's rights become nonforfeitable, the employer is an organization described in section 501 (c) (3) and exempt under section 501 (a). If an organization described in section 501 (c) (3) loses its exemption under section 501 (a) for any year, the exclusion allowance provided by the new section 403 (b) will not apply for such year.

Any contributions (including amounts treated as contributions by the new section 403 (b) (6)) to purchase an annuity contract to which the new section 403 (b) applies are generally includible in gross income under section 61 to the extent that they do not come within the exclusion of section 403 (b).

The new section 403 (b) provides further that when an employee receives payments under an annuity contract subject to such section, such payments are taxable under section 72 of the 1954 Code, except that section 72 (e) (3) (relating to limit on amount of tax attributable to receipt of lump sums) shall not apply. In determining the investment in the contract under section 72, section 72 (f) will be applicable. It provides that only the employer contributions which were includible in gross income or which would not have been includible in gross income if paid directly to the employee are to be treated as part of the investment in the contract. Thus, any contributions which are excludable under new section 403 (b) are not to be treated as part of the employee's investment in the contract.

Exclusion allowance

The exclusion allowance for any taxable year is determined by multiplying 20 percent of the employee's includible compensation by the number of his years of service. Includible compensation is defined to mean the compensation which he receives from an employer described in section 501 (c) (3) and exempt under section 501 (a). It does not, therefore, include any compensation which he may receive from any other person. The amount of the includible compensation is determined by reference to the amount of such compensation which the employee must include in his gross income. However, the amount of the includible compensation is to be determined without regard to the exclusions provided by sections 105 (d) and 911 of the 1954 Code. Thus, his includible compensation will include any sick pay that he receives even though such sick pay is excludable in whole or in part under section 105 (d), and will include any income which he earns abroad even though it is subject to the exclusion of section 911. The includible compensation is to be determined without regard to any contributions to purchase the annuity to which the new section 403 (b) is applicable, whether or not such contributions are excludable under such section. Consequently, even where the contributions to purchase the annuity contract exceed the exclusion provided by section 403 (b), such excess contributions are not to be taken into consideration in computing includible compensation for purposes of such section.

The amount of the includible compensation which is taken into consideration in computing the exclusion allowance is the amount of such compensation received for the most recent period (ending not later than the close of the taxable year of the employee) which constitutes a full year of service. For the full-time employee, this means the amount of includible compensation which he receives for the taxable year. For the part-time employee, it means that he will aggregate his most recent periods of part-time employment until they constitute a full year of service. For example, if an employee works for the employer half time through the year and receives an annual salary of $4,000, the exclusion allowance for the first year of such employment is 20 percent of $4,000, but for the second year of such employment, the exclusion allowance is based upon includible com-

pensation of $8,000. The period during which the includible compensation is received shall not end later than the close of the taxable year for which the exclusion allowance is determined, but such period may end at any time before the close of such taxable year and may even end before the beginning of such taxable year. Accordingly, an exclusion allowance for the taxable year 1960 may be based upon the includible compensation which the employee received for 1958, if 1958 is the most recent period during which the employee received includible compensation. This type of situation may occur, for example, in a terminal funding arrangement.

The amount so ascertained is then multiplied by the number of years of service, but in no case shall such amount be multiplied by less than 1. For this purpose, each full year in which the employee was a full-time employee of the organization shall be considered as 1 year of service. In determining what constitutes a full year of employment and what constitutes full-time employment, it will be necessary to consider the nature of the employment and the periods normally worked by individuals engaged in such employment. For example, in the case of doctors who normally work throughout the 12 months of the year, except for a vacation period of a month or so, 11 months' work would be considered a full year of employment, but a member of the academic staff of a college or university will be considered to have worked a full year if he teaches for the full academic year of approximately 9 months. Whether a teacher is working full time will generally depend upon his workload as compared to the workload normally carried by the full-time members of the faculty. In addition, each part of a year in which the individual was a full- or part-time employee of the organization, and each full year in which he was a part-time employee, shall be considered as a part of a year of service, but the determination of how much consideration shall be given to such part-time employment shall be based upon the regulations to be prescribed by the Secretary or his delegate.

The exclusion allowance so computed shall, however, be reduced by any amounts which were contributed to purchase an annuity for the employee and which were excludable for any taxable year prior to the taxable year for which the exclusion allowance is determined. Thus, for example, there must be a reduction in the exclusion allowance on account of any prior contributions that were excludable under this new provision or under the special provision of prior law relating to the purchase of annuities by organizations described in section 501 (c) (3) and exempt under section 501 (a), or that were excludable because they were contributions under a qualified annuity plan, or because the employee was not taxable at the time forfeitable rights became nonforfeitable.

The computation of the exclusion allowance may be illustrated by the following example:

E became an employee of X on January 1, 1957, and continued as a full-time employee of X through the years 1957, 1958, and 1959. He received includible compensation in the amount of $10,000 for 1957, $11,000 for 1958, and $12,000 for 1959. X is an organization described in section 501 (c) (3) and for the years 1957, 1958, and 1959 exempt under section 501 (a). In 1957, X commenced to purchase for E annuity contracts under which E's rights are nonforfeitable. X paid

as premiums for such contracts $2,000 in 1957, $2,400 in 1958, and $2,800 in 1959. The $2,000 premium paid in 1957 is not subject to this amendment and was excludable under section 403 (a) (1). E's exclusion allowance for 1958 is determined in the following manner: First, 20 percent of his includible compensation for 1958 is $2,200. Secondly, $2,200 times his years of service, 2, is $4,400. Finally, $4,400 less any contributions excludable in a prior year, $2,000, leaves $2,400. Accordingly, the $2,400 premium paid in 1958 is entirely excludable. E's exclusion allowance for 1959 is determined in the following manner: First, 20 percent of his includible compensation is $2,400. Secondly, $2,400 times his years of service, 3, is $7,200. Finally, $7,200 less any contributions excludable in prior years, $4,400, leaves $2,800. Accordingly, the $2,800 premium paid in 1959 is entirely excludable.

The amendments made by subsections (a), (b), and (c) of section 24 of the bill are applicable to taxable years beginning after December 31, 1957. Any contributions which are made (including amounts treated as contributions under the new section 403 (b) (6)) during a taxable year beginning after December 31, 1957, to purchase an annuity contract subject to the new section 403 (b) will generally be includible in gross income except to the extent of the exclusion provided by such section.

Death benefit exclusion

Subsection (d) of this section is a committee amendment to section 101 (b) (2) (B) of the 1954 Code relating to certain death benefits.

Under existing law, section 101 (b) provides that amounts received by the beneficiaries or the estate of an employee which are paid by or on behalf of the employer because of the employee's death are not includible in gross income. With respect to the death of any employee, however, this exclusion is limited to $5,000. Paragraph (2) (B) of section 101 (b) excepts from the exclusion amounts with respect to which the employee, immediately before his death, possessed a nonforfeitable right to receive the amounts while living. Under the paragraph, however, total distributions payable (defined in sec. 402 (a) (3)) which are paid by an employee's trust described in section 401 (a) and exempt under section 501 (a) or under an annuity contract under a qualified annuity plan to a distributee within 1 taxable year of the distributee because of the employee's death are subject to the exclusion.

Subsection (d) of section 24 of the bill amends section 101 (b) (2) (B) by providing that the death benefit exclusion shall also apply to the total distributions payable under an annuity contract purchased by an employer which is an organization referred to in section 503 (b) (1), (2), or (3), (relating to certain religious, educational, and public organizations) and exempt under section 501 (a). The exclusion applies only to that portion of such total distributions payable which bears the same ratio to the amount of the total distributions payable which is includible in gross income (determined without regard to section 101 (b)) as the amounts contributed by the employer for the annuity contract which are excludable from gross income under new section 403 (b) bear to the total amounts contributed by the employer for such contract. For purposes of section 101 (b), the death benefit payments provided by the employer less the amounts contributed, or

deemed contributed, by the deceased employee are the total distributions payable which are subject to section 101 (b). Thus, if the total death benefit payable to a distributee is $10,000, of which the employee has made contributions of $1,000 and has included $2,000 of the employer's contributions in gross income, then, $7,000 is considered as the total distribution payable which is subject to section 101 (b). If, in this case, the actual amount contributed by the employer was $6,000, and of this amount $4,000 is excludable under section 403 (b), then the death benefit exclusion would be $4,667, since $4,667 is to $7,000 (total distributions payable includible in gross income without regard to the death benefit exclusion) as $4,000 (employer contributions for annuity contract excludable from gross income under sec. 403 (b)) is to $6,000 (total amounts contributed by the employer for such contract). In no case can the death benefit exclusion under section 101 (b) exceed $5,000.

The amendments made by subsection (d) of section 24 are applicable for taxable years beginning after December 31, 1957.

Estate-tax exclusion

Subsection (e) of section 24 of the bill is a committee amendment to section 2039 (c) of the 1954 Code, relating to the exclusion of certain annuities from the gross estate. Section 2039 (c) presently provides an exclusion from the gross estate for the value of an annuity or other payments receivable by a beneficiary (other than the executor) under certain plans qualified under section 401 (a). However, the exclusion does not apply to that part of the value of such annuity or other payment attributable to payments or contributions made by the decedent in the proportion that the total payments or contributions made by the decedent bears to the total payments or contributions made.

Subsection (e) of section 24 of the bill amends section 2039 (c) by adding to that section a new paragraph (3). This amendment makes the gross-estate exclusion provided for in section 2039 (c) applicable to the value of an annuity or other payment receivable under a retirement-annuity contract described in new paragraph (3). Such a contract is one purchased for an employee by an employer which is an organization referred to in section 503 (b) (1), (2), or (3), and which is exempt from tax under section 501 (a). The value of the retirement-annuity amounts which are payable under such a contract after the decedent's death and which are attributable to payments or contributions by the decedent is not subject to the gross-estate exclusion in the proportion that the decedent's total payments or contributions bears to total payments or contributions made. This is the same rule that is applied presently under section 2039 (c) to the value of amounts payable under plans now described in section 2039 (c), and attributable to the decedent's payments or contributions. For purposes of retirement-annuity contracts described in new paragraph (3), contributions or payments made by the decedent's employer or former employer toward the purchase of such an annuity contract are not considered to be contributed by the decedent to the extent that such contributions or payments are excludable from gross income under section 403 (b).

The amendments made by subsection (e) of section 24 are applicable with respect to estates of decedents dying after December 31, 1957.

Gift-tax exclusion

Subsection (f) of section 24 of the bill is a committee amendment to section 2517 (relating to the gift-tax treatment of certain annuities) which is added to the 1954 Code by section 72 of this bill. New section 2517 is the gift-tax provision comparable to the estate-tax provision of section 2039 (c) of the 1954 Code which is amended by subsection (e) of section 24 of the bill. Under section 2517 (a), the exercise or nonexercise by an employee of an election or option whereby an annuity or other payment will become payable to any beneficiary at or after the employee's death, is not considered a transfer subject to the gift tax if the option or election and annuity or other payment is provided for under certain plans qualified under section 401 (a). Under section 2517 (b), if an annuity or other payment subject to section 2517 (a) is attributable to payments or contributions by the employee, then that part of the value of such annuity or other payment which bears the same proportion to the total value of the annuity or other payment as the total payments or contributions by the employee bear to the total payments or contributions made is considered a transfer subject to the gift tax. A former employee is considered as an employee for purposes of section 2517.

Subsection (f) of this section amends the new section 2517 (a) so that the provisions of new section 2517 (a) and (b) are also applicable to retirement-annuity contracts described in a new paragraph (3) of section 2517 (a). A contract is described in that paragraph if it is purchased by an employer which is an organization referred to in section 503 (b) (1), (2), or (3), and which is exempt under section 501 (a).

Subsection (f) also amends new section 2517 (b). The amendment provides that, in determining under section 2517 (b) an employee's contributions or payments to find the value of the annuity or other payment to which section 2517 (a) does not apply, payments or contributions by the employee's employer or former employer toward the purchase of a retirement contract described in new paragraph (3) of section 2517 (a) shall be considered to have been made by the employee to the extent that such payments or contributions are not excludable from gross income under section 403 (b).

The amendments made by subsection (f) of section 24 are applicable to calendar years after 1957.

SECTION 25. CONTRIBUTIONS OF EMPLOYER TO EMPLOYEES' TRUST OR ANNUITY PLAN

This section, which is identical with section 20 of the House bill, amends section 404 (a) of the 1954 Code (relating to the deduction of employer contributions to certain employees' trusts and annuity plans, etc.) by inserting punctuation. The amendment makes no substantive change in the section.

SECTION 26. EMPLOYEE STOCK OPTIONS GRANTED BY PARENT OR SUBSIDIARY CORPORATION

Section 26 of the bill, which is identical with section 21 of the House bill, amends section 421 (a) of the 1954 Code (relating to employee stock options) to add at the end thereof a new sentence to be appli-

cable in determining whether an individual, who is an employee of a parent or subsidiary corporation of the corporation which granted him an option or which issued or assumed the option under section 421 (g), meets the employment requirements of such section.

The problem may be illustrated by the situation where P corporation, which owns all of the stock of S corporation, grants a restricted stock option to E, an employee of S corporation. Section 421 (d) (1) of the 1954 Code, which defines the term "restricted stock option," makes clear that the special tax treatment provided by section 421 was intended to apply when an option is granted to an employee of a parent or subsidiary corporation in accordance with the requirements of such section, but because of the definitions of "parent corporation" and "subsidiary corporation" in section 421 (d) (2) and (3), such an employee is unable to meet the employment requirements of section 421 (a). Under section 421 (a), an individual is not entitled to the special tax treatment of section 421 unless he is at the time he exercises the option an employee of the corporation which granted the option or of a parent or subsidiary corporation of such corporation, or has been an employee of any of such corporations within 3 months before such time. Whether a corporation is a parent corporation or subsidiary corporation under section 421 (d) (2) and (3) is determined with respect to whether such corporation is a parent or subsidiary of the employer corporation, and, accordingly, the employer corporation cannot constitute a parent corporation or subsidiary corporation within such definitions. Hence, although E continues to be employed by S corporation, he does not meet the employment requirements of section 421, since S corporation does not constitute a subsidiary corporation within the meaning of section 421 (d) (3). A similar problem arises when an option is issued or assumed in a transaction to which section 421 (g) applies by a corporation which is a parent or subsidiary of the employer corporation.

The new sentence provides that for the purpose of determining whether an individual is or has been an employee of a parent or subsidiary corporation of the corporation which granted the option or which issued or assumed the option under section 421 (g), the term "employer corporation" as used in section 421 (d) (2) and (3) shall be read as "grantor corporation" or "corporation issuing or assuming a stock option in a transaction to which subsection (g) is applicable," as the case may be.

Thus, for purposes of the employment requirements, the determination of whether a corporation is a parent corporation or subsidiary corporation is based on whether the corporation is a parent or subsidiary of the grantor corporation or of a corporation which issued or assumed an option under section 421 (g). When the definition of "subsidiary corporation" is applied in this manner, S corporation is a subsidiary corporation, and E meets the employment requirement.

Under section 1 (c) of the bill, the amendment made by section 26 of the bill is applicable to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SECTION 27. VARIABLE PRICE RESTRICTED STOCK OPTIONS

Section 27 of the bill, except for a change in the effective date, is identical with section 22 of the House bill. This section amends

section 421 of the 1954 Code (relating to employee stock options) to provide a new definition of the term "variable price option." The provisions relating to the definition of such term, which in the present law appear in section 421 (d) (1) (A) (ii), are stricken, and a new definition is set forth in a new paragraph (7) which is added to section 421 (d).

Paragraph (7) provides that the term "variable price option" means an option under which the purchase price of the stock is fixed or determinable under a formula in which the only variable is the fair market value of the stock at any time during a period of 6 months which includes the time the option is exercised; except that, in the case of options granted after September 30, 1958, such term does not include any such option in which such formula provides for determining such price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised. In the case of options granted before October 1, 1958, this definition does not differ from the present law, and such options are not affected by this amendment, unless they are modified so that they are considered to be granted after September 30, 1958.

Options granted, or considered granted, after such date are subject to a new and further limitation if the option provides for determining the option price by reference to the fair market value of the stock at any time before the option is exercised. A restricted stock option having a variable price formula may provide for determining the option price by reference to the fair market value of the stock at the time the option is exercised ~~or~~ at any time during a period of 6 months which begins on the day the option is exercised, at any time during a period of 6 months which ends on such day, or at any time during any other 6-month period which includes such day. Only the options which take into consideration the fair market value of the stock at a time before the day on which the option is exercised are subject to the new limitation; but such an option is subject to such limitation whether the prior value with respect to which the option price may be computed is the fair market value of the stock at a time during the month in which the option is exercised or during an earlier time within the 6-month period. Restricted options may, moreover, contain price formulas which take into consideration, in addition to the value of the stock, other factors, such as a maximum and a minimum price. An option containing a pricing formula which takes into consideration the value of the stock at any time before the option is exercised is subject to the new limitation, even though the option price is not actually based upon such prior fair market value either at the time the option is exercised or at the time the option price is computed as if it were exercised for the purpose of applying the 85 percent test of section 421 (d) (1) (A). In other words, whether an option is subject to the new limitation is determined by reference to the terms of the option, and the circumstances existing at the time the option is granted or exercised are immaterial for purposes of such new limitation.

Similarly, whether an option subject to the new limitation is to be treated as a restricted stock option is determined solely by reference to the terms of the option. If under the terms of an option the price is to be determined by reference to the fair market value of the stock

at a time before the option is exercised, whether such value is higher or lower than the average fair market value of the stock during the month the option is exercised, such option will not be considered a restricted stock option since the option price may be based upon the prior value of the stock when such value exceeds the average fair market value of the stock during the month the option is exercised. However, if an option provides for determining the option price by reference to a prior fair market value of the stock which is lower than such average value of the stock, such option can qualify as a restricted stock option. For example, an option providing that the option price is to be 90 percent of the average value of the stock during the month the option is exercised or the average value of the stock during the preceding month, whichever is lower, can qualify. On the other hand, an option providing that the option price is to be 45 percent of the fair market value of the stock 30 days before the date on which the option is exercised, but not more than $85, cannot qualify since under this formula the price may be determinable by reference to a higher prior value. The only way that a variable price option which provides for determining the option price by reference to the fair market value of the stock at a time before the option is exercised can come within the new definition is to provide that the option price is to be determinable by reference to such fair market value only if such fair market value is not greater than the average fair market value of the stock during the month in which the option is exercised.

In applying paragraph (7), the average fair market value of the stock during the month in which the option is exercised means such value during the calendar month the option is exercised and not merely during a 30- or 31-day period including the time the option is exercised. To compute the average fair market value of the stock for the month, it will be necessary to ascertain the fair market value of the stock for each day during the month, including those days which are not business days. In ascertaining the fair market value of the stock for each day, the generally accepted principles for ascertaining such value will be applied.

The amendments made by section 27 of the bill are to apply to taxable years ending after September 30, 1958.

SECTION 28. TRANSFERS OF INSTALLMENT OBLIGATIONS TO CONTROLLED INSURANCE COMPANIES

Section 28 of the bill, except for the change in the effective date, is identical to section 23 of the House bill.

Subsection (a) of section 28 of the bill adds a new paragraph (5) to section 453 (d) of the 1954 Code (relating to gain or loss on disposition of installment obligations). This new paragraph denies the tax-free transfer of installment obligations, which otherwise is provided in subtitle A of the 1954 Code with respect to any gain resulting under section 453 (d) (1), in situations where an installment obligation is disposed of by any person (other than a life insurance company as defined in sec. 801 (a) of the code) to such an insurance company or to a partnership of which such an insurance company is a partner.

New paragraph (5) further provides that if a corporation which is a life insurance company for the taxable year was, for the preceding taxable year, a corporation which was not such a life insurance com-

pany, such corporation shall (for the purpose of par. (1) of sec. 453 (d) and new par. (5)) be treated as having transferred to a life insurance company on the last day of the preceding taxable year all installment obligations which it held on such last day.

The effect of the preceding provision can be illustrated by the following example: The M corporation was not a life insurance company for the taxable year 1958, and on December 31, 1958, held $60,000 of installment obligations. During 1959, the M corporation qualified for the taxable year as a life insurance company as defined in section 801 (a). For purposes of new paragraph (5), the M corporation is treated as having transferred to a life insurance company on December 31, 1958, all installment obligations which it held on that day.

Similarly a partnership, of which a life insurance company becomes a partner, shall be treated (for purposes of pars. (1) and (5) of sec. 453 (d)) as having transferred to a life insurance company on the last day of the preceding taxable year of the partnership all the installment obligations which it holds at the time the life insurance company becomes a partner even though the composition of the partnership may otherwise have changed since the end of the preceding year.

The amendment made by section 28 of the bill is to apply to taxable years ending after December 31, 1957, but only as to transfers or other dispositions of installment obligations occurring after such date.

SECTION 29. PREPAID INCOME FROM NEWSPAPER AND PERIODICAL SUBSCRIPTIONS

This section for which there is no corresponding provision in the House bill adds a new section 455 to the 1954 Code.

Under existing law some taxpayers, regardless of the method of accounting employed, have been required to report prepaid subscription income as income in the year of receipt. Section 455 as added by your committee provides certain of such taxpayers with an election to include prepaid subscription income in gross income for the taxable years during which the liability exists to furnish or deliver a newspaper, magazine, or other periodical. Taxpayers who have been permitted previously to report such income in accordance with an established and consistent method of accounting practice may continue to report income in accordance with such accounting practice without making an election under the new section.

Subsection (a) of section 455 provides that taxpayers shall include prepaid subscription income to which that section applies in gross income for the taxable years during which the liability exists to furnish or deliver a newspaper, magazine, or other periodical.

Subsection (b) of section 455 provides that where a taxpayer dies or goes out of existence or where, for any other reason, the liability with respect to any prepaid subscription income ceases, the payments not previously reported as income become taxable in the year in which such an event occurs.

Subsection (c) of section 455 contains the rules under which a taxpayer may elect to apply the provisions of that section. The election may be made only with respect to a trade or business the income from which is not reported on the cash receipts and disbursements method. The election once made is applicable to all items of prepaid subscription income attributable to such trade or business.

If the taxpayer is engaged in two or more trades or businesses, he may elect to defer all prepaid subscription income items of any one or more of the businesses. An exception is provided, however, with respect to subscription income of that character which will be earned within 12 months after receipt, in which case the entire amount received may be included in gross income when received to the extent permitted by regulations prescribed by the Secretary or his delegate. The election is effective for the taxable year with respect to which it is first made and for all subsequent taxable years unless the taxpayer secures consent of the Secretary or his delegate to the revocation of such election. The election to defer prepaid subscription income will not apply to amounts received in taxable years beginning before January 1, 1958, even though the amounts will not be earned until after that date.

The taxpayer may make the election to defer prepaid subscription income without consent of the Secretary or his delegate for the first taxable year beginning after December 31, 1957, in which he received such prepaid income in the particular trade or business. The election must be made not later than the time prescribed by law for the filing of the return (including extensions). If the taxpayer wishes to make an election at a later time, the consent of the Secretary or his delegate must be obtained.

Subsection (d) of section 455 defines prepaid subscription income as any amount (includible in gross income) which is received in connection with, and is directly attributable to a liability as defined in paragraph (2) and the liability extends beyond the taxable year in which the amount is received. Prepaid subscription income shall be treated as received during the year in which it is includible in gross income without regard to section 455. Such income shall be included in gross income, to the extent properly allocable to the taxable year in which received and to each of the succeeding taxable years over which the liability may extend. A proper allocation under this section requires that such income be included in gross income as the liability to which the income relates is discharged or as it is deemed to be discharged on the basis of the taxpayer's experience. Liability means a liability to furnish or deliver a newspaper, magazine, or other periodical.

Subsection (e) of section 455 permits a taxpayer to continue to treat prepaid subscription income, as defined in this section, in the manner employed for taxable years prior to the first taxable year to which this section applies if done under an established and consistent method of accounting, notwithstanding the provisions of this section.

Subsection (b) of the bill contains a technical conforming amendment.

The amendment made by this section shall apply with respect to taxable years beginning after December 31, 1957.

SECTION 30. ADJUSTMENTS REQUIRED BY CHANGES IN METHOD OF ACCOUNTING

This section amends section 481 (relating to adjustments required by changes in method of accounting) and section 381 (relating to carryovers in certain corporate acquisitions) of the 1954 Code. It is the same as section 24 of the House bill except that your committee has amended the special rules respecting the treatment of adjustments

for 1939 Code years and has also provided a new subsection (e) to permit certain taxpayers who have commenced the use of a different method of accounting since enactment of the 1954 Code to return to the method formerly used.

Adjustments for 1939 Code years

Section 481 (a) of the 1954 Code now provides that, in computing the taxpayer's taxable income for any taxable year for which he changes his method of accounting from that used for the immediately preceding taxable year, those adjustments which are determined to be necessary solely by reason of the change shall be taken into account in order to prevent amounts from being duplicated or omitted; except that any adjustment in respect of any taxable year to which section 481 does not apply shall not be taken into account. Thus, under the present law adjustments in respect of taxable years beginning before January 1, 1954, or in respect of taxable years beginning in 1954 and ending before August 17, 1954, are not taken into account under section 481.

Subsection (a) (1) of this section, which is the same as in the House bill, amends section 481 (a) (2) of the 1954 Code so that adjustments in respect of taxable years beginning before January 1, 1954, or in respect of taxable years beginning in 1954 and ending before August 17, 1954, will be taken into account under section 481 (a) in computing taxable income for the year of the change if such adjustments are attributable to a change in accounting method which has been initiated by the taxpayer.

Subsection (a) (2) of this section, as amended by your committee, amends section 481 (b) (relating to limitations on the tax where the adjustments are substantial) by adding thereto new paragraphs (4), (5), and (6). The new paragraph (4) applies only to the net amount of the adjustments required by section 481 (a) to the extent that such amount does not exceed the net amount of the adjustments which would have been required if the change in method had been made in the first taxable year beginning after December 31, 1953, and ending after August 16, 1954, and only in a case where such adjustments are attributable to a change initiated by the taxpayer and where such net amount would increase the taxable income for the year of the change by more than $3,000. The net amount of adjustments not taken into account under the new paragraph (4) will be taken into account as otherwise provided in section 481.

As passed by the House, paragraph (4) (B) provided that the net amount of the adjustments in respect of 1939 Code years to which paragraph (4) (A) applied were to be taken into account ratably in the year of the change and in so many of the taxable years following the year of the change as were the lesser of (1) 9 years or (2) the number of such years equal to the number of taxable years beginning before January 1, 1954, and ending before August 17, 1954, in which the taxpayer was engaged in the same trade or business as that in which the adjustments under paragraph (4) (A) arose.

Your committee has amended proposed paragraph (4) (B) of section 481 (b) to provide that, except as provided in paragraphs (4) (C), (5), and (6), the net amount of the adjustments described in paragraph (4) (A) are to be taken into account ratably over that

period of 10 successive taxable years which begins (1) with the year of the change or, (2) if the taxpayer so elects and if the year of the change was a taxable year beginning after December 31, 1953, and ending after August 16, 1954, but before January 1, 1958, with the taxpayer's first taxable year beginning after December 31, 1957. The 10-year period which begins with the first taxable year beginning after December 31, 1957, shall be reduced, however, in the case of a taxpayer whose year of change ended before January 1, 1958, but who elected to use the period described in (2) above, by the number of years which corresponds to the number of taxable years, beginning with the year of the change, in respect of which assessment of tax is prevented on the date of the enactment of the bill by the operation of any law or rule of law. In the case of such a shortened period which begins with the first taxable year beginning after December 31, 1957, the portion of the net adjustments to be taken into account in any 1 taxable year within such a shortened period shall be one-tenth of such net adjustments, that is, the same prorata portion which would have been taken into account in such taxable year if the 10-year period beginning with such first taxable year had not been shortened.

The net amount of adjustments required to be taken into account under paragraph (4) (B) in any specific taxable year of the 10-year period, or of the shortened period which begins with the first taxable year beginning after December 31, 1957, shall be taken into account in that specific taxable year (and in no other taxable year) notwithstanding the fact that assessment of tax for such specific taxable year is prevented by operation of any law or rule of law. If, for example, in a case where the 10-year period is properly used, assessment of a deficiency is prevented with respect to 1 of the 10 taxable years in which one-tenth of the net amount of the adjustments is required to be taken into account, then only nine-tenths of such net amount is to be taken into account ratably in the other 9 taxable years. Moreover, if assessment of a deficiency is barred with respect to a taxable year in which a prorated part is required to be taken into account under paragraph (4) (B), this section of the bill does not serve to reopen that year for assessment purposes.

An election under proposed paragraph (4) (B) of section 481 (b) to begin the 10-year period with the first taxable year which begins after December 31, 1957, shall be made at such time and in such manner as the Secretary or his delegate shall by regulations prescribe.

Proposed paragraph (4) (C) of section 481 (b), which is the same as in the House bill, provides that the net amount of any adjustments described in paragraph (4) (A), to the extent not taken into account in prior taxable years under paragraph (4) (B), is to be taken into account as follows: (1) In the case of an individual taxpayer, such amount shall be taken into account in the taxable year in which he dies or ceases to engage in a trade or business; (2) in the case of a partner, his distributive share of such amount shall be taken into account in his taxable year in which the partnership terminates or in which his entire interest is transferred or liquidated; or (3) in the case of a corporation, such amount shall be taken into account in the taxable year in which the corporation ceases to engage in a trade or business unless the amount is required to be taken into account by the acquiring corporation under section 381 (c) (21).

Proposed paragraph (4) (D) of section 481 (b), which is the same as in the House bill, provides that the new paragraph (4) relating to pre-1954 adjustments shall cease to apply with respect to changes in methods of accounting made in taxable years beginning after December 31, 1963.

The new paragraph (5) of section 481 (b), which provides a special rule for pre-1954 adjustments in the case of certain decedents, is the same as in the House bill except that your committee has amended it to apply to changes made on or after August 16, 1954, and before January 1, 1958. In the House bill the paragraph applied to changes made on or after August 16, 1954, and before November 7, 1956.

The new paragraph (6), as added to section 481 (b) by your committee, did not appear in the House bill. It gives the taxpayer an election to take the net amount of the adjustments in respect of 1939 Code years which are described in proposed section 481 (b) (4) (A) into account in the manner provided by section 481 (b) (1) or section 481 (b) (2), in lieu of taking such net adjustments into account under the 10-year allocation rule prescribed by section 481 (b) (4) (B). In applying section 481 (b) (1) or section 481 (b) (2) for this purpose, it is immaterial whether any of the preceding taxable years involved are not taxable years beginning after December 31, 1953, and ending after August 16, 1954. Paragraph (6) applies only to cases where the adjustments are attributable to a change in the method of accounting initiated by the taxpayer. The paragraph will have no application to changes in methods of accounting made in taxable years beginning after December 31, 1963.

An election under paragraph (6) to take the net adjustments described in section 481 (b) (4) (A) into account in the manner provided by section 481 (b) (1) or section 481 (b) (2) may be made only if the taxpayer consents in writing to the assessment within such period as may be agreed on with the Secretary or his delegate of any deficiency (for the year of the change) which results from taking such adjustments into account in the manner so elected, even though at the time of filing such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law. Such an election shall be made at such time and in such manner as the Secretary or his delegate shall by regulations prescribe.

Example

The application of proposed section 481 (b) (4) may be illustrated by the following example: X corporation has been filing its tax returns and keeping its books on the cash receipts and disbursements method of accounting for the calendar year. It requests, and is granted, the permission of the Commissioner, effective with the calendar year 1960, to change to an accrual method of accounting. As of January 1, 1954, the taxpayer had an opening inventory of $20,000, accounts receivable of $22,000, and accounts payable of $14,000. As of January 1, 1960, its records reflect an opening inventory of $34,000, accounts receivable of $32,000, and accounts payable of $19,000. The corporation has no other items which require adjustment under section 481 (a). The net amount of the adjustments required to be made by X corporation in 1960 under section 481 (a) is $47,000 ($34,000 plus $32,000 less $19,000). The net amount of such adjustments which X corporation would have been required to make if it had changed

its method of accounting for the calendar year 1954 is $28,000 ($20,000 plus $22,000 less $14,000). Since such $28,000 of net adjustments in respect of 1939 Code years would increase the taxable income for 1960 (the year of the change) by more than $3,000, and since the adjustments are attributable to a change in method of accounting initiated by the taxpayer, such $28,000 of net adjustments shall be taken into account under section 481 (b) (4) (B), unless X corporation elects under section 481 (b) (6) to take such net adjustments into account in the manner provided by section 481 (b) (1) or section 481 (b) (2). The remaining portion ($19,000) of the net amount of the adjustments required to be taken into account by section 481 (a) is to be taken into account in 1960 subject, however, to the tax limitation applicable under the 3-year allocation method of section 481 (b) (1) or the new-accounting-method allocation of section 481 (b) (2).

On the other hand, if the facts in the above example were the same except that as of January 1, 1960, the three adjustments are such that only $20,000 of net adjustments is required to be taken into account under section 481 (a) for 1960, then the $20,000 amount, rather than the $28,000 amount, would be taken into account in the manner provided by section 481 (b) (4) or section 481 (b) (6).

Technical amendments

Section 30 (b) of the bill, which is the same as in the House bill except for section 30 (b) (4), provides for various technical amendments in section 481 (b) of the 1954 Code. Section 30 (b) (1) amends section 481 (b) (1) and section 481 (b) (2) to provide that the rules therein contained do not apply to the portion of the net amount of adjustments which is treated under new paragraph (4) or (5) of section 481 (b). However, if the taxpayer elects under section 481 (b) (6) to take the net amount of the adjustments described in new paragraph (4) (A) of section 481 (b) into account in the manner provided by section 481 (b) (1) or section 481 (b) (2), then such net amount will be taken into account with the other adjustments required by section 481 (a) (2) in applying the rules of section 481 (b) (1) or section 481 (b) (2).

Section 30 (b) (2) corrects a technical error contained in present section 481 (b) (1) by changing the words "the aggregate of the taxes" appearing therein to read "the aggregate increase in the taxes." To conform to the change made by section 30 (b) (2), section 30 (b) (3) makes a change in section 481 (b) (1) by striking "which would result if one-third of such increase" and inserting in lieu thereof "which would result if one-third of such increase in taxable income."

Section 30 (b) (4), which was added by your committee, amends section 481 (b) (2) by adding the expression "or under the corresponding provisions of prior revenue laws" after the expression "increase in the taxes under this chapter." This change will be necessary in applying section 481 (b) (2) pursuant to an election under section 481 (b) (6); it also conforms section 481 (b) (2) in this respect to section 481 (b) (1).

Section 30 (b) (5) makes a technical change in the rules provided in section 481 (b) (3) for the computation of the limitation on tax under section 481 (b) (1) and section 481 (b) (2). Under section 481 (b) (3) (A) of present law it is provided that, in computing the increase

in taxes attributable to the allocation under the rule set forth in section 481 (b) (2), the effect that the adjustments have on other taxable years by virtue of their effect on a net operating loss or capital loss carryover in the years of adjustment is to be taken into account. Section 481 (b) (3) (A) does not at present apply to allocations under section 481 (b) (1). The amendment made by section 30 (b) (5) extends the application of section 481 (b) (3) (A) to allocations under the rule set forth in section 481 (b) (1).

Amendment of section 381 (c)

Section 30 (c) of the bill, which is the same as in the House bill, amends section 381 (c) of the 1954 Code (relating to items carried over in certain corporate acquisitions) by adding thereto a new paragraph (21) which provides that the acquiring corporation shall take into account the net amount of any adjustments described in section 481 (b) (4) (A) which are available to a distributor or transferor corporation at the close of the date of distribution or transfer and have not been taken into account by such distributor or transferor corporation. The acquiring corporation shall take such net amount into account in the same manner and at the same time as it would have been taken into account by the distributor or transferor corporation if the transaction causing section 381 to apply had not occurred.

Effective date

Section 30 (d) of the bill, which is the same as in the House bill, contains the effective date provisions. Section 30 (d) (1) provides that the amendments made by this section shall apply with respect to any change in a method of accounting where the year of the change is a taxable year beginning after December 31, 1953, and ending after August 16, 1954.

Section 30 (d) (2) contains an exception to the effect that the amendments made by subsections (a), (b) (1), and (c) of this section shall not apply if before the date of the enactment of the bill (1) the taxpayer applied for a change in the method of accounting in the manner provided by regulations prescribed by the Secretary or his delegate and (2) the taxpayer and the Secretary or his delegate agreed to the terms and conditions for making the change.

Election to return to former method

Section 30 (e) of the bill, which was added by your committee, allows certain taxpayers to return to the method of accounting previously used. Section 30 (e) (1) provides that any taxpayer (other than one specifically excepted) who, for any taxable year beginning after December 31, 1953, and ending after August 16, 1954, but ending before the date of the enactment of the bill, computed his taxable income under a method of accounting different from the method used for the immediately preceding taxable year may elect to recompute his taxable income, beginning with the taxable year for which such different method was first used, under the method used for such preceding taxable year. The election must be made within 6 months after the date of the enactment of the bill and in such manner as the Secretary or his delegate may provide. An election may not be made under section 30 (e) (1) by a taxpayer to whom section 30 (d) (2) of the bill applies or by a taxpayer who was required, before the date of the enactment of the bill, by the Secretary or his delegate to change

his method of accounting. For purposes of the preceding sentence, a taxpayer who on his own initiative changed his method of accounting in order to conform to the requirements of regulations prescribed by the Secretary or his delegate or to the requirements of any Internal Revenue ruling shall not, merely because of such fact, be considered to be a taxpayer who was required by the Secretary or his delegate to change his method of accounting.

Section 30 (e) (2) extends for 1 year the period for the assessment of any deficiency, or for filing claims for refund or credit of any overpayment, resulting from an election made under subsection (e) (1) of this section in a case where the assessment, credit, or refund is prevented on the date on which the election is made (or at any time within 1 year after such date).

SECTION 31. DENIAL OF EXEMPTION TO ORGANIZATIONS ENGAGED IN PROHIBITED TRANSACTIONS

This section corresponds to section 25 of the House bill. It contains substantially the same provisions as section 25 of the House bill, but has been amended by your committee to include, also, provisions similar to those of H. R. 9049, which was passed by the House and which was referred to your committee.

Existing law

Paragraph (1) of section 503 (c) of the 1954 Code (relating to prohibited transactions in the case of certain exempt organizations) provides that, if any exempt organization subject to section 503 lends any part of its income or corpus to a person described in section 503 (c) without the receipt of adequate security and a reasonable rate of interest, it has engaged in a prohibited transaction (and, by reason of sec. 503 (a), it loses its exempt status).

Lending to certain persons

Subsection (a) of section 31 of the bill amends section 503 of the 1954 Code by adding at the end thereof a new subsection (h). New subsection (h) provides that certain transactions entered into by an employees' trust described in section 401 (a) are not to be considered as loans made without the receipt of adequate security. These transactions will not constitute, by reason of the phrase "without the receipt of adequate security," prohibited transactions, but they can constitute prohibited transactions for other reasons; for example, the lack of receipt of a reasonable rate of interest. The transactions referred to in the new subsection (h) are the acquisition by an employees' trust described in section 401 (a) of the 1954 Code of a bond, debenture, note, or certificate or other evidence of indebtedness (referred to in the subsection as "obligation"). Such acquisitions are not to be considered as loans made without the receipt of adequate security if all of the following conditions which are applicable are met.

(1) The obligation must be acquired (A) on the market, either at the price prevailing on a national securities exchange which is registered with the Securities and Exchange Commission, or, if the obligation is not traded on such an exchange, at a price not less favorable to the trust than the offering price for the obligation as established by current bid and asked prices which are quoted by persons independent of the issuer; or (B) from an underwriter at a price at which

a substantial portion of the same issue is acquired by persons independent of the issuer and which is not in excess of the public offering price for the obligation as set forth in a prospectus or offering circular filed with the Securities and Exchange Commission; or (C) directly from the issuer at a price not less favorable to the trust than that paid currently for a substantial portion of the same issue by persons independent of the issuer.

(2) Immediately following acquisition of the obligation, not more than 25 percent of the aggregate amount of the obligations issued in such issue and outstanding at the time of the acquisition is held by the trust, and at least 50 percent of such aggregate amount is held by persons independent of the issuer.

(3) Immediately following acquisition of the obligation, not more than 25 percent of the assets of the trust is invested in all obligations of all persons described in section 503 (c), including those obligations which meet the requirements of new subsection (h) or (i) of section 503, or those obligations which are made with the receipt of adequate security and a reasonable rate of interest.

Loans with respect to which employers are prohibited from pledging certain assets

Subsection (b) of section 31 of the bill is a committee amendment which adds a new subsection (i) to section 503. New subsection (i) of section 503 is substantially the same as H. R. 9049, which was passed by the House in the last session. The new subsection provides that the requirements of section 503 (c) (1), relating to adequate security and a reasonable rate of interest, are not to apply in the case of loans to an employer made or renewed by an employees' pension, profit-sharing, or stock-bonus trust described in section 401 (a) of the code if the loan bears a reasonable rate of interest and three conditions are met.

First, in order to qualify under this exception, the employer must be prohibited (at the time of the making or renewal of the loan) by law of the United States or regulation thereunder from directly or indirectly pledging as security for a loan from one of these employees' trusts classes of his assets which represent at such time more than half of the value of all his assets. Under this condition, the employer must be prohibited from pledging classes of his assets at the time the loan is made or renewed, and the value of those assets is to be determined at that time. A subsequent change in law, permitting a class of assets to be pledged which previously could not be pledged, would, therefore, not make the loan ineligible on the grounds that it is now possible (but was not previously possible) for the employer to pledge more than one-half of his assets for loans from employees' trusts.

Second, the making or renewal of the loan must be approved in writing by a trustee who is independent of the employer as being a loan which is consistent with the exempt purposes of the trust as indicated by section 401 of the code and as indicated by the trust instrument. In addition, no other such independent trustee of the trust may previously have refused to approve the making or renewal of the loan, if it is to qualify under this provision. Your committee's bill provides that, for purposes of this requirement, the term "trustee" means, with respect to any trust for which there is more than one trustee who is independent of the employer, a majority of such independent trustees. Thus, where there is more than one trustee who is

independent of the employer, it is necessary that a majority of such independent trustees give their approval to the loan, and that a majority of such trustees have not previously refused to give such approval.

Third, the amount loaned without adequate security by the employees' trust to the employer must not represent more than 25 percent of the value of all of the assets of the trust. This test is to be applied as of the time of the making or renewal of the loan. However, if adequate security was at one time provided with respect to a loan and, subsequently, this security is withdrawn, for purposes of this provision, such a withdrawal would constitute the making of a new loan and this 25-percent test would be applicable at that time. Whether any loan by the trust to the employer is made without the receipt of adequate security is to be determined for purposes of this requirement without regard to new subsection (h) of section 503 (which is added by subsection (a) of this section of the bill). For example, if, on any day after the date of enactment of this bill 24 percent of the trust's assets have previously been loaned to the employer without adequate security (but such loan is not considered as a prohibited transaction because of new subsection (h) of sec. 503), the trust may on that day invest without adequate security an additional 1 percent of its assets under the provisions of new subsection (i).

Effective date

Under subsection (c) of section 31 of the bill, the new subsection (h) of section 503 is to be effective for taxable years ending after March 15, 1956, and the new subsection (i) of section 503 is to be effective for taxable years ending after the effective date of the bill, but only with respect to periods after such date. It is expressly provided, however, that nothing in subsection (a) of section 31 of the bill is to be construed to make any transaction a prohibited transaction which, under announcements of the Internal Revenue Service made before the date of the enactment of the bill with respect to section 503 (c) (1) of the code, would not constitute a prohibited transaction.

A special rule is included in the effective date provisions for obligations described in new subsection (h) of section 503 acquired before the date of enactment of the bill and which are held on such date. Under this special rule, if the conditions described in paragraphs (2) and (3) of that subsection would have been satisfied if the obligation had been acquired on such date of enactment, then these requirements shall be treated as satisfied immediately following acquisition of the obligation.

Correction of cross-references

Subsection (d) of section 31 of the bill corrects several cross-references in the 1954 Code.

SECTION 32. CERTAIN LEASES BY MEDICAL RESEARCH ORGANIZATIONS

This section, for which there is no corresponding provision in the House bill, amends section 514 (b) (3) (A) of the 1954 Code, relating to exceptions to the definition of business lease.

Under existing law, exempt organizations subject to the unrelated business income tax must include in their gross income derived from an unrelated trade or business a percentage of the rentals derived

from business leases of their real property. The term "business lease" is defined in section 514 (b) (1), and exceptions to this definition are provided in section 514 (b) (3). Section 514 (b) (3) (A) states that no lease shall be considered as a business lease if it is either entered into primarily for purposes which are substantially related (other than the need for income) to the exercise or performance of the charitable, educational, and so forth, purpose or function which constitutes the basis of the organization's exemption, or if the lease is of premises in a building primarily designed for occupancy, and is occupied, by the organization.

Subsection (a) of section 32 of the bill adds a sentence at the end of section 514 (b) (3) (A). This sentence provides that a lease to a medical clinic by a scientific organization engaged in medical research of premises adjoining those occupied by such scientific organization is a lease primarily entered into for a purpose related to the organization's exempt purpose (and thus is not a business lease), if the scientific organization utilizes the medical clinic for medical research purposes by referring to the clinic's case histories, and by using the donated services of clinic doctors.

Under subsection (b) of section 32 of the bill, the amendment made to section 514 (b) (3) (A) is effective for taxable years beginning after December 31, 1957. Subsection (b) of section 32 also provides that for taxable years beginning before January 1, 1958, the determination as to whether a lease described in the amendment to section 514 (b) (3) (A) is not a business lease under section 514 (b) (3) (A), or under the corresponding provision of the 1939 Code, shall be made as if the amendment made to section 514 (b) (3) (A) by subsection (a) of section 32 had not been enacted and without inferences drawn from the fact that such amendment is not applicable to taxable years beginning before January 1, 1958.

SECTION 33. CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS

This section is identical with section 26 of the House bill.

Adjustments to taxable income for charitable contributions

Section 531 of the 1954 Code imposes a tax on the accumulated taxable income of a corporation improperly accumulating earnings and profits. Section 535 defines the term "accumulated taxable income" and provides rules for its computation.

Section 535 (b) (2) of the present law provides for the allowance of the deduction for charitable contributions in computing accumulated taxable income. This provision allows the deduction for charitable contributions provided under section 170 of the 1954 Code without regard to the limitation in section 170 (b) (2). Section 170 (b) (2) provides for a limitation of 5 percent of taxable income and, in addition, it provides for the allowance of a carryover to the 2 succeeding taxable years of the excess of contributions not deductible in the taxable year under the 5-percent limitation. In view of the carryover provisions of section 170 (b) (2) a taxpayer might contend that he is entitled to obtain the benefit of a duplicate deduction for contributions in the computation of accumulated taxable income by taking a deduction for charitable contributions in one taxable year (being in excess of the 5 percent allowable to the corporation for regular corporate

income-tax purposes) and in the following year again taking a charitable deduction to the extent allowable as a carryover under section 170 (b) (2) for regular corporate income-tax purposes.

Subsection (a) of section 33 of the bill amends section 535 (b) (2) to make it clear that the deduction for charitable contributions provided under section 170 shall be allowed without regard to section 170 (b) (2).

Adjustment to taxable income for long-term capital gains

Section 535 (b) (6) of the 1954 Code provides that in computing "accumulated taxable income" a deduction shall be allowed for the excess of net long-term capital gain for the taxable year over net short-term capital loss for such year (determined without regard to the capital loss carryover provided in sec. 1212) minus the income tax attributable to "such excess." The report of the Senate Committee on Finance on the 1954 Code states (on p. 316) that this provision conforms to the corresponding provisions in the 1939 Code, and that since the capital-gains tax is allowed as a deduction in computing accumulated taxable income under section 535 (b) (1), the deduction allowed under section 535 (b) (6) in the amount of the capital gains is reduced by the income tax attributable to such capital gains.

In determining the tax attributable to "such excess," it accordingly seems clear that the term "such excess" should be treated as being the excess of long-term capital gain over short-term capital loss, taking into account any capital loss carryover. This is the amount of tax which will have been allowed as a deduction under section 535 (b) (1) in computing accumulated taxable income, and it is this amount which should be used to reduce the amount of the deduction for capital gains under section 535 (b) (6).

Subsection (b) of section 33 of the bill makes it clear that in determining the taxes attributable to "such excess" the capital loss carryover provided in section 1212 shall be taken into account.

Effective date

Under section 1 (c) of the bill the amendments made by section 33 of the bill apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SECTION 34. UNDISTRIBUTED PERSONAL HOLDING COMPANY INCOME

This section, except for a change in the effective date of subsection (b), is identical with section 27 of the House bill.

Charitable contributions

Section 541 of the 1954 Code imposes a tax on the undistributed personal holding company income of personal holding companies. Section 545 (a) defines the term "undistributed personal holding company income" as the taxable income of the corporation with the adjustments provided in section 545 (b), minus the dividends paid deduction as defined in section 561.

Section 545 (b) (2) allows a deduction for charitable contributions provided under section 170 of the 1954 Code but with the limitations in section 170 (b) (1) (A) and (B) (in lieu of the limitation in sec. 170 (b) (2)). Section 545 (b) (2) allows a personal holding company to deduct charitable contributions to the same extent as allowed an

individual in section 170. Thus, the limitation in section 170 (b) (2) that corporations may not deduct charitable contributions in excess of 5 percent of taxable income under the regular corporate income tax does not apply in computing income subject to personal holding company tax.

Section 170 (b) (2) in addition, however, allows corporations a carryover for 2 taxable years of contributions in excess of the amount deductible under the 5-percent limitation. Thus, a corporation might contend that it is entitled to take an amount as a deduction for charitable contributions to the extent allowable to an individual in one taxable year (being in excess of the 5 percent allowable to the corporation for regular corporate income-tax purposes) and in the following year again to take the same amount as a charitable deduction to the extent allowable as a carryover under section 170 (b) (2) for regular corporate income-tax purposes.

Section 34 (a) of the bill makes it clear that the 2-year carryover provision of section 170 (b) (2) is not applicable in arriving at the amount of the deduction under section 545 (b) (2), and that the 2-year carryover provision of section 170 (b) (2) is not an adjustment to taxable income in arriving at adjusted gross income for purposes of the percentage limitations on charitable contributions under section 170 (b) (1) (A) and (B).

Under section 1 (c) of the bill, which is identical with section 1 (c) of the House bill, the amendment made by section 34 (a) of the bill applies to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

Net operating loss

Section 545 (b) (4) of the 1954 Code provides for the allowance of a deduction for the amount of the net operating loss for the preceding taxable year in computing undistributed personal holding company income. Section 545 (b) (3) provides that the special deductions allowed corporations under sections 241 to 247, inclusive, for regular corporate income-tax purposes are not allowed for personal holding company tax purposes.

However, a taxpayer may indirectly obtain the benefit of the special deductions provided by sections 241 and 243 to 247, inclusive, through a deduction for a net operating loss for the preceding taxable year created or increased by virtue of those special deductions.

Subsection (b) of section 34 of the bill amends section 545 (b) (4) of the 1954 Code to provide for the allowance of a net operating loss for the preceding taxable year computed without the special deductions for corporations which are provided in sections 241 to 247, inclusive.

Under subsection (c) of section 34 of the bill, the amendment made by subsection (b) of this section shall apply with respect to adjustments under section 545 (b) (4) for taxable years beginning after December 31, 1957.

SECTION 35. FOREIGN PERSONAL HOLDING COMPANIES

This section, except for changes in effective dates, is identical with section 28 of the House bill.

Adjustments to taxable income for charitable contributions

Subsection (a) of section 35 of the bill changes section 556 (b) (2) of the 1954 Code with respect to foreign personal holding companies in the same manner and for the same purposes that the amendment made by section 34 (a) of the bill would change section 545 (b) (2) for domestic personal holding companies.

Special deductions disallowed

Paragraph (1) of section 35 (b) of the bill amends section 556 (b) (3) to provide that the deduction for partially tax-exempt interest under section 242 shall be disallowed in computing undistributed foreign personal holding company income. Under section 556 (b) (3) this deduction is now allowed to the corporation and, at the same time, by reason of section 551 (c) a United States shareholder is allowed a credit against tax for his share of the partially tax-exempt interest of the foreign personal holding company. Thus, a double benefit may be obtained for the same partially tax-exempt interest. The amendment made by subsection (b) (1) corrects this error.

Paragraph (2) provides that the amendment made by paragraph (1) shall apply with respect to taxable years of the foreign personal holding company ending after December 31, 1957.

Net operating loss

Paragraph (1) of section 35 (c) of the bill amends section 556 (b) (4) of the 1954 Code. The purpose of this amendment is to make the same correction with respect to foreign personal holding companies as is made with respect to section 545 (b) (4) for domestic personal holding companies by section 34 (b) of the bill.

Paragraph (2) provides that the amendment made by paragraph (1) shall apply with respect to adjustments under section 556 (b) (4) of the 1954 Code for taxable years ending after December 31, 1957.

Cross-reference

Subsection (d) of section 35 of the bill adds to the foreign personal holding company provisions of the code, a cross-reference to section 6035 of the code (relating to returns of officers, directors, and shareholders of foreign personal holding companies).

SECTION 36. BOND, ETC., LOSSES OF BANKS

This section of the bill, which is identical with section 29 of the House bill, amends section 582 (c) of the 1954 Code (relating to losses of banks with respect to bonds). As enacted, section 582 (c) related only to bonds or other evidences of indebtedness issued with interest coupons or in registered form. Section 36 of the bill eliminates the reference to "with interest coupons or in registered form."

Under section 1 (c) of the bill, this amendment applies to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SECTION 37. DEPLETION ALLOWANCE IN CASE OF ESTATES

This section is identical with section 30 of the House bill, which amends section 611 (b) (4) of the 1954 Code (relating to allowance of

deduction for depletion in the case of estates) to correct a misspelling of the word "devisees."

SECTION 38. RATE OF PERCENTAGE DEPLETION FOR CERTAIN GOLD MINED IN THE UNITED STATES

This section, for which there is no corresponding provision in the House bill, amends section 613 (b) (2) (B) of the 1954 Code so as to provide a 23 percent depletion rate for gold in those cases where the principal product of the taxpayer is gold ore.

In order to qualify for the benefits of this amendment for any taxable year, a taxpayer must produce gold as the principal product of his operation rather than as a byproduct. For example, a taxpayer mining ore from which several metals are recovered, and from which gold is produced as a byproduct, would only be entitled to the 15 percent depletion rate on that portion of his gross income attributable to gold production.

This section would apply to taxable years beginning after December 31, 1957.

SECTION 39. PERCENTAGE DEPLETION RATES FOR CERTAIN TAXABLE YEARS ENDING IN 1954

This section is the same as section 31 of the House bill. The section amends section 613 of the 1954 Code (relating to percentage depletion) to allow a taxpayer to apply the percentage depletion rates listed under the 1954 Code to that portion of a taxable year subject to the 1939 Code which occurs in 1954. It would also allow the 1954 Code percentage depletion rates to be applied to any taxable year beginning after December 31, 1953, and ending before August 17, 1954.

In the case of a taxpayer having a taxable year beginning in 1953 and ending in 1954 who elects to have this section apply, the percentage depletion allowance shall be the sum of two parts. One part consists of a tentative allowance computed for that portion of the taxable year after December 31, 1953. This allowance shall be computed by applying the percentage rates under the 1954 Code to the taxpayer's gross income from the property for the entire taxable year, and then determining that portion of such allowance which the number of days in the taxable year falling after December 31, 1953, bears to the total number of days in the taxable year. In making the above computation the law otherwise applicable to such year, with the exception of the percentage depletion rate, shall apply. Thus the "gross income from the property" and the "net income from the property" will be determined with reference to the 1939 Code rules. The second part consists of a tentative allowance which shall be similarly computed for that portion of the taxable year before January 1, 1954, except that the percentage depletion rates listed under section 114 (b) (4) (A) of the 1939 Code will be applicable.

The computation of the percentage depletion allowance under this section may be illustrated by the following example:

Example

A is a taxpayer who reports income on the basis of a fiscal year ending June 30. In the taxable year ended June 30, 1954, A had gross income from a uranium property in the amount of $100,000.

His net income from this property, for purposes of limiting the depletion allowance, was $40,000. The depletion allowance computed with reference to the 23 percent rate in effect under the 1954 Code is $23,000 ($100,000 times 23 percent). This allowance is limited to $20,000 (50 percent of A's net income from the property). A's tentative allowance for the portion of the taxable year after December 31, 1953, is $9,917.80 (181/365 times $20,000). A will then compute a tentative allowance for that portion of the taxable year before January 1, 1954, applying the percentage rate under the 1939 Code. His allowance, thus computed, for the entire year is $15,000 ($100,000 times 15 percent). The tentative allowance applicable to the portion of the taxable year before January 1, 1954, is $7,561.64 (184/365 times $15,000). A's depletion allowance with respect to this property for the taxable year ended June 30, 1954, is $17,479.44.

The use of this section is on an elective basis, and the election may be made with respect to each property of the taxpayer. Also, this section is available to a taxpayer who has computed his depletion allowance for the taxable year on the basis of cost depletion or discovery depletion. In such a case, the taxpayer will compute the allowance on the basis of cost or discovery depletion for that portion of the taxable year before January 1, 1954. In making this computation the taxpayer will determine his allowance for the entire taxable year on such basis, and then take that portion of such allowance which the number of days in the taxable year before January 1, 1954, bears to the total number of days in the taxable year. The computation for the 1954 portion of the taxable year will be made as explained above (that is, it will take into account the percentage depletion rate under the 1954 Code).

Subsection (b) of section 39 provides that if the amendment gives rise to an overpayment, and a refund or credit of this overpayment is not permitted on the date of enactment of the bill, or within 6 months from such date, because of the operation of any law or rule of law (other than the provisions relating to closing agreements and compromises), nonetheless refund or credit may be made or allowed if the taxpayer files a claim for refund within 6 months from the date of enactment of the bill. It is also provided, however, that no interest shall be paid or allowed on any overpayment resulting from the application of the amendment made by this section.

SECTION 40. DEFINITION OF PROPERTY FOR PURPOSES OF THE DEPLETION ALLOWANCE

This section corresponds to section 32 of the House bill, which would amend section 614 of the code. The House bill added a new subsection to section 614 which, in effect, provided that a taxpayer may elect to treat any property as if the 1954 Code definition of property had not been enacted and as if the 1939 Code rules still applied. The choice provided by the House bill with respect to applying the rules under the 1954 Code to operating mineral interests was upon a basis of operating units. Thus, for example, a taxpayer might elect to apply the 1954 Code rules to all interests owned by him within one operating unit and continue to apply the 1939 Code rules to all other interests owned by him. If, for example, within 1 operating unit a taxpayer aggregated all interests in 2 leases as a single property, he would be

regarded as having elected to apply section 614 of the 1954 Code for that operating unit and could not aggregate as a separate property his interests in a third lease within such operating unit.

Your committee's bill represents a substantial amendment of the House bill insofar as it concerns the treatment of operating mineral interests in the case of mines and other natural deposits (except oil and gas) and the treatment of all nonoperating mineral interests.

Section 614 (a) of existing law, which defines the term "property" to mean each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land, is retained.

Subsection (a) of this section of your committee's bill amends section 614 (b) of the 1954 Code by adding thereto a new paragraph (4) to provide that in the case of mines and other natural deposits (except oil and gas), an election made under the provisions of section 614 (b) of existing law shall be inapplicable for any taxable year beginning after December 31, 1957.

Subsection (b) of this section amends section 614 by inserting in lieu of present subsection (c) a new subsection (c) to provide, for taxable years beginning after December 31, 1957, a new elective rule for the aggregation of operating mineral interests in the case of mines and other natural deposits (except oil and gas). This new rule permits a taxpayer, within any operating unit, to elect to aggregate and treat as 1 property all interests owned by him which comprise any 1 mine or any 2 or more mines and to elect to treat as a separate property any interest or interests (not part of such mine or mines) which are not included within such aggregation or aggregations. In ascertaining what constitutes an operating unit or a mine, the taxpayer's determination will not be disturbed in the absence of clear and convincing basis for a change. A taxpayer may elect to form more than one aggregation within an operating unit, but no aggregation may include less than a complete mine or mines. To illustrate the application of this new rule, assume that, within a single operating unit, a taxpayer owns 25 operating mineral interests and that such interests comprise 5 mines of 5 interests each. The taxpayer may elect under the new rule, for example, to aggregate all 15 interests within mines 1, 3, and 4 and treat them as 1 property; to aggregate his 5 interests in mine 2 and treat them as 1 property; and to treat each of the 5 interests comprising mine 5 as a separate property. As a further example, he may elect to aggregate all 25 interests in the 5 mines and treat them as a single property, or he may elect to form 5 properties by aggregating and treating as a property the 5 interests within each mine. A number of combinations is available to the taxpayer under the new rule, so long as no aggregation formed thereunder contains less than a complete mine or mines. Under your committee's bill, once a taxpayer elects to form an aggregation of all interests in a mine or mines under the new rule, any interest which thereafter becomes a part of such mine or mines shall be included in such aggregation. The time at which an interest becomes a part of a mine is a question of fact to be determined in accordance with the facts and circumstances in each case.

Subparagraph (A) of section 614 (c) (3), as amended by your committee, provides that for taxable years beginning after December 31, 1957, the election under the new rule shall be made with respect to each operating mineral interest, in accordance with regulations

prescribed by the Secretary or his delegate, not later than the time prescribed by law for filing the return (including extensions thereof) for whichever of the following taxable years is the later: The first taxable year beginning after December 31, 1957, or the first taxable year in which any expenditure for development or operation in respect of such interest is made by the taxpayer after acquisition of such interest. If, with respect to a particular interest, the development stage has been reached by the time prescribed for filing the return for the first taxable year beginning after December 31, 1957, then the election must be made on that return. Subparagraph (D) of section 614 (c) (3), as amended, provides, however, that in no event shall the time for making an election under the new rule expire prior to the first day of the first month which begins more than 90 days after the date of publication in the Federal Register of final regulations issued under the authority of section 614, as amended by this bill. An exercise of such election shall be binding upon the taxpayer for the first taxable year to which the election is applicable and all subsequent taxable years, except that the Secretary or his delegate may consent to a different treatment of any interest with respect to which such election has been made.

Under existing law, in the cases of properties explored by the taxpayer, he must, as a general rule, exercise his election to aggregate with respect to each operating mineral interest, if at all, no later than the time for filing the return for the taxable year in which he makes the first expenditure for exploration in respect of such interest after acquisition. Under your committee's amendment a taxpayer is to be permitted to postpone his election with respect to an operating mineral interest to the time for filing the return for the taxable year in which he makes the first expenditure for development or operation in respect of such interest.

Postponing the time for election to the taxable year in which the first expenditure for development or operation is made, however, may result in coincidental reductions of tax in some cases if the interest is not aggregated until the time of its development or operation with an interest which was in production at the time exploration expenditures were being made by the taxpayer with respect to the former interest. Were the taxpayer using the percentage method of computing his depletion allowance with respect to the producing interest, and had the interests been aggregated in the year in which the first of such exploration expenditures were made, as is required under existing law, such expenditures would have been taken into account in computing the taxable income from the aggregated properties for purposes of the 50-percent limitation contained in section 613 (a) of the code. In an appropriate case, then, aggregation of an interest under exploration with a producing interest could result in lower depletion allowances for the aggregated property than if the aggregation had been postponed until the exploratory work was completed. By delaying the time for making his election to aggregate an interest until the first year of development or operation with respect to such interest, the taxpayer avoids having to take exploration expenditures into account in computing the taxable income from the aggregated property for purposes of computing the depletion allowance.

Paragraph (4) of section 614 (c), as amended by your committee's bill, provides a means of recovering the tax saving, if any, that a taxpayer may thus obtain by waiting to aggregate an interest under exploration with another interest until the year in which the first development expenditures are made with respect to the former interest. In a case in which an interest is aggregated with another interest subsequent to the taxable period for which a deduction for exploration expenditures taken under section 615 (a) with respect to the former interest would have been reflected in computing taxable income had the properties been aggregated at the time of such expenditures, the tax for the earlier period and for the taxable year or years affected thereby is to be recomputed. The recomputation is to be made as though the taxpayer had elected to aggregate the interests for the first taxable year in respect of which the taxpayer deducted exploration expenditures under section 615 (a) with respect to such former interest. The recomputation is applicable only to those interests forming a part of the present aggregation which the taxpayer owned and on which he made any expenditure for exploration, development, or operation at the time of exploration of the interest in respect of which a deduction was taken under section 615 (a). The excess, if any, of the tax so recomputed (resulting solely from the effect of exploration expenditures previously deducted) for any taxable year or years over the tax previously determined for such year or years shall then, beginning with the first taxable year to which the election to aggregate is applicable, be added to the taxpayer's tax liability under chapter 1 for that year and for each succeeding taxable year until the total of increases in tax resulting from the recomputation is returned in full. The amount to be added for each such taxable year is an amount equal to the quotient obtained by dividing such excess by the total number of years in respect of which a deduction under section 615 (a) was taken in connection with one or more of the aggregated interests prior to the taxable year of its aggregation if a determination of tax for such year in accordance with the recomputation described in subparagraph (B) would have resulted in an increase in tax (but not an increase resulting by reason of a decrease in a net operating loss deduction) or a reduction of the net operating loss over that actually determined for such year or years. In making the recomputation, there shall be taken into account the effect that any increase in taxable income resulting from the recomputation would have on any item directly affected by such increase, such as the charitable contribution deduction in the case of corporations. If the taxpayer dies or ceases to exist, then so much of the total increases in tax resulting from a recomputation under subparagraph (B) as was not taken into account under this tax-recovery rule for taxable years preceding such death or cessation of existence shall be taken into account for the taxable year in which such death or cessation of existence occurs.

Except for the effect of a carryback of a net operating loss, any taxable year prior to the first taxable year to which the rules under the new section 614 (c) apply with respect to an operating unit shall be disregarded in applying this tax-recovery rule with respect to such operating unit. Thus, assume the case of a calendar-year taxpayer who, for 1954, 1955, 1956, and 1957, has made a binding election under section 614 (b) of existing law to treat operating mineral interests A and B, which

are operated as a unit, as separate properties. Assume, further, that interest A was a producing property the income from which was subject to percentage depletion in 1956, 1957, 1958, and 1959; that exploration expenditures with respect to interest B were made and deducted in 1956, 1957, 1958, and 1959; that development of interest B began in 1960; and that, under the new aggregation rule provided in section 614 (c) (1), the taxpayer exercised his election to aggregate interests A and B in the return for 1960. The taxpayer did not exercise the election provided for in section 614 (c) (3) (B) to apply section 614 (c) to those interests for any taxable year before 1958. Since the taxpayer made a binding election under section 614 (b) of existing law with respect to 1954, 1955, 1956, and 1957, the rule contained in section 614 (c) did not become applicable to the interests referred to until 1958, and, for this reason, the taxpayer will not be required to recompute his tax, for purposes of the tax-recovery rule, for any taxable year prior to 1958. It will be necessary, however, for him to make a recomputation for 1958 and 1959 and for any year affected by a net operating loss for either of such years.

The following example will illustrate the operation of the tax-recovery rule: In 1958, the taxpayer, a corporation, purchases leases A and B, which it plans to operate as a unit. Lease A has been explored and developed by the taxpayer's vendor, but no exploration expenditures were made by such vendor with respect to lease B. In 1959, a mine goes into operation on lease A; and such mine is extracting from the single deposit on lease A a mineral entitled to percentage depletion at the 15 percent rate. For the years 1959 through 1962, the taxpayer computes the depletion allowance with respect to the mineral being extracted from this property as follows:

TABLE 1.—*Computation of depletion deduction in case of mine on lease A*

	1959	1960	1961	1962
Mining gross income	$300,000	$700,000	$500,000	$900,000
Mining taxable income	120,000	300,000	130,000	250,000
Cost depletion	30,000	100,000	70,000	110,000
Depletion deduction	45,000	105,000	70,000	125,000

The taxpayer, for each year from 1959 through 1962, makes and deducts exploration expenditures of $40,000 with respect to lease B, and the first development expenditure with respect to lease B is made on January 1, 1963. In accord with the new rule, the taxpayer elects to aggregate his interests in leases A and B commencing with 1963. Under the tax-recovery rule, the taxpayer must recompute his tax for the years 1959 through 1962 as though leases A and B had been aggregated in 1959; and the first step in such computation is to redetermine the depletion deductions for the years 1959 through 1962 as though the mines on leases A and B had been aggregated for 1959. In each year the taxable income from the property for the mine on lease A will be reduced by $40,000 to reflect the exploration expenditures on lease B; and for purposes of this example, assume there is an upward adjustment of 10 percent in the per-unit cost depletion rate for the mineral being extracted from the mine on lease A to reflect the effect of this aggregation. The following table shows

the depletion deductions recomputed as though the mines on leases A and B had been aggregated in 1959:

TABLE 2.—*Computation of depletion deduction as though mines on leases A and B had been aggregated in 1959*

	1959	1960	1961	1962
Mining gross income	$300,000	$700,000	$500,000	$900,000
Mining taxable income	80,000	260,000	90,000	210,000
Cost depletion	33,000	110,000	77,000	121,000
Depletion deduction	40,000	110,000	77,000	121,000

By comparing table 2 with table 1, it can be seen that in 1959 and 1962, the taxpayer's depletion deductions would have been, respectively, $5,000 and $4,000 less had the properties been aggregated in 1959. While it is true that aggregation in 1959 would have also produced increased cost depletion allowances for 1960 and 1961, increases in the cost depletion allowance are ignored for purposes of the tax-recovery rule except insofar as such an increase serves to reduce a tax saving in a particular year. For example, the taxpayer's percentage depletion deduction in 1962, had the properties been aggregated in 1959, would have been only $105,000 or $20,000 less than the deduction taken for that year were it not for the fact that an aggregation of the properties as of that year would have also resulted in a higher cost depletion allowance for that year. Having determined that, for 1959 and 1962, the taxpayer's depletion deduction would have been, respectively, $5,000 and $4,000 less had the properties been aggregated in 1959, it is now necessary to convert such determination into tax savings. To do this, it is necessary to recompute the taxpayer's tax for those years. Table 3 shows the taxpayer's computation of its tax for the years 1957 through 1962 before recomputation under the tax-recovery rule.

TABLE 3.—*Computation of income tax*

	1957	1958	1959	1960	1961	1962
Sec. 63 (a) taxable income	$200,000	$100,000	[1] $150,000	$300,000	$400,000	$500,000
1959 net operating loss carryback deduction	150,000					
Taxable income as adjusted by net operating loss carryback deduction	50,000	100,000	0	300,000	400,000	500,000
Income tax on taxable income as adjusted	20,500	46,500	0	150,500	202,500	254,500

[1] Net operating loss.

Under the recomputation, the net operating loss of $150,000 in 1959 would be reduced by $5,000, the amount by which the depletion deduction claimed in that year would have exceeded the allowable deduction had the properties been aggregated in that year. The recomputation produces a $5,000 reduction of the net operating loss and an increase of tax liability for 1957, the year to which it was carried back as a deduction under section 172. Increasing taxable income for 1957 by $5,000 would produce an increased tax liability for that year of $2,600. A recomputation of tax for the years 1960 and 1961 would produce no additional tax liability for those years since the

depletion deductions taken in those years were less than the amounts allowable had the aggregations been effective for such years. Since the taxpayer's depletion deduction taken for 1962 exceeded by $4,000 the amount which would have been deducted had the tax for that year been determined in accordance with the recomputation, the taxpayer's taxable income of $500,000 in that year is increased under the recomputation by $4,000, thus showing an additional tax liability of $2,080. The total of the increases in tax, then, amounts to $2,600 plus $2,080, or $4,680. The total is then to be divided by the number of taxable years, between 1956 and 1963, in respect of which (1) exploration expenditures were deducted with respect to the mine on lease B and (2) the recomputation of tax under the tax-recovery rule would result in a reduction of a net operating loss or an increase in tax (but not an increase resulting from a reduction of a net operating loss deduction). Since 1959 and 1962 are the only years in which these two requirements are met, the total tax increase of $4,680 is divided by 2, producing a quotient of $2,340. The taxpayer's tax liability in each of the years 1963 and 1964 is then increased by $2,340. Subparagraph (D) of section 614 (c) (4) as contained in your committee's bill provides that appropriate adjustments shall be made, in accordance with regulations prescribed by the Secretary or his delegate, to the basis of the aggregated property to reflect any reduction of the depletion allowance in respect thereof under the provisions of this rule.

Subparagraph (B) of section 614 (c) (3), as amended by your committee, also provides, in the case of mines and other natural deposits (except oil and gas), that the taxpayer may apply the new aggregation rules provided by section 614 (c) with respect to any operating unit in lieu of those prescribed by section 614 (b) (1) of existing law for certain taxable years beginning before January 1, 1958. Under this subparagraph the new aggregation rules provided for in section 614 (c) (1) may be applied to whichever of the following taxable years is the later (excluding any taxable year in respect of which an assessment of deficiency is prevented on the date of the enactment of this bill by operation of any law or rule of law): The first taxable year to which the 1954 Code applies or the first taxable year in which the taxpayer made any expenditure for development or operation in respect of any operating mineral interest after its acquisition. In no event, however, shall the time for making such election to use the new aggregation rules with respect to taxable years beginning before January 1, 1958, expire prior to the first day of the first month which begins more than 90 days after the date of publication in the Federal Register of regulations issued under the authority of section 614 as amended by this bill.

Subparagraph (E) of section 614 (c) (3) provides that if the new aggregation rules are made applicable to any taxable year (excluding any taxable year in respect of which assessment of a deficiency is prevented on the date of enactment of this bill by any law or rule of law) in respect of which assessment of a deficiency resulting from the election is prevented on the first day of the first month beginning more than 90 days after final regulations under section 614, as amended, are published in the Federal Register or within 1 year thereafter, assessment may nevertheless be made within 1 year after such first day. Subparagraph (E) contains corresponding rules with respect

to extending the period for claiming refund or credit resulting from the exercise of the election. Thus, if the first taxable year to which the election is otherwise applicable is 1954 but assessment of deficiency in respect thereof is prevented on the date of enactment of this bill, the election may not be made applicable with respect to 1954. If the election is properly applicable to 1955 or a subsequent year and if assessment of a deficiency in respect thereof is not prevented on the date of enactment of this bill but is prevented on the first day of the first month which begins more than 90 days after the regulations under the new section 614 (c) are published or within 1 year thereafter, the election is applicable to such year or years but assessment of a deficiency in respect of any such year or years may be made at any time within 1 year after such first day.

This election to apply the new aggregation rules with respect to taxable years beginning before January 1, 1958, is available with respect to the operating mineral interests which constitute each operating unit. Thus, with respect to such years, a taxpayer may elect to apply the new aggregation rules to all of his interests in one operating unit and elect to treat all of his interests in another operating unit in accordance with section 614 (b) of existing law; but no aggregation or aggregations of interests within an operating unit may be made based upon a combination of the rules provided for in the new section 614 (c) and in section 614 (b) of existing law. If, for the first taxable year beginning after December 31, 1953, and ending after August 16, 1954, with respect to which assessment of a deficiency is not prevented on the date of enactment of this bill, a taxpayer elects to aggregate his interests constituting part or all of any operating unit under the provisions of the new aggregation rules provided in section 614 (c) such election shall be binding upon the taxpayer for such first taxable years, including taxable years beginning after December 31, 1957, except that the Secretary or his delegate may consent to a different treatment of any interest with respect to which such election has been made. If, for the first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in respect of which assessment of a deficiency is not prevented on the date of enactment of the bill, a taxpayer makes a binding election to aggregate his interests constituting part or all of any operating unit under the provisions of section 614 (b) of existing law, such election shall also be binding upon him for all subsequent taxable years beginning before January 1, 1958, except to the extent that the Secretary or his delegate consents to a different treatment. For such years, the taxpayer must make a new election pursuant to the new aggregation rules provided for in section 614 (c) (1) as amended by your committee with respect to such interests for taxable years beginning after December 31, 1957, within the time prescribed for making such election. Failure to make such an election within the prescribed time will constitute an election to treat the interests as separate properties.

The following example illustrates the application of the foregoing elections in the case of mines and other natural deposits (except oil and gas): On January 1, 1958, a taxpayer, who reports his income on a calendar-year basis, owns 20 operating mineral interests, all of which he acquired prior to 1953. These 20 interests comprise 4 mines of 5 interests each. Two of these mines constitute operating unit A, and

the remaining 2 mines constitute operating unit B. Each of these mines was in operation on January 1, 1954, and has been in operation ever since. Assume that the bill is enacted on September 1, 1958, and that assessment of a deficiency in respect of 1954 is prevented by operation of the statute of limitations on that date. Assume further that the taxpayer had previously exercised elections under section 614 (b) of existing law by aggregating 8 interests in unit A as a single property and by aggregating 6 interests in unit B as a single property; and that he used these aggregations in computing his income from such properties for 1954, 1955, 1956, and 1957. On September 1, 1958, assessment of a deficiency for the years 1955, 1956, and 1957 was not prevented by the statute of limitations. Assume also that the first day of the first month which begins more than 90 days after the date of publication of final regulations under section 614, as amended, is April 1, 1959. The taxpayer's elections under section 614 (b) of existing law for 1954 are binding upon him for that year since assessment of a deficiency for such year was prevented on September 1, 1958. If assessment of a deficiency with respect to 1955 is prevented on April 1, 1959, assessment of any deficiency resulting from the exercise of the election provided for in section 614 (c) (3) (B) may, nevertheless, be made at any time before April 1, 1960. Correspondingly, if credit or refund resulting from the application of section 614 (c) (3) (B) is prevented on April 1, 1959, claim therefor may be made at any time before April 1, 1960. If the taxpayer intends to aggregate any of his 20 interests under the new aggregation rule provided for in section 614 (c) (1), he must exercise his elections thereunder before April 1, 1959. He may, for example, maintain his elected aggregation under section 614 (b) of existing law with respect to operating unit A for 1955, 1956, and 1957, elect to apply the new rule under subsection (c) (1) to aggregate the 5 interests comprising each mine in operating unit A as a separate property for 1958 and all subsequent years, and elect under the new rule provided for in section 614 (c) (1) to treat the 10 interests comprising the 2 mines in operating unit B as a single property for 1955 and all subsequent years. On the other hand, he may elect, for example, to apply the new rule provided for in section 614 (c) (1) to treat the 5 interests comprising each of the 4 mines as a property for 1955 and all subsequent years; or he may maintain his elected aggregations under existing law with respect to operating units A and B for 1955, 1956, and 1957, and elect to apply the new rule for 1958 and all subsequent years to treat the 10 interests constituting each operating unit as a property.

Section (b) of your committee's bill also provides under section 614 (c) (2), in the case of mines and other natural deposits (except oil and gas), for an election to treat a single mineral interest as more than one property. If a single tract or parcel of land contains a mineral deposit which is being extracted, or will be extracted, by means of two or more mines in respect of each of which an expenditure for development or operation has been made by the taxpayer, then the taxpayer may elect to allocate, under regulations prescribed by the Secretary or his delegate, to such mines, all of the tract or parcel of land and the mineral deposit contained therein and treat as a separate property that portion of the tract or parcel of land and mineral de-

posit so allocated to each mine. Each separate property so formed may then in turn be treated as more than one property under, but subject to, the provisions of this new provision permitting a division of a single mineral interest. Each separate property so formed may be aggregated with other property or properties pursuant to the provisions relating to aggregation of properties under section 614 (c) if the latest time for exercising an election under that subsection has not expired. The tax-recovery rule provided for in section 614 (c) (4) will not apply to exploration expenditures deducted with respect to a separate property formed under the provisions of section 614 (c) (2) which is then aggregated in accordance with the new aggregation rule in section 614 (c) (1) and (3). The election provided for in section 614 (c) (2) may not be made with respect to any property which is a part of an aggregation formed by the exercise of the election under section 614 (c) (1) except with the consent of the Secretary or his delegate. If a taxpayer elects, in accordance with this new division rule, to treat a single operating mineral interest in a single tract or parcel of land as more than one property, then, under regulations prescribed by the Secretary or his delegate, such tract or parcel of land and the mineral deposit representing such interest shall be allocated in its entirety to the mines to which the election is applicable. This does not mean that the taxpayer must make a complete vertical allocation of the tract or parcel of land. If, for example, the taxpayer, having properly elected under this new division rule to treat a single mineral interest as 2 properties, has or discovers a second mineral deposit on the original tract, such second mineral deposit is a separate mineral interest in a single tract or parcel of land.

As a general rule, the election provided for in section 614 (c) (2) to treat a single operating mineral interest as more than one property shall be made, in accordance with regulations prescribed by the Secretary or his delegate, not later than the time prescribed by law for filing the return (including extensions thereof) for whichever of the following taxable years is the later: the first taxable year beginning after December 31, 1957, or the first taxable year in which the taxpayer has made any expenditure for development or operation of more than one mine with respect to such interest after acquisition. Your committee has provided, however, in section 614 (c) (3) (B) that the taxpayer may elect to apply this new division rule to any operating mineral interest, in accordance with regulations prescribed by the Secretary or his delegate, for whichever of the following taxable years is the later (excluding any taxable year in respect of which an assessment of a deficiency is prevented on the date of the enactment of the bill by the operation of any law or rule of law): the first taxable year to which the 1954 Code applies or the first taxable year in which expenditures for development or operation of more than one mine in respect of the property are made by the taxpayer after the acquisition of the property. In no event, however, shall the time for making an election to apply this new division rule for a taxable year expire prior to the first day of the first month which begins more than 90 days after the publication in the Federal Register of final regulations issued under authority of section 614 as amended by the bill. Subparagraph (E) of section 614 (c) (3) provides that if such rule is made applicable to any taxable year (excluding any taxable year in respect

of which assessment of a deficiency is prevented on the date of enactment of the bill) in respect of which assessment of a deficiency resulting from the election is prevented on the first day of the first month beginning more than 90 days after final regulations under this section, as amended, are published in the Federal Register or within 1 year thereafter, assessment may nevertheless be made within 1 year after such first day. Subparagraph (E) contains corresponding rules with respect to extending the period for claiming refund or credit resulting from the exercise of the election. Any election made under this new division rule shall be binding upon the taxpayer for the taxable year and for all subsequent years except to the extent that the Secretary or his delegate may consent to a change. Subparagraph (B) of section 614 (b) (4) provides that if a taxpayer makes an election to apply the new division rule with respect to an interest in an operating unit for any taxable year beginning before January 1, 1958, any election made under section 614 (b) with respect to any interest in such operating unit shall not apply for any taxable year for which the election to apply the new division rule is effective. Thus, if the taxpayer elects to divide an interest for a taxable year beginning before January 1, 1958, and also wishes to aggregate other interests in the same operating unit, he must aggregate such interests under the provisions of the new aggregation rules contained in section 614 (c) (1).

A case illustrating the application of this election to treat a single operating mineral interest as more than one property would be as follows: A taxpayer who reports his income on a calendar-year basis acquired 11 separate tracts of land in 1940 by means of 11 acquisitions. In 1950 he put mines A and B into operation on tract 1 by means of which he extracted mineral X from a single deposit. In 1953, a second deposit of the same mineral was discovered on tract 1; and in 1954, the taxpayer began extraction of the mineral in this deposit by means of mine A, which is also employed to extract the mineral from the first deposit. Prior to 1953, the taxpayer also put mine C into operation extracting mineral X from a deposit underlying tracts 2 through 6 and mine D into operation extracting mineral X from a deposit underlying tracts 7 through 11. The taxpayer operates mines A, B, C, and D as a unit. Assume that the bill is enacted on September 1, 1958, and that the first day of the first month which begins more than 90 days after the date of publication in the Federal Register of final regulations issued under authority of section 614, as amended, is April 1, 1959. On his return for the year 1954, in respect of which assessment of a deficiency was prevented before September 1, 1958, the taxpayer elected under section 614 (b) of existing law to aggregate his two interests (i. e., the interests in the first and second deposits) in tract 1 with his single interests in tracts 2, 3, 4, 8, and 9 as a single property and to treat his single interests in tracts 5, 6, 7, 10, and 11 as separate properties. The taxpayer used this aggregation in reporting his income for 1954, 1955, 1956, and 1957. On September 1, 1958, assessment of a deficiency with respect to the year 1955 was not prevented but would otherwise have become prevented on March 15, 1959. If the taxpayer intends to apply the new aggregation and division rules in section 614 (c) with respect to the 12 interests in his 11 tracts for any taxable year he must make his elec-

tion thereunder before April 1, 1959. Once having decided to apply the new aggregation and division rules and having decided how he wants to apply them, the taxpayer must also make a third decision on or before April 1, 1959. He may apply these new rules with respect to all of his properties for 1955 and all subsequent years, or he may adhere to his previous election under section 614 (b) of existing law with respect to the years 1955 through 1957, and apply the new rules for 1958 and all subsequent years. He may not, however, apply the rules provided for in section 614 (b) (1) of existing law as to part of his interests in the operating unit and apply the rules in section 614 (c) as to any of the remainder of such interests. Assume that the taxpayer elects to apply the new division and aggregation rules for 1955 and all subsequent years. As to dividing a single interest, he may elect to treat his single interest in the first deposit in tract 1 as an interest in tract 1 (a) and an interest in tract 1 (b) since mines A and B are working that deposit, and he may elect to treat his single interest in the second deposit in tract 1 as a separate property. If he so elects, no election to aggregate any of the remaining interests in the operating unit may be made under section 614 (b) of existing law for 1955, 1956, and 1957. Such remaining interests must either be treated as separate properties or aggregated in accordance with the new rules provided for in section 614 (c) as amended. If the taxpayer does not elect on or before April 1, 1959, to aggregate the remaining interests in accordance with the rules provided in section 614 (c), each such remaining interest shall be treated as a separate property for 1955 and all subsequent years unless the Secretary or his delegate consents to a different treatment with respect to any such interest. The taxpayer may elect under the new aggregation rule in section 614 (c), for example, to aggregate his interest in the second deposit on tract 1 with his interest in tract 1 (a); but if he forms such an aggregation, he may not later treat the property formed by the exercise of such an election as more than one property without the consent of the Secretary or his delegate since an interest which is a part of an aggregation may not be subdivided. If, on the other hand, he does not elect, on or before April 1, 1959, to aggregate his single interest in the second deposit with his interest in tract 1 (a), he may thereafter elect to treat such single interest in the second deposit as 2 properties for the future taxable year in which he begins development of such second deposit by means of a second mine. Assume, for example, that he does not elect, on or before April 1, 1959, to aggregate his single interest in the second deposit with his interest in tract 1 (a) as mine A and that in 1960 he begins development of that part of the second deposit underlying tract 1 (b) through existing mine B. In his return for 1960, then, he may elect to treat his single interest in such second deposit as two properties, an interest in tract 1 (c) (that part of the second deposit which is being extracted by means of mine A) and an interest in tract 1 (d) (that part of the second deposit which is being developed by means of mine B). If the taxpayer wants to aggregate his interests in tracts 1 (b) and (d) as mine B under section 614 (c), he must exercise his election to do so in his return for 1960, since that is the year in which the first development expenditure with respect to the interest in tract 1 (d) was made. He may not elect, however, without the consent of the Secretary or his delegate to aggregate his interests in

tracts 1 (a) and (c) as mine A since the time for exercising an election to aggregate the interests comprising mine A expired on April 1, 1959.

Under subsection (c) of your committee's bill, section 32 of the House bill has been retained as section 614 (d) of the code, insofar as it relates to the treatment of operating mineral interests in the case of oil and gas wells. Thus, in the case of oil and gas wells, a taxpayer may treat any property (determined as if the 1939 Code continued to apply) as if subsections (a) and (b) of section 614 of the Internal Revenue Code of 1954 had not been enacted. If any such treatment would constitute an aggregation under section 614 (b) of existing law, the rule provides that such treatment shall be taken into account in applying section 614 (b) of existing law to other such property of the taxpayer. If the taxpayer desires to treat any property in accordance with the rules applicable under the 1939 Code, there is no provision in section 614 (d) with respect to any taxable year subject to the 1954 Code which will permit the taxpayer to treat such property in a manner inconsistent with the manner in which it was treated under the 1939 Code. Therefore, if a taxpayer's treatment of any property or properties for taxable years to which the 1939 Code was applicable would have been binding upon him for all future years but for the enactment of section 614 (a) and (b) of the 1954 Code, his application of the rule in section 614 (d) permitting him to treat such property or properties as though section 614 (a) and (b) had never been enacted has the effect of continuing the effect of his 1939 Code treatment for taxable years beginning after December 31, 1953, and ending after August 16, 1954, insofar as those properties are concerned.

If the taxpayer desires to treat any operating oil and gas property in accordance with section 614 (b) for any taxable year he must make a timely election within the time prescribed by section 614 (b) with respect to such property for the first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in respect of which assessment of a deficiency or credit or refund of an overpayment, as the case may be, is not prevented by operation of any law or rule of law. Any election under section 614 (b) shall be binding upon the taxpayer for the year for which such election is made and for all subsequent years, except to the extent that the Secretary or his delegate consents to a different treatment.

An example illustrating the application of these rules for operating mineral interests in the case of oil and gas would be as follows: On January 1, 1954, a taxpayer who reports his income on a calendar-year basis owns 18 operating oil and gas interests, which he acquired in 1950 and with respect to each of which he has made exploration expenditures. These interests are in 6 tracts of land, each of which tracts contains 3 interests. For purposes of section 614 (b), the interests in tracts 1, 2, and 3 constitute operating unit A; and the interests in tracts 4, 5, and 6 constitute operating unit B. On his returns for taxable years prior to 1954, the taxpayer treated the 3 interests within each tract in operating unit A as a property and treated 2 of the 3 interests within each tract in operating unit B as a property. On his return for 1954, however, he exercised his election under section 614 (b) to treat as a property the 9 interests consti-

tuting each of his 2 operating units; and these aggregations were used in reporting his income for 1955, 1956, and 1957. Assume, for purposes of this illustration, that regulations prescribed by the Secretary or his delegate under section 614 (b) provide, in effect, that the time for making a binding election thereunder with respect to operating mineral interests in the case of oil and gas shall not expire prior to February 1, 1959. Assume further that on February 1, 1959, the assessment of a deficiency is prevented for 1954. For this reason the taxpayer's treatment of his interests for 1954 cannot be disturbed. For 1955 and all subsequent years, then, if the taxpayer desires to treat all of his interests in either or both of his operating units under the 1939 Code rules, he must, before February 1, 1959, revoke his election under section 614 (b) for such years with respect to such interests. If the taxpayer takes this action, he may not, for 1955 and all subsequent years, treat such properties in a manner different from that in which he treated them for years prior to 1954. For example, if the taxpayer, before February 1, 1959, revokes his election under section 614 (b) with respect to his interests in operating unit A for 1955 and all subsequent years, he must continue the treatment accorded such interests for years before 1954, and must treat the 3 interests within each of tracts 1, 2, and 3 as a separate property and may not treat only 2 of such 3 interests as a separate property or treat each of such 3 interests as a separate property.

Subsection (d) of section 40 of your committee's bill contains an amendment to section 614 (c) of the 1954 Code, which is redesignated by section 40 (b) of the bill as section 614 (e). Your committee has modified the rules of existing law for the treatment of all nonoperating mineral interests, including nonoperating mineral interests in the case of oil and gas. The first sentence of section 614 (e) (1) (as redesignated by section 40 (b) of the bill) is amended to provide that, if a taxpayer owns 2 or more separate nonoperating mineral interests in a single tract or parcel of land or in 2 or more adjacent tracts or parcels of land, the Secretary or his delegate shall, on showing by the taxpayer that a principal purpose is not the avoidance of tax, permit the taxpayer to treat all such mineral interests in each separate kind of mineral deposit as one property. The corresponding provision of existing law gives the Secretary or his delegate the discretionary authority to permit the aggregation of nonoperating mineral interests but only in a case in which the tracts containing such interests are contiguous and only in respect of which the taxpayer makes a showing that to treat each interest as a separate property would result in undue hardship. Under existing law, tracts or parcels of land are not considered to be contiguous if intervening mineral rights separate them. For example, 2 tracts of land are not considered contiguous if they are separated by a right-of-way or stream the mineral interest in which right-of-way or stream does not properly belong in either tract. Under your committee's bill, this requirement of contiguity has been discarded in favor of a requirement that the tracts or parcels of land be adjacent to each other. Thus, under your committee's rule, the two tracts separated by a right-of-way or stream in the example posed would be adjacent to each other. Your committee does not intend, however, that this example represent the only case in which tracts

will be considered adjacent for purposes of this subsection. Tracts will be considered adjacent if they are in reasonably close proximity to each other, a determination which must turn on the facts and circumstances of each case. Under your committee's rule, a showing that a principal purpose of aggregation is not the avoidance of tax is not to be confined to a showing of an absence of overt intent. The fact of substantial reduction of tax as such may be taken as indicative of a purpose to avoid tax. Your committee also clarifies existing law to permit the taxpayer to treat all nonoperating mineral interests in each separate kind of mineral deposit as one property, provided the requirements of section 614 (e) (1) (as redesignated by subsection (b) of the bill) are met. This amendment with respect to the treatment of nonoperating mineral interests shall apply with respect to taxable years beginning after December 31, 1957, except that with respect to any taxpayer such amendment shall, at the taxpayer's election, apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954, in respect of which assessment of a deficiency or credit or refund of any overpayment is not prevented by operation of any law or rule of law.

SECTION 41. INVESTMENT COMPANIES FURNISHING CAPITAL TO DEVELOPMENT CORPORATIONS

This section of the bill, which is identical with section 33 of the House bill, makes 2 technical amendments to section 851 (e) of the 1954 Code.

Subsection (a) of section 41 corrects an unintended change made to the provisions of supplement Q of the Internal Revenue Code of 1939 as they were incorporated in the 1954 Code.

Under the 1939 Code, in order for a regulated investment company to qualify as an investment company furnishing capital to a development corporation, the Securities and Exchange Commission was required to certify to the Secretary of the Treasury "not more than 60 days" prior to the close of the regulated investment company's taxable year that the regulated investment company was so engaged in furnishing capital. As that language was incorporated in section 851 (e) (1) of the 1954 Code, the wording was inadvertently changed to "not less than 60 days." Subsection (a) of section 41 of the bill corrects the unintended change by striking out "not less than 60 days" and inserting the language "not earlier than 60 days."

Subsection (b) of section 41 of the bill corrects a typographical error in section 851 (e) (2) of the 1954 Code by changing the word "issues" to "issuer."

SECTION 42. TREATMENT OF DIVIDENDS OF REGULATED INVESTMENT COMPANIES WHOSE ASSETS CONSIST MAINLY OF STATE AND LOCAL OBLIGATIONS

This section, for which there is no corresponding provision in the House bill, amends subchapter M of chapter 1 of the 1954 Code to permit a regulated investment company, the bulk of whose assets is invested in State or local securities (i. e., a municipal bond fund), to pass on the tax-free interest it receives from such securities (under

sec. 103 (a) (1)) to its shareholders in the form of exempt-interest dividends.

Subsection (a) of section 42 of the bill amends section 851 of the 1954 Code (by adding a new subsec. (f)) to permit a municipal bond fund to meet the source of income requirements for a regulated investment company and to prescribe a new set of diversification of asset requirements which such municipal bond funds must meet in order to qualify for the new exempt-interest dividend treatment.

Paragraph (1) of new subsection (f) provides 3 requirements that a municipal bond fund must meet at the close of each quarter of the taxable year in lieu of the diversification of assets requirements of section 851 (b) (4). First, at least 90 percent of the value of its total assets must be represented by cash, cash items (including receivables) and obligations the interest on which is excludable from gross income under section 103 (a) (1). Secondly, at least 50 percent of the value of the municipal bond fund's total assets must be represented by cash and cash items (including receivables), Government securities, and other securities. For the purpose of the 50-percent calculation, (second requirement) "other securities" are limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the municipal bond fund. Finally, not more than 25 percent of the value of the company's total assets may be invested in the securities of any one issuer.

A municipal bond fund may use the above three alternatives, in lieu of the diversification of assets requirements of section 851 (b) (4) in order to qualify as a regulated investment company only if the amount of interest excludable (for the taxable year) from gross income of the municipal bond fund under section 103 (a) (1) is greater than 95 percent of the municipal bond fund's gross income (including as gross income the tax-free interest and excluding from gross income gains from sale or other disposition of capital assets).

Paragraph (2) of section 851 (b) of present law requires that a corporation, to qualify as a regulated investment company, must derive 90 percent of its gross income from dividends, interest, and gains from the sale or disposition of stock or securities. The new subsection (f) (2) of section 851 has the effect of permitting a municipal bond fund, wishing to qualify as a regulated investment company under section 851 (f), to qualify as such if at least 90 percent of its gross income is derived from the sources permissible under present law or from interest otherwise excludable from gross income under section 103 (a) (1).

Paragraph (3) of section 851 (b) of present law requires that a corporation to qualify as a regulated investment company must derive less than 30 percent of its gross income from the sale or other disposition of stock or securities held for less than 3 months. For purposes of subsection (f) the term "gross income" as used in section 851 (b) (3) would include interest excludable from gross income under section 103 (a) (1).

The rules provided in paragraph (4) and (5) of section 851 (c) of present law are made applicable to new subsection (f).

Subsection (b) of section 42 of the bill amends section 851 (d), relating to the determination of status of a regulated investment company, so that section 851 (d) also applies to a regulated investment

company which meets the requirements of section 851 (f) in lieu of the requirements of section 851 (b) (4).

Subsection (c) of section 42 of the bill amends section 852 (a) so that the provisions of the 90-percent dividends-paid deduction (defined in sec. 561) of present paragraph (1) thereof applies only to regulated investment companies which do not meet the qualifications of section 851 (f) (i. e., are not municipal-bond funds). This is accomplished by redesignating the material presently in paragraph (1) as subparagraph (A) and inserting the new material as subparagraph (B) to prescribe distribution requirements for regulated investment companies which meet the qualifications of section 851 (f) for a taxable year. Subparagraph (B) provides that, in order to qualify for the treatment prescribed by subchapter M, such companies (i. e., municipal-bond funds) must, during the taxable year, pay exempt-interest dividends and distribute amounts which would be treated as dividends under section 562 (b) (if the deduction for dividends paid, under 561, were allowed) which, together, equal or exceed 90 percent of its investment-company taxable income for the taxable year. Such taxable income shall be determined by including in gross income interest otherwise excludable from gross income under section 103 (a) (1) and by deducting from gross income amounts disallowed under section 265 (expenses and interest relating to tax-exempt income) and section 171 (a) (2) (amortizable bond premiums). Amounts may be treated as dividends under section 562 (b) to the extent chargeable to earnings and profits. Thus, for the purpose of meeting the distribution requirements, an open-end regulated investment company may include that portion of any amount paid out to redeem shares presented by shareholders desiring to withdraw which represents the shareholders' pro rata part of the company's income received since the last dividend payment.

Subsection (d) of section 42 of the bill amends section 852 (b) (2) (D) so that the rule presently stated therein does not apply to a municipal-bond fund meeting the requirement of section 851 (f). Thus, for the purpose of computing investment-company taxable income, section 852 (b) (2) (D) continues to allow the dividends-paid deduction to a regulated investment company which does not meet the requirements of section 851 (f). In computing the investment-company taxable income of a regulated investment company which meets the requirements of section 851 (f), no deduction is allowed for any distributions, since the taxable income of the company will not include interest which is exempt under section 103 (a) (1).

Subsection (e) of section 42 of the bill creates a new paragraph (4) under section 852 (b) of the 1954 Code to define "exempt-interest dividends" and to provide for the treatment of such dividends by shareholders. In defining the term "exempt-interest dividends," subparagraph (A) of new paragraph (4) adopts the general principles and requirements applicable under section 852 (b) (3) (C) in the case of a capital-gain dividend. Specifically, an exempt-interest dividend is defined as any dividend or part thereof paid by a regulated investment company and designated as such in a notice mailed to its shareholders not later than 30 days after the close of its taxable year, but only if the regulated investment company for that taxable year meets the requirements of section 851 (f). Capital-gains dividends are

specifically excluded from exempt-interest dividends. If the aggregate amount designated as exempt-interest dividends with respect to a taxable year of the company exceeds the investment-company taxable income for the taxable year (determined as provided in new sec. 852 (a) (1) (B)), the exempt-interest dividends shall be only that proportion of the amount so designated as the amount of the investment-company taxable income, for such taxable year, bears to the aggregate amount so designated. The aggregate amount so designated may include exempt-interest dividends paid after the close of the taxable year, as described in section 855.

Subparagraph (B) of new paragraph (4) of section 852 (b) provides that the shareholders of a regulated investment company which meets the requirements of section 851 (f) shall treat exempt-interest dividends (for all purposes of subtitle A) as an item of interest excludable from gross income under section 103 (a) (1). Among the purposes for which such exempt-interest dividend shall be considered interest excludable from gross income are—

(*a*) the determination of gross income and taxable income;

(*b*) the determination of distributable net income under subchapter J (trusts and estates);

(*c*) the allowance of, or calculation of the amount of, any credit or deduction; and

(*d*) the determination of the basis of any share of stock of the company.

Thus, the exempt-interest dividend cannot be used for purposes of the credit, the exclusion, or the deduction for dividends received under section 34, 116, or 243. Further, it is the intention of your committee that the earnings and profits of a municipal-bond fund shall be adjusted (for purposes of sec. 312) for distributions of exempt-interest dividends as if such dividends were not excludable from gross income of the shareholder.

Subsection (f) of section 42 of the bill makes two technical amendments to the code. First, it adds a new subsection (c) to section 103 of the 1954 Code to provide a cross-reference to the proposed section 852 (b) (4) (B). Secondly, it amends section 265 of the code (nondeductible expenses and interest relating to tax-exempt income) by adding a new paragraph 3, which denies a deduction for interest on indebtedness incurred or continued to purchase or carry stock of a regulated investment company for any period during which such company meets the requirements of section 851 (f).

Finally, subsection (g) of section 42 of the bill provides that the amendments made by this section shall apply only with respect to taxable years of regulated investment companies beginning after the date of the enactment of this bill.

SECTION 43. TRANSACTIONS IN REGULATED INVESTMENT COMPANY SHARES AROUND TIME OF DISTRIBUTING CAPITAL GAINS DIVIDENDS OR EXEMPT-INTEREST DIVIDENDS

This section of the bill, which corresponds to section 34 of the House bill, amends section 852 (b) of the 1954 Code to provide a rule in certain cases for losses on the sale or exchange of regulated investment company stock which the shareholder holds for less than 31 days.

Your committee changed section 34 of the House bill to impose restrictions comparable to the ones contained therein to shareholders who receive exempt-interest dividends from a regulated investment company which qualifies under section 851 (f).

Under your committee's bill (as under the House bill), if, with respect to any shares of a regulated investment company that a shareholder holds, he is required under section 852 (b) (3) (B) or (D) of the 1954 Code to treat any amount as a long-term capital gain, and if such share is held by the shareholder for less than 31 days, any loss on the sale or exchange of such share shall be treated as a long-term capital loss, but only to the extent of the amount that the shareholder is required to treat as a long-term capital gain by subparagraph (B) or (D) of section 852 (b) (3).

Your committee added subparagraph (B) to paragraph (5), which the bill adds to section 852 (b). Under your committee's amendment, if, with respect to any shares of a regulated investment company that a shareholder holds, he is required under section 852 (b) (4) (B) to treat any amount as an item of interest excludable from gross income under section 103 (a) (1), and if such share is held by the shareholder for less than 31 days, any loss on the sale or exchange of such share shall not be recognized, but, such nonrecognition extends only to an amount equal to the amount that the shareholder is required to treat as exempt income by subparagraph (B) of section 852 (b) (4).

For the purpose of determining the period for which any such share is held, your committee's bill (as did the House bill) provides that the rules of section 246 (c) (3) of the 1954 Code (as added by sec. 20 (a) of the bill) are made applicable except that 30 days is substituted for the number of days specified in such section 246 (c) (3).

The House bill provided that the amendment be made applicable with respect to taxable years ending after November 7, 1956, but only with respect to shares of stock acquired after November 7, 1956. Your committee kept the House provision but changed the effective date to December 31, 1957.

The operation of subparagraph (A) of proposed section 852 (b) (5) may be illustrated by the following example: M purchases a share of the XYZ regulated investment company on December 15, 1958, for $20 per share. The XYZ regulated investment company declares a capital-gain dividend to shareholders of record on December 31, 1958, of $2 per share. M therefore receives a check for $2 which he must treat as a gain from the sale or exchange of a capital asset held for more than 6 months. M sells his share of stock in the XYZ company on January 5, 1959, for $17.50. Prior to the enactment of this section, M would have realized a short-term capital loss of $2.50. Under the amendment made by section 43 of the bill, he must treat $2 of his loss (an amount equal to his capital gain dividend received on the stock) as a long-term capital loss and $0.50 as a short-term capital loss.

The operation of subparagraph (B) of proposed section 852 (b) (5) may be illustrated by the following example: N purchases a share of the ZYX regulated investment company on December 15, 1958, for $20 per share. For the taxable year 1958, the ZYX regulated investment company qualifies under section 851 (f) to distribute exempt-interest dividends. The ZYX regulated investment company declares

an exempt-interest dividend to shareholders of record on December 31, 1958, of $2 per share. N therefore receives a check for $2, which he must treat as an item of interest excludable from gross income under section 103 (a) (1). N sells his share of stock in ZYX on January 5, 1959, for $16.50. Prior to the enactment of this section, N would have a short-term loss of $3.50. Under the amendment made by section 43 of the bill, $2 of his loss (an amount equal to the exempt-interest dividend received on his stock) is not recognized. The remaining $1.50 is treated as a short-term capital loss.

SECTION 44. SPECIAL METHOD OF TAXATION FOR REAL ESTATE INVESTMENT TRUSTS

Section 44, for which there is no comparable provision of the House bill, amends subchapter M of chapter 1 of the code by adding a part II thereto which provides a special method of taxation for real estate investment trusts.

Section 856 (as proposed by this section) provides a definition of real estate investment trusts. In general terms, real estate investment trusts are defined as unincorporated trusts or associations meeting certain general requirements and, in addition, meeting a series of requirements as to amounts of various types of gross income. The general requirements include provisions that they be managed by one or more trustees, that beneficial ownership be evidenced by transferable shares or certificates of beneficial interest, and that they be a type of organization which would be taxed as an ordinary domestic corporation in the absence of the provisions of this new part II.

Proposed section 856 also provides that qualifying real estate investment trusts meet the following requirements:

(a) The beneficial ownership must at all times during the taxable year be held by 100 or more persons;

(b) The trust or association must be one which would not be a personal holding company (as defined in sec. 542) if all of its gross income constituted personal holding company income (as defined in sec. 543);

(c) The trust must elect to be treated as a real estate investment trust for the taxable year or must have made the election for a previous taxable year which began after December 31, 1957;

(d) The trust may not during the taxable year hold any property primarily for sale to customers in the ordinary course of its trade or business; and

(e) The trust must meet the gross income requirements of the new section 856 (b).

The first three of the above requirements are similar to conditions which must be met by regulated investment companies. The 100-or-more-persons ownership test is substantially the equivalent of a requirement which regulated investment companies must meet in complying with the Investment Company Act of 1940. The second test which must be complied with prohibits a trust which would be a personal holding company if all of its gross income were personal holding company income from qualifying under section 856. Under present law a personal holding company may not qualify as a regulated investment company.

The provision as to the election also is substantially the same as a provision applying at present to regulated investment companies.

The fourth requirement, that the trust not be holding property primarily for sale to customers in the ordinary course of its trade or business, is one of the provisions in the proposed amendment designed to make sure that the trust does not engage in an active business enterprise.

The income requirements imposed by proposed section 856 (b), all of which must be met by a qualifying real estate investment trust, are divided into four categories.

The first of these tests provides that 90 percent or more of a trust's gross income must be of the type provided if it is to qualify. The types of income which qualify for the 90-percent test are dividends, interest, rents from real property, gains from the sale or other disposition of stocks, securities, and real property (including interests in real property and interests in mortgages on real property), and abatements and refunds of taxes on real property. This provision corresponds to the present 90-percent test provided for regulated investment companies.

The second income test provided for real estate investment trusts is entirely new; there is no corresponding provision for the regulated investment companies. Under this test at least 60 percent of the trust's gross income must, in one manner or another, be derived from real property. The types of income within the 60 percent category include rents from real property, interest on obligations secured by mortgages on real estate, gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property), dividend or other distributions from other real estate investment trusts qualifying under this section, gains from the sale or other disposition of transferable shares (or certificates of beneficial interest) in such other qualifying real estate investment trusts, and abatements and refunds of taxes on real property.

The third and fourth income requirements are concerned with gains from the sale of property. The third test provides that the short-term gains on security sales must be less than 30 percent of the trust's gross income. This is computed by netting gains from sales or other dispositions of stock or securities held for less than 6 months against losses from such sales or other dispositions. This provision is similar, although not identical, to a provision in present law applying to regulated investment companies. The 30 percent in the case of the trust applies to sales of securities held for less than 6 months, while that for regulated investment companies applies to sales of securities held for less than 3 months. In addition, the percentage in the case of the trusts is applied only with respect to the extent that the short-term gains exceed the short-term losses, while the 30 percent test in the case of the regulated investment companies applies without the reduction for losses.

The fourth test applies a "less than 30 percent" limitation on the amount of gross income which may be derived from gains on the voluntary sale or other voluntary disposition of real property (including interests in real property and interests in mortgages on real property) held for less than 5 years. In this case also the 30 percent test is applied only to the gains in excess of losses. This, in conjunction with

the requirement that the trust must not hold any property primarily for sale to customers in the ordinary course of its trade or business, will give assurance of qualifying little if any income from trading in real estate except sales of investment property.

In the definition of rents from real property, your committee has made sure that transactions which might be considered active business operations are not given the conduit type of tax treatment accorded under this section. Consequently, "rents from real property" is defined as excluding amounts derived from real property if these amounts depend in whole or in part on the income or profits derived by any person from the property. This is provided to give assurance that no profit-sharing arrangement, provided for in the rental contract, will in effect make the trust an active participant in the operation of the property. Income from the operation of a store or a business property would, of course, be income derived from this property.

An exception to the general rule is provided for amounts based on a fixed percentage or percentages of receipts and sales since these are customary types of rental contracts and are not generally considered related to the profit or loss of the lessee. Generally speaking, therefore, rents received from real estate would not be disqualified solely by reason of the fact that the rent is based on a fixed percentage of total receipts or sales of the lessee (whether or not adjusted for such items as returned merchandise, or Federal, State, or local sales taxes). It is not intended to disqualify situations where the lease provides for differing percentages of receipts or sales from different departments or from separate floors of a retail store, for example, so long as each percentage is fixed at the time of entering into the lease. However, the fact that a lease is based upon a percentage of total receipts would not necessarily qualify the rent as "rent from real property." Thus, for example, rent would not qualify if the lease provides for a rental measured by varying percentages of receipts, and the arrangement does not conform with normal business practices where rental percentages are based on receipts, but is in reality used as a means of basing the rent on income or profits.

Still another restriction provided in the case of "rents from real property" excludes from the definition of that term amounts received from any person if the trust has an interest (directly or indirectly) of 10 percent or more in the business, assets, or profits of that person. In the case of a corporate payor, the definition excludes amounts as rent from real property if the trust owns (directly or indirectly) 10 percent or more of the total combined voting power of all classes of stock entitled to vote or 10 percent of the total number of shares of all classes of stock of the corporation.

It is provided that for the purpose of the above-mentioned restrictions, the rules prescribed by section 318 (a) (for determining the ownership of stock) shall apply in determining the ownership of stock, business, assets, or net profits of any person. For purposes of applying the section 318 (a) rule, paragraph (2) (C) of such section shall be applied without regard to the 50-percent limitation contained therein. This prevents the avoidance of the restrictions described above with respect to rents from real estate through the device of setting up a related organization. It also forecloses the opportunity of any substantial relationship between the trust and the business of any tenant.

Finally, rents from real property also does not include any amount received or accrued with respect to any real property if the trust or association furnishes or renders services to the tenants thereof or manages or operates such property other than through an independent contractor from whom the trust or association itself does not derive or receive any income. Thus, if the trust or association does furnish any services to the tenants of the property, all of the amounts received as rent from such property must be excluded from the term "rents from real property."

The amendment provides (in proposed sec. 857) the conduit type of tax treatment in the case of a real estate investment trust which distributes at least 90 percent of the amount by which its real estate investment trust taxable income for the taxable year exceeds the sum of its net long-term and net short-term capital gains for such year. Any amount in excess of the 90 percent which the trust retains, however, is subject to the regular corporate income tax.

The beneficiaries of the trust in general will continue to be taxed in the same manner as ordinary dividend recipients. The excess of the net long-term capital gain over the net short-term capital loss of the trust, however, to the extent it is distributed is free of tax at the trust level and at the shareholder level is taxed as long-term capital gain rather than as an ordinary dividend. This treatment corresponds to the treatment accorded to the distributed capital gains of regulated investment companies. The net long-term capital gains retained by the trust are, however, taxable to such trusts as provided in section 857 (b) (3) (A). In addition, the amendment provides a limitation on the loss on the sale or exchange of stock (or shares of beneficial ownership) of a real estate investment trust held for less than 31 days where the shareholder (etc.) receives a capital gain dividend from such trust. This limitation is similar to the limitation found in section 852 (b) (5) (A), as added by section 43 (a) of this bill.

Where more than 25 percent of the gross income of the real estate investment trust is from rents, interest, or other nondividend income, the trust beneficiary is to treat as a dividend only that portion of the dividend payment he receives which corresponds to the percentage of the trust's gross income which was attributable to dividends. Any amount not treated as a dividend to the beneficiary would not be eligible for the dividends received credit, exclusion or deduction, but would be taxed as ordinary income to the recipient. If the interest and other nondividend income is 25 percent or less of the trust's total gross income, the entire distribution to the beneficiary (exclusive of capital gains dividends) is treated as if it were the receipt of an ordinary dividend and eligible for dividends received credit, exclusion, or deduction.

The treatment outlined above for real estate investment trusts is substantially that now provided in the case of regulated investment companies, although it should be noted that the differences include some variations in the treatment of undistributed capital gains and the foreign tax credit.

Proposed section 859, relating to dividends paid after the close of the taxable year, is substantially the same as section 855 of the 1954 Code except that no provision is made for the foreign tax elec-

tion because such election is not available to a real estate investment trust.

The amendments made by section 44 are applicable only to taxable years of real estate investment trusts beginning after December 31, 1957.

SECTION 45. TAX ON NONRESIDENT ALIENS

This section of the bill, which is identical with section 35 of the House bill, amends section 871 (a) and section 1441 of the 1954 Code so as to make amounts described in section 403 (a) (2) of the 1954 Code which are considered to be gains from the sale or exchange of capital assets subject to tax and withholding under those sections.

Section 871 of the 1954 Code corresponds to section 211 of the 1939 Code but contains several new provisions, including one pursuant to which a nonresident alien individual not engaged in trade or business within the United States (even though not present in the United States during the taxable year) is subject to a tax of 30 percent upon amounts received from sources within the United States which are described in section 402 (a) (2) of the 1954 Code and are considered to be gains from the sale or exchange of capital assets. Section 402 (a) (2) relates to gain recognized on certain distributions by a qualified employees' trust where the total distributions, with respect to any employee, are payable to the distributee within 1 taxable year. The amounts so considered to be capital gains were also made subject to withholding of tax at source under the provisions of section 1441 (b) and (c) (5) of the 1954 Code.

While the above-cited lump-sum distributions under a so-called trusteed employee pension plan were made subject to tax under section 871 (a) when received by a nonresident alien individual not engaged in trade or business within the United States, the lump-sum payments made to such an individual pursuant to a so-called insured employee pension plan were not made subject to tax under section 871 (a), nor were they made subject to withholding of tax at source under section 1441 (b) and (c) (5).

Subsection (a) of section 45 of the bill amends section 871 (a) (1) of the 1954 Code by adding to the items which are subject to the 30 percent tax amounts described in section 403 (a) (2) which are considered to be gains from the sale or exchange of capital assets. This amendment is to apply to taxable years ending after the date of the enactment of the bill.

Subsection (b) of section 45 of the bill amends section 1441 (b) and (c) (5) of the 1954 Code in order to make amounts described in section 403 (a) (2) which are considered to be gains from the sale or exchange of capital assets subject to withholding in the same manner as the amounts described in section 402 (a) (2) are subject to withholding under section 1441. These amendments to section 1441 are to take effect on the day following the date of the enactment of the bill.

SECTION 46. CREDITS FOR DIVIDENDS RECEIVED AND FOR PARTIALLY TAX-EXEMPT INTEREST IN CASE OF NONRESIDENT ALIENS

This section of the bill is the same as section 36 of the House bill, except that the effective date has been changed so that the amendments made by this section shall apply only with respect to taxable years beginning after December 31, 1957.

Minimum tax

Section 871 (a) of the 1954 Code imposes a tax of 30 percent of the gross amount of certain items of income received by nonresident alien individuals not engaged in trade or business within the United States. This tax is imposed in lieu of the regular individual income tax imposed by section 1. If the aggregate amount of those items exceeds $15,400, then, in accordance with section 871 (b), the alien is subject to the regular income tax imposed by section 1, but in no case may the tax so imposed be less than the 30-percent tax which would otherwise be imposed under section 871 (a). Thus, when section 871 (b) (3) applies for the taxable year, the tax is 30 percent of the gross amount of those items received during that year, even though that amount exceeds $15,400. In such instance, the alien is subject to tax in the same manner as in the case of the alien whose tax is imposed under section 871 (a).

However, a nonresident alien individual whose tax is determined in accordance with section 871 (b) (3) is now entitled to both the dividends-received credit and exclusion, since, under the provisions of sections 34 (e) and 116 (d) of the 1954 Code, the credit and exclusion are disallowed only in the case of "a nonresident alien individual with respect to whom a tax is imposed for the taxable year under section 871 (a)."

Subsection (a) of section 46 of the bill strikes out the present section 871 (b) (3) of the 1954 Code and substitutes therefor a provision pursuant to which, in a case where the aggregate amount received exceeds $15,400, the tax payable will be the 30-percent tax imposed by section 871 (a) if the tax otherwise imposed by section 1 or section 1201 (b), minus the sum of the credits against tax allowable under sections 34 and 35, is less than an amount equal to such 30-percent tax.

Amendments to sections 34 (e) and 116 (d) of the 1954 Code are unnecessary, since they now deny the dividends-received credit and exclusion when the tax for the taxable year is imposed under section 871 (a). Thus, in determining the tax payable under section 1 or section 1201 (b) pursuant to the provisions of section 871 (b), both the credit and exclusion will be allowed, but, if the tax liability determined in such manner (and also by taking into account the credit allowed under sec. 35 for partially tax-exempt interest) is less than 30 percent of the sum of the aggregate amounts received from the sources specified in section 871 (a) (1) and the amount of capital gains determined under section 871 (a) (2), such 30 percent being determined without regard to the dividends-received exclusion, then the tax will not be imposed by section 1 or section 1201 (b) but will be imposed by section 871 (a) even though the aggregate amount received exceeds $15,400. Because of the application of sections 34 (e) and 116 (d), the dividends-received credit and exclusion will not be allowed against, or in computing, the tax so imposed by section 871 (a).

The proposed addition to section 871 (b) provides that, for purposes of that subsection, the expression "aggregate amount received from the sources specified in subsection (a) (1)" is to be applied without any exclusion under section 116 in respect of dividends received. Thus, the exclusion will not be taken into account in determining whether the aggregate amount received exceeds $15,400 for purposes of determining whether section 871 (b) applies, nor will the exclusion apply when determining the 30-percent limitation under that subsection.

Credit for partially tax-exempt interest

Section 35 of the 1954 Code allows a credit against the income tax of any individual in respect of partially tax-exempt interest. Subject to specified limitations, the credit is equal to 3 percent of the amount of the interest included in gross income. A nonresident alien individual not engaged in trade or business within the United States is now entitled to the credit allowed by this section even though his tax for the taxable year is the 30-percent tax which is imposed either because of the application of section 871 (a), when the total income is not more than $15,400, or because of the application of section 871 (b) (3), when the total income exceeds $15,400.

Under the bill, the credit for partially tax-exempt interest is to be treated in the same manner as the dividends-received credit will be treated. To accomplish this objective, in addition to the changes made in section 871 (b) of the 1954 Code, it is also necessary to amend section 35 by adding thereto a new subsection (c) which provides that the credit for partially tax-exempt interest shall not be allowed to a nonresident alien individual with respect to whom a tax is imposed for the taxable year under section 871 (a). Thus, the credit under section 35 will never be allowed when the tax is imposed under section 871 (a), even in a case where the aggregate amount received exceeds $15,400. The credit under section 35 (as well as the credit under sec. 34) will always be allowed when the tax is imposed under section 1 or 1201 (b) pursuant to the application of section 871 (b); if the tax liability so obtained, however, is less than the 30-percent limitation of section 871 (b), then the provisions of section 871 (b) do not apply and the tax is imposed for the taxable year under section 871 (a) regardless of the amount of income involved.

Effective date

The amendments made by this section apply only with respect to taxable years beginning after December 31, 1957.

SECTION 47. BASIS OF PROPERTY ACQUIRED BY GIFT

This section for which there is no corresponding provision in the House bill amends section 1015 of the 1954 Code by adding a new subsection (d) thereto. Under the present operation of section 1015 the basis of property acquired by gift after December 31, 1920, is the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. However, if such basis (adjusted for the period before the date of the gift as provided in sec. 1016 for depreciation, depletion, capital expenditures, etc.) is greater than the fair market value of the property at the time of the gift, then for purposes of determining loss the basis is such fair market value.

Section 1015 (d) (1) (A), as added by your committee, will increase the basis of property acquired by gift on or after the date of enactment of the bill by the amount of the gift tax paid under chapter 12 of the 1954 Code in connection with the making of the gift. However, any increase in basis resulting from the application of section 1015 (d) (1) (A) cannot increase the basis of the property above the fair market value of the property at the time the gift is made. Therefore, if the adjusted basis of such property in the hands of the donor as of the time

of the gift is an amount in excess of the fair market value of the property at that time, the provisions of section 1015 (d) (1) (A) will have no effect on the basis of the property in the hands of the donee.

Section 1015 (d) (1) (B), as added by your committee, will increase the basis of property acquired by gift before the date of enactment of the bill by the amount of the gift tax paid under chapter 12 of the 1954 Code or the corresponding provisions of prior law in connection with the making of the gift, provided the property has not been sold, exchanged, or otherwise disposed of before that date. However, any increase in basis resulting from the application of section 1015 (d) (1) (B) cannot exceed an amount equal to the amount by which the fair market value of the property at the time of the gift exceeded the basis of the property in the hands of the donor at the time of the gift.

No increase in basis is allowed under section 1015 (d) unless the gift tax actually is paid. However, when such gift tax is paid, any increase in basis under section 1015 (d) (1) (A) resulting therefrom relates back to and is effective as of the date of the gift, and any increase in basis under section 1015 (d) (1) (B) resulting therefrom is effective as of the date of enactment of the bill.

In order to determine the amount of the increase in basis under section 1015 (d), it is necessary to ascertain the amount of gift tax paid with respect to the gift. For this purpose the amount of gift tax paid with respect to the gift is determined in the same manner in which the amount of gift tax paid in respect of such a gift would be determined for purposes of the credit against the estate tax which is authorized by section 2012 of the 1954 Code or the corresponding provisions of prior law for gift tax paid in respect of property included in the gross estate. Under such method where more than one gift of a present interest in property is made to the same donee during a calendar year, the annual exclusion applies to the first of such transfers made in point of time. Similarly, where the donor and his spouse elect under section 2513 of the 1954 Code or the corresponding provisions of prior law to have the gifts made by the donor considered as made one-half by each, for purposes of the increase in basis authorized by section 1015 (d), the amount of gift tax paid with respect to the gift is the sum of the amounts of tax (computed separately) paid with respect to each half of the gift by the donor and his spouse.

It is immaterial whether the gift tax is paid by the donor or by the donee. Furthermore, regardless of who pays the tax, any increase in basis under section 1015 (d) will, for purposes of section 1016 (b) (pertaining to adjustments to a substituted basis), be treated as an adjustment under section 1016 (a) to the property in the hands of the donee.

The application of section 1015 (d) may be illustrated by the following examples:

Example (1).—A purchased property for $100,000. On January 1, 1959, at which time it has an adjusted basis of $60,000 in his hands, A gives the property to B. The fair market value of the property at the time of the gift to B is $78,000. A pays gift tax in the amount of $15,000 on the gift. The basis for the property in the hands of B, immediately after the gift, both for gain or loss on the sale of the property is $75,000 ($60,000, A's adjusted basis, plus $15,000 gift tax

paid on the gift). It should be noted that for purposes of section 1016 the increase of $15,000 is treated as an adjustment to the basis in the hands of B as if B had made capital additions to the property of $15,000.

Example (2).—The facts are the same as in example (1), with the following additional facts. On January 1, 1960, when the property has a fair market value of $80,000, and an adjusted basis in the hands of B of $72,500 (B being allowed depreciation of $2,500 for 1959), B gives the property to C. Gift tax of $9,000 is paid on the transfer. If an increase in the basis were allowed for the full amount of the gift tax, the basis of the property in C's hands would be $81,500 ($72,500, B's adjusted basis, plus $9,000 gift tax). However, since such amount exceeds $80,000, the fair market value of the property at the time of the gift, the adjusted basis of the property in C's hands (both for gain or loss on the sale of the property) immediately following the making of the gift, is limited to $80,000.

Example (3).—Property was given by D to E on June 1, 1935, at which time it had a fair market value of $20,000 and a basis in the hands of D of $5,000. D paid gift tax of $4,000 on the transfer. On December 25, 1950, E gave the property to F who still held it on the date of enactment of the bill. The value of the property on the date of the gift to F was $30,000 and E paid gift tax of $7,500 on the transfer. Since the property was not sold, exchanged, or otherwise disposed of by F before such date of enactment and the gift tax paid on the transfer to F did not exceed $25,000 ($30,000, fair market value of property at time of gift to F, less $5,000, basis of property in E's hands at that time), the basis of the property in his hands is increased on the date of enactment by $7,500, the amount of gift tax paid by E on the transfer. No increase in basis is allowed for the $4,000 gift tax paid by D on the transfer to E since E had sold, exchanged, or otherwise disposed of the property before the date of enactment of the bill.

SECTION 48. PROPERTY ACQUIRED IN TAX-FREE EXCHANGE

Basis

Section 48 (a) of the bill, which is identical with section 38 (a) of the House bill, amends section 1031 (d) of the 1954 Code (relating to basis of property acquired in certain nontaxable exchanges) in order to provide the prop'r basis adjustment where loss is recognized in transactions which are partially within and partially without the nonrecognit'on provisions of sections 1031 (a) (exchanges solely in kind), 1035 (a) (certain exchanges of insurance policies), or 1036 (a) (stock for stock of same corporation).

Section 1031 (d) corresponds in part to section 113 (a) (6) of the 1939 Code. Section 113 (a) (6) contained the general rule that the basis of property acquired in certain nontaxable exchanges shall be the same as that of the property exchanged, decreased in the amount of any money received and increased in the amount of gain or decreased in the amount of loss recognized upon the exchange. Section 1031 (d) does not provide for adjustment in the amount of recognized loss. However, a loss may be recognized if nonqualified property is transferred together with qualified property, and this loss must be reflected in determining the basis of the property received.

This may be illustrated by the following example: A taxpayer exchanges an apartment building with an adjusted basis of $100,000, and a fair market value of $150,000, plus shares of stock with a basis of $60,000 and a fair market value of $50,000, for an apartment building with a fair market value of $200,000. Since the exchange of the stock in part consideration for the apartment building is not within the provisions of section 1031, the taxpayer has a recognized loss of $10,000.

Under the present language of section 1031 (d), if the transaction described above is not separated, for purposes of computing basis, into the nontaxable portion (as to which basis is determined under sec. 1031 (d)) and the taxable portion (as to which basis is determined under sec. 1012), it could be argued that the basis of the property received in the above example would be $160,000, the basis of the property transferred. The correct basis of the property received is $150,000, the basis of the property transferred decreased by the $10,000 loss recognized. This amendment adds the phrase "or decreased in the amount of loss" to section 1031 (d), thereby making it unnecessary to compute the basis of the property received by reference to two different basis provisions.

Clerical amendment

Section 48 (b) of the bill, which is identical with section 38 (b) of the House bill, makes a clerical amendment to change the word "paragraph" to "subsection" in section 1031 (d) of the code.

Effective date

Under section 1 (c) of the bill, the amendments apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SECTION 49. INVOLUNTARY CONVERSIONS

Section 49 of the bill, which is identical with section 39 of the House bill, amends section 1033 (a) (2) of the 1954 Code (relating to involuntary conversions) to provide expressly that the term "control" for purposes of section 1033 (a) (2) and (3) means the ownership of 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 the corporation.

Under the 1939 Code, "control" for purposes of section 112 (f), the counterpart of section 1033 of the 1954 Code, was specifically defined in terms of the 80 percent test. This was accomplished in section 112 (h), which defined control for purposes of section 112. However, these provisions have been rearranged in the 1954 Code so that the counterpart of 112 (h) is section 368 (c) of the 1954 Code, which by its terms does not apply to section 1033. Inadvertently, no definition of "control" was prescribed in section 1033.

This amendment makes clear that the 80 percent test is still applicable for purposes of the involuntary conversion provisions.

Under section 1 (c) of the bill the amendment is applicable to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SECTION 50. CONDEMNATION OF REAL PROPERTY HELD FOR PRODUCTIVE USE IN TRADE OR BUSINESS OR FOR INVESTMENT

This section, for which there is no corresponding provision in the House bill, amends sections 1033 and 1034 of the 1954 Code.

Under present section 1033, in order to avoid recognition of gain on an involuntary conversion of property, the property must be converted into property that is similar or related in service or use to the converted property or, within a prescribed period of time, replaced either with such similar property or with stock resulting in the acquisition of control of a corporation owning such similar property.

Subsection (a) of this section of the bill amends section 1033 to provide a special rule, which applies in addition to existing rules, in cases where real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment is compulsorily or involuntarily converted as a result of its seizure, requisition, or condemnation, or threat or imminence thereof. In such cases the nonrecognition of gain provided for in section 1033 will apply if the property is converted into or, within the prescribed period of time, replaced by, property of a like kind to be held either for productive use in trade or business or for investment. For this purpose the term "like kind" shall have the same meaning as it has in section 1031 of the 1954 Code.

This special rule does not apply to the purchase of stock in the acquisition of control of a corporation described in section 1033 (a) (3) (A). Therefore, the rule of existing law (which requires that the corporation must own property similar or related in service or use) will apply in all cases where a taxpayer wishes to satisfy the replacement requirements of section 1033 through the purchase of stock.

The amendment to section 1033 applies only if the disposition of the converted property occurs after December 31, 1957.

Subsection (b) of this section of the bill amends section 1034 (i) of the 1954 Code to provide that for purposes of section 1034, the seizure, requisition, or condemnation of property, or sale or exchange of property under threat or imminence thereof, if occurring after December 31, 1957, shall, at the election of the taxpayer, be treated as the sale of such property. The election shall be made at such time and in such manner as the Secretary or his delegate shall prescribe by regulations.

SECTION 51. PROPERTY ACQUIRED BEFORE MARCH 1, 1913

Section 51, which is identical with section 40 of the House bill, amends section 1053 of the 1954 Code (relating to the basis of property acquired before March 1, 1913). Section 1053 (which corresponds to sec. 113 (a) (14) of the 1939 Code) erroneously refers to basis determined under part IV of subchapter O of chapter 1 of the 1954 Code instead of referring to subtitle A of the 1954 Code. This amendment supplies the correct reference.

SECTION 52. POSTPONEMENT OF GAIN FROM SALE OR EXCHANGE TO EFFECTUATE FEDERAL COMMUNICATIONS COMMISSION POLICIES

Requirement of change of policy

Section 52 (a) of the bill, which is identical with section 41 (a) of the House bill, amends section 1071 (a) of the 1954 Code (relating to nonrecognition of gain or loss from sale or exchange to effectuate policies of the Federal Communications Commission). Under the amendment, section 1071 (a) will apply only if the sale or exchange is certified by the Commission to be necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the Commission.

Effective date

The amendment made by section 52 (a) of the bill applies with respect to any sale or exchange after December 31, 1957.

SECTION 53. CASUALTY LOSSES SUSTAINED UPON CERTAIN UNINSURED PROPERTY

This is a new section for which there was no corresponding section in the House bill.

This section amends section 1231 (a) of the 1954 Code by making it inapplicable to any loss in respect of which the taxpayer is not compensated by insurance in any amount if the loss arose from fire, storm, shipwreck, or other casualty, or from theft, and the loss occurred with respect to property used in the trade or business or a capital asset held for more than 6 months and held for the production of income.

Under section 1231, uninsured casualty losses on depreciable property or real estate used in the trade or business or on capital assets must be aggregated with various other types of section 1231 gains and losses. If, in a particular taxable year, the recognized gains on sales or exchanges of section 1231 property plus the recognized gains from involuntary conversions of such property and capital assets held for more than 6 months exceed the recognized losses from such sales, exchanges, and conversions, the net gain is in effect treated as a longterm capital gain subject to reduced rates of taxation. If the losses exceed the gains, the net loss is in effect treated as an ordinary loss deductible from income from other sources. Consequently, whether an uninsured casualty loss will be deducted in whole or in part against ordinary income or against gains subject to capital gain rates will depend on the overall gain or loss position of the taxpayer under section 1231 for the taxable year.

Your committee has provided this section to separate certain uninsured casualty losses from the computation of section 1231 gain or loss, but only with respect to property used in the trade or business and capital assets held for the production of income which have been held more than 6 months. The amendment applies with respect to, for example, loss incurred as the result of the destruction of a taxpayer's oil tanks which he used for oil storage in his trade or business, but on

which he was unable to obtain insurance. On the other hand, the amendment does not apply to loss arising from the destruction or theft of the taxpayer's uninsured personal automobile. The amendment is intended to benefit business taxpayers who, because of the special hazards of their business or for other reasons, carry their own insurance. As compared with business taxpayers who carry insurance with outside insurance companies and can deduct the net premium costs of such insurance as ordinary business expense, the self-insured taxpayer cannot deduct amounts set aside in reserves to cover the contingency of a casualty loss. In the eventuality of such loss, it may be recognized as a capital rather than an ordinary loss deduction, depending on the overall gain or loss position of the taxpayer in the particular taxable year. Under this amendment, net gains with respect to section 1231 property continue to be treated as capital gains, but the casualty losses to which the amendment applies are fully deductible against ordinary income under section 165 of the 1954 Code.

The amendment made by this section is to apply with respect to taxable years begining after December 31, 1957.

SECTION 54. BONDS ISSUED AT DISCOUNT

This section, which corresponds to section 42 of the House bill, amends section 1232 (a) of the 1954 Code, relating to bonds and other evidences of indebtedness.

Under section 1232 (a) (2) (A), in the case of the sale or exchange of bonds or other evidences of indebtedness which are issued with an "original issue discount," any gain realized, to the extent it does not exceed an amount which bears the same ratio to the "original issue discount" as the number of complete months that the bond or other evidence of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity, is to be considered as gain from the sale or exchange of property which is not a capital asset.

Under the amendment made by section 42 (a) of the House bill, any gain realized, to the extent it does not exceed an amount equal to the "original issue discount," is to be considered as gain from the sale or exchange of property which is not a capital asset. The amendment was to be effective for taxable years ending after November 7, 1956, but only with respect to dispositions of bonds after that date.

Your committee has adopted a provision applying the House rule only where the taxpayer is unable to make a reasonable showing that there was no collusion involved in connection with the original issuance of the particular bond. To do this, your committee has provided that, to the extent of the "original issue discount," ordinary income will be realized from the disposition of a bond or similar property at a gain unless there was, at the time of original issue, no intention to call the particular bond at an early call date. Where there was no such intention, the rule which is in the present provisions of section 1232 (a) is to be applied.

The taxpayer acting in good faith should have little difficulty in showing facts which adequately negative the possibility of collusion, although your committee realizes that this may often necessitate demonstrating the lack of collusion by indirect evidence. For ex-

ample, the fact that the issue price and term of the bond appear to be reasonable, taking into account the interest rate, if any, on the bond, for a corporation in the financial condition of the issuer at the time of issue should be given considerable weight in negativing the likelihood of a collusive arrangement. Furthermore, the fact that the taxpayer and the corporation are not related within the meaning of section 267 (b) and have not engaged in transactions with each other (other than concerning the bond) is entitled to very great weight in the taxpayer's favor for the purpose of showing that there was no intention, at the time of issue, to have the particular bond called early. Other circumstances which strongly tend to negative a collusive intention to call the particular bond early are (1) the lack of relationship and transactions between the taxpayer and the officers and directors of the issuing corporation, and (2) the fact that the officers and directors of such corporation at the time of issue of the bond are different than those in control at the time the bond is called or the taxpayer disposes of it.

On the other hand, your committee realizes that a showing of a lack of intent, at the time of issue, to call a particular bond early may also be shown directly in some cases. In addition, your committee believes that whether or not the bond is issued with provisions for calling it early on its face is of no particular significance in itself in making a satisfactory showing with respect to the absence of an intention to call it early.

Your committee has also changed the effective date of this section of the bill by making it effective with respect to taxable years ending after December 31, 1957, but only as to dispositions made after that date.

SECTION 55. BONDS WITH COUPONS DETACHED

This section, except for changes in the dates of purchase which determine whether section 1232 (c) (1) or section 1232 (c) (2) applies to gain on the sale of certain bonds, is identical with section 43 of the House bill.

Section 55 of the bill amends section 1232 (c) of the 1954 Code (relating to bonds with excess number of coupons detached). At present, section 1232 (c) does not apply unless coupons maturing more than 12 months after the date of purchase are detached. The amendment provides that bonds purchased after December 31, 1957, with any unmatured coupons detached, if subsequently sold at a gain, shall be considered to give rise to ordinary income to the extent that the gain realized does not exceed the excess of the fair market value (determined as of the time of purchase) of the bonds with all coupons attached over the purchase price of the bonds. As under existing section 1232 (c), the date of issue of the bonds is immaterial for this purpose.

In addition to the change in section 1232 (c) explained above, two clarifying changes have been made. The first of these is the insertion of a parenthetical expression which makes it clear that the provision also applies to gain realized by a person whose basis is determined by reference to the basis of the bond in the hands of a purchaser who acquired it with unmatured coupons detached.

The other clarifying change is the replacement of the word "retirement" in the latter part of the subsection with the words "sale or

exchange." The effect of this change is to clarify the applicability of section 1232 (c), as it was not intended to be limited to gain upon the retirement of an obligation. Since section 1232 (a) (1) provides in effect that retirement shall be deemed an exchange, the words substituted for the word "retirement" make subsection (c) applicable whether gain arises from the sale, exchange, or retirement of an obligation.

A change has been made in the heading for the subsection consistent with the amendments proposed.

Under section 1 (c) of the bill, the amendment made by section 55 of the bill is to apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SECTION 56. SHORT SALES

This section, which corresponds to section 44 of the House bill, amends section 1233 of the 1954 Code, relating to gains and losses from short sales.

Under present law, as the result of section 1233 (a) of the code, the special holding period provisions of section 1233 (b) are not applicable to a short sale which is closed with property which is not a capital asset. In the case of a dealer in stock who closes a short sale with stock held for sale to customers, the holding period of substantially identical stock which he holds as an investment (rather than for sale to customers) is not affected, unlike the holding period of similar stock held by an ordinary investor.

Subsection (a) of the House bill added a fourth paragraph to section 1233 (e) to provide that in the case of a dealer in securities who sells a security short and closes such sale more than 20 days later, the holding period of substantially identical property which he has held in his investment portfolio for less than 6 months shall be considered to begin on the date of the closing or the date on which he disposes of the substantially identical property, whichever occurs first. In addition, the paragraph provided that the last sentence of section 1233 (b), providing that an option to sell at a fixed price is a short sale and that the exercise or failure to exercise such an option is a closing of a short sale, was to apply in determining whether or not a dealer had made a short sale. Your committee has rewritten this subsection to restrict its application to stock, but including not only shares or certificates of stock, but also bonds convertible into stock and any evidences of interests in, or rights to subscribe to or purchase, stock or convertible bonds.

Subsections (b) and (c), except for the change in the effective date, are identical with the corresponding provisions of the House bill.

Subsection (b) of section 56 of this bill adds a new subsection (g) to section 1233 of the code to exclude hedging transactions in commodity futures from the operation of section 1233 entirely. Section 1233 (a) now excludes such hedging transactions from the rule of that subsection, which provides for capital gain or loss treatment if the property used to close a short sale is a capital asset in the hands of the taxpayer.

Your committee has changed the effective date provision relating to section 1233 (e) (4) to short sales made after December 31, 1957, instead of October 24, 1956, as provided in the House bill. The

clarifying amendment of subsection (b), of course, has the same effective date as the bill generally.

SECTION 57. OPTIONS TO BUY OR SELL

This section is identical with section 45 of the House bill. It arranges section 1234 of the 1954 Code (relating to options to buy or sell) into three subsections. The new subsection (a) provides the general rule that gain or loss attributable to the sale or exchange of a privilege or option to buy or sell property (or loss attributable to failure to exercise such a privilege or option) shall be treated as gain or loss from the sale or exchange of property which has the same character as the property to which the privilege or option relates has in the hands of the taxpayer, or would have in the hands of the taxpayer if acquired by him.

The new section 1234 (b) provides that, for purposes of the new section 1234 (a), if loss is attributable to failure to exercise a privilege or option, the privilege or option is to be deemed to have been sold or exchanged on the day it expired. This is merely a rearrangement of existing law.

The new section 1234 (c) provides for exceptions to the application of section 1234.

(1) The section is not to apply to a privilege or option which constitutes property described in paragraph (1) of section 1221 of the 1954 Code (relating to stock-in-trade, etc.).

(2) The section is not to apply, in the case of gain attributable to the sale or exchange of a privilege or option, to any income derived in connection with such sale or exchange which (without regard to sec. 1234) is treated as other than gain from the sale or exchange of a capital asset. Under this exception, for example, to the extent that gain on the sale or exchange of an option to purchase stock is in the nature of compensation to an employee, such gain is not to be treated as capital gain merely because the stock, if acquired, would be a capital asset in his hands. Similarly, section 1234 does not apply to the extent that the option is treated as section 306 stock the disposition of which would result in ordinary income. A third example of the application of the new section 1234 (c) (2) is that, by reason of this paragraph, section 1234 is not to apply to the extent that gain is a distribution of earnings and profits taxable as a dividend.

(3) This section is not to apply to a loss attributable to failure to exercise an option described in section 1233 (c) of the 1954 Code (relating to certain short-term, fixed-price options to sell). This exception to the application of section 1234 is contained in the existing provisions of section 1234.

(4) This section is not to apply to gain attributable to the sale or exchange of a privilege or option acquired by the taxpayer before March 1, 1954, if such privilege or option is a capital asset in the hands of the taxpayer. It will be noted that this exception deals only with gain, and does not apply to losses.

Under section 1 (c) of the bill, the amendment made by section 57 of the bill is to apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SECTION 58. SALE OR EXCHANGE OF PATENTS

This section of the bill, which corresponds to section 46 of the House bill, amends section 1235 of the 1954 Code (relating to the sale or exchange of patents). The House bill provided that, for purposes of section 1235, section 267 (c) should be treated as defining the family of an individual to include only his spouse, ancestors and lineal descendants and that the phrase "50 percent or more" in section 267 (b) should be changed wherever it appeared to "25 percent or more." Your committee bill eliminates the latter provision of the House bill, but retains the former provision.

Section 1235 (a) of the 1954 Code provides, in certain cases, that a transfer of rights to a patent is to be considered the sale or exchange of a capital asset held for more than 6 months. Section 1235 (d) provides that section 1235 (a) is not to apply to any sale or exchange between an individual and any other related person (as defined in section 267 (b) of the 1954 Code), except brothers and sisters, whether by the whole or half blood. Section 267 (b) of the 1954 Code refers to members of a family (as defined in section 267 (c) (4)), to certain corporations more than 50 percent in value of the outstanding stock of which is owned (directly or indirectly) by or for the same person, and to certain other persons. Section 267 (c) (4) (relating to constructive ownership of stock) provides that the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendents.

Under the amendment made by section 58 of the bill, section 1235 (d) provides that section 1235 (a) shall not apply to any transfer, directly or indirectly, between persons specified within any one of the paragraphs of section 267 (b). However, in applying section 267 (b) and (c) for purposes of section 1235, paragraph (4) of section 267 (c) is to be treated as providing that the family of an individual is to include only his spouse, ancestors, and lineal descendants.

Under section 1 (c) of the bill, the amendment made by section 58 of the bill is to apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SECTION 59. REAL PROPERTY SUBDIVIDED FOR SALE

This section is identical with section 47 of the House bill.

Section 1237 (a) (1) of the 1954 Code (relating to real property subdivided for sale) was intended to deny the benefits of the section both in the case of real property which had previously been held by the taxpayer for sale to customers and in the case of real property sold or exchanged in the same taxable year in which the taxpayer holds other real property for sale to customers. To make this clear, section 59 of the bill amends section 1237 (a) (1) to replace the disjunctive word "or" by the conjunctive word "and".

SECTION 60. GAIN FROM SALE OF CERTAIN PROPERTY BETWEEN SPOUSES ETC.

This section, which is identical with section 48 of the House bill, provides that section 1239 of the code shall apply only with respect to gain arising from a sale or exchange made after May 3, 1951.

Section 1239 of the 1954 Code (relating to gain from sale of certain property between spouses or between an individual and a controlled corporation) continues without substantive change section 117 (o) of the 1939 Code. However, section 117 (o) was made applicable by section 328 (b) of the Revenue Act of 1951 only with respect to sales or exchanges made after May 3, 1951. The amendment made by section 60 of the bill makes it clear that section 1239 of the 1954 Code applies only to gain arising from a sale or exchange made after May 3, 1951.

SECTION 61. SMALL BUSINESS INVESTMENT COMPANIES

This section of the bill, for which there is no corresponding provision in the House bill, provides special rules with respect to losses on the stock of small business investment companies operating under the Small Business Investment Act of 1958 and with respect to losses of, and dividends received by, such companies.

Subsection (a) of section 61 amends part IV of subchapter P of chapter 1 of the 1954 Code, which part contains special rules for determining capital gains and losses, by adding at the end thereof new sections 1242 and 1243.

The new section 1242 provides that if a loss is on stock of a small business investment company operating under the Small Business Investment Act of 1958, and such loss would (but for the provisions of new sec. 1242) be a loss from the sale or exchange of a capital asset, then such loss shall be treated as a loss from the sale or exchange of property which is not a capital asset. Thus, the new section 1242 provides ordinary loss treatment on the stock of small business investment companies for losses which would otherwise be considered capital losses. Any amount of such loss treated by reason of section 1242 as a loss from the sale or exchange of property which is not a capital asset is treated, for purposes of section 172 of the code, which relates to the net operating loss deduction, as a loss attributable to a trade or business of the taxpayer. Accordingly, section 172 (d) (4), relating to nonbusiness deductions of taxpayers other than corporations and limiting the effect of such deductions in the computation of the net operating loss to be carried back or forward to other years, is rendered inapplicable to such losses.

The new section 1243 provides that if a small business investment company incurs a loss on convertible debentures acquired pursuant to section 304 of the Small Business Investment Act of 1958, and such loss would (but for sec. 1243) be a loss from the sale or exchange of a capital asset, then such loss shall be treated as a loss from the sale or exchange of property which is not a capital asset. Convertible debentures, for purposes of section 1243, include stock received pursuant to a conversion privilege.

Subsection (b) of section 61 amends section 243 of the code to provide for a 100-percent dividend received deduction (in lieu of the 85-percent deduction allowed corporations generally) in the case of dividends received by a small-business investment company from a domestic corporation which is subject to taxation under chapter 1 of the code.

The amendments made by this section apply with respect to taxable years beginning after the date of enactment of this bill.

SECTION 62. AMOUNTS RECEIVED AS DAMAGES FOR INJURIES UNDER THE ANTITRUST LAWS

This section, for which there is no corresponding provision in the House bill, renumbers section 1306 of the Internal Revenue Code of 1954 as 1307 and adds a new section 1306. Such new section provides that if an amount representing damages is received or accrued by a taxpayer as a result of an award in, or settlement of, a civil action brought under the provisions of section 4 of the Clayton Act for injuries sustained by the taxpayer under the antitrust laws, then the tax attributable to the inclusion of such amounts in gross income in the taxable year of receipt or accrual shall not exceed the aggregate of the increases in tax which would have resulted had such amount been received ratably over the period during which such injuries were sustained by the taxpayer. If the civil action resulting in the award of damages establishes the period during which the injuries were sustained by the taxpayer, the amount received or accrued by the taxpayer shall generally be allocated ratably over such period. If the period during which the injuries were sustained is not established in the civil action, such period is to be determined upon the basis of the facts of the particular case.

In determining the amount of tax attributable to the award of damages, the taxpayer is required to make two computations. One computation is based upon including the entire amount of the award in the taxpayer's gross income for the taxable year of receipt or accrual. The other computation is based upon allocating the award so that a proportionate part of such award is included in gross income for each taxable year during which injuries were sustained by the taxpayer. The lesser tax resulting from these two computations is the amount of tax which is attributable to the inclusion of the amount of the award in gross income for the taxable year of receipt or accrual under the operation of the new section.

The new section applies to any amount which represents damages received as a result of the bringing of a civil action under section 4 of the Clayton Act whether such amount is received as a result of an award in such civil action or as a result of the settlement of such civil action after the commencement of the action. Thus, the new section applies to any amount awarded pursuant to a decree or judgment or a consent decree or judgment as a result of a civil action under section 4 of the Clayton Act, and also applies to any amount received or accrued pursuant to a settlement of such action (after commencement of the action) regardless of whether such amount is received or accrued after a decree or judgment has been entered or in a case where no decree or judgment has been entered. For the purpose of the new section, the term "damages" includes treble damages awarded under section 4 of the Clayton Act.

Subsection (c) of this section of your committee bill provides that the new section 1306 will apply to taxable years ending after the date of enactment of the bill, but only with respect to amounts received or accrued after such date as a result of awards or settlements made after such date.

SECTION 63. MITIGATION OF EFFECT OF LIMITATIONS

This section, which corresponds to section 49 of the House bill, contains amendments to sections 1312 and 1314 of the 1954 Code relating to the mitigation of the effect of the statute of limitations in certain cases.

Section 63 (a) of your committee's bill amends section 1312 of the 1954 Code (relating to circumstances of adjustment) by renumbering paragraph (6) as (7), and by inserting after paragraph (5) a new paragraph (6) to provide for an adjustment under section 1311 in a case in which a determination (as defined in sec. 1313 (a)) allows or disallows a deduction (including a credit) in computing the taxable income (or as the case may be, net income, normal tax net income, or surtax net income) of a corporation, and a correlative deduction or credit has been erroneously allowed, omitted, or disallowed, as the case may be, in respect of a related taxpayer described in section 1313 (c) (7).

Section 63 (b) of your committee's bill adopts the amendment made by section 49 of the House bill to the second sentence of section 1314 (c) of the 1954 Code (relating to adjustment unaffected by other items) to strike from that sentence the following phrase: "Other than in the case of an adjustment resulting from a determination under section 1313 (a) (4), the" and inserting in lieu thereof "The."

Except for this phrase, the second sentence of section 1314 (c) is substantially the same as the second sentence of section 3801 (e) of the 1939 Code. The purpose of the respective sentences is to preclude both the taxpayer and the Government from recovering the amount of any adjustment, if paid, by claim or suit for refund or suit for erroneous refund, as the case may be, unless such action is based solely on the item which was the subject of the adjustment.

The deleted phrase was included in section 1314 (c) of the 1954 Code because it was then thought to be necessary in view of the possibility of an alteration or revocation of a determination described in section 1313 (a) (4). However, section 1314 (b) contains the necessary authority to redetermine the tax consequences resulting from an alteration or revocation of such a determination, and the presence of the deleted phrase may create the implication that the treatment of other items in the closed year may be corrected when the determination is under section 1313 (a) (4). This result would be inconsistent with the treatment accorded adjustments made pursuant to other forms of determinations described in section 1313 (a), and was not intended.

The amendments made in this section apply to determinations made after November 14, 1954 (90 days after the enactment of the 1954 Code, or the effective date of secs. 1312 and 1314).

SECTION 64. COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT

This section, which corresponds to section 50 of the House bill, amends section 1341 of the 1954 Code in several respects. The House bill added a new paragraph (3) to section 1341 (b), in order to obviate the following problem:

Under section 1341, if the taxpayer included an item in gross income in 1 taxable year because it appeared that he had an unrestricted right to such item, and in a subsequent taxable year becomes entitled to a deduction (in excess of $3,000) because it is established that he did not have an unrestricted right to the item or a portion thereof, the tax for the year of restoration is the lesser of either (1) the tax for that year computed with the deduction, or (2) the tax for that year computed without such deduction reduced by the decrease in tax for the prior year which would result from the removal of the item from gross income for the prior year.

Existing law does not, however, make it clear that, if the tax for the year of restoration is computed under method (2) described above, the deduction is not to be taken into account, for example, in computing a net operating loss for the year of restoration or in computing carrybacks or carryovers from such year. For purposes of clarity, the amendment made by subsection (d) of this section, which subsection is the same as section 50 of the House-bill, provides that the deduction is not to be taken into account for any purpose of subtitle A of the 1954 Code except section 1341 in cases when the tax is so computed.

The operation of this amendment may be illustrated by the following example: In 1955, a corporation has taxable income of $90,000. In 1957, it has a net operating loss of $80,000. It also develops in 1957 that $10,000 of the corporation's taxable income for 1955 is no longer subject to its unrestricted use, and it is accordingly restored to another person. The restored amount is available as a deduction for 1957 (and it is assumed to be of such a nature that it would increase the net operating loss for that year). Under section 1341 (a) (4), the tax for the taxable year (taking the $10,000 deduction into account) is zero, and the net operating loss carryback to 1955 would be $90,000.

Under section 1341 (a) (5), however, without taking the deduction into account, while the tax under section 1341 (a) (5) (A) for the year of restoration (1957) would be zero, the decrease in tax under section 1341 (a) (5) (B) for 1955 would be $3,000. The decrease is computed by reducing 1955 taxable income by $80,000, the amount of the net operating loss carryback from 1957 computed without taking into account the deduction for the $10,000 restored. The decrease in tax resulting from excluding the $10,000 item previously included for 1955 under a claim of right is $3,000, and the entire amount constitutes the decrease in tax under section 1341 (a) (5) (B). Taxpayer, therefore, becomes entitled to a refund of $3,000, the amount by which the decrease under section 1341 (a) (5) (B) exceeds the tax of zero computed under section 1341 (a) (5) (A).

This amendment made by the bill makes it clear that since the taxpayer's tax for the year of restoration is computed under section 1341 (a) (5), the amount of the net operating loss for 1957 is $80,000, not $90,000, because the deduction of $10,000 for the restoration cannot be taken into account for purposes of determining such loss.

Your committee's bill makes three further amendments to section 1341. The first of these amends the last sentence of section 1341 (a). Section 1341 (a) (5) provides for the computation of the decrease in tax under chapter 1 of the 1954 Code (or the "corresponding provisions" of prior revenue laws) which would result solely from the

exclusion from income of an item originally included under a claim of right in a prior taxable year. The last sentence of section 1341 (a) defines the "corresponding provisions" of the 1939 Code as chapter 1 thereof, other than subchapter E. This provision of present law fails to take into account the World War II excess-profits-tax provisions. Your committee's bill adds a provision to include in the corresponding provisions of the 1939 Code subchapter E of chapter 2 thereof in order to remedy this omission.

Secondly, your committee's bill contains a provision amending the last sentence of section 1341 (b) (2). That subsection excepts from the application of section 1341 repayments of items which were included in gross income under a claim of right because of the disposition of stock in trade, inventory property, or property held for sale in the ordinary course of business. Carved out of the exception are refunds or repayments made by certain regulated public utilities, required to be made by order of the regulatory body. The amendment makes it clear that the refunds or repayments concerned must be with respect to rates. In addition the special treatment of such refunds or repayments is extended to those required by an order of court or which are made in settlement of litigation or under the threat or imminence of litigation.

Thirdly, subsection (c) of this section of the bill adds a new provision to section 1341 (b) (2) which carves out of the section 1341 (b) (2) exception certain payments or repayments made pursuant to a price redetermination. Where a taxpayer enters into a subcontract to furnish items to a prime contractor or another subcontractor and the subcontract contains a provision for price redetermination in favor of the prime contractor or other subcontractor, the taxpayer may be required to refund a substantial amount to the prime contractor or other subcontractor. Since the refund is made directly to the prime contractor or other subcontractor, rather than to the United States, the taxpayer is not able to avail himself of the benefits of section 1481. Because there accordingly remains under existing law a significant area between section 1341 and section 1481 in which taxpayers who receive income in one year and who are required to repay it in another must suffer the consequences of distortion in income, your committee's bill would permit the application of section 1341 (a) to refunds arising out of such price redeterminations. The amendment would apply only in cases where a refund has been made pursuant to a price redetermination in a subcontract, the parties to the subcontract do not bear the relationship set forth in section 267 (b), the subcontract is subject to statutory renegotiation and no adjustment is available under section 1481 solely because the refund is not paid by the subcontractor to the United States, or any agency thereof.

The several amendments made by this section have various effective dates. Subsections (a) and (d) are to apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954, that is, in general, the 1954 Code years. The amendment made by subsection (b) shall apply with respect to taxable years beginning after December 31, 1957. The amendment made by subsection (c) applies with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954, provided the subcontract was entered into before January 1, 1958.

SECTION 65. CLAIMS AGAINST UNITED STATES INVOLVING ACQUISITIONS OF PROPERTY

This section, which corresponds to section 51 of the House bill, amends section 1347 of the 1954 Code to conform it to section 106 of the 1939 Code, which limited the surtax to 30 percent of the amount received with respect to a claim against the United States involving the acquisition of property and remaining unpaid for more than 15 years.

Section 65 of the bill also amends section 1347 to limit the application of such section to claims filed with the United States before January 1, 1958.

The first amendment made by section 65 of the bill is to apply only with respect to taxable years beginning after December 31, 1957.

SECTION 66. MITIGATION OF EFFECT OF PRICE REDETERMINATIONS OF SUBCONTRACTS SUBJECT TO RENEGOTIATION

This section which has been added by your committee, amends the Internal Revenue Code of 1954 by adding a new section 1482, relating to the tax treatment of payments made because of price redeterminations of subcontracts subject to statutory renegotiation. The amendment fills a gap which exists under present law because of the limited application of section 1481 of the 1954 Code. Section 1481 provides relief to taxpayers whose contracts with the United States are renegotiated. Frequently, however, subcontracts of Government contracts contain price redetermination provisions as between a subcontractor and a prime contractor, or as between two subcontractors. The subcontractor may be required as a result of a redetermination to refund a substantial amount to the prime contractor, or the other subcontractor. Since the repayment is made directly to a private party to the subcontract, and not to the United States or an agency thereof, the provisions of section 1481 generally do not apply. In the event of a change in tax rates between the year in which an amount was originally paid and the year in which that amount or a portion thereof is repaid pursuant to price redetermination, distortion of the income of both the subcontractor and the prime contractor (or other subcontractor) will result. This section is designed to eliminate this distortion.

In contrast to provisions such as section 1341, your committee's amendment would apply both to the payor and payee of a repayment pursuant to a price redetermination. In the case of a payor, his tax for the prior taxable year (or years) in which he originally received the payment which is the subject of subsequent adjustment is recomputed as if the original payment did not include an amount equal to the amount of the repayment to the other contractor. The difference between the tax for the prior taxable year (or years) before the application of the amendment and the tax as recomputed after the application of the amendment will be treated as an overpayment for the current taxable year, that is, for the taxable year in which the repayment is made. Similarly, the tax of the payee is recomputed for a prior taxable year (or years), and any resulting deficiency shall be collected as if it were an underpayment for the current taxable year.

Your committee's amendment would apply only to subcontracts which are subject to statutory renegotiation under a Federal renegoti-

ation act and would not apply to the extent that section 1481 applies to the amount repaid.

The amount of the repayment shall not be taken into account in a manner which results in duplicate effect upon either the payor or the payee. Thus, the payor would not get a double benefit by way of utilizing the repayment as a deduction in the year of repayment, and the amount of the repayment could not be used to increase a net operating loss for the year. Similarly, the payee will not be subjected to double taxation for the year of the repayment.

The amendment made by your committee by this section shall apply only to subcontracts entered into after December 31, 1957.

SECTION 67. REVOCATION OF ELECTION PERMITTING CERTAIN PROPRIETORSHIPS AND PARTNERSHIPS TO BE TAXED AS CORPORATIONS

Section 67 of the bill corresponds to section 52 of the House bill. Your committee's bill, however, omits the provision in the House bill which would have repealed section 1361 of the 1954 Code.

Revocation of election

Section 1361 of the 1954 Code permits certain unincorporated business enterprises to elect to be treated as domestic corporations. Subsection (a) of section 67 of the bill provides that a statement of election to be taxed as a corporation under section 1361 filed in accordance with regulations prescribed by the Secretary or his delegate shall be treated as a valid election.

However, subsection (a) further provides that a valid election may be subsequently revoked in accordance with regulations prescribed by the Secretary or his delegate. This revocation may be made at any time after the date of the enactment of the bill and on or before the last day of the third month following the month in which final regulations prescribed under section 1361 are published in the Federal Register. Such revocation, if made, shall be effective retroactively to the first taxable year to which the election applied and all succeeding taxable years to which the election applied.

Tolling of statute of limitations.

Subsection (b) of section 67 of the bill provides for a tolling of the statute of limitations with respect to (1) the assessment of deficiencies attributable to an enterprise which makes an election under section 1361, and (2) the credit or refund of any overpayments attributable to such an enterprise. This subsection applies regardless of whether the election is revoked pursuant to subsection (a).

Since the person concerned may have items of income, deduction, or credit which are completely unrelated to the enterprise, subsection (b) does not toll the statute of limitations for all amounts of deficiencies or overpayments of such persons. Subsection (b) relates only to deficiencies or overpayments which are attributable to the enterprise; that is, the increase or decrease in tax previously determined which results from the correct treatment of all items which pertain to the enterprise (with due regard given to the effect of the items in the computation of gross income, taxable income, and other matters under subtitle A of the 1954 Code).

Under subsection (c) of section 67, the period for which the periods of limitation are tolled expires 1 year after whichever of the following days is the earlier:

(1) The last day of the third month following the month in which regulations prescribed under section 1361 of the 1954 Code are published in the Federal Register.

(2) If the election is revoked under section 67 (a) of the bill, the day on which such revocation is filed with the Secretary of the Treasury or his delegate.

Exception

Subsection (d) provides that section 67 does not apply to any statement of election filed under section 1361 if such statement of election has been withdrawn with the permission of the Secretary of the Treasury or his delegate before the date of enactment of this bill.

SECTION 68. ELECTION OF CERTAIN SMALL BUSINESS CORPORATIONS

This section, for which there is no corresponding provision in the House bill, amends the Internal Revenue Code of 1954 by adding at the end of chapter 1 a new subchapter, designated subchapter S and composed of sections 1371 through 1377. Subchapter S is applicable to a "small business corporation" which elects not to be subject to the income tax imposed by chapter 1 of the 1954 Code and to the shareholders of such corporation.

Definitions

Section 1371 (a) defines a "small business corporation" to mean a domestic corporation which is not a member of an affiliated group of corporations and which does not have more than 10 shareholders, have as a shareholder a person (other than an estate) who is not an individual, have a nonresident alien as a shareholder, or have more than one class of stock. Section 1371 (b) defines an "electing small business corporation" to mean for any taxable year a small business corporation which has made a valid election under section 1372 (a) which election is in effect for the taxable year in question.

Election requirements and effects

Under section 1372 (a) a small-business corporation may elect not to be subject to the tax under chapter 1 if all of the persons who held stock in the corporation on the first day of the first taxable year for which the election is effective, or on the date of the election, if the election is made after such first day, consent to the election. Thus, an election made prior to the beginning of the first taxable year to which it relates must be perfected by the consent of any persons who are stockholders on the first day of such year who were not stockholders on the day of the election, and an election made after the first day of the taxable year which it affects need not have the consent of persons whose shareholder status ceased between the first day of that year and the date of the election.

Under section 1372 (b) (1), the effect on a small-business corporation of a valid election is to exempt the corporation from income tax for any taxable year with respect to which the election is in effect and to subject the corporation for those years and for all subsequent years

to the special rules of section 1377 relating to adjustments to earnings and profits. Under section 1372 (b) (2), the effect of a valid election upon the shareholders of a small-business corporation is to subject them, during years in which the corporation's election is in effect, to the provisions of section 1373 (relating to the taxation of corporation undistributed taxable income to the shareholders), section 1374 (allowing as a deduction to the shareholders the net operating loss of the electing corporation), and section 1375 (containing special rules for distributions by electing small-business corporations). As to years covered by the election and all subsequent taxable years, section 1376 (relating to adjustment of the basis of stock of, and indebtedness owing, shareholders) applies to the shareholders.

The new section 1372 (c) provides, generally, that the election of a small-business corporation with respect to any taxable year is to be made during the first month of such taxable year or during the preceding month. However, if the taxable year in question begins on or before the date of the enactment of subchapter S, and after December 31, 1957, and ends after the enactment of subchapter S, then the election must be made within 90 days following the date of enactment or before the close of the corporation's taxable year, whichever is earlier. As to such taxable years beginning before the enactment of subchapter S, an election may be made only if the corporation has been a small-business corporation, as defined in section 1371 (a), at all times since the enactment of subchapter S and before the day of the election. Thus, a corporation which lacked the qualifications of a small-business corporation for that portion of its taxable year prior to the enactment of the new subchapter but did not lack such qualifications during the remainder of such year, would be entitled to make the election provided in section 1372 (a) for such taxable year.

The new section 1372 (d) provides that an election under subsection (a) shall be effective for the taxable year of the corporation and for all succeeding taxable years of the corporation with respect to which it is not terminated. The election, therefore, has a continuing effect and need not be renewed annually, although annual returns of information by the corporation are required under new section 6037.

Termination of election

An election under section 1372 (a) may be terminated by any one of the occurrences described in paragraphs (1), (2), (3), (4), and (5) of section 1372 (e).

Under section 1372 (e) (1), an election is terminated by the failure of a new shareholder to consent thereto within a time to be specified by the Secretary or his delegate. A new shareholder is a person who was not a shareholder on the first day of the first taxable year with respect to which the election is effective or on the day of the election if the election was made after such first day.

Under section 1372 (e) (2), an election may be terminated by revocation by the corporation with the unanimous consent of the persons who are shareholders on the day of revocation. Such revocation must be made in such manner as the Secretary or his delegate shall prescribe by regulations.

Under section 1372 (e) (3), an election terminates if the corporation ceases to be a small-business corporation. Thus, if an eleventh person or a nonresident alien becomes a shareholder in the corporation,

if a corporation, partnership, or trust becomes a shareholder, or if another class of stock is issued by the corporation, the election is thereby terminated.

Under section 1372 (e) (4) and (5), an election terminates if for any taxable year of the corporation for which the election is in effect the corporation has gross receipts, more than 80 percent of which are derived from sources outside the United States or more than 20 percent of which are derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. For purposes of determining the amount of gross receipts from the sale or exchange of stock or securities, only the gain from such sales is taken into consideration.

The termination of an election under paragraphs (1), (3), (4), or (5) of section 1372 (e) is effective for the taxable year of the corporation in which occur the events causing the termination, and for all succeeding taxable years. A termination by revocation under paragraph (2) of section 1372 (e) cannot be effective as to the first taxable year of the corporation for which the election is effective. As to years following such first year a revocation under paragraph (2) is effective for the year in which it is made, if it is made during the first month of the year, or, if it is not made during such first month, for the taxable year following the year in which it is made, and for all subsequent years.

Election after termination

Section 1372 (f) provides that a corporation, and any successor to such corporation, which has once made an election under section 1372 (a) cannot again make such an election for any taxable year prior to its fifth taxable year following the first taxable year for which the termination or revocation of the prior election is effective, unless the Secretary or his delegate consents to such election.

Corporation income taxed to shareholders

Section 1373 of the new subchapter provides rules for the inclusion of income of an electing small-business corporation in the gross income of the shareholders of such corporation. In particular, the "undistributed taxable income" of an electing small-business corporation is to be included in the gross income of such of its shareholders as were shareholders on the last day of the taxable year of the corporation. The amount includible in the gross income of each such shareholder is the amount which he would have received as a dividend if on the last day of the taxable year of the corporation there had been distributed pro rata to the persons who were shareholders on that date an amount equal to the corporation's undistributed taxable income for its taxable year. This amount is taken into income by a shareholder in his taxable year in which or with which the taxable year of the corporation ends and is considered to have been received on the last day of the corporation's taxable year.

The "undistributed taxable income" of a small-business corporation is the corporation's taxable income, minus the amount of money distributed as dividends during the taxable year out of earnings and profits of the taxable year as specified in section 316 (a) (2) of the 1954 Code. Thus, distributions in kind do not reduce "undistributed taxable income"; nor is "undistributed taxable income" reduced by

distributions of money which are deemed to be out of accumulated earnings and profits. Taxable income, for purposes of the new subchapter S, is determined without regard to the net operating loss deduction of section 172 and the various special corporation deductions allowed by part VIII of subchapter B except the deduction relating to organization expenditures provided in section 248.

Dividends actually distributed to the shareholders of an electing small-business corporation will be taken into gross income by the shareholders of an electing small-business corporation pursuant to section 301 of the 1954 Code, subject, however, to the special rules of section 1375 (a) providing for a degree of capital gain treatment of certain distributions, and section 1375 (d) providing an exception for distributions of previously taxed undistributed taxable income. Amounts distributed as dividends and amounts treated as dividends under section 1373 (b) are also subject to reallocation among members of a family group under certain circumstances, as will be discussed below in connection with section 1375 (c).

The operation of section 1373 may be illustrated by the following example:

Corporation X, which qualifies as a "small-business corporation" under section 1371 (a), has taxable income and earnings and profits of $100,000 for a year as to which an election under section 1372 (a) is in effect. During the year it distributes as a dividend $70,000 in money among its 10 equal shareholders. The "undistributed taxable income" of the corporation for the year in question is $30,000, which amount must be taken into gross income by the shareholders in proportion to their shareholdings; that is, $3,000 per shareholder.

Net operating loss allowed to shareholders

Section 1374 provides for the passthrough of the net operating loss of an electing small-business corporation to the stockholders of such a corporation. Under section 1374 (b) each person who was a shareholder in such a corporation at any time during the taxable year in which the loss was sustained is entitled to a deduction for his taxable year in which or with which the taxable year of the corporation ends, in the amount of his proportionate share of the corporation's loss. Under section 1374 (d) (1) this deduction is, for purposes of chapter 1 of the 1954 Code, to be considered as a deduction attributable to a trade or business of the shareholder. Thus, section 172 (d) (4), relating to nonbusiness deductions of taxpayers other than corporations and limiting the effect of such deductions in the computation of the net operating loss to be carried back or forward to other years, is rendered inapplicable to a shareholder's proportionate share of a small-business corporation's operating loss.

Each shareholder's portion of the net operating loss of the electing small-business corporation is computed, pursuant to new section 1374 (c) (1), by dividing the corporation's net operating loss by the number of days in its taxable year (thus determining the daily net operating loss of the corporation), by apportioning this amount among the shareholders on a day-by-day basis in proportion to the number of shares held by each shareholder on each day of the year, and by totaling these daily amounts as to each shareholder. For purposes of section 1374 (c) (1), the electing small-business corporation's net operat-

ing loss is computed as in section 172 (c), but without the deductions provided in part VIII (except sec. 248) of subchapter B.

The amount of the net operating loss apportioned to any shareholder pursuant to the above rule is limited under section 1374 (c) (2) to the adjusted basis of the shareholder's investment in the corporation; that is, to the adjusted basis of the stock in the corporation owned by the shareholder and the adjusted basis of any indebtedness of the corporation to the shareholder. The basis of a shareholder's stock for purposes of this limitation is determined as of the close of the taxable year of the corporation, unless the stock is sold during the taxable year, in which case basis is determined as of the day before the sale. The basis of an indebtedness owing the shareholder by the corporation is determined as of the close of the taxable year or, if the shareholder sells all his stock during the year, as of the close of the last day of the year in which the shareholder was a shareholder in the corporation. Any adjustment to basis required by section 1376 for the taxable year will not be considered in determining the basis of stock and indebtedness for purposes of the limitation imposed by section 1374.

The deduction allowed to the shareholders of an electing small-business corporation on account of the net operating loss of the corporation is not intended by your committee to affect the shareholders' income tax liability for years beginning prior to the effective date of new subchapter S. Thus, in section 1374 (d) (2) it is provided that the deduction allowed by section 1374 shall be disregarded in determining the amount of the shareholders' net operating loss for the taxable year of the deduction for purposes of determining the net operating loss carrybacks to years beginning prior to January 1, 1958. The deduction is to be given effect, however, in computing the amount of the shareholders' net operating loss for purposes of carrying the same forward and backward to any year other than a year beginning prior to January 1, 1958. For purposes of determining the amount of the operating loss which may be carried to such years, the loss shall not be diminished by income for years beginning before January 1, 1958, except to the extent that it was allowed to offset the income of those years.

Since the net operating loss of the electing small-business corporation is allowed as a deduction directly to its shareholders, section 172 is amended to provide that, in determining the net operating loss of any corporation, there shall be disregarded the net operating loss of such corporation for any taxable year for which the corporation was an electing small-business corporation.

The operation of section 1374 may be illustrated by the following examples:

Example (1).—Corporation X, an electing small-business corporation, has a net operating loss for its taxable year ending December 31, 1960, of $10,000. At all times during its taxable year 1960 the corporation had as shareholders the same 10 individuals, each of whom owned one-tenth of the stock on each day of the corporation's taxable year. As a result of the corporation's net operating loss, each of the 10 shareholders has a $1,000 deduction for his taxable year in which or with which the taxable year of the corporation ends, assuming that the limitation of section 1374 (c) (2) is inapplicable.

Example (2).—Assume the same facts as in example (1) except that A, one of the shareholders of the corporation, sells his stock to B as of the close of business on July 1, 1960, and B holds the stock for the remainder of the year. A and B would each have a $500 deduction resulting from the corporation's net operating loss, assuming that the limitation of section 1374 (c) (2) is inapplicable. If A's taxable year ends November 30, 1960, the $500 item will be a deduction in his taxable year ending November 30, 1961.

Example (3).—B is entitled under section 1374 to a deduction in his taxable year ending December 31, 1958, of $6,000 resulting from the net operating loss of an electing small-business corporation. During 1958 he has a net operating loss, computed without regard to such $6,000 deduction, of $20,000. In each of his taxable years ended December 31, 1956, and December 31, 1957, he had taxable income of $13,000. In each of his taxable years 1959 and 1960 he had taxable income of $3,000. Under section 1374 (d) (2) the net operating loss carryback from 1958 to 1956 and 1957 does not include the $6,000 deduction resulting from the loss of the small-business corporation, so that $6,000 of taxable income remains in the year 1957 after the carryback. For purposes of carrying the 1958 net operating loss forward to 1959 and 1960, the $6,000 amount is included in the net operating loss, so that the taxable income for the taxable years 1959 and 1960 is reduced to zero by the carryover. (The total taxable income for 1956 and 1957 is deemed not to be in excess of $20,000, the amount of the net operating loss carryback to those years.)

Special rules applicable to distributions

New section 1375 provides special rules with regard to the treatment of capital gains by the shareholders of an electing small-business corporation, the disallowance of the dividends received credit and exclusion, the allocation of dividends among members of family groups, and the distribution of undistributed taxable income which has been previously taxed to shareholders.

Capital gain passthrough

Under subsection (a) of new section 1375 a shareholder may treat as long-term capital gain that portion of any amount includible in his gross income as dividends out of the current earnings and profits of a small-business corporation (including amounts treated as dividends under sec. 1373 (b)) which represents his pro rata share of the corporation's excess of net long-term capital gain over net short-term capital loss for the corporation's taxable year. However, the amount of the excess for any year may not, for purposes of section 1373 (a), be an amount greater than the taxable income of the corporation for such year. For example, if a corporation has net long-term capital gain in excess of its net short-term capital loss in the amount of $100,000 and taxable income and current earnings and profits each of $80,000, it cannot, by distributing $100,000 during the year, pass down to its shareholders $20,000 of accumulated earnings and profits at capital gain rates.

The rule of section 1375 (a) applies only to distributions of dividends out of earnings and profits of the taxable year as specified in section 316 (a) (2) of the 1954 Code.

The pro rata share of the excess of the net long-term capital gain

over short-term capital loss allocable to each shareholder of the corporation is a fraction of such excess the numerator of which is the amount of dividends from the corporation out of its earnings and profits of the taxable year includible in the gross income of the particular shareholder during the taxable year of the corporation and the denominator of which is the entire amount of such dividends from the corporation during its taxable year includible in the gross income of all the shareholders. This may be illustrated by the following example:

Corporation X, in which there are three equal shareholders, has net long-term capital gain in excess of net short-term capital loss of $9,000 for its taxable year ending December 31, 1959. In that year it has taxable income and current earnings and profits in excess of $9,000 but makes no distributions. Of the undistributed taxable income includible in the gross income of each of the three shareholders, pursuant to section 1372 (b), as dividends received during the corporation's taxable year ending December 31, 1959, $3,000 is treated as long-term capital gain.

In the event that several distributions of dividends out of the current year's earnings and profits of an electing small-business corporation are made to a particular shareholder during the year, the amount which is treated as capital gain to the shareholder pursuant to section 1375 (a) is to be allocated ratably to the various distributions. Thus, if the taxable year of the corporation should include 2 taxable years of the shareholder and in both of such years there are distributions treated as dividends out of earnings and profits of the corporation's taxable year as specified in section 316 (a) (2), the capital gain rule cannot be applied so as to cause all the capital gain allocable to that shareholder to be included in 1 of his 2 taxable years. It will be noted in this regard that the amount of dividends from an electing small-business corporation which constitutes capital gain to the shareholder is based upon the taxable year of the corporation rather than that of the shareholder. Therefore, if the corporation and a shareholder have different taxable years, the computation of the amount of dividends treated as capital gain to the shareholder during his entire taxable year which ends during the corporation's taxable year must await the close of the corporation's year.

Distributions not to be treated as dividends under sections 34, 37, and 116

Consistent with the theory of the new subchapter by which the corporate income is taxed directly to the shareholders, section 1375 (b) provides that amounts includible in gross income as dividends from an electing small-business corporation shall not be considered dividends for purposes of section 34 (dividends received credit), section 37 (retirement income credit), and section 116 (partial dividend exclusion) to the extent that they constitute distributions not in excess of the taxable income of the corporation for the taxable year. This rule applies to amounts treated as dividends under section 1373 (b) as well as to actual distributions.

Reallocation among members of family groups

Section 1375 (c) provides a special rule for the reallocation of income from a small-business corporation among members of a family

group if the Secretary or his delegate determines that reallocation is necessary to reflect the value of services rendered to the corporation by such shareholders. Under this provision the Secretary or his delegate would have authority to prevent the avoidance of tax by reallocating an appropriate portion of corporate income from one member of a family group to another member of such group who has performed services for the corporation for inadequate compensation. The definition of "family" in section 704 (e) (3) of the 1954 Code is made applicable for purposes of this section.

Distributions of previously taxed income

Section 1375 (d) of new subchapter S provides rules whereby a shareholder's "net share of undistributed taxable income" of an electing small-business corporation for prior years may be distributed, under regulations prescribed by the Secretary or his delegate, to such shareholder in a later year (with respect to which the election is still in effect) free of dividend consequences to the shareholder. Such a distribution is treated as a distribution which is not a dividend and, therefore, will reduce the basis of the shareholder's stock in the small-business corporation and, to the extent that it exceeds such basis, will be subject to the provisions of section 301 (c) (3) of the 1954 Code. However, it will not reduce the earnings and profits of the corporation.

A shareholder's net share of previously taxed undistributed taxable income is defined in section 1375 (d) (2) as the sum of the amounts included in the gross income of the shareholder under section 1373 (b) for all prior taxable years, less the amounts allowable under section 1374 (b) as a deduction from gross income of the shareholder for all prior taxable years and the amounts previously distributed during the taxable year and all prior taxable years to the shareholder which, under section 1375 (d) (1), were not considered dividends. The term "all prior taxable years" does not include a taxable year to which the provisions of section 1375 do not apply and to taxable years prior to such year.

Thus, under section 1375 (d) (2) a shareholder's net share of previously taxed undistributed taxable income is computed by first determining the total amount of the corporation's undistributed taxable income which has been actually included in his gross income for all his prior taxable years in which or with which ended a taxable year of the corporation with respect to which an election was in effect, excluding any taxable year prior to a break in the election. The computation would not, therefore, include any amount of undistributed taxable income prior to a year in which the election was not in effect or any amount of undistributed taxable income which was not in fact included in the shareholder's gross income. The second step in the computation is the determination of the total amount of the shareholder's portion of the corporation's net operating loss allowable as a deduction in prior taxable years of the shareholder in which or with which ended a taxable year of the corporation governed by an election, excluding years prior to a break in the election. This amount includes all allowable deductions under section 1374 (b), whether or not the deductions were claimed or resulted in any tax benefit. The third step in the computation is the determination of the total amounts previously distributed to the shareholder (in prior

taxable years of the shareholder in which or with which ended a taxable year of the corporation governed by an election, excluding years prior to a break in the election, and in the current taxable year) which under section 1375 (d) were considered distributions which were not dividends. The sum of the shareholder's portion of the net operating loss allowable as a deduction in previous years plus the previous distributions to the shareholder which were not considered dividends pursuant to section 1375 (d) is then subtracted from the amount of undistributed taxable income included in the shareholder's gross income for previous years. The difference between these amounts represents the shareholder's net share of undistributed taxable income.

It will be noted that under new section 1375 (d) an individual who becomes a shareholder in an electing small-business corporation will not be entitled to the benefits of section 1375 (d) until, at the earliest, the year following a year in which he has included in his gross income a share of the corporation's undistributed taxable income and then only to the extent, at most, of his share of such undistributed taxable income. However, if such an individual was formerly a stockholder in the corporation during a taxable year as to which it was an electing small-business corporation and the election has been in effect continually since such previous year, he would be entitled to the benefits of section 1375 (d) with respect to distributions not in excess of amounts of undistributed taxable income of the corporation included in his gross income for such previous year.

The operation of section 1375 (d) may be illustrated by the following example:

Corporation X, of which B is the sole stockholder at all material times, is an electing small-business corporation for its taxable years ending December 31, 1958, 1959, and 1960. For its taxable year 1958 it has a net operating loss of $10,000. For its taxable year 1959 it has undistributed taxable income of $50,000. Assuming that B properly included in his gross income the undistributed taxable income of the corporation for the taxable year 1959 and assuming that the 1958 net operating loss did not exceed the limitation imposed by section 1374 (c) (2), B's net share of the corporation's undistributed taxable income as of December 31, 1959, is $40,000. On January 1, 1960, in accordance with regulations, the corporation makes a distribution to B of $20,000 of his share of the corporation's undistributed taxable income. For 1960, X corporation has a net operating loss of $40,000. This loss, although it may be fully utilized by B as a deduction for his taxable year 1960 does not alter the nature of the distribution made on January 1, 1960. The $20,000 distribution is a distribution which is not considered a dividend.

Adjustments to basis of stock and indebtedness

New section 1376 requires adjustments to the basis of stock of, and indebtedness owing, shareholders of an electing small business corporation under certain circumstances.

Subsection (a) of section 1376 provides that, to the extent that a shareholder in an electing small-business corporation is required to, and in fact does, report as part of his gross income amounts includible by virtue of section 1373 (b), the basis of such shareholder's stock in the corporation is increased. This effect is the same as if the undis-

tributed taxable income had in fact been distributed and then reinvested by the shareholder.

Subsection (b) of section 1376 provides for the reduction (but not below zero) of the basis of a shareholder's stock in an electing small-business corporation by an amount equal to the amount of his portion of the corporation's net operating loss for any taxable year attributable to such stock. The basis of any indebtedness of such a corporation to its shadeholders is also reduced (but not below zero) by such amount, but only to the extent that such amount exceeds the basis of the shareholder's stock in the corporation. Thus, the amount of the portion of the net operating loss attributable to the shareholder's stock is first applied in reduction of the basis of his stock and only the remainder, if any, reduces the basis of the indebtedness.

Adjustments to earnings and profits

In order to avoid double taxation of the income of an electing small-business corporation which does not distribute all of its income currently, subsection (a) of section 1377 provides that the accumulated earnings and profits shall be reduced as of the close of the corporation's taxable year by the amount of the undistributed taxable income for such year required to be included in the gross income of the shareholders under section 1373 (b).

Subsection (b) of section 1377 provides the special rule that the current year's earnings and profits of a small-business corporation which has made the election under section 1371 (b) shall not be reduced by any amount which is not allowable as a deduction in computing the taxable income of the corporation for the year. This rule is necessary in order that a corporation may not decrease its current earnings and profits by expenditures and losses which do not qualify as deductions for Federal tax purposes, and thereby defeat the general purpose of taxing the corporation's taxable income as dividends to the shareholders.

Under subsection (c) of section 1377, the earnings and profits and the accumulated earnings and profits of an electing small-business corporation are not affected by any item of gross income or any deduction taken into account in determining the amount of any net operating loss (computed as provided in sec. 1374 (c)) of such corporation. In the absence of a statutory provision to the contrary, the earnings and profits of the corporation would be reduced by approximately the amount by which the corporation's deductions for the taxable year exceeded its gross income for that year. Since this amount (adjusted as provided in section 1374 (c)) would also be allowable as a deduction to the shareholders of the corporation, and since a reduction in a corporation's earnings and profits has the potential effect of allowing earnings to be withdrawn from a corporation in the form of capital, a double benefit to the shareholders might result from a net operating loss in the absence of the provisions of section 1377 (c).

Net operating loss not available to the corporation

Subsection (b) of section 68 of the bill amends section 172 of the 1954 Code by inserting therein a new subsection (h) providing that, in determining the net operating loss deduction of a corporation, any net operating loss sustained by it for any taxable year in which it was an electing small-business corporation shall be disregarded. This

provision follows from the policy of allowing the net operating loss of the electing small-business corporation as a deduction to the shareholders of such corporation.

Annual returns required

Notwithstanding the fact that an electing small-business corporation is not subject to the tax imposed by chapter 1 of the 1954 Code, such corporation must make a return for each taxable year in accordance with new section 6037 as added by subsection (c) of section 68 of the bill. Such return will be considered as a return filed under section 6012 for purposes of the provisions of chapter 66, relating to limitations. Thus, for example, the period of limitation on assessment and collection of any corporate tax found to be due upon a subsequent determination that the corporation was not entitled to the benefits of subchapter S, will run from the date of filing of the return required under the new section 6037.

Effective date

The amendments made by section 68 of the bill are effective with respect to taxable years beginning after December 31, 1957. However, section 1372 (c) (2) permits an election to be made only for taxable years ending after the date of the enactment of subchapter S.

SECTION 69. PERIOD OF LIMITATION FOR FILING CLAIM FOR CREDIT FOR STATE DEATH TAXES

This section of the bill is identical with section 53 of the House bill.

Under existing law, State death taxes generally must be paid within 4 years after the estate-tax return is filed in order to obtain credit for such taxes for estate-tax purposes. If an extension of time is granted to pay the Federal estate tax, the State death taxes need not be paid until the expiration of 4 years or the period of the extension. Similarly, if a petition for redetermination of a deficiency is filed with the Tax Court within 90 days after notice of a deficiency is mailed, the State death taxes may be paid within 60 days after the Tax Court's decision becomes final. However, if the Federal estate tax is paid and a refund claim is subsequently filed, no extension of time for payment of State death taxes is allowed.

Subsection (a) of section 69 of the bill amends section 2011 (c) of the 1954 Code, and subsection (b) amends section 813 (b) of the 1939 Code. These amendments extend, in cases where payment of the Federal estate tax is made and a refund claim is filed, the time in which State death taxes may be paid and claimed as a credit for estate tax purposes. Pursuant to these amendments, an executor who has filed a timely claim for refund but who has not paid State death taxes within 4 years after the estate tax return was filed would be able to obtain credit for State death taxes if such taxes are paid (1) before the expiration of 60 days from the date of mailing, by certified or registered mail, by the Secretary of the Treasury or his delegate to the taxpayer of a notice of disallowance of any part of such claim, or (2) before the expiration of 60 days after a final decision by a court of competent jurisdiction with respect to a timely suit instituted upon such claim, whichever period is the last to expire.

The amendment made to section 813 (b) of the 1939 Code is applicable with respect to the estates of decedents dying after February 10,

1939, and on or before August 16, 1954; and the amendment made to section 2011 (c) of the 1954 Code is applicable with respect to the estates of decedents dying after August 16, 1954.

SECTION 70. ESTATE TAX IN CASE OF REVERSIONARY OR REMAINDER INTEREST IN PROPERTY

This section of the bill, which is identical with section 54 of the House bill, amends sections 925, 926, and 927 of the 1939 Code and sections 2015, 6163, and 6601 (b) of the 1954 Code. Under existing law, where a decedent possessed a reversionary or remainder interest in property and that reversionary or remainder interest was included in his gross estate for estate-tax purposes, the executor of the decedent's estate may elect to postpone, until 6 months after the termination of the precedent interest or interests in the property, the payment of the Federal estate tax attributable to the inclusion of the reversionary or remainder interest in the gross estate. As surety for payment of the tax at the expiration of the period of postponement, the estate is required to file a bond. Under these circumstances, that portion of the State or foreign death taxes which is attributable to the reversionary or remainder interest, and for which a credit otherwise is allowable under section 2011 or 2014, may be allowed as a credit against the Federal estate tax if such portion of the State or foreign tax is paid, and credit therefor claimed, within 60 days after the termination of the precedent interest or interests.

In those cases where the Secretary of the Treasury or his delegate finds that the payment of the Federal estate tax at the expiration of the period of postponement will result in undue hardship to the estate, the amendment to section 6163 of the 1954 Code would permit him to extend the time for payment for an additional period or periods not to exceed in the aggregate 2 years from the expiration of the period of postponement. An example of undue hardship is a case where, by reason of the time required to settle the complex issues involved in a trust, the decedent's heirs or beneficiaries cannot reasonably expect to receive the decedent's remainder interest in the trust before the expiration of the period of postponement. A corresponding amendment to section 925 of the 1939 Code extends a similar benefit to the estates of decedents who died during the period covered by the 1939 Code. The extensions authorized by the amendment to section 6163 and to section 925 are applicable only if the period of postponement has not expired prior to the date of enactment of this bill.

The amendment to section 926 insures to the Government the right to require, in 1939 Code cases, surety for the payment of the tax at the expiration of the hardship extension. A corresponding amendment to the 1954 code is not needed.

The amendment to section 6601 (b) insures, in 1954 Code cases, that the 4-percent interest rate effective during the period of postponement will continue during the period covered by the hardship extension. A corresponding amendment to the 1939 Code is not needed as the wording of existing law is sufficient to carry the 4-percent rate through the period covered by the hardship extension.

In cases where a hardship extension for the payment of the Federal estate tax attributable to a reversionary or remainder interest has been granted by the Secretary or his delegate, the amendment to sec-

tion 2015 of the 1954 Code (and the corresponding amendment to sec. 927 of the 1939 Code) extends to the expiration of the period covered by the hardship extension, the time within which State and foreign death taxes attributable to the reversionary or remainder interest can be paid and credit therefor claimed against the Federal estate tax. The amendment made to section 2015 (and the corresponding amendment to sec. 927) is applicable only if the period within which such State and foreign death taxes otherwise could be paid and claimed as a credit has not expired prior to the date of enactment of this bill.

SECTION 71. RETIREMENT ANNUITIES EXCLUDED FROM GROSS ESTATE

This section of the bill, which is identical with section 55 of the House bill, amends section 2039 (c) (2) of the 1954 Code (relating to the exclusion of certain retirement annuity contracts from the gross estate). Section 2039 (c) (2) applies to annuity contracts purchased by an employer pursuant to a nontrusteed plan which "met the requirements of section 401 (a) (3)." However, for income-tax purposes, a qualified nontrusteed employee annuity plan must also meet the requirements of section 401 (a) (4), (5), and (6). This amendment makes clear that the exclusion from the gross estate is restricted to annuities purchased pursuant to plans which meet all of the requirements for qualification for income-tax purposes.

The amendment made by this section of the bill is to apply to decedents dying after December 31, 1953.

SECTION 72. GIFT TAX NOT TO APPLY TO ELECTION OF SURVIVOR BENEFITS UNDER CERTAIN QUALIFIED PLANS

This section is identical to section 56 of the House bill except for an amendment to subsection (c) of the bill designed to limit the effect of this bill to the calendar year 1955 and all calendar years thereafter.

Section 72 of the bill adds a new section 2517 to subchapter B of chapter 12 of the 1954 Code (relating to transfers for purposes of gift tax). Under section 2039 (c) of the 1954 Code, the portion of the survivor benefits payable under a qualified plan which is attributable to the employer's contributions are excluded from the employee's gross estate for estate-tax purposes. The new section 2517 provides, for gift-tax purposes, a rule which is similar to that provided by section 2039 (c) for estate-tax purposes. Under section 2517 (a), an employee who irrevocably exercises an election or option provided for in a qualified plan to have certain benefits under the plan paid to a beneficiary who survives him is not to be considered as having made a gift of that portion of such survivor benefits which is attributable to his employer's contributions under the plan. Similarly, the employee is not to be treated as having made a gift of that portion of such survivor benefits which is attributable to his employer's under the plan where he fails to exercise an election or option whereby he could prevent the vesting of these rights in a beneficiary, or where, by failure to revoke within the necessary period, he permits a previously revocable election to become irrevocable.

Subsection (b) of the new section 2517 provides that the exclusion contained in new section 2517 (a) does not apply to that part of the value of the survivor benefits which bears the same proportion to the

value of the survivor benefits as the total payments or contributions made by the employee bears to the total payments or contributions made. The exclusion does not apply to a transfer of a right under a qualified plan if the transfer is not pursuant to an election or option provided for in the plan. Nor does the exclusion apply to the value of any benefits payable to the beneficiary during the employee's lifetime.

The principles followed under section 2039 of the 1954 Code in connection with determining the value of survivor benefits and the amounts of employees' and employers' payments or contributions are equally applicable under section 2517.

As used in section 2517, the term "employee" includes a former employee.

Under subsection (c) of section 72 of the bill the amendments made by subsections (a) and (b) are to apply to all elections which become irrevocable on or after January 1, 1955. Your committee has amended subsection (c) of the House bill to provide that for calendar years before 1955, the determination as to whether the exercise or nonexercise by an employee of an election or option described in section 2517 of the Internal Revenue Code of 1954 shall be considered a transfer for purposes of chapter 4 of the Internal Revenue Code of 1939 shall be made as if this section had not been enacted and without inferences drawn from the fact that this section is not made applicable with respect to calendar years before 1955.

SECTION 73. OASI COVERAGE FOR EMPLOYEES OF FOREIGN SUBSIDIARIES

This section of the bill, which is identical with section 57 of the House bill, amends section 3121 (l) (3) of the 1954 Code (relating to agreements entered into by domestic corporations for the purpose of extending old-age and survivors insurance coverage to service performed by certain employees of foreign subsidiaries) to correct a typographical error in the heading by changing "BE" to "BY."

SECTION 74. FEDERAL SERVICE

This section of the bill, which is identical with section 58 of the House bill, amends section 3122 of the 1954 Code (relating to collection and payment of employment taxes with respect to Coast Guard Exchanges) to correct erroneous references in the last sentence by changing "this subsection" wherever found therein to "this section."

SECTION 75. ACTS TO BE PERFORMED BY AGENTS

This section of the bill, which is identical with section 59 of the House bill, amends section 3504 of the 1954 Code (relating to acts to be performed by agents in the case of employment taxes) to correct an erroneous reference to subtitle C by changing "this subtitle" to "this title."

SECTION 76. PERSONS REQUIRED TO MAKE RETURNS

Section 76 of the bill, except for the change in the effective date, is identical with section 60 of the House bill. This section amends section 6012 of the 1954 Code (relating to persons required to make

returns of income), by adding a new subsection (c), to provide that in determining whether a taxpayer is required to file a return by reason of having $600 or more of gross income, gross income includes earned income excludable under section 911 (relating to earned income from sources without the United States). Thus, an individual citizen under age 65, with $600 or more of gross income, including income excludable under section 911, would be required to make a return under section 6012. The administrative provisions of subtitle F applicable to returns would generally apply in the case of returns required by reason of the amendment. For example, a return filed by reason of the amendment would start the running of the periods of limitations under section 6501, and penalty provisions for failure to file proper returns and for the filing of improper returns would apply.

Under the amendment, earned income excludable under section 911 would constitute gross income only for purposes of the return requirements of section 6012. The amendment would not deprive United States citizens of the income exclusion now provided by section 911 either in determining tax liabilities or in applying various administrative provisions where the amount of gross income is a relevant factor. Thus, for example, in determining under section 6501 (e) whether a taxpayer omitted an amount in excess of 25 percent of the gross income stated in his return, the earned income excludable under section 911 (a) would not be considered gross income.

Subsection (b) of section 76 of the bill adds a cross-reference to section 911 directing attention to sections 6001, 6011, 6012 (c), and the other provisions of subtitle F for administrative and penal provisions relating to the exclusion provided by section 911.

Subsection (c) of section 76 of the bill provides that the amendment made by this section shall be applicable with respect to taxable years beginning after December 31, 1957.

SECTION 77. ELECTION TO MAKE JOINT RETURN AFTER FILING SEPARATE RETURN

This section, which is identical with section 61 of the House bill, corrects an erroneous section reference in section 6013 (b) (2) (C) of the 1954 Code (relating to limitation on election to make joint return after filing separate return) by changing "such section" to "section 6213."

SECTION 78. RETURNS TREATED AS DECLARATIONS OF ESTIMATED TAX BY INDIVIDUALS

Section 78 of the bill, which is identical with section 62 of the House bill, amends subsection (f) of section 6015 of the 1954 Code (relating to returns treated as declarations of estimated income tax by individuals) to provide that, in the case of a taxpayer on a fiscal-year basis, the months which correspond to those specified in such subsection shall be substituted therefor. A similar rule was provided by section 60 (c) of the 1939 Code.

SECTION 79. PUBLICITY OF EXEMPT ORGANIZATION INFORMATION

This section, except for a change in an effective date, is identical with section 63 of the House bill.

Publicity required

Section 79 (a) of the bill amends section 6104 of the 1954 Code (relating to publicity of information required from certain exempt organizations and certain trusts) to provide for the inspection of certain applications for income-tax exemption under section 501 (a) and of the papers submitted in support of such applications. If an organization described in section 501 (c) or (d) is exempt from taxation for any taxable year, the application filed by the organization with respect to which the Secretary or his delegate determined that the organization was so entitled to exemption, and any papers submitted by the organization in support of that application, are to be open to public inspection at the national office of the Internal Revenue Service. In the case of any such application which is filed after the date of enactment of this provision, a copy of the application is to be made available for public inspection at the appropriate field office of the Internal Revenue Service, as prescribed by regulations. Any application, and any papers submitted in support of such application, are not to be open for any public inspection if a determination has not been made with respect to such application that the organization is exempt under section 501 (a) for any taxable year. All public inspection under this amendment is to be made at such times, and in such manner, as the Secretary or his delegate may by regulations prescribe.

After the application of any organization has been opened for public inspection under this amendment, the Secretary or his delegate is to furnish, upon the request of any person with respect to such organization, a statement indicating the subsection and paragraph of section 501 which it has been determined describes the organization.

Upon request of an organization submitting any papers supporting its application (including any organization which filed its application and supporting papers before the effective date of this amendment), the Secretary or his delegate is to withhold from public inspection any information contained in such supporting papers which he determines relates to any trade secret, patent, process, style of work, or apparatus of the organization, if he also determines that public disclosure would adversely affect the organization. Further, the Secretary or his delegate is to withhold from public inspection any information contained in papers supporting an application, if he determines that the public disclosure of such information would adversely affect the national defense.

The amendment to section 6104 also provides that section 6103 (d) of the 1954 Code (relating to inspection by committees of Congress of tax returns) is to apply to the application for exemption of any organization described in section 501 (c) or (d) which is exempt from taxation under section 501 (a) for any taxable year, and to any other papers in the possession of the Secretary or his delegate which relate to such application, as if such application and other papers constituted returns.

The references to the provisions of section 501 of the Internal Revenue Code of 1954 in this amendment are to be considered also as references to the corresponding provisions of the Internal Revenue Code of 1939 and prior revenue laws. Claims for exemption filed under sections 503 and 504 of the 1954 Code (or under the corresponding provisions of the 1939 Code), relating to requirements for exemption and denial of exemption, respectively, are to be considered as applications for exemption for purposes of this amendment.

The provisions discussed above are set forth in subsection (a) of section 6104, and the provisions of existing section 6104, which are retained without change, are designated by section 79 (a) of the bill as subsection (b) of section 6104.

The amendments to section 6104 are to take effect on the 60th day after the date of enactment of the bill.

Annual information with respect to total contributions

Section 79 (b) of the bill amends section 6033 (b) of the 1954 Code (relating to the information required annually from certain tax-exempt organizations described in sec. 501 (c) (3)). The information required to be furnished by section 6033 (b) must be made available to the public under existing section 6104.

The information presently required to be filed under existing section 6033 (b) relates to the organizations' financial affairs. The amendment provides that, in addition to the information presently required to be submitted annually, the organizations shall state the total of the contributions and gifts received by them during the year. Your committee bill requires such information for taxable years ending on or after December 31, 1958.

SECTION 80. ADDRESS FOR NOTICE OF DEFICIENCY

This section of the bill, which is identical with section 64 of the House bill, amends section 6212 (b) (1) of the 1954 Code (relating to address for notice of deficiency in the case of income and gift taxes) to correct erroneous references to chapter 1 of the 1954 Code, which should be references to subtitle A of the 1954 Code.

SECTION 81. RELEASE OF LIEN OR PARTIAL DISCHARGE OF PROPERTY

This section of the bill, which is identical with section 65 of the House bill, amends section 6325 of the 1954 Code (relating to release of lien or partial discharge of property) to provide expressly for the discharge of a specific property from the special estate- or gift-tax lien where the Secretary or his delegate finds that the tax liability has been fully satisfied or provided for. This amendment will restore the provisions of the 1939 Code under which such a discharge could be effected without regard to the general requirement that the fair market value of the property remaining subject to the lien must be at least double the amount of the unsatisfied liability secured by such lien and the amount of all other prior liens upon the property.

SECTION 82. CORRECTION OF REFERENCES TO UNITED STATES ATTORNEYS

This section of the bill, which is identical with section 66 of the House bill, corrects certain provisions of the 1954 Code by changing

references to "United States district attorney" to "United States attorney."

SECTION 83. CONVEYANCE OF TITLE

This section of the bill, which is identical with section 67 of the House bill, amends section 6339 (b) (2) of the 1954 Code (relating to conveyance of title) to correct a grammatical error in the heading by changing "OF" to "AS."

SECTION 84. REQUEST FOR PROMPT ASSESSMENT

This section of the bill is the same as section 68 of the House bill. Subsection (a) of this section amends section 6501 (d) of the 1954 Code (relating to request for prompt assessment) to clarify existing law when the period of limitations on assessment in section 6501 (e) or (f) is applicable and a request for prompt assessment is filed. If the period of limitations on assessment is longer than the normal 3-year period prescribed in section 6501 (a) as a result of any of the exceptions in subsections (c), (e), or (f) of section 6501, the amendment makes it clear that the longer period will be applicable notwithstanding the filing of a request for prompt assessment under section 6501 (d).

Subsection (b) of this section amends section 6501 (d) of the 1954 Code to make it clear that, in the case of a corporation, the request for prompt assessment may be filed by a corporation in the process of dissolution or by one already dissolved.

SECTION 85. LIMITATIONS ON ASSESSMENT AND COLLECTION

This section of the bill is the same as section 69 of the House bill. Subsection (a) of this section amends section 6501 (g) (2) of the 1954 Code (relating to returns as exempt organizations) to indicate clearly that the filing of a return as an exempt organization will start the running of the period of limitations for assessment if such organization is later held to be taxable, regardless of whether the organization is a corporation or a trust. This is accomplished by substituting the word "organization" for the word "corporation" each place it appears in section 6501 (g) (2).

Subsection (b) of this section amends section 6501 of the 1954 Code (relating to limitations on assessment and collection) to provide that a deficiency for any taxable year attributable to the application of a net operating loss carryback to such year may be assessed at any time within the period of limitations on assessment applicable to the taxable year in which the loss arose. This provision, corresponding to section 276 (d) of the 1939 Code, was inadvertently omitted from the 1954 Code.

SECTION 86. LIMITATIONS ON CREDIT OR REFUND

This section of the bill is identical with section 70 of the House bill. Subsections (a) and (b) of this section amend section 6511 of the 1954 Code (relating to limitations on credit or refund) to provide that a claim for credit or refund may be filed within 3 years from the date the return was actually filed. Under existing law a claim for refund or credit must be filed within 3 years from the due date of the

return (determined without regard to any extension), whereas an assessment may be made within 3 years from the date the return was actually filed. Thus, the amendment conforms the period on filing claim for credit or refund more nearly to the period on assessment. To correlate the limit on the amount of a credit or refund to this amendment, where payments are made during the period of an extension of time within which to file the return, section 6511 (b) (2) (A) (relating to the limit on the amount of credit or refund when claim is filed within 3-year period) is also amended to provide that there shall be added to the period of 3 years immediately preceding the filing of the claim a period equivalent to the period of any extension for filing the return to which the claim relates.

Subsection (d) of this section amends section 6511 (d) (2) (A) of the 1954 Code (relating to special period of limitation for credit or refund in case of net operating loss carrybacks) to provide that, in the case of taxpayers other than corporations, a claim for credit or refund may be filed within the period which expires with the 15th day of the 40th month following the end of the taxable year of the net operating loss. The 15th day of the 39th month is retained for corporations. This amendment reflects the change made in the 1954 Code in the filing date for income tax returns.

SECTION 87. CORRELATION OF INTEREST WHERE OVERPAYMENT OF TAX IS CREDITED AGAINST UNDERPAYMENT OF TAX

In general

Section 6611 (b) (1) of the 1954 Code provides that interest on an overpayment of tax which is credited against an additional assessment—e. g., an assessed deficiency—shall be allowed from the date of the overpayment to the date of assessment. If the overpayment were refunded, rather than credited, interest on it would be allowed until a date preceding by 30 days the issuance of the refund check. On the other hand, interest on a deficiency runs from the due date thereof to the date it is paid. In the case of a credit, it would run until the date the credit is scheduled, which may be long subsequent to the date that interest on the overpayment is cut off by assessment of a deficiency. In cases where a waiver of the restrictions on assessment is filed, interest on an overpayment may be running while, during the period between the 30th day after the waiver and the issuance of notice and demand, interest on an offsetting deficiency may be suspended.

This section, which corresponds to section 71 of the House bill, amends section 6601 of the 1954 Code (relating to interest on underpayments, etc.) by adding a new subsection (g) dealing with satisfaction of underpayments by credits. This subsection denies interest to the Government on any portion of an underpayment satisfied by the crediting against it of an overpayment for the period during which interest would run on the overpayment so credited if the credit had not been made, e. g., if it had instead been refunded. The rule would, of course, not apply in special cases where interest does not run on overpayments, but would apply where interest runs for a specially limited period to the extent of that period. In addition, section

6611 (b) (1) is amended to remove the distinction now existing in the running of interest where the overpayment is credited against an underpayment of original tax and where it is credited against an additional assessment. Interest on a credited overpayment would in either case now run only from the date of the overpayment to the original due date of the amount against which it is credited. Thus, if it is credited against an underpayment antedating the overpayment, no interest would run on the overpayment at all. Since interest would otherwise run on the overpayment from the date of overpayment to the date of refund, interest on the underpayment will stop running as of the date of the overpayment; that is, when the mutuality of indebtedness arises. Similarly, in the case of an overpayment which antedates the due date of an underpayment, interest will run on the overpayment only until such due date, that is, when the mutuality of indebtedness arises.

In addition, it was necessary to make similar amendments to the 1939 Code to take care of transitional situations where there exists an underpayment or an overpayment arising under the 1939 Code, but, respectively, an overpayment or underpayment exists under the 1954 Code. These amendments will also apply in cases where both the overpayment and underpayment arose under the 1939 Code. The amendments made to both codes will have only limited retroactivity, since the amendments will apply only to credits made after December 31, 1957.

Section 6611 (c) is repealed. Since the distinction between credits against original tax and against an additional assessment is not to be preserved, the definition of an additional assessment contained in section 6611 (c) is obsolete.

Interest attributable to net operating loss carryback for certain taxable years ending in 1954

Subsection (e) of this section of the bill is intended to take care of a different problem, which arises because of changes made by section 172 of the 1954 Code (relating to net operating loss deduction). Under the 1939 Code as it existed just prior to enactment of the 1954 Code, a taxpayer was entitled to carry back a net operating loss only to the taxable year immediately preceding the loss year. The 1954 Code permits a carryback to the 2 taxable years immediately preceding the loss year. Accordingly, situations may exist where refunds have been made for the year immediately preceding the loss year but where, because of the enactment of the 1954 Code, the refunds become erroneous, since instead a refund should have been made with respect to the second preceding taxable year. Thus, the enactment of the 1954 Code may have created deficiencies for the taxable year immediately preceding the loss year, but an overpayment for the second preceding taxable year. Under section 3771 (e) of the 1939 Code, no interest runs on the overpayment for the second preceding taxable year until a claim for refund is filed, although interest on the deficiency has started to run. Subsection (e) of this section of the bill cuts off interest on the deficiency in these cases for any period during which there existed a corresponding amount of overpayment with respect to which no interest is payable.

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SECTION 88. INTEREST ON UNDERPAYMENTS

This section, which corresponds to section 72 of the House bill, amends section 6601 of the 1954 Code (relating to interest on underpayments of tax) to provide expressly that interest may be assessed and collected at any time during the period within which the tax to which such interest relates may be collected. Section 6601 (a) imposes interest on any unpaid tax from the date the tax is required to be paid until it is paid, and section 6601 (f) (1) provides that, except as otherwise provided, any reference to tax shall be deemed also to refer to the interest imposed on such tax. The amendment makes it clear that interest need not be assessed within the period of limitations applicable to the assessment of the tax to which such interest relates.

SECTION 89. FAILURE TO FILE CERTAIN INFORMATION RETURNS

This section, which is identical with section 73 of the House bill, amends subsection (a) of section 6652 of the 1954 Code, relating to failure to file certain information returns, to make it clear that the additional amount will apply if the returns are not filed within the time prescribed therefor and that in the absence of reasonable cause late filing will not prevent imposition of the additional amount. Further, the application of the section has been limited to those information returns for which a fixed due date is prescribed by regulations, as distinguished from those returns (such as returns of brokers required under sec. 6045) which are required to be filed only upon request of the Secretary of the Treasury or his delegate.

SECTION 90. DEFINITION OF UNDERPAYMENT

Section 90 of the bill, which is identical with section 74 of the House bill, clarifies section 6653 (c) (1) of the 1954 Code, relating to the definition of the term "underpayment," by expressly providing that the tax shown on the return shall be taken into account where the return is filed on the due date as well as where it is filed before the due date.

SECTION 91. TERMINATION OF TAXABLE YEAR IN CASE OF DEPARTING ALIENS

This section of the bill, which is identical with section 75 of the House bill, amends section 6851 (d) of the 1954 Code (relating to departure of alien from the United States) to provide that the Secretary or his delegate may, by regulations, waive the basic requirement of such section that every alien before departure from the United States must secure a certificate that he has complied with all obligations imposed upon him by the income tax laws. Under the provisions of existing law such requirement is mandatory. Section 6851 (d) is also amended to provide that (subject to such exceptions as the Secretary of his delegate may prescribe by regulations) payment of taxes not otherwise due, or the furnishing of bond for the payment thereof, will not be required under section 6851 if the Secretary or his delegate determines that the collection of the tax will not be jeopardized by the departure of the alien.

SECTION 92. BANKRUPTCY AND RECEIVERSHIP PROCEEDINGS

This section of the bill, which is identical with section 76 of the House bill, amends section 6871 (a) of the 1954 Code (relating to claims for income, estate, and gift taxes in bankruptcy and receivership proceedings) to provide expressly for immediate assessment of a deficiency upon the filing of a petition by a taxpayer in a proceeding under the Bankruptcy Act, where approval of the petition is not required by such act. Section 6871 (a) now provides expressly for immediate assessment upon the adjudication of bankruptcy of any taxpayer in any liquidating proceeding, or the approval of a petition of, or against, any taxpayer in any other bankruptcy proceeding, but in the case of certain proceedings under the Bankruptcy Act (such as a proceeding under ch. 11 thereof) approval of the petition is not required. The amendment merely makes it clear that in case there is no provision for approval of the petition under the Bankruptcy Act, the assessment is to be made when the petition is filed.

A similar amendment is also made in section 6871 (b) of the 1954 Code (relating to claims filed despite pendency of Tax Court proceedings) to provide expressly that a petition for redetermination by the Tax Court shall not be filed after the filing of a petition in a proceeding under the Bankruptcy Act where approval of the petition is not required under such act. Section 6871 (b) now provides expressly for such a rule in the case of adjudications in bankruptcy and approval of a petition in bankruptcy, and the amendment merely makes clear that the rule is applicable when the petition is filed in case there is no provision for approval of the petition under the Bankruptcy Act.

SECTION 93. USE OF CERTIFIED MAIL

This section, which is identical with section 77 of the House bill, amends section 7502 (c) of the 1954 Code (relating to registered mail) to authorize the Secretary of the Treasury or his delegate to prescribe by regulations the extent to which the provisions of that section relating to prima facie evidence of delivery and to postmark date, now applicable to registered mail, shall apply to certified mail.

Subsection (b) of section 93 of the bill amends sections 167 (d), 534 (b), 6164 (d) (2), 6212 (a) and (b) (2), and 6532 (a) (1) and (4), which presently require the Internal Revenue Service and taxpayers to send certain notices by registered mail, and section 7455 (which provides for service by registered mail of any pleading, notice, or process in respect of Tax Court proceedings), to permit the use of either certified or registered mail in sending such notices or effecting such service.

Subsection (c) of section 93 of the bill provides for the use of certified or registered mail under any unrepealed section of the 1939 Code.

Subsection (d) of section 93 of the bill provides that the amendments made by this section shall apply only to mailing which occurs after the date of enactment of the bill.

SECTION 94. REPRODUCTION OF RETURNS AND OTHER DOCUMENTS

This section of the bill, which adds a new section to the 1954 Code (relating to the reproduction of returns and other documents), is

identical with section 78 of the House bill, except that the number of the new section which is added has been changed from 7512 to 7513.

The new section 7513 authorizes the Secretary or his delegate to have any Federal agency or any person process any film or photoimpression of any return, document, or other matter, and to make any reproductions from any film or photoimpression of any return, document, or other matter. The Secretary or his delegate shall prescribe regulations which shall provide such safeguards as in the opinion of the Secretary or his delegate are necessary or appropriate to protect the film, photoimpressions, and reproductions made therefrom, against any unauthorized use, and to protect the information contained therein against any unauthorized disclosure.

The new section 7513 also provides that any reproduction made in accordance with such section shall have the same legal status as the original. Thus, a reproduction of a return may be shown to a shareholder who is entitled to examine the return in accordance with section 6103 (c). Similarly, a shareholder who examines a reproduction of a return will be subject to the penalty of section 7213 (a) (3) if he makes any unauthorized disclosure of the information contained in such reproduction. In addition, the new section 7513 provides that if a reproduction is properly authenticated, it shall be admissible in evidence in any judicial or administrative proceeding as if it were the original, whether or not the original return, document, or other matter is in existence.

Section 94 of your committee bill also amends section 7213 of the 1954 Code (relating to the penalties for unauthorized disclosures of information) to provide that any person who uses any film or photoimpression, or reproduction therefrom, or who discloses any information contained in any such film, photoimpression, or reproduction, in violation of any provision of the regulations prescribed pursuant to the new section 7513 (b), shall be fined not more than $1,000, or imprisoned not more than 1 year, or both.

SECTION 95. SEALS FOR OFFICES OF TREASURY DEPARTMENT

This section of the bill, which adds a new section to the 1954 Code (relating to authority to prescribe or modify seals), is identical with section 79 of the House bill, except that the number of the new section which is added has been changed from 7513 to 7514.

The new section 7514 authorizes the Secretary of the Treasury or his delegate to prescribe or modify seals of office for district directors of internal revenue and other officers or employees of the Treasury Department to whom any of the functions of the Secretary are delegated. Any such seal will be a seal of the office and not of the individual holding the office, and it will remain in the custody of the officer designated by the Secretary or his delegate. Such seal may, in accordance with regulations prescribed by the Secretary or his delegate, be affixed in lieu of the seal of the Treasury Department to any certification or attestation, except that such seal shall not be affixed to material to be published in the Federal Register.

The facsimiles of the seals prescribed under the new section 7514 will be published in the Federal Register, and such section provides that judicial notice shall be taken of any seal so published.

SECTION 96. INCOME TAXES PAID UNDER CONTRACT

Amendment of 1939 Code

Subsection (a) of section 96 of the bill, which corresponds to subsection (a) of section 80 of the House bill, amends section 22 of the 1939 Code by adding a new subsection (p), relating to income taxes paid under contract by one corporation for another corporation. The House bill would have limited the application of the new subsection to income taxes paid under a lease. Your committee has amended subsection (a) of section 96 to make the new subsection (p) applicable to contractual agreements generally.

Your committee bill provides that the new subsection applies if (1) a contract was entered into before January 1, 1952, (2) under the contract, one party (the payor) is obligated to pay, or to reimburse another party (the payee) for, any part of the tax imposed by chapter 1 of the 1939 Code on the payee with respect to the income derived under the contract by the payee from the payor, and (3) both the payor and the payee are corporations. If the new subsection applies, then gross income of the payee shall not include any such payment or reimbursement other than the payment or reimbursement of the tax imposed by chapter 1 of the 1939 Code on the payee with respect to the income derived under the contract by the payee from the payor, determined without the inclusion of any such payment or reimbursement in gross income. Thus, for taxable years beginning in 1952 and for subsequent years to which the 1939 Code applies, the payee upon satisfying the above three conditions is taxed only upon the amount of the payment required under the contract and the amount of any Federal income tax paid by the payor (determined without "pyramiding").

This section further provides that a deduction shall be allowed to the payor for all such payments or reimbursements made but only to the extent that any such payment or reimbursement is attributable to an amount paid by the payor to the payee under the contract (other than any payment or reimbursement of the tax imposed by ch. 1 of the 1939 Code) which is allowable as a deduction to the payor. Thus, if the payment under the contract (other than the payment or reimbursement of tax) is deductible, the deduction would include these payments: the amount of the payment under the contract; the initial or original amount of Federal income tax attributable to such payment; and the tax attributable to such initial or original tax.

This section applies to a contract to which the payor and the payee are parties. Also, it has no application to a contract which provides for payment of Federal income taxes on income which is not derived under the contract by the payee.

The new subsection (p) further provides that a contract shall be considered to have been entered into before January 1, 1952, if it is a renewal or continuance of a contract entered into before such date and if such renewal or continuance was made in accordance with an option contained in the contract on December 31, 1951. For purposes of the new subsection, a contract includes a lease.

Effective date

Subsection (b) of section 96 of the bill provides an effective date provision which states that the amendment made by subsection (a) of such section shall apply with respect to taxable years beginning

after December 31, 1951, to which the Internal Revenue Code of 1939 applies. If refund or credit of any overpayment resulting from the application of the amendment made by subsection (a) is prevented on the date of the enactment of the bill, or within 6 months after such date, by the operation of any law or rule of law (other than sec. 3760 of the Internal Revenue Code of 1939 and sec. 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and sec. 3761 of the Internal Revenue Code of 1939 and sec. 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefore is filed within 6 months after such date. No interest shall be paid on any overpayment resulting from the application of the amendment made by section 96 (a) of the bill.

SECTION 97. CERTAIN RECAPITALIZATIONS OF RAILROAD CORPORATIONS

Section 97 of the bill, for which there is no corresponding provision in the House bill, amends section 723 of the 1939 Code (relating to equity invested capital in special cases) by adding at the end thereof a new subsection (c). Under the amendment, the equity invested capital of a railroad corporation which has been recapitalized after December 31, 1938, in pursuance of an order of the court having jurisdiction of such corporation, either in a receivership proceeding or in a proceeding under section 77 of the National Bankruptcy Act, at the election of the taxpayer will be determined in the same manner as if the assets which the corporation held immediately following the recapitalization had been transferred to a new corporation in a transaction to which section 760 of the Internal Revenue Code of 1939 is applicable. The election allowed by this section may be made under such regulations as the Secretary or his delegate may prescribe. For this purpose, all of such assets are to be considered as having been transferred to a new corporation in exchange for the stock, securities, and other liabilities existing immediately after the recapitalization. The amendment is effective with respect to taxable years beginning after December 31, 1941.

SECTION 98. BEQUESTS, ETC., TO SURVIVING SPOUSE

This section for which there is no corresponding provision in the House bill amends section 812 (e) (1) (F) of the Internal Revenue Code of 1939.

Section 812 (e) of the Internal Revenue Code of 1939 allows as a deduction from the gross estate certain property interests passing to the decedent's surviving spouse. With several exceptions, no deduction is allowable under that section in the case of terminable interests. Paragraph (1) (F) of subsection (e) provided an exception to this rule in the case of certain terminable interests provided a number of conditions were met. The transfer was required to be in trust and did not qualify for the deduction unless (1) the surviving spouse was entitled to all of the income from corpus of the trust during her life, (2) the income was payable at annual or more frequent intervals to her, and (3) the surviving spouse was given a complete and unrestricted power to appoint the entire remainder in the trust property to herself or to her estate. It has been held that a trust

under which the surviving spouse was entitled to income from only a part of the trust or had a power to appoint only part of the trust property did not qualify for the marital deduction to any extent. For example, if H bequeathed property to T in trust to pay half of the income from the trust property to W during her life and at her death to distribute the trust property to whomever W should appoint by her will, no portion of the trust would qualify for the marital deduction, nor would any part of the trust qualify for the marital deduction if W were paid the entire income for life but at her death had a power to distribute only half of the trust property to whomever she desired to appoint by will.

Subsection (a) of section 98 of this bill amends section 812 (e) (1) (F) of the Internal Revenue Code of 1939 in order to apply rules comparable to the provisions of section 2056 (b) (5) of the Internal Revenue Code of 1954. Thus, if an interest in property passes from the decedent to his surviving spouse (whether or not in trust) and the spouse is entitled to all the income from the entire interest or all the income from a specific portion of the entire interest, with a power in her to appoint the entire interest or the specific portion, the interest which passes to her qualifies as a marital deduction in computing the taxable estate of the decedent if it satisfies the following five conditions:

(1) The surviving spouse must be entitled for life to all of the income of the entire interest, or to all of the income from a specific portion of the entire interest.

(2) The income payable to the surviving spouse must be payable annually or at more frequent intervals.

(3) The surviving spouse must have the power to appoint the entire interest or the specific portion to either herself or to her estate.

(4) The power in the surviving spouse must be exercisable by her alone, and (whether exercisable by will or during life) must be exercisable in all events.

(5) The entire interest, or the specific portion, must not be subject to a power in any other person to appoint any part to any person other than the surviving spouse.

For example, if H in his will provided for the creation of a trust under the terms of which the income from all of the trust property is payable to his surviving spouse with uncontrolled power in the spouse to appoint one-half of the trust property by will, such interest will qualify as an exception from the terminable interest rule to the extent of the value of one-half of the trust property. If, in the above example, the surviving spouse was to receive one-half of the income from all of the trust property with an uncontrolled power to appoint all of such property by will, such interest will qualify as an exception from the terminable interest rule to the extent of the value of one-half of the trust property. The foregoing rules are equally applicable to transfers by the decedent not in trust.

Subsection (b) of section 98 of this bill provides that the amendment made by subsection (a) shall apply with respect to estates of decedents dying after April 1, 1948, and before August 17, 1954. Subsection (b) further provides that if refund or credit of any overpayment resulting from the application of such amendment is prevented on the date of the enactment of this act, or at any time within 1 year from such date by the operation of any law or rule of law

(other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within 1 year after the date of the enactment of this act. No interest shall be allowed or paid on any overpayment resulting from the enactment of this section.

SECTION 99. CHANGE FROM RETIREMENT TO STRAIGHT LINE METHOD OF COMPUTING DEPRECIATION IN CERTAIN CASES

This section, which may be cited as the "Retirement-Straight Line Adjustment Act of 1958," provides a settlement of a problem involving the retirement method of accounting which has existed for a number of years and has presented difficulties in tax administration. It is the same as section 81 of the House bill except for a technical amendment in subsection (d) thereof.

Subsection (b) provides that any taxpayer who held retirement-straight line property (as defined in subsection (c)) on its 1956 adjustment date (as defined in subsection (g) (4)) may elect to have the section apply. The election shall be irrevocable and shall apply as provided in this section to all retirement-straight line property, including such property for periods when held by predecessors (as defined in subsection (g) (5)) of the taxpayer. An election under this section shall be made at such time and in such manner as the Secretary or his delegate shall prescribe.

Subsection (c) defines the term "retirement-straight line property" to mean any and all property of a kind or class with respect to which the taxpayer (or a predecessor of the taxpayer) changed, pursuant to the terms and conditions prescribed for it by the Commissioner of Internal Revenue, from the retirement to the straight line method of computing the allowance for any taxable year beginning after December 31, 1940, and before January 1, 1956, of deductions for depreciation.

Subsection (d) provides the basis adjustments to be made by the taxpayer as of the 1956 adjustment date in respect of all periods before that date in order to determine the adjusted basis of all retirement-straight line property held by the taxpayer on that date. This adjusted basis on the 1956 adjustment date, that is, on the first day of the taxpayer's first taxable year beginning after December 31, 1955, shall be used by the taxpayer as a starting point in determining taxable income for any taxable year beginning after December 31, 1955. In order to arrive at the adjusted basis on the 1956 adjustment date, the taxpayer will start with the unadjusted basis of all retirement-straight line property held by the taxpayer or a predecessor on the changeover date (that is, on the first day of the first taxable year for which the change from the retirement to the straight line method of computing the depreciation allowance was effective) and will make the adjustments prescribed by subsection (d) taking into account those required, in accordance with the method of accounting regularly used, for additions and retirements and other dispositions of property

occurring on or after the changeover date and before the taxpayer's 1956 adjustment date. The adjustments required by subsection (d) shall be made in lieu of the adjustments for exhaustion, wear and tear, and obsolescence otherwise required by section 1016 (a) (2) and section 1016 (a) (3) of the Internal Revenue Code of 1954.

Paragraph (1) of subsection (d) requires an adjustment to be made as of the 1956 adjustment date for depreciation sustained before March 1, 1913, on all retirement-straight line property held by the taxpayer or a predecessor on March 1, 1913, for which cost was or is claimed as basis and which was either (1) retired by the taxpayer or a predecessor before the changeover date or (2) held by the taxpayer or a predecessor on the changeover date. This rule of adjustment for depreciation sustained before March 1, 1913, is subject to several restrictions, however. In the case of property retired before the changeover date the adjustment is required only if a deduction was allowed in computing net income by reason of the retirement and the deduction was computed on the basis of cost of the property without adjustment for depreciation sustained before March 1, 1913. Moreover, in the case of any such property retired during any taxable year beginning after December 31, 1929, the adjustment shall not exceed that portion of the amount attributable to depreciation sustained before March 1, 1913, on the property retired which resulted, by reason of the deduction so allowed, in a reduction of taxes under the 1954 Code or under prior income, war-profits, or excess-profits tax laws. In the case of property held on the changeover date the adjustment for depreciation sustained before March 1, 1913, is not required if the property was disposed of on or after the changeover date and before the 1956 adjustment date and is property to which paragraph (2) of subsection (d) applies.

Subsection (d) (1) provides that the adjustment required to be made thereunder for depreciation sustained before March 1, 1913, shall be allocated, in the manner prescribed by the Secretary or his delegate, among all retirement-straight line property held by the taxpayer on its 1956 adjustment date. It is anticipated that the adjustment for depreciation sustained before March 1, 1913, on property no longer held by the taxpayer on its 1956 adjustment date will be allocated, perhaps on the basis of a weighted average or some other reasonable method, among the remaining retirement-straight line properties held by the taxpayer on such adjustment date.

Paragraph (2) of subsection (d) requires an adjustment to be made as of the 1956 adjustment date for that portion of the reserve (hereinafter referred to as the "terms letter" reserve) prescribed by the Commissioner of Internal Revenue in connection with the changeover to the straight-line method which was applicable to any retirement-straight line property disposed of by sale, casualty, or "abnormal" retirement in the nature of special obsolescence, but only if the sale occurred in, or a deduction by reason of such casualty or "abnormal" retirement was allowed for Federal income-tax purposes for, a period beginning on or after the changeover date and ending before the taxpayer's 1956 adjustment date. Since the "terms letter" reserve includes an adjustment for depreciation sustained before March 1, 1913, no adjustment is required under paragraph (1) (B) of subsection (d) in respect of property to which paragraph (2) of

subsection (d) applies; otherwise, there would be a double adjustment for the depreciation sustained before March 1, 1913, on the same property.

Paragraph (3) of subsection (d) requires an adjustment to be made as of the 1956 adjustment date for the entire amount of depreciation allowable, pursuant to the terms and conditions prescribed by the Commissioner of Internal Revenue in connection with the changeover, for all periods beginning on or after the changeover date and ending before the taxpayer's 1956 adjustment date. This adjustment shall include any such depreciation allowable with respect to any retirement-straight line property which was disposed of on or after the changeover date and before the taxpayer's 1956 adjustment date.

Example

The operation of subsection (d) of this section may be illustrated by the following example. Assume that on its changeover date, January 1, 1943, the taxpayer or its predecessor held retirement-straight line property with an unadjusted cost basis of $10,000. Depreciation sustained before March 1, 1913, on retirement-straight line property held by the taxpayer or its predecessor on March 1, 1913, for which cost was or is claimed as basis amounts to $800. Of this total depreciation sustained before March 1, 1913, $200 is attributable to retirement-straight line property retired before January 1, 1943, under circumstances requiring the adjustment under subsection (d) (1) (A), and $600 is attributable to retirement-straight line property held by the taxpayer or its predecessor on January 1, 1943. On December 31, 1954, retirement-straight line property costing $1,500 was permanently retired under circumstances giving rise to an abnormal retirement in the nature of special obsolescence. The "terms letter" reserve applicable to this retired property was $450, of which $120 represents depreciation sustained before March 1, 1913. On December 31, 1954, retirement-straight line property costing $1,000 was also permanently retired under circumstances giving rise to a normal retirement. None of the property retired on December 31, 1954, had any market or salvage value on that date. Depreciation allowable on retirement-straight line property under the terms and conditions prescribed by the Commissioner in connection with the changeover for all periods beginning on or after January 1, 1943, and ending before the taxpayer's 1956 adjustment date (January 1, 1956), amounts to $2,155, of which $135 is applicable to the property retired as an abnormal retirement and $850 is applicable to the property retired as a normal retirement. The adjusted basis on January 1, 1956, of the retirement-straight line property held by the taxpayer on that date is $5,800, determined as follows and in accordance with subsection (d) of this section:

Asset account:		
1. Unadjusted cost on Jan. 1, 1943		$10,000
2. Less:		
(a) Adjustment for abnormal retirement	$1,500	
(b) Adjustment for normal retirement	1,000	
		2,500
3. Balance as of Jan. 1, 1956		7,500

Item		
Additions to reserve for depreciation:		
1. Depreciation sustained before Mar. 1, 1913, on—		
(*a*) Property retired before Jan. 1, 1943		$200
(*b*) Property held on Jan. 1, 1943	$600	
Less portion of such depreciation sustained on property withdrawn by abnormal retirement on Dec. 31, 1954	120	
		480
2. Portion of "terms letter" reserve applicable to abnormal retirement on Dec. 31, 1954 (including $120 depreciation sustained before Mar. 1, 1913)		450
3. Depreciation allowable under "terms letter" from Jan. 1, 1943, to Dec. 31, 1955		2,155
4. Total additions		3,285
Charges to reserve for depreciation:		
1. Adjustment for abnormal retirement:		
(*a*) Portion of "terms letter" reserve applicable to such property	$450	
(*b*) Depreciation applicable to such property and allowed from Jan. 1, 1943, to Dec. 31, 1954	135	
		585
2. Adjustment for normal retirement		1,000
3. Total charges		1,585
Balance in reserve for depreciation:		
1. Total additions, as above		3,285
2. Total charges, as above		1,585
3. Balance as of Jan. 1, 1956		1,700
Adjusted basis of retirement-straight line property:		
1. Balance in asset account, as above		7,500
2. Balance in reserve account, as above		1,700
3. Adjusted basis as of Jan. 1, 1956		5,800

The $5,800 adjusted basis on January 1, 1956, of the retirement-straight line property held by the taxpayer on that date is to be recovered over the remaining useful life of such property. The remaining useful life of the property will be reviewed regularly, and appropriate adjustments in the rates will be made as necessary in order to spread the remaining basis less salvage over the average remaining useful life.

Subsection (e) provides the adjustments to be made in determining the adjusted basis of any retirement-straight line property as of any time on or after the changeover date and before the taxpayer's 1956 adjustment date and is to be used in determining taxable (or net) income for taxable years beginning on or after the changeover date and before the taxpayer's 1956 adjustment date. The adjustments prescribed by subsection (e) are interim adjustments only; they will not be used in determining the basis of property for taxable years beginning before the changeover date or on or after the taxpayer's 1956 adjustment date. In order to arrive at the adjusted basis under subsection (e), the taxpayer will start with the unadjusted basis of all retirement-straight line property held by the taxpayer or its predecessor on the changeover date and will make the adjustments prescribed by subsection (e) taking into account those required, in accordance with the method of accounting regularly used, for additions and retirements and other dispositions of retirement-straight line property oc-

curring on or after the changeover date and before the 1956 adjustment date. The adjustments required by subsection (e) shall be made in lieu of the adjustments for exhaustion, wear and tear, and obsolescence otherwise required by section 1016 (a) (2) and section 1016 (a) (3) of the Internal Revenue Code of 1954 and by the corresponding provisions of prior revenue laws. Subsection (e) is not to apply in determining adjusted basis for purposes of section 437 (c) (relating to the determination of equity capital for purposes of the Excess Profits Tax Act of 1950) of the Internal Revenue Code of 1939.

Paragraph (1) of subsection (e) provides that the basis of the property involved must be adjusted as of the specific applicable date for so much of the "terms letter" reserve as is applicable to that specific property. Paragraph (2) of subsection (e) provides that the basis of the property involved must be adjusted as of the specific applicable date for so much of the depreciation allowable under the terms and conditions prescribed by the Commissioner in connection with the changeover as is applicable to the specific property involved.

It is intended by subsection (e) to provide that the adjustments to basis prescribed by the Commissioner of Internal Revenue in connection with the changeover, including the full "terms letter" reserve, and the depreciation allowable from the changeover date, computed in accordance with the terms and conditions prescribed by the Commissioner in connection with the changeover, shall be considered the proper adjustments to basis in determining taxable income for any taxable year beginning on or after the changeover date and before the taxpayer's 1956 adjustment date.

Example

The operation of subsection (e) may be illustrated by the following example. The facts are assumed to be the same as those in the example illustrating subsection (d), except that (1) it is desired to determine the adjusted basis of retirement-straight line property as of January 1, 1955, (2) the full "terms letter" reserve prescribed by the Commissioner as of January 1, 1943, is $3,000, and (3) the depreciation allowable under the "terms letter" from the changeover date to December 31, 1954, is $2,100. The adjusted basis on January 1, 1955, of the retirement-straight line property held by the taxpayer on that date is $3,985, determined as follows and in accordance with subsection (e) of this section:

Asset account:		
1. Unadjusted cost on Jan. 1, 1943		$10,000
2. Less:		
a. Adjustment for abnormal retirement	$1,500	
b. Adjustment for normal retirement	1,000	
		2,500
3. Balance as of Jan. 1, 1955		7,500
Additions to reserve for depreciation:		
1. Full "terms letter" reserve as of Jan. 1, 1943		3,000
2. Depreciation allowable under "terms letter" from Jan. 1, 1943, to Dec. 31, 1954		2,100
3. Total additions		5,100

Charges to reserve for depreciation:		
1. Adjustment for abnormal retirement:		
a. Portion of "terms letter" reserve applicable to such property	$450	
b. Depreciation applicable to such property and allowed from Jan. 1, 1943, to Dec. 31, 1954	135	
		$585
2. Adjustment for normal retirement		1,000
3. Total charges		1,585
Balance in reserve for depreciation:		
1. Total additions, as above		5,100
2. Total charges, as above		1,585
3. Balance as of Jan. 1, 1955		3,515
Adjusted basis of retirement straight line property:		
1. Balance in asset account, as above		7,500
2. Balance in reserve account, as above		3,515
3. Adjusted basis as of Jan. 1, 1955		3,985

Subsection (f) provides the adjustments to be made in determining equity invested capital under the Excess Profits Tax Acts of 1940 and 1950, and in determining equity capital under the Excess Profits Tax Act of 1950. These adjustments are to be made notwithstanding the terms and conditions prescribed by the Commissioner of Internal Revenue in connection with the changeover to the straight line method of computing depreciation.

Paragraph (1) of subsection (f) provides that, in computing equity invested capital under section 458 (relating to the Excess Profits Tax Act of 1950) and section 718 (relating to the Excess Profits Tax Act of 1940) of the Internal Revenue Code of 1939, accumulated earnings and profits as of the changeover date, and as of the beginning of each taxable year thereafter, shall be reduced by the depreciation sustained before March 1, 1913, on retirement-straight line property held by the taxpayer or its predecessor on March 1, 1913, for which cost was or is claimed as basis and which was held by the taxpayer or its predecessor on the changeover date, except that depreciation sustained before March 1, 1913, on property to which subsection (d) (2) applies will not be taken into account. This adjustment under subsection (f) (1) is in lieu of any other adjustments for depreciation in respect of retirement-straight line property for any period prior to the changeover date.

Paragraph (2) of subsection (f) provides that, in determining the adjusted basis of assets for the purpose of computing equity capital under section 437 (c) (relating to the Excess Profits Tax Act of 1950) of the Internal Revenue Code of 1939, the basis of the assets which enter into the computation must reflect (1) an adjustment computed in accordance with subsection (d) of this section for depreciation sustained before March 1, 1913, not only on the retirement-straight line property held by the taxpayer or its predecessor on the changeover date but also on the retirement-straight line property retired by the taxpayer or its predecessor before the changeover date and (2) the depreciation allowable under subsection (e) (2) of this section for any period beginning on or after the changeover date and

ending before the taxable year for which the excess profits credit is being computed.

The difference in the adjustments under subsection (f) (1) and subsection (f) (2) of this section reflects the fact that accumulated earnings and profits computed under section 458 and section 718 of the Internal Revenue Code of 1939 have already been reduced, as a result of retirements prior to the changeover date of retirement-straight line property held by the taxpayer or its predecessor on March 1, 1913, by the full basis of such property (less salvage, if any) undiminished by any depreciation. Any further reduction of accumulated earnings and profits under section 458 and section 718 of the 1939 Code to reflect such depreciation would constitute a double adjustment in the computation of the taxpayer's equity invested capital.

SECTION 100. AMENDMENTS TO 1954 CODE WITH RESPECT TO PROPERTY ACQUIRED FROM RETIREMENT METHOD CORPORATION

This section, which provides for an adjustment to the basis of certain retirement-straight line property acquired in certain reorganizations for depreciation sustained before March 1, 1913, is the same as section 82 of the House bill, except that your committee has added a provision under subsection (b) (2) which makes the section inapplicable in certain cases where there has been a previous judicial determination of the adjusted basis of such property.

Subsection (a) of this section amends section 372 of the 1954 Code (relating to basis in connection with certain receivership and bankruptcy proceedings) by adding thereto a new subsection (b) which is applicable to taxable years beginning after December 31, 1955. Paragraph (1) of proposed section 372 (b), which is the same as in the House bill except for a minor technical amendment, provides the adjustment to be made in respect of depreciation sustained before March 1, 1913, in order to determine the adjusted basis of all retirement-straight line property (as defined in sec. 372 (b) (2)) held by the taxpayer on its adjustment date (as defined in sec. 372 (b) (3) (B)). This new paragraph relates solely to the adjustment for exhaustion, wear and tear, and obsolescence sustained before March 1, 1913, on retirement-straight line property. The adjustment required by such paragraph shall be made in lieu of the adjustment for exhaustion, wear and tear, and obsolescence otherwise required by section 1016 (a) (3) (A) of the 1954 Code in respect of any period before March 1, 1913, and shall apply to all periods beginning on or after the taxpayer's adjustment date. The provisions of proposed section 372 (b) are mandatory and are not dependent upon any election exercised by the taxpayer.

The new paragraph (1) provides that, if the taxpayer has acquired property in a transaction described in section 373 (b) or section 374 (b) of the 1954 Code, relating to the basis of property acquired in certain railroad reorganizations, and if any of the property so acquired constitutes retirement-straight line property, then, in determining the adjusted basis of all retirement-straight line property held by the taxpayer on its adjustment date, adjustment must be made for depreciation sustained before March 1, 1913, on retirement-straight line property held on March 1, 1913, for which cost was or is claimed as basis

and which was either (1) retired before the acquisition of the retirement-straight line property by the taxpayer, or (2) acquired by the taxpayer. In the case of property retired before the acquisition by the taxpayer, however, the adjustment is required only if a deduction was allowed in computing net income by reason of the retirement and the deduction was computed on the basis of cost without adjustment for depreciation sustained before March 1, 1913. Moreover, in the case of any such property retired during any taxable year beginning after December 31, 1929, the adjustment shall not exceed that portion of the amount attributable to depreciation sustained before March 1, 1913, on the property retired which resulted, by reason of the deduction so allowed, in a reduction of taxes under subtitle A of the 1954 Code or under prior income, war-profits, or excess-profits tax laws.

Paragraph (1) of proposed section 372 (b) provides that the adjustment required to be made thereunder for depreciation sustained before March 1, 1913, shall be allocated, in the manner prescribed by the Secretary or his delegate, among all retirement-straight line property held by the taxpayer on its adjustment date. It is anticipated that the adjustment for depreciation sustained before March 1, 1913, on property previously acquired by the taxpayer but no longer held on the adjustment date will be allocated, perhaps on the basis of a weighted average or some other reasonable method, among the remaining retirement-straight line properties held by the taxpayer on the adjustment date.

Paragraph (2) of proposed section 372 (b), which is the same as in the House bill, defines the term "retirement-straight line property" to mean any property of a kind or class with respect to which (1) the corporation transferring such property to the taxpayer was, at the time of transfer, using the retirement method of computing the allowance of deductions for depreciation and (2) the acquiring corporation has adopted, at any time after the transfer, any other method of computing such allowance.

Paragraph (3) of proposed section 372 (b), which is the same as in the House bill, provides other definitions for purposes of that subsection. The term "adjustment date" is defined therein to mean the first day of the taxpayer's first taxable year beginning after December 31, 1955, or, if later in point of time, the first day of the first taxable year in which the taxpayer uses a method other than the retirement method of computing the allowance of deductions for depreciation.

Subsection (b) (1) of this section, which contains the general effective date provision, is the same as in the House bill. Subsection (b) (2), which was added by your committee, provides that the amendment of section 372 by this section shall not apply with respect to any taxpayer if, before the date of the enactment of the bill, there has been a determination, for any taxable year, of the adjusted basis of retirement-straight line property of the taxpayer of the type described in section 372 (b), as added by this section, by the Tax Court or by any other court of competent jurisdiction, in any proceeding in which the decision of the court became final after December 31, 1955, and which established the right of the taxpayer to use the straight line depreciation method of computing the annual depreciation allowance with respect to such property for Federal tax purposes for any taxable year. See, for example, *The Akron, Canton & Youngstown Railroad Company* v. *Commissioner* ((1954) 22 T. C. 648, case remanded (1956) 56–1 USTC ¶ 9282).

SECTION 101. EXTENSION OF TIME FOR FILING CLAIMS FOR REFUNDS OF OVERPAYMENTS OF INCOME TAX BASED UPON EDUCATION EXPENSES PAID OR INCURRED IN 1954

This section, for which there is no corresponding provision in the House bill, extends the period for filing claims for refund or credit relating to educational expenses paid or incurred for the taxpayer's first taxable year beginning after December 31, 1953, and ending after August 16, 1954. As the statutory period for filing claims for refund or credit of income tax for the calendar year 1954 expired on April 15, 1958, a short time after the promulgation of the regulations pertaining to educational expenses, your committee feels that an additional period should be provided in which claims for credit or refund of an overpayment of income tax resulting from the application of section 1.162-5 of the Income Tax Regulations (relating to expenses for education) may be filed. Accordingly, section 101 of the bill provides that if the application of section 162 of the Internal Revenue Code of 1954, insofar as this section relates to expenses for education, as described in section 1.162-5 of the Income Tax Regulations, results in an overpayment of income tax, refund or credit of which is barred on the date of enactment of this act, or at any time within 60 days after such date, refund or credit shall be made irrespective of any provision or rule of law (other than secs. 7121 and 7122 relating to closing agreements and compromises) if a claim therefor has been filed on or before the date of enactment of this act or is filed within 60 days after the date of enactment of this Act.

SEC. 102. DEDUCTIBILITY OF ACCRUED VACATION PAY

This section for which there is no corresponding provision in the House bill relates to the deduction under section 162 for accrued vacation pay. Revenue Ruling 54-608 denies a deduction for accrued vacation pay if during the taxable year (1) the liability for the vacation pay to a specific person has not been clearly established, or (2) the amount of the liability to each individual is not capable of computation with reasonable accuracy. Subsequent administrative rulings made the provisions of Revenue Ruling 54-608 inapplicable to taxable years ending prior to January 1, 1959.

Under your committee's amendment, the deduction for accrued vacation pay would not be denied for any taxable year ending before January 1, 1961, solely by reason of the existence of either of these conditions, provided that at the time of the accrual, the employee must have fully performed the qualifying service necessary under the terms of the vacation plan to entitle him to receive a vacation with pay (or payment in lieu thereof).

This section shall not apply unless the accrual for vacation pay is computed in accordance with the method of accounting consistently followed by the taxpayer in arriving at such deduction. This section is intended to apply only to those accrual method taxpayers who applied the principles of I. T. 3956 to deduct vacation pay in the year accrued, and who, since the publication of Revenue Ruling 54-608, have continued to compute the deduction in such manner. However, this section is not intended to limit or increase the deduction for vacation pay that would otherwise be allowable to those accrual

method taxpayers who under I. T. 3956 have consistently computed the deduction for vacation pay in the year paid.

SECTION 103. REIMBURSEMENT FOR MOVING EXPENSES RECEIVED BY EMPLOYEES OF CERTAIN CORPORATIONS FORMED EXCLUSIVELY TO OPERATE LABORATORIES FOR THE ATOMIC ENERGY COMMISSION

This section, for which there is no corresponding provision in the House bill, provides an exclusion from gross income of amounts received as reimbursement for moving expenses of new employees of certain corporations, to the extent that such amounts do not exceed the actual expenses paid or incurred by the employee for such purposes. Under existing law, payments or reimbursements to a new employee of moving or relocation expenses come within the statutory description of gross income, and the expenses incurred by a new employee in moving his family and household goods are not expenditures for which deductions may be taken in computing income taxes. *U. S.* v. *Sherrill O. and Doris M. Woodall*, *U. S.* v. *Glenn S. and Margaret H. Mills* (— F. 2d — (C. A. 10th 1958)) (cert. applied for); (Rev. Rul. 55-140, C. B. 1955-1, 317.)

Section 103 of your committee's bill provides that, notwithstanding any other law or rule of law, a reimbursement of moving expenses under the circumstances described below shall be treated as an amount which was not includible in the gross income of the individual, to the extent that such reimbursement did not exceed the actual moving expenses paid or incurred by the individual.

The applicability of section 103 is limited to reimbursements received from a corporation which was (1) formed exclusively for the purpose of, and was engaged exclusively in, operating without profit a scientific laboratory for the Atomic Energy Commission and (2) operated solely on funds appropriated to the Atomic Energy Commission.

This section further provides that the general rule, and not the exception provided in section 103, will apply where the individual was advised, at the time of his employment, by an authorized officer, employee, or agent of such corporation that the amount of such reimbursement would be includible in gross income.

SECTION 104. EXTENSION OF TIME FOR MAKING REFUND OF OVERPAYMENTS OF INCOME TAX RESULTING FROM ERRONEOUS INCLUSION OF CERTAIN COMPENSATION FOR INJURIES OR SICKNESS

This section, for which there is no corresponding provision in the House bill, provides that the period prescribed by section 3772 (a) (2) of the Internal Revenue Code of 1939 for commencing suits for refund shall not expire prior to 1 year after the date of the enactment of this bill in the case of any overpayment of income tax resulting from the inclusion as an item of gross income of any amount which was excludable from gross income under section 22 (b) (5) of the Internal Revenue Code of 1939 (relating to compensation for injuries or sickness) as an amount received, through accident or health insurance, as compensation for personal injuries or sickness, if claim for credit or refund of such overpayment was filed after December 31, 1951, and

within the time prescribed by law. Many such claims have been disallowed and the period prescribed by section 3772 (a) of the 1939 Code for filing suit has expired. The amendment will make it possible for the Internal Revenue Service to reconsider such claims and make refunds which, without the amendment, would be erroneous refunds under section 3774 (b) of such code.

SECTION 105. AMOUNTS RECEIVED BY CERTAIN MOTOR CARRIERS IN SETTLEMENT OF CLAIMS AGAINST THE UNITED STATES

This section, for which there is no corresponding provision in the House bill, provides that notwithstanding section 42 of the Internal Revenue Code of 1939, amounts received in settlement of any claim against the United States arising out of the "taking" by the United States under Executive Order 9462 of possession or control of any motor carrier transportation system, shall, at the election of the taxpayer, be deemed to be income accrued in the taxable year during which such motor carrier transportation system was in possession or control of the United States. It also provides that the election shall be made within 1 year after the enactment of the bill, and if made, shall be irrevocable. The bill further provides that the period for assessing any deficiency attributable to the inclusion of income by reason of the application of this act shall not expire prior to 1 year after date on which the taxpayer makes his election.

Under existing law, income accrues to a taxpayer using an accrual method of accounting in the year in which the right to receive, or the obligation to pay, has become final and definite in amount. This section of the bill permits the taxpayer to elect to accrue the income in the year during which the motor carrier transportation system was in possession or control of the Government, rather than accruing it in the year during which the award is made by the Motor Carrier Claims Commission. In the event the carrier's transportation system was in possession or control of the Government for a period of more than 1 taxable year, your committee has provided that the income resulting from this "taking" by the Government shall accrue ratably over such period.

An example of the operation of this bill would be as follows: A "taking" of the carrier's operations by the Government occurred in 1944. In 1950, carrier submits a claim for compensation, and receives an award from the Motor Carrier Claims Commission in 1953. Under the bill, the taxpayer is permitted to accrue the income represented by the award in 1944, the year in which the "taking" occurred. Under present law, the taxpayer is required to report such income in the year in which his right to receive the award became fixed and unconditional, which in this case would be 1953.

SECTION 106. REASONABLE CAUSE FOR FAILURE TO FILE RETURN

This section, which was added by your committee, provides with respect to certain claims against the United States a new application of the second sentence of section 106 of the 1939 Code.

Section 106 limits the surtax of individuals to 30 percent on certain payments received from the United States. Pursuant to subsection (b), the limitation extends to payments arising under a contract for

the construction of installations or facilities for any branch of the armed services of the United States, if such claims were unpaid for more than 5 years from the date such claim first accrued. The second sentence of section 106, for the purposes of applying section 291 (a) of the 1939 Code (relating to additions to tax for failure to file a return), provides that in any case to which subsection (b) applies the term "reasonable cause" for failure to file shall include the filing of a timely incomplete return under circumstances which led the taxpayer to believe that no tax was due on amounts received under a settlement with the United States.

This section provides that the second sentence of section 106 shall apply with respect to taxable years ending after December 31, 1942, in any case in which an amount is received in any taxable year ending after such date by a taxpayer in settlement of a claim arising under the same contract as a claim the settlement of which resulted in the receipt in a subsequent taxable year of any amount to which section 106 (b) applies. This section further provides that refund or credit of any overpayment resulting from its application may be made in any event if claim therefor is filed within 1 year after the date of enactment of this bill.

V. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

VI. INDIVIDUAL VIEWS OF SENATOR PAUL H. DOUGLAS

As this bill came from the House, it was, on balance, a reasonably good bill. But, even as it came from the House, at best it dealt with comparatively minor abuses and, for the most part, closed relatively insignificant loopholes. It pointedly ignored the many shocking injustices within our tax structure which permit certain favored taxpayers to pay a much lower tax on a given amount of income than that which other taxpayers pay on equal incomes from other sources. These unjust tax differentials in the aggregate cost the Government several billion dollars a year in revenue. They have increased over the years so that the tax structure of the country is now seriously eroded.

Among the most serious of these inequities and evasions are the following:

(1) Excessive depletion allowances in oil and gas and certain other subsurface deposits;

(2) The dividends-credit monstrosity, including the exclusion from gross income of the first $50 of dividends received and a deduction of 4 percent of the remaining dividends received, not against taxable income but against the actual tax liability itself;

(3) The fact that, while the basic income tax of 20 percent on wages and salaries is withheld at the source, withholding upon dividends and interest received is not required;

(4) Abuses in the conversion of ordinary income into capital gains;

(5) Abuses in the area of family partnerships;

(6) Abuses in the taxation of corporate "spin-offs" and "split-offs";

(7) Abuses in the field of stock options and other fringe benefits for executive and other employees;

(8) Abuse of the "ordinary and necessary" business expenses deduction;

(9) Excessive benefits to upper income groups from income splitting on a joint return.

Unless Congress cures these and other erosions and injustices, they will continue to spread like a cancer through our tax system. For when some are given favored treatment, others chafe at the additional burdens imposed upon them and demand similar exemptions. Loopholes widen into huge apertures; a breed of skilled tax lawyers develops, skilled in helping wealthy clients avoid taxes in return for big fees. The general taxpayer, too public spirited or too uninformed to obtain similar tax favors, is left bearing the burdens. Democratic government is itself weakened by the unfairness of the whole setup. Just as injustices in the collection of taxes helped to undermine the Roman republic and the ancient regime in France, so similar practices serve to breed discontent here at home and undermine men's faith in their government.

It is important, therefore, that we not only stop further erosion of the tax structure but that we begin to undo some of the damage already

done. It would be plainly impossible to cure all of the defects at once. There is not time enough in this session for that. Nor is public and legislative opinion sufficiently informed and aroused. But a start can and should be made.

I therefore proposed in committee that we deal with 3 of the most important abuses, namely, the excessive depletion allowances on oil and gas; the failure to provide a withholding tax at the source on dividends; and the 4 percent dividends received credit against tax and the $50 dividends received exclusion from gross income.

These are the reasons in brief why these features of our present tax laws should be changed. A more detailed discussion will be given when these issues are discussed on the floor.

I

The most conspicuous of these abuses is the 27½ percent depletion allowance on income from oil and gas. Under the present law, a host of costs and special allowances are deductible from gross income before even the depletion allowance applies. These are:

(1) Operating costs.

(2) Intangible drilling and development costs. These can be written off in 1 year and not spread over a period of years as is the case in other industries. It has been estimated that between 75 percent and 90 percent of all costs can be written off in 1 year in this manner. We have, therefore, accorded to this industry virtually the ultimate in accelerated depreciation and fast tax writeoffs.

(3) Unsuccessful or dry holes, of course, can be written off.

(4) The 14-point reduction in the tax itself—or a reduction from 52 percent to 38 percent on taxable income—for income derived from operations abroad in the Western Hemisphere.

(5) Royalty payments abroad, particularly in the Near East, may be disguised as income-tax payments for which the foreign tax credit is then available so that a company then escapes liability for United States tax by being allowed to take a tax credit for payment which a domestic taxpayer would be permitted only to deduct from gross income rather than to take as a credit against tax.

But, in addition to all these provisions which would seem to be quite generous, a further allowance is permitted called the percentage depletion allowance. In the case of gas and oil, this amounts to an additional 27½ percent of gross income up to one-half of net income. This allowance is, moreover, permitted in perpetuity as long as there is any flow of oil or gas from the well. It is not limited to recapturing the cost of the well in question, most of which cost—as we have seen—is recovered for tax purposes in the year the outlay is made through the intangible drilling and development cost deduction. This allowance is in addition to all other deductions and it continues through time without relationship to the taxpayer's investment in the venture and whether or not that investment has been recovered for taxpurposes.

The beginnings of this allowance go back a little over 30 years when an effort was made to revise the prevailing discovery depletion provisions. From its inception, the percentage depletion allowance has been 27½ percent. As corporation income taxes have risen from

14 percent to the present 52 percent, the value of this allowance has grown. Not only is this true but it has brought in its train a host of similar deductions on virtually everything else that is extracted from the earth and sea, including oystershells, clamshells, sand and gravel. There would seem to be no danger of "dry holes" here. It is almost a perfect example of a case where instead of closing a loophole in the law, an attempt has been made to make the loophole universal.

These deductions for depletion allowances in the extractive industries were $2.8 billion in 1955, the latest year for which official figures are available. For oil and gas alone, the deductions came to over $2 billion in that year.

The results of investigations which appear in the compendium on Federal tax policy, published by the Joint Economic Committee in 1955 (see p. 902), show that in 1954, the effective tax rate paid by 1 major oil company was only 9.2 percent. For another company, the rate was 16.3 percent, while another paid only 18.5 percent. The effective tax rate paid by 24 large petroleum companies was only 22.6 percent, while all other corporations in that year paid taxes at an effective rate of 48.1 percent. A study which I have made of 27 producing companies dealing in oil and/or gas shows that many paid infinitesimal fractions of their profits in taxes.

In 1951, the Secretary of the Treasury published official statistics on certain unidentified individuals in the oil and gas industry which showed that one individual operator, with net income in the years 1943–47 of $14.3 million, paid income taxes of only $80,000 in this period. The following table submitted by the Secretary of the Treasury in the House hearings on the Revenue Act of 1950 gives examples of the excessive income tax deductions from the depletion allowance and the allowance for drilling and development costs:

TABLE 9.—*Income, deductions, and tax liabilities of 10 selected individual oil and gas operators, for the 5-year period 1943–47*

[Money figures in millions]

Individual operator	Net income			Special deductions		Taxable net income	Income tax liability	
	From oil and gas [1]	From other sources	Total	Percentage depletion [2]	Development costs [3]		Amount	Percent of total net income
A	$10.5	$3.8	$14.3	2.2	$13.0	[4] –$0.9	$0.08	0.6
B	5.0	.8	5.8	3.1	2.1	.6	.5	8.6
C	3.9	.5	4.4	3.2	4.4	[4] –3.2	.15	3.4
D [5]	9.3	.3	9.6	2.7	0	6.9	6.1	63.5
E	2.7	.8	3.5	1.0	.3	2.2	1.4	40.0
F	1.7	1.4	3.1	.8	1.5	.8	.6	19.4
G	7.7	–1.3	6.4	8.5	2.1	.8	.5	7.8
H	2.1	3.6	5.7	1.0	.6	4.1	2.2	38.6
I	1.7	.1	1.8	.5	1.0	.3	.2	11.1
J	8.0	–.7	7.3	2.9	1.7	2.7	2.2	30.1
Total	52.6	9.3	61.9	20.9	26.7	14.3	13.93	22.5

[1] Income after deductions for operating expenses, depreciation, adjusted-basis depletion, exploration costs and losses on abandonment.

[2] Excess of percentage depletion over adjusted-basis depletion.

[3] Development costs are expenditures for the preparation of mineral properties for production, which are deducted as expenses in the year incurred. Consequently, these expenditures are not included in the tax basis of the property and future cost or adjusted-basis depletion is correspondingly reduced. The treatment of development costs as a current expense, however, does not diminish percentage depletion in subsequent years, since the latter is determined on the basis of income in those years.

[4] While special deductions more than offset the total net income for the 5 years, some income tax was paid because there were deficits only in some years. A deficit caused by excess percentage depletion cannot be carried over against net taxable income of other years.

[5] Includes only 4 years, 1943–46.

Source: Bureau of Internal Revenue, special tabulation.

While no such statistics have been published by the Treasury in recent years, there is no reason to suppose that the facts are any different or any better now.

The justification given for such a high deduction is that it is a needed inducement for exploration and drilling. There is something to this contention but not enough to justify the added allowance of 27½ percent of gross revenue. In the first place, the other tax features provided for the industry—as we have seen—are extremely liberal and, in addition to this, the capital gains treatment, which I have not gone into, gives even further advantages.

I have, therefore, proposed an amendment which would reduce the depletion allowance of 27½ percent to 15 percent if the taxpayer's gross income from oil and gas wells exceeds $5 million in any one year, but that the allowance be reduced only from 27½ percent to 22 percent for those with a gross income from oil and gas wells of between $1 million and $5 million, and that the depletion allowance remain at 27½ percent for those whose gross income from oil and gas wells does not exceed $1 million per year.

This amendment is not a punitive one for (1) it does not do away with the depletion allowance altogether, and (2) it would not affect the small wildcat driller or the small producer.

There is a good reason for this last provision. Drilling for oil and gas involves some risk. It is estimated that only about 1 in 9 wells which are drilled actually produce gas or oil. The small driller, with only a few wells over which to spread this risk, does not have enough wells to assure that he will hit the 1 in 9 and may, in fact, drill 20 or 30 dry holes before hitting oil or gas. Consequently, without a great number of wells over which to spread the risk, he takes a greater risk than the large driller, who will average 1 in 9 successful wells if he drills 100 or 200 wells per year. It is only proper that this fact be recognized in the law. This is precisely what my amendment is intended to accomplish.

The Treasury estimates that the adoption of this amendment would result in a net revenue increase to the Federal Treasury of $305 million to $310 million per year at the present time. Others have estimated that it would bring in as much as $400 millon to $500 million additional revenue per year.

II. THE DIVIDENDS RECEIVED CREDIT AND EXCLUSION

It is estimated that the provisions of the 1954 Tax Code which grant the 4 percent dividend received credit and $50 exclusion from gross income cost the Treasury about $360 million per year. The provisions give a special tax credit and exclusion for income from dividends. The result is that an individual taxpayer pays a lower tax on a given amount of income than he pays on an equal amount of wages or salaries.

These credits and exclusions go to a very few people. According to Statistics of Income for 1955, only 2.2 percent of all the returns which were filed contained 75 percent of all the reported dividends. In addition, the bulk of the dollar amounts of the dividends were received by a relatively small proportion of those who received any dividends at all. Thus, in 1955, only 28 percent of the very small number of returns which reported any dividends at all included 75 percent of the total amounts of the dividends received.

The difference in tax treatment may be seen from an example of a married individual with 2 children who has a yearly earned income of $10,000 and a similar individual who has $10,000 in income entirely from dividends. Their tax liabilities would differ by $416 per year as follows:

Married taxpayer with 2 children and income of $10,000 per year

Joint return of taxpayer A—all income from wages and salary:	
Income	$10, 000
Less 10 percent standard deduction	1, 000
Income after deduction	9, 000
Less personal exemptions	2, 400
Taxable income	6, 600
Tax owed	1, 372

Joint return of taxpayer B all income from dividends: [1]	
Income from dividends	$10, 000
Less dividend exclusion	100
Income after dividend exclusion	9, 900
Less 10 percent standard deduction	990
Income after dividend exclusion and the 10 percent standard deduction	8, 910
Less personal exemptions	2, 400
Taxable income	6, 510
Tax liability before credit	1, 352
Less 4 percent of $9,900 credit against taxes	396
Tax owed	956

[1] Stocks on which dividends paid owned jointly by husband and wife.

NOTE.—With the same income, taxpayer A pays $1,372 in taxes while taxpayer B with all income from dividends, pays only $956, a tax savings of $416 or 30.3 percent.

III. WITHHOLDING OF DIVIDENDS AT THE SOURCE

Virtually every study made of individual income reporting for the Federal income tax shows a significant gap between the amount of dividends which should be reported and the amount actually reported on individual income-tax returns. In a paper presented before the American Finance Association at the end of 1957, Daniel Holland estimated this dividend gap for the taxable year 1955 to be about $1,235 million, or about 12.1 percent of total dividend receipts, adjusted for comparability with tax returns. Even if one assumes that 20 percent of this "gap"—about $250 million—were the dividends received by individuals not required to file income-tax returns and/or by individuals required to file returns but not taxable, there remains about $1 billion of dividends which should have appeared, but did not, to *taxable* individual returns in 1955. If the effective rate were only 20 percent in the case of these dividends—and there is every reason to believe that it would be higher—the revenue loss in 1955 amounted to $200 million to the Treasury. It is conceivable that the revenue loss could be as much as $300 million.

I have therefore submitted an amendment which, while recognizing some of the administrative problems, would withhold the basic tax on dividends at the source, as is now done for personal income.

Such a system of withholding on dividend income would contribute materially to improving compliance with the law. From the point of view of the taxpayer who is not a deliberate evader of the law,

dividends withholding has the positive virtue of assisting him to be as honest as he would wish to be. From the point of view of the deliberate tax evader, withholding—by reducing the rewards of dishonesty—might well produce a net gain in revenues *above* those from the withholding itself, as he is often in a bracket higher than the basic or minimum bracket and the Government would recoup not only the amount withheld but the additional taxes which would not otherwise be paid.

IV. HOW THE SAVINGS COULD BE USED

These three amendments, if passed, could result in a savings to the Treasury of almost $1 billion per year. How should this $1 billion be used?

Personally, I have always felt that our tax laws should provide that taxpayers with a specific amount of income should pay essentially the same tax as any other taxpayer with the same income, no matter from what source. If this were done, it would be possible for us to lower rates across the board and not only give some tax savings to low income groups, but also to reduce the extremely high surtax rates which very few taxpayers—even with great amounts of income—actually pay but which a few taxpayers do pay.

Therefore, if we were to close the loopholes in our tax laws, we could increase our revenues to such an extent that a reduction in the general level of taxation for all taxpayers could be brought about.

The three amendments I have proposed would, of course, be only a beginning and would not provide enough revenue to carry out this purpose. However, they could be a start and if we made a good start, the act of closing loopholes could become contagious; in which case, we would have enough revenues to both make our tax system more equitable and to reduce the rates which the average person pays in order to make up the revenues which are lost by the great number of special privileges given to particular taxpayers or groups of taxpayers.

The $1 billion in savings from these amendments might be used initially to reduce or repeal many of the numerous wartime excises which are nuisances, regressive, and unfair, or, if these amendments should pass, I am prepared to offer further amendments which will distribute these savings equitably over the range of income-tax payers.

There are those who are frightened by the deficits in our budget. Personally, I believe that these deficits should be reduced in times of prosperity and I am not overly alarmed by them in times of recession. However, the savings could be used for such purposes and if it is the will of Congress and these savings should, therefore, appeal to those who are frightened by the deficits.

Moreover, there are great needs to be met both in our defense and domestic economy. We are in a race with the Russians to produce missiles, and over the years we shall be needing additional revenues for this purpose. We have huge social gaps in the shortage of schools and hospitals and in the need to clear the slums of our great cities.

These needs are so great that it is unconscionable to allow a few taxpayers the special privileges which they receive by way of favored tax treatment. Thus, the ways in which these savings could be used in a constructive way are almost too numerous to mention and, if we were to make a start in closing the loopholes by way of these three

amendments, and then if the tax experts in the Treasury would come forward with constructive proposals to close numerous other loopholes, we could save enough in lost revenues to have a really constructive revision of our entire tax structure.

V

I hope that it will not be taken amiss if, as a junior member of the Finance Committee, I offer some comments upon the way Congress is being increasingly called upon to pass legislation granting tax favors and interpretative legislation to aid specific firms and individuals.

I have always assumed that the function of Congress was to pass general legislation and then to allow the administrative agencies and finally the courts to determine the precise application of these laws to individual instances. For this purpose, we have created a Tax Court with rights of appeal to the Supreme Court. In this way, we provided for the judicial review of administrative decisions and thus protected the individual from arbitrary action by the Internal Revenue Service and the Treasury Department. If, to be sure, some of these judicial decisions seemed to be unjust and at variance with the purposes of Congress and the country, then Congress should have not only the power but the duty to act.

But these powers should be invoked sparingly and should be a last and not a first resort. In practice, however, there appears to be a growing departure from this principle. Individuals and companies dissatisfied with administrative rulings or Tax Court decisions come to Congress and ask for legislative relief. They propose legislation which is ostensibly general in nature but which is in fact tailormade for their particular purposes. This is quite commonly done before they have exhausted their judicial remedies. Highly complicated questions of interpretation are thus brought before the committees of Congress. The hearings on these proposals are seldom adequate and are frequently nonexistent. Tax lawyers and lobbyists buttonhole Senators, committee members and staff, and present their side of the case.

While the lawyers for the Treasury are heard in executive session, the testimony and pressures tend to be one sided in character. The general public is almost completely ignorant of what is going on and Members of Congress who are not members of the appropriate committees are relatively in the dark.

The usual result is for the committees to propose, and Congress to pass (generally in the closing days of the session), a group of amendments to the tax laws designed to give relief and tax favors to specific person and corporations. Some of these are undoubtedly wise, but many are not. In nearly all cases, there have been no adequate hearings and the pleadings have been largely ex parte. Senators swamped with other duties must find it hard to go into the minutiae of tax law involving such questions as depreciation, the precise nature of income and of capital gains, and a myraid of others.

More and more individuals are carrying their grievances with the Treasury over the interpretation of existing laws to Congress rather than to the courts. Our preoccupation with these relatively limited questions, moreover, absorbs time and energy on our part which might

better be devoted to broad questions of tax policy, to trade and tariffs, and to social security.

What I fear, therefore, is that we may be passing ill-considered legislation which frequently increases rather than diminishes injustices in our tax structure, opens new loopholes rather than closing old ones, and broadens and deepens those that already exist. In addition, we are overburdening ourselves by taking on administrative and judicial functions which tend to break down that wise separation of powers which our constitutional fathers so sagely provided.

I would modestly and respectfully suggest that Congress refrain from reinterpreting the law until after the courts have finally spoken and that if and when it does consider these issues, no proposal be considered unless there has been a public hearing upon it, or adequate discussion within the committee itself.

VI

When H. R. 8381 came from the House, it was a reasonable bill although, as I have said, it dealt with only minor problems. The Senate Finance Committee, however, added numerous questionable amendments. Further, the committee adopted the principles in a number of unprinted amendments, the precise language of which was not considered by the committee. The bill has since had three committee prints but apparently the committee is not to review the numerous changes which have been made in the specific language of the bill.

The following descriptions of actions of the committee illustrates some of the general points which I have previously made and identify some of the specific objections to the provisions which have been added, stricken, or changed.

Retirement income credit

Section 2 of the bill relative to the retirement income credit provided by section 37 of the existing law, as it passed the House, was intended to correct an unintended discrimination against residents in common law jurisdictions and in favor of residents in community property jurisdictions. Under section 37, the community property resident who files a joint return with a spouse who has never been employed, nevertheless can claim two retirement income credits. The resident of a common law jurisdiction, under identical circumstances, can claim only one credit as, in my opinion, was the intent of the Congress when this provision was enacted.

Section 2, as passed by the House, would permit the retirement income credit to be claimed only by the taxpayer who meets the specific tests set forth in section 37. As amended by the Senate Finance Committee, however, the differential between retired individuals in community property and common law jurisdiction would be eliminated by extending the additional unintended benefits to the common law State resident.

Section 2, as amended by the Finance Committee, also creates a new differential against a widow or widower. Moreover, it would increase benefits for retired persons with relatively large amounts of retirement income while providing no comparable increase in benefits for the retired individual whose total retirement income is so small as to limit him to one credit, or a part of a credit, in any case.

Thus, a discrimination which the House bill would have solved by closing a loophole was changed in the Senate bill by extending the loophole. Not only that, the Senate provision creates an additional bias against the neediest individuals.

Collapsible corporations

Section 22 of the bill would change the present law provisions dealing with collapsible corporations in order to afford relief to persons in situations probably not within the scope of the intent of existing law.

So-called collapsible corporations have been set up in many cases by individuals in very high income brackets in order to convert ordinary income into capital gains. The present law provisions were intended to foreclose this avoidance device. Revision of the law is, indeed, needed in order to prevent tax avoidance practices which have not yet been effectively foreclosed as well as to prevent penalizing taxpayers where no tax avoidance is involved in certain legitimate business reorganizations.

Section 22 of the bill will not achieve either of these results. Until a more thorough study of these problems can be undertaken, it would be unwise to adopt a piecemeal adjustment obviously directed toward providing relief in one or, at best, few cases.

Carryover of foreign tax credit

Section 37 of the bill as passed by the House was designed to correct a situation in which a taxpayer with income from foreign sources is taxed both in the foreign country and at home on the same income to such an extent that the total taxes exceed the highest amount which would be payable in either country. This is a result primarily of conflicts between the United States and the foreign tax laws concerning the concept of taxable income. One important aspect of such conflict is a difference in determination of the particular year in which income is received. By virtue of such differences, the taxpayer may lose part of the benefit of the foreign tax credit and, in some cases, could conceivably have his entire income confiscated through taxes in both countries.

Section 37 of the House bill was drafted very carefully in an effort to solve this problem without opening up new problems. This section was stricken in the Senate version on the basis that some new problems *might* arise, and no substitute provision of any kind was offered in its place. A constructive legislative effort would have called for careful examination of any such possibility and amendment of section 37 to deal with any specific problems discovered. Deletion of the section has left an important problem unsolved.

Depletion allowance for gold

Section 38 of the bill would increase the percentage depletion allowance for gold from 15 percent to 23 percent. For all practical purposes, there is but one major company engaged exclusively in gold mining, although others produce gold as a byproduct.

At worst, this section merely expands an existing loophole in the law on the ground that since other mineral and mining interests are so favorably treated, it should be extended to gold.

At best, it is argued that it is necessary to keep this industry alive. Even if one were to accept this latter proposition at its face value, the fact remains that the means adopted, namely favored tax treat-

ment, can hardly be justified in terms of the theory of depletion or good tax law.

If we must subsidize a particular industry, and I am not advocating a subsidy in this case, it should be done directly and openly so that the Congress may pass on annual grants to an industry and thus have an annual review of its decisions.

"Pass-through" treatment for interest on State and local bonds

Section 42 of the bill provides so-called "pass-through" treatment for State and local government bond interest received by regulated investment companies meeting certain qualifications. This treatment presumably is intended to broaden and strengthen the market for State and local government bonds and to improve the capacity of the States and localities to finance the numerous projects which an expanding population demands. While this is a laudable objective, little evidence has been provided to show that the pass-through treatment in section 42 will, in fact, achieve it. It is certain, however, that the 3 or 4 mutual investment trusts now holding significant amounts of State and local government bonds will be able to pass on tax savings to their high-bracket investors.

The basic issue to which section 42 relates is whether tax exemption of State and local government bond interest is a sound approach to resolving the problem of the proper allocation of tax sources and functions among the three levels of government. This question has not yet been resolved. Until such time as a broad approach to the solution to these problems can be provided, it is unwise further to entrench in the Federal tax law the existing preferential treatment.

Another major danger of the pass-through principle is that once in the law for even a worthy purpose it would be extended to less worthy objectives. This is precisely what has happened. The pass-through principle for interest on State and local bonds has been extended in the Finance Committee bill to real-estate investment trusts.

"Pass-through" principle extended to real-estate investment trusts

Section 44 of the committee bill, providing the pass-through treatment to real-estate investment trusts, would create another case of preferred tax treatment for a relatively small group of taxpayers. Many corporations derive income from the rental or real property as well as from their principal business activities. Such rental income is taxable at the corporate level. No one has seriously suggested that shareholders in these companies be allowed to receive this rental income free of the corporate tax. It would be patently inequitable, therefore, to permit shareholders in companies which derive most of their income from rentals to receive such income free of the corporate tax.

Moreover, no one has seriously suggested that it is more in the public interest to promote investment in real-estate investment trusts than it is to promote investment in many other types of venture. The enactment of section 44, however, by providing preferential tax treatment for such investments would offer significant incentives for directing investment away from other types of activities to real-estate operations. The interests of economic growth and stability would not be served by introducing this type of preferential treatment.

Bonds issued at a discount

Section 54 of the committee bill is an attempt to eliminate a tax avoidance practice whereby bonds issued at a discount are purchased by the issuing corporation before their maturity date at an amount which exceeds the original issue plus the accrued discount. The bondholder, under present law, gets capital gains treatment with respect to the amount of such excess. Such a transaction frequently reflects collusion on the part of the bond issuer and purchaser. Section 54 would disallow capital gains treatment except where there was no intent at the time of the issue to call the bond before maturity. The purpose of this section is certainly laudable, but by virtue of the fact that it specifically calls for determination of the intent of the issuer, it is unlikely that the section can ever become effective. The same result could be achieved, without requiring determination of intent, by permitting the issuer to deduct, in the year in which the bonds are redeemed, only the prorate accrued discount.

Attempt at piecemeal solution of general problem results in adding new complexities to the law

Section 68 of the committee bill would extend to certain small business corporations the election to be taxed as partnerships. This provision, presumably, is intended to complement section 1361 of the Internal Revenue Code of 1954, which permits certain proprietorships and partnerships to be taxed as corporations.

The major problem with which section 68 is concerned is the fact that the present law does not integrate the individual and corporation income taxes and therefore gives rise to the alleged problem of double taxation. The taxability of dividends, as indicated elsewhere, is surely a matter of major concern in the present tax law. The approach in section 68, however, makes no major progress toward an equitable solution of this problem, but introduces an additional element of complexity in an already overcomplicated tax law.

The point is that if a business is taxed as a corporation it is subjected to the ordinary corporate rate of 52 percent. The individual who receives income from the corporation also pays tax on his personal income including the amount from the corporation.

However, if the corporation can be taxed as a partnership, then the income from the corporation is "passed through" to the partner and he pays taxes on the earnings only to the extent of his personal income-tax liability and escapes the corporate tax.

The same would be true of any losses and if an election were made to be taxed as a partnership, then the individual could offset the losses of the corporation against his personal income-tax liability. This, of course, in certain circumstances, would afford a great tax advantage to certain taxpayers.

Section 1361 and the proposed section 68 are presumably intended to provide tax relief for small businesses. Small-business enterprises, both incorporated and unincorporated, have fared poorly in the last 4 or 5 years and surely we must be concerned with equitable tax revision to mitigate tax biases against them. Experience with section 1361, however, demonstrates that this type of tax revision provides benefits only to a very small number of companies and therefore offers no major solution to the basic problems arising in taxation of small business. Moreover, regulations pursuant to section 1361 have not

yet been issued because of the numerous and extremely difficult problems of administration and compliance. Section 68 offers no promise of easier administration. It will, on the other hand, further complicate the law without dealing in any consequential way with the problems to which it is presumably addressed.