[COMMITTEE PRINT]

THE REVENUE ACT OF 1962

COMMITTEE ON FINANCE
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BRIEF SUMMARY OF PROVISIONS IN H.R. 10650
THE "REVENUE ACT OF 1962"

AS PASSED BY THE HOUSE OF REPRESENTATIVES
ON MARCH 29, 1962

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SUMMARY OF H.R. 10650, THE REVENUE ACT OF 1962

(As Passed by the House on March 29, 1962)

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1 *Short title, etc.*—The act is to be cited as the "Revenue Act of 1962."

2 *Investment credit.*—Under the House-passed bill an investment credit against tax liability is provided. It generally is 7 percent (3 percent in the case of certain public utilities) of investments in new tangible personal property and most other depreciable real property except buildings and structural components of buildings. No credit is allowed for property with a useful life of less than 4 years. For property with a life of 4 to 6 years, one-third of the investment is taken into account; for property of 6 to 8 years, two-thirds is taken into account; and for property with longer lives, the full amount of the investment is taken into account. Purchases of used property, up to $50,000 worth, also is eligible for the credit. The credit may offset tax liability in full up to $25,000, but above that point the credit may not reduce tax liability by more than 25 percent. Any unused credit may be carried over for 5 years and used in those years to the extent there is sufficient tax liability under the applicable limitation. This provision is effective for taxable years ending after December 31, 1961, but only with respect to property acquired or to the extent constructed, reconstructed, or erected after that date.

3 *Appearances with respect to legislation.*—A deduction is provided for costs relating to appearances before, presentation of statements to, or communications sent to a legislative body, a legislative committee, or individual legislator (Federal, State, or local), if the expenses are otherwise ordinary and necessary business expenses. A deduction also is allowed for the portion of dues paid to an organization which are used for similar legislative expenses to the extent they are related to the businesses of its members. In addition, the expense of communication of information between the taxpayer and the organization with respect to legislation is deductible. This provision does not permit the deduction of expenses incurred for attempts to influence the general public, or segments of the public (by advertising or otherwise), or for expenses concerned with political campaigns. This provision applies to taxable years beginning after December 31, 1962.

4 *Entertainment expenses.*—Deductible expenses for entertainment, amusement, or recreation generally are limited to those directly related to the active conduct of a trade or business and, in the case of facilities, a further restriction is imposed to the effect that the facility must be used more than 50 percent for the furtherance of the taxpayer's trade or business. Club dues are treated the same as facilities. An exception to this

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limitation is provided for business meals where the surroundings are such as to be conducive to a business discussion. Eight other specific exceptions also are provided.

A second feature of the provision limits the deduction for business gifts to $25 per year per individual recipient. In a third feature of the provision, rules are set forth providing that the deduction of entertainment or travel expenses will be denied unless they are substantiated (by adequate records, etc.) as to amount, time and place, business purpose, and business relationship to the taxpayer of the persons involved. Fourth, in the case of traveling expenses, only a "reasonable" allowance for amounts spent for meals and lodging is to be deductible rather than the "entire" amount so spent.

This provision applies to taxable years ending after June 30, 1962, for periods after that date.

5 *Distributions in kind by a foreign corporation.*—Distributions in kind from foreign corporations to domestic corporations are treated as having a value equal to the fair market value of the property distributed (and not the adjusted basis of this property in the hands of the distributing corporation where this is lower). This applies to distributions made after December 31, 1962.

6 *Allocation of income in the case of sales to or from a foreign corporation.*—Where goods are sold by a domestic corporation to a related foreign corporation, or vice versa, the taxable income arising from these transactions is to be allocated between the parties on the basis of the location of the assets used in the operations, the payroll attributable to them, and the related selling expenses. Other factors may also be taken into account. This rule is not to apply where an arm's length price can be established by the taxpayer for the purchases or sales. Sales commissions of a related corporation are to be treated under similar rules. This is effective for taxable years beginning after December 31, 1962.

7 *Foreign personal holding companies.*—At present, the entire income of a foreign personal holding company is taxed to the U.S. shareholders if 60 percent (50 percent after the first year) or more of its income is from passive sources (such as interest, royalties, and dividends). The bill provides that if 20 percent or more of the income is from these passive sources, then the passive portion of the income is to be taxed to the U.S. shareholders and if more than 80 percent of the income is from these passive sources, then the entire income is to be taxed to the U.S. shareholders (to the extent of their holdings). This applies to taxable years beginning after December 31, 1962.

8 *Mutual savings banks, etc.*—Mutual savings banks, domestic building and loan associations, and cooperative banks under present law are allowed to add all of their income to bad debt reserves until reserves reach 12 percent of deposits. In lieu of this, they are to be permitted deductions for additions to bad debt reserves generally of up to 60 percent of their taxable income (before this deduction) or, if larger, an amount bringing their reserves up to 3 percent of improved

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real property loans, plus a reasonable addition for other loans. (Existing reserves in excess of this amount are disregarded.) The bill also provides that the reserves may be accumulated in excess of 3 percent of these loans if the taxpayer's experience shows this is required.

Under the House-passed bill in the case of stock savings and loan associations, distributions to shareholders will be considered as paid first out of already tax-paid funds and, only when these are exhausted, out of reserve funds on which a tax has to be paid by the association at the time of distribution. Also, under the bill, a domestic building and loan association is defined as one which is insured under the National Housing Act or subject to State or Federal supervision but only if substantially all of its business consists of accepting savings and investing the loans in residential real property or in loans authorized for a Federal savings and loan association under section 5(c) of the Home Owners Loan Act. In addition, the exemption for Federal savings and loan associations from the excise taxes on communications and transportation of persons is repealed.

Generally, these provisions are effective for taxable years ending after December 31, 1962. The excise tax changes, however, are effective as of June 30, 1962.

9 *Distributions by foreign trusts.*—Distributions by foreign trusts established by U.S. grantors (or added to by U.S. transferors) are to be taxed to any U.S. beneficiaries in substantially the same manner as if the beneficiaries had received this income directly in the year earned rather than later when the distribution is made. However, the additional tax is payable at the time of the actual distribution. For those preferring not to make the calculations required under this "exact method" of taxation, an averaging device is provided. This applies to distributions, (accumulated after the effective date of the 1954 Code) made in taxable years beginning after the date of enactment of the bill.

10 *Mutual fire and casualty insurance companies.*—Mutual fire and casualty insurance companies are to be taxed on their "total" income less a deduction for additions to a reserve for protection against losses equal to one-fourth of their underwriting gains plus 1 percent of their insurance claims. After a 5-year interval, the 1 percent set-aside with respect to insurance claims and one-half of the amount attributable to underwriting gains is brought back into the taxable income to the extent not already offset by losses. The remainder, to the extent not offset by losses, will remain in the loss reserve but no amount may be added to this reserve which would build it up to a level of more than 10 percent of the current year's premiums.

Companies whose total receipts do not exceed $75,000 are to remain exempt from tax, and companies with total receipts of between $75,000 and $300,000 are to be taxed only on their investment income. For those with gross receipts above $300,000, a special deduction of $6,000 is provided which

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decreases as gross receipts rise and disappears at a level of gross receipts of $900,000. Factory mutual companies are to be taxed like stock companies without the special reserve referred to above. However, in computing their underwriting profits they will be permitted to determine their premium income on the basis of "absorbed" premium deposits (i.e., in general, excluding the portion of the deposit returnable to the person insured). The amount so determined is then increased by 2 percent. Reciprocal underwriters and interinsurers are in effect permitted to combine the underwriting income of their corporate attorney-in-fact with their own for purposes of offsetting losses but not for purposes of computing the underwriting income addition to their loss reserve.

These provisions apply to taxable years beginning after December 31, 1962.

11 *Domestic corporations receiving dividends from foreign corporations.*—Under present law when the income of a foreign subsidiary is distributed to a domestic parent corporation only the income of the subsidiary remaining after tax is treated as a dividend and a foreign tax credit is allowed the parent corporation for that part of the foreign taxes paid by the subsidiary attributable to this income. Under the bill the amount included in the tax base of the domestic corporation, if it elects the foreign tax credit, is to be not only the dividend itself but also the tax paid by the foreign corporation as well and then the full amount of the taxes paid by the foreign corporation may be allowed as a credit.

Also, where a foreign corporation is eligible for the 85 percent intercorporate dividends received deduction with respect to income earned in the United States, the 15 percent of this income for which no deduction is allowed is not to be treated as foreign source income for purposes of the foreign tax credit. The subsection of present law making the foreign tax credit available for royalty income received from wholly owned subsidiaries in certain cases is repealed.

These amendments become fully effective for distributions received by domestic corporations after December 31, 1964. In the case of distributions received by domestic corporations before 1965 but in taxable years after December 31, 1962, the new rules are to apply in the case of distributions made out of profits of a foreign corporation accumulated in taxable years beginning after December 31, 1962.

12 *Earned income from sources outside the United States.*—Under existing law individuals who are present in a foreign country or countries for 17 out of 18 months may exclude from their U.S. tax base up to $20,000 per year of income earned abroad. If they are bona fide residents of a foreign country there is no ceiling on this exclusion. In the case of these bona fide foreign residents, a ceiling is to be provided of $20,000 for the first 3 years they are abroad and $35,000 thereafter. In addition, contributions made by employers for employee benefits under qualified pension plans with respect to future employment are to be taxable to the employee when he receives these amounts

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after retirement. Generally these provisions are effective with respect to taxable years ending after December 31, 1962.

13 *Controlled foreign corporations.*—In the case of controlled foreign corporations, where more than 50 percent of the stock is owned by U.S. persons, U.S. shareholders who own 10 percent or more of the stock in these corporations are to report for tax purposes the undistributed earnings of these corporations to the extent they represent (*a*) income from insuring or reinsuring U.S. risks; (*b*) income from patents, copyrights, and exclusive formulas or processes developed in the United States or acquired here from related persons; (*c*) passive types of income; and (*d*) income from purchases or sales with related persons where the goods are produced or grown and the property is sold for use outside of the country of incorporation of the foreign corporation involved. In these latter two cases, the combination of the two types of income must equal 20 percent of total income before it is taken into account (and sales income must equal 20 percent of income other than the passive income to be taken into account). Where this combined income equals more than 80 percent of the total, then all income is attributed to the shareholders. However, reductions in the income taxed to shareholders are allowed in these two latter cases to the extent the income is invested in active businesses in less developed countries, where the corporation in which the investment is made is, to the extent of 50 percent or more, owned by five or fewer U.S. persons, but only if the taxpayer has at least a 10-percent interest.

To the extent the 10-percent U.S. shareholders are not taxed on the income of the controlled foreign corporation under the provisions described above, they are to be subject to taxation on the undistributed earnings of the controlled foreign corporation to the extent these earnings are not invested in substantially the same trade or business as that in which the taxpayer was engaged for the prior 5 years (or on December 31, 1962), or invested in less developed countries in new trades or businesses or in the controlled subsidiaries, 50 percent or more of which is held by five or fewer U.S. persons. The 50-percent test referred to above is relaxed where the foreign country prohibits ownership by Americans and others of as much as 50 percent of the stock of a corporation established under their laws.

Undistributed earnings which are taxed to the U.S. shareholders under any of the above provisions may subsequently be actually distributed to U.S. shareholders without further payment of tax. These provisions apply to taxable years of foreign corporation beginning after December 31, 1962, and to taxable years of U.S. persons falling in such years.

14 *Ordinary income on certain gains from depreciable property.*—In the case of personal property (other than livestock) and most real estate, other than buildings and structural components, when such property is sold or exchanged at a gain, this gain, to the extent of depreciation taken for taxable years beginning after December 31, 1961, is to be treated as ordinary

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income for tax purposes (instead of capital gain). In the case of dispositions of property other than by sale or exchange this same treatment is to apply except that the amount of the presumed gain is to be determined by the excess of the fair market value of the property at the time of its disposition over its then adjusted basis.

This treatment is to apply in the case of most dispositions of property whether or not gain is otherwise recognized. The treatment described above does not apply, however, in the case of gifts, although in the case of charitable contributions the amount of the charitable contribution deduction which may be taken is reduced by the amount which would be treated as ordinary income if this provision were applicable. Other exceptions are provided for property transferred at death, for transfers where no gain is recognized and the basis of the property is carried over to the transferor, and for transfers in like kind exchanges and involuntary conversions to the extent no gain is recognized. In the case of partnerships, distribution to partners or sales of partnership interests are taxed to the partners to the extent of the underlying depreciable property in much the same way as if the depreciable property had been sold directly.

The bill also provides that in computing the basis on which depreciation may be taken salvage value may be ignored up to an amount equal to 10 percent of the cost or other basis of the property. Also, under the bill taxpayers are permitted to elect to change their method of depreciation with respect to property coming within the scope of this provision from any declining balance, or sum-of-the-years digit method to a straight-line method.

This provision applies to taxable years beginning after December 31, 1961, and ending after the date of enactment of this bill.

15 *Foreign investment companies.*—When stock in foreign investment companies is sold, the gain realized by the U.S. shareholders is to be ordinary income (instead of capital gain) to the extent of the taxpayer's share of the earnings and profits of the corporation accumulated in taxable years beginning after December 31, 1962, and during the period in which he held the stock. In the case of stock in a foreign investment company acquired from a decedent, the basis of the stock is not to be increased at the date of death to the extent of the amount which would have been taxed as ordinary income to the decedent had he sold the stock before death. A deduction for estate tax attributable to this amount will be allowed, however, upon subsequent sale of this stock by the heir or legatee.

The companies and shareholders can avoid the treatment described above if the companies distribute 90 percent or more of their taxable income, other than capital gains, designate in a written notice to the shareholders each year their ratable share of the capital gains of the corporation and provide such other information as the Treasury requires to enforce this provision. The shareholders, however, must also report as capital gains

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their share of the capital gains of the corporation, whether the gains are distributed or not.

These provisions apply with respect to taxable years beginning after December 31, 1962.

16 *Gain from sales or exchanges of stock in foreign corporations.*—Where there is a redemption or liquidation of the stock of a controlled foreign corporation or where stock in such a corporation is sold, then any gain to the extent it represents earnings and profits of the corporation accumulated abroad is to be taxed to 10-percent U.S. shareholders as ordinary income or as dividends. In the case of the redemptions and liquidations, the earnings and profits taken into account are those accumulated since February 28, 1913. In this case, a foreign tax credit is to be allowed corporate shareholders for taxes paid to foreign countries. In the case of sales and other exchanges, the earnings and profits taken into account with respect to any shareholder is his share of profits accumulated during the period in which he held the stock. In this case, no foreign tax credit is available. These provisions apply with respect to sales or exchanges occurring after the date of enactment of this bill.

17 *Tax treatment of cooperatives and patrons.*—Cooperatives are to receive a deduction for patronage dividends paid to their patrons in cash or by allocations if the patron has the option to redeem the notices of allocation in cash for a 90-day period after they are issued or if he consents to this income being treated as constructively received by him and then reinvested in the cooperative. The patron, either a member or nonmember, may give his consent individually in writing. Alternatively, a patron who is a member may also consent by retaining membership in a cooperative after it adopts a bylaw requiring consent by all members and gives written notice of this bylaw to all members. In the case of allocations which do not qualify, the cooperative will initially be taxed on this type of patronage dividends. However, when such a patronage dividend is redeemed, the cooperative will receive a deduction (or refund of tax) at that time.

Where consent is given, or where the option to receive cash was available, the patron will be required to include the patronage dividends which arise from business activity as taxable income. The patron will also be required to take into account nonqualifying patronage dividends when they are redeemed (assuming they arise from business activity).

In addition, all cooperatives (rather than merely tax-exempt cooperatives as under present law) are given until 8½ months after the end of the year in which patronage occurs to allocate amounts to the accounts of their patrons and in most cases are also given this same period of time for the filing of their own income tax returns. These provisions apply to taxable years of cooperatives beginning after December 31, 1962, and with respect to amounts received by patrons attributable to years of the cooperatives to which the new law applies. The new provisions will not, however, apply to future redemptions of patronage dividends declared when the old law was applicable.

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18 *Inclusion of foreign real property in gross estate.*—Real property located outside of the United States, in the case of citizens or residents of the United States, is to be included in their tax base for purposes of the Federal estate tax imposed at the time of their death. This provision will be fully effective for decedents dying on of after July 1, 1964. For those dying after the date of enactment of this bill, and before July 1, 1964, real property located outside of the United States will be included in their gross estate only if acquired on or after February 1, 1962.

19 *Withholding of tax on interest, dividends, and patronage dividends.*—Withholding at the source is provided for dividends, most interest, and patronage dividends at a rate of 20 percent. No receipts are required to be given by the payors to the taxpayers under this system and no significant change is made in the information returns which presently must be filed by the payors with the Federal Government.

No withholding is to occur in the case of dividends, savings account interest, or Government Series E bond interest if the recipient files an exemption certificate indicating that he is under age 18. These exemption certificates may also be filed (but on an annual basis) by those over age 18 with respect to any year in which they reasonably expect to have no income tax liability. Claims for quarterly refunds may also be filed by individuals (with gross incomes of not over $5,000 in the case of single individuals and not over $10,000 in the case of married couples) where there is expected to be significant amounts of overwithholding of their tax liability. Corporations and tax-exempt organizations may also file for quarterly refunds. In addition, corporations may credit, against amounts payable to the Government for that which the corporations withhold on their own dividend or interest payments, amounts withheld with respect to dividend or interest payments they receive. Tax-exempt organizations may also claim credits with respect to amounts withheld on the dividend and interest payments they receive against wage and salary withholding on their employees for income tax and social security tax liability.

Generally these provisions apply in the case of interest and dividends paid on or after January 1, 1963.

20 *Information with respect to foreign entities.*—A number of changes are made in the annual information return which domestic corporations presently are required to file with respect to their subsidiaries or foreign corporations which they control. The changes are: This return is to be filed not only by corporations but by others as well which control foreign corporations; "control" is defined more broadly by adding certain constructive ownership rules; information must be provided not only with respect to subsidiaries of foreign corporations but also for other foreign corporations which are further down the chain of ownership; and additional information may be required which is similar or related in nature to that already specified.

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Present law also requires U.S. citizens or residents who are officers or directors of a foreign corporation within 60 days of its organization or reorganization and also 5-percent shareholders who have this status within 60 days of the organization or reorganization to supply certain information to the Treasury Department with respect to the corporation. This same information is also to be required of U.S. citizens or residents who at some later time become officers, directors, or shareholders with an interest of 5 percent or more. A penalty provision also is provided.

Generally, these additional information requirements become effective as of January 1, 1963.

21 *Treaties.*—It is made clear that any provision contained in this bill is intended to have precedence over any prior tax treaty obligation.

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