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TAX EVASION AND AVOIDANCE

REPORT

OF THE

JOINT COMMITTEE ON TAX EVASION AND AVOIDANCE OF THE CONGRESS OF THE UNITED STATES

PURSUANT TO

PUBLIC RESOLUTION NO. 40, SEVENTY-FIFTH CONGRESS TO CREATE A JOINT CONGRESSIONAL COMMITTEE ON TAX EVASION AND AVOIDANCE

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JOINT COMMITTEE ON TAX EVASION AND AVOIDANCE

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REPORT OF THE JOINT COMMITTEE ON TAX EVASION AND AVOIDANCE

To the Senate and House of Representatives of the United States of America in Congress assembled:

FOREWORD

On June 1, 1937, the President of the United States transmitted the following message to the Congress:

To the Congress of the United States:

A condition has been developing during the past few months so serious to the Nation that the Congress and the people are entitled to information about it.

The Secretary of the Treasury has given me a report of a preliminary study of income-tax returns for the calendar year 1936. This report reveals efforts at avoidance and evasion of tax liability so widespread and so amazing both in their boldness and their ingenuity that further action without delay seems imperative.

We face a challenge to the power of the Government to collect, uniformly, fairly, and without discrimination, taxes based on statutes adopted by the Congress.

Mr. Justice Holmes said, "Taxes are what we pay for civilized society." Too many individuals, however, want the civilization at a discount.

Methods of escape or intended escape from tax liability are many. Some are instances of avoidance which appear to have the color of legality; others are on the border line of legality; others are plainly contrary even to the letter of the law.

All are alike in that they are definitely contrary to the spirit of the law. All are alike in that they represent a determined effort on the part of those who use them to dodge the payment of taxes which Congress based on ability to pay. All are alike in that failure to pay results in shifting the tax load to the shoulders of others less able to pay, and in mulcting the Treasury of the Government's just due.

I commend to your attention the following letter from the Secretary of the Treasury:

THE SECRETARY OF THE TREASURY,
Washington, May 29, 1937.

MY DEAR MR. PRESIDENT: As you know, the Treasury was surprised and disturbed by the failure of the receipts from the income tax on March 15 to measure up to the Budget estimates. Therefore, we undertook an immediate investigation. Only a preliminary report can be made at this time, because the complete investigation covering all the income-tax returns filed will require the balance of this year. Furthermore, since many of the returns of large manufacturing corporations have not yet been filed, the present report is confined almost wholly to data disclosed by the individual tax returns.

But even this preliminary report discloses conditions so serious that immediate action is called for. More than the usual examination and audit by the Treasury are needed. It seems clear that if tax evasion and tax avoidance can be promptly stopped through legislation and regulations resulting from a special investigation a very large portion of the deficiency in revenues will be restored to the Treasury.

I herewith enumerate some of the principal devices now being employed by taxpayers with large incomes for the purpose of defeating the income taxes which would normally be payable by them. As we continue our preliminary examination other devices are being disclosed.

1. THE DEVICE OF EVADING TAXES BY SETTING UP FOREIGN PERSONAL HOLDING CORPORATIONS IN THE BAHAMAS, PANAMA, NEWFOUNDLAND, AND OTHER PLACES WHERE TAXES ARE LOW AND CORPORATION LAWS LAX

Americans have formed 64 such companies in the Bahamas alone in 1935 and 1936, and 22 more were organized by Americans in the Bahamas during the past

2 months. Panama and Newfoundland seem to be even more fertile territory since their corporation laws make it more difficult to ascertain who the actual stockholders are. Moreover, the stockholders have resorted to all manner of devices to prevent the acquisition of information regrding their companies. The companies are frequently organized through foreign lawyers, with dummy incorporators and dummy directors, so that the names of the real parties in interest do not appear.

One American citizen with a $3,000,000 Bahamas corporation has apparently attempted to prevent the Bureau of Internal Revenue from catching up with him by filing his individual tax returns in successive years from towns in New Brunswick, British Columbia, and Jamaica.

Another individual believes that he has been so successful in removing his assets from the United States to the Bahamas that he is defying the Treasury to collect a tax upon a $250,000 fee he has received; and by way of insult, he has offered to compromise his admitted tax liability of $33,000 for past years by a payment of $1,700.

Still another individual showed a large net loss on his personal return for 1936. In considerable part the loss was due to the large deduction he claims for interest on a loan made to him by his personal holding company. But the man in question is no object of charity, for his personal holding company, organized in Canada, had an income of over $1,500,000 from American dividends in 1936, though it has not yet filed a return.

Perhaps the most flagrant case of this character is that of a retired American Army officer with a large income from valuable American securities which he desires to sell at a very large profit. To escape our income and inheritance-tax laws, he used the device of becoming a naturalized Canadian citizen, and 6 days later organized four Bahamas corporations to hold his securities. He and his lawyers apparently think that he can now sell his securities free from any taxes on his profits, since there are no income taxes in the Bahamas, and that he has adroitly escaped American taxes.

2. THE DEVICE OF FOREIGN INSURANCE COMPANIES

Two New York insurance agents have caused the organization of insurance companies in the Bahamas with a view to enabling taxpayers to secure spurious deductions for interest through an ingenious scheme for the issuance of life-insurance policies. Americans who went into the scheme purported to pay a large single premium for their policies, but immediately borrowed back practically the entire sum. Under the plan the so-called policyholders sought to obtain a large deduction for interest on this loan, although the fact was that no interest was really paid. By this means five prominent Americans sought to evade nearly $550,000 in income taxes in the years 1932 to 1936. This fraud was discovered by the Treasury's investigators and all of the taxpayers have now submitted offers to pay the full amount of taxes evaded, plus interest. Until our investigation is completed we do not know how many similar companies may have been organized in other countries, and utilized by our citizens; nor do we yet know whether this newly invented type of fraud has other ramifications.

3. THE DEVICE OF DOMESTIC PERSONAL HOLDING COMPANIES

The rates of tax applicable to personal holding companies were reduced in 1936 at the time of the enactment of the undistributed-profits tax. It was believed at that time that the combined rates of the two taxes would be sufficient to insure the distribution of the entire incomes of these companies, and the consequent imposition of surtaxes upon their owners. This expectation has not been realized.

Thus, the single stockholder of one large personal holding company saved himself $322,000 by causing his company to distribute none of its income to him.

In another case, a man and his wife saved $791,000 through the use of personal holding companies in 1936.

In a third case, the personal holding company reported over $500,000 of net income but the total taxes paid by the two stockholders, husband and wife, were less than $60,000, due principally to credits for payments on indebtedness the holding company prudently incurred in accumulating properties for its owners. If the personal holding company had not been in existence, the stockholders would have paid over $200,000 additional income taxes.

Another favorite device is to organize a considerable number of personal holding companies, not only for the sake of reducing the tax, but of increasing the Treasury's difficulties in auditing transactions between companies. At last accounts one man had caused to be set up some 96 companies scattered all over the country. Two other individuals were utilizing 23 personal holding companies.

4. THE DEVICE OF INCORPORATING YACHTS AND COUNTRY ESTATES

Many wealthy taxpayers today are dodging the express provisions of the law denying deductions for personal expenses by incorporating their yachts or their country estates, turning over to the yacht or to the estate securities yielding an income just sufficient to pay the entire expenses of operation. Hundreds of thousands of dollars in income taxes are annually avoided in this way.

Thus, one man's yacht is owned by his personal holding company, along with $3,000,000 in securities. He rents the yacht from his company for a sum far less than the cost of upkeep, and the company uses its income from the securities to pay the wages of the captain and crew, the expenses of operating the yacht, and an annual depreciation allowance. None of these items would be deductible if this individual owned the yacht personally.

A great many wealthy taxpayers are utilizing a similar arrangement for the operation of their country places and town houses.

One man has placed his $5,000,000 city residence in such a corporation; another his racing stable whose losses last year were nearly $200,000. The tax savings he thus sought to obtain through the use of the holding company were $140,000.

One wealthy woman has improved on the general plan of evasion by causing her personal holding company, which owns her country place, to employ her husband at a salary to manage it. She can thereby supply him with pocket money, and in effect claims a tax deduction for the expense of maintaining him.

5. THE DEVICE OF ARTIFICIAL DEDUCTIONS FOR INTEREST, LOSSES, ETC.

Taxpayers are seeking greatly to reduce their personal income taxes by claiming deductions for interest on loans to them by their personal holding companies, or on loans to them by their family trusts. These transactions normally have no business purpose, but are merely an artificial means of shifting income from one member of the family subject to high surtax rates to another member of the family subject to lower rates.

Thus, one woman claims a large annual deduction for interest on a loan made to her by her husband as trustee of a trust which she created for their children. The mother thereby seeks to secure a deduction for her contribution to the children's support, and since the trust is revocable by her husband, the parents still have the desired control over the property and its income.

In the same category are losses deducted by taxpayers who claim that their racing stables or hobby farms were operated for profit, even though a profit is never realized. Thus, a prominent manufacturer seeks a deduction of over $125,000 against his income from his business, on account of his losses in operating a chicken farm.

6. THE DEVICE OF THE CREATION OF MULTIPLE TRUSTS FOR RELATIVES AND DEPENDENTS

Splitting income two ways, between husband and wife, reduces income taxes and leaves the family income intact. Splitting the family income many ways by means of many trusts, all for the same beneficiaries, may effect a much greater saving, while leaving the money actually in the same hands. For the creator of the trust often constitutes himself or his wife as trustee, and thus retains full control over the investment and disposition of the fund itself and of its income.

One thrifty taxpayer has formed 64 trusts for the benefit of four members of his immediate family, and thereby claims to have saved them over $485,000 in 1 year in taxes.

Another thrifty pair have constituted 40 trusts for their relatives, and a prominent lawyer and his wife utilize 16 trusts for the same purpose. The first pair maintains numbered brokerage accounts, and only at the end of the year are the beneficial owners identified. In this way innumerable transactions are carried on, often between accounts, which do not actually affect the beneficial interests of their owners, but which are designed solely to reduce tax liability.

7. THE DEVICE OF HUSBAND AND WIFE OR FATHER AND CHILDREN PARTNERSHIPS

The purpose of these partnerships, like the multiple trusts, is to split the family income artificially into two parts; or, if the children are taken in, into still smaller fractions.

There are many instances of this kind; but to illustrate the point, it is sufficient to cite the case of a New York brokerage firm which late in 1935 admitted into partnership the four minor children, two boys and two girls, of one of the partners. The tax saving he sought thereby in 1936 amounted to over $50,000.

8. THE DEVICE OF PENSION TRUSTS

For 10 years the revenue acts have sought to encourage pension trusts for aged employees by providing corporations with a special deduction on account of contributions thereto, and exempting the trust itself from tax. Recently this exemption has been twisted into a means of tax avoidance by the creation of pension trusts which include as beneficiaries only small groups of officers and directors who are in the high income brackets. In this fashion high-salaried officers seek to provide themselves with generous retiring allowances, while at the same time the corporation claims a deduction therefor, in the hope that the fund may accumulate income free from tax.

Thus, in one case $43,000 is annually appropriated by the corporation to a pension trust for the benefit of its two chief owners. One of the co-owners will retire at the age of 65 with a monthly pension of $1,725, and the other will retire at 60 with a monthly pension of $1,425.

These eight types of tax avoidance are sufficient to show that there is a well-defined purpose and practice on the part of some taxpayers to defeat the intent of Congress to tax incomes in accordance with ability to pay. In some cases, the Bureau of Internal Revenue under existing law can establish a liability or, indeed, proceed on the ground of fraud; but many of these cases fall in the category of a legal though highly immoral avoidance of the intent of the law. It seems, therefore, that legislation should be passed at this session of the Congress in order to eliminate these loopholes which our preliminary investigation has proved; and that as a result of the further investigation this summer and autumn the next session of the Congress should finally close any further loopholes which may be discovered.

In addition to these cases of moral fraud, there are three other major instances in which the law itself permits individuals and corporations to avoid their equitable share of the tax burden.

1. PERCENTAGE DEPLETION

This is perhaps the most glaring loophole in our present revenue law. Since 1928 large oil and mining corporations have been entitled to deduct from 5 to 27½ percent of their gross income as an allowance for the depletion of their mines or wells, and the deduction may be taken even though the cost of the property has been completely recovered. Thus, in 1936, one mining company deducted nearly $3,000,000 under this provision, although it had already completely recovered the cost of its property. The amount of the deduction was a sheer gift from the United States to this taxpayer and its stockholders, and the revenue that we lost thereby was $818,000. Similar annual losses of revenue in the cases of a few other typical companies are $584,000, $557,000, $512,000, $272,000, $267,000, $202,000, and $152,000. The estimated annual loss of revenue due to this source alone is about $75,000,000. I recommended in 1933 that this provision be eliminated but nothing was done at that time; and it has since remained unchanged.

2. THE DIVISION OF INCOME BETWEEN HUSBAND AND WIFE IN THE EIGHT COMMUNITY PROPERTY STATES

This is another major cause of revenue loss, which is unjustifiable because obtained at the expense of taxpayers in the 40 States which do not have community-property laws. A New York resident with a salary of $100,000 pays about $32,525 Federal income tax; a Californian with the same salary may cause one-half to be reported by his wife and the Federal income taxes payable by the two will be only $18,626. The total loss of revenue due to this unjustifiable discrimination against the residents of 40 States runs into the millions.

3. TAXATION OF NONRESIDENT ALIENS

The 1936 act eliminated the requirement that a nonresident alien (without United States office or business) should file a return; fixed the withholding rate for individuals at 10 percent; and freed the nonresident alien from taxation on American capital gains. Since the total Federal tax upon a citizen or resident amounts to 10 percent of his total net income at about $25,000 (in the case of a married individual with no dependents), the withholding rate has proved in practice to be too low as applied to wealthy nonresident alien individuals. There are a number of cases of nonresident aliens with large incomes from American trusts or with large American investments whose taxes have been cut to one-third or one-fifth of what they paid under the prior act.

Thus, one American woman who married an Englishman had an income from this country in 1935 of nearly $300,000. Her tax for 1936 will, therefore, be approximately $30,000 as against over $160,000 under the prior law.

Another American woman who married a Frenchman has an income of over $150,000 from American trusts on which she paid a tax of about $55,000 in 1935. Her tax is reduced to about $15,000 by the 1936 law. Although the tightening of the withholding provisions in 1936 will tend to insure more revenue from nonresident aliens in the lower-income brackets, the present taxing provisions are not satisfactory as applied to nonresident aliens with incomes in the higher brackets.

The problem of tax avoidance is not new. The Congress devoted particular attention to it in 1933 and 1934, and by legislation effectively put a stop to many evasive devices discovered then as having been in use. The practices outlined above can and should be stopped in the same way.

In conclusion, I have two observations to make from the evidence before me. In the first place, the instances I have given above are disclosed by a quick check of comparatively few individual returns. As I have said before, most of the large corporation returns have not yet been filed. The general audit of 1936 returns is just beginning. Nevertheless, it is likely that the cases I have digested above are symptomatic of a large number of others, which will be disclosed by the usual careful audit.

In the second place, the ordinary salaried man and the small merchant does not resort to these or similar devices. The great bulk of our 5,500,000 returns are honestly made. Legalized avoidance or evasion by the so-called leaders of the business community is not only demoralizing to the revenues; it is demoralizing to those who practice it as well. It throws an additional burden of taxation upon the other members of the community who are less able to bear it, and who are already cheerfully bearing their fair share. The success of our revenue system depends equally upon fair administration by the Treasury, and upon completely honest returns by the taxpayer.

The disclosures are so serious that I recommend that authority be given to the Treasury Department with an adequate appropriation in order that a complete and immediate investigation may be conducted. The cost of such an investigation will be returned many times over to the Treasury of the United States.

Faithfully,

HENRY MORGENTHAU, Jr.

The PRESIDENT,
The White House.

A feeling of indignation on reading this letter will, I am confident, be yours, as it was mine.

What the facts set forth mean to me is that we have reached another major difficulty in the maintenance of the normal processes of our Government. We are trying harder than ever before to relieve suffering and want, to protect the weak, to curb avarice, to prevent booms and depressions, and to balance the Budget. Taxation necessary to these ends is the foundation of sound governmental finance. When our legitimate revenues are attacked, the whole structure of our Government is attacked. "Clever little schemes" are not admirable when they undermine the foundations of society.

The three great branches of the Government have a joint concern in this situation. First, it is the duty of the Congress to remove new loopholes devised by attorneys for clients willing to take an unethical advantage of society and their own Government. Second, it is the duty of the executive branch of the Government to collect taxes, to investigate fully all questionable cases, to prosecute where wrong has been done, and to make recommendations for closing loopholes. Third, it is the duty of the courts to give full consideration to the intent of the Congress in passing tax laws and to give full consideration to all evidence which points to an objective of evasion on the part of the taxpayer.

Very definitely, the issue immediately before us is the single one relating to the evasion or unethical avoidance of existing laws. That should be kept clearly in mind by the Congress and the public. Already efforts to befog this issue appear. Already certain newspaper publishers are seeking to make it appear, first, that if an individual can devise unanticipated methods to avoid taxes which the Congress intended him to pay, he is doing nothing unpatriotic or unethical; and, second, that because certain individuals do not approve of high income-tax brackets, or the undistributed-earnings tax, or the capital-gains tax, the first duty of the Congress should be the repeal or reduction of those taxes. In other words, not one but many red herrings are in preparation.

But it seems to me that the first duty of the Congress is to empower the Government to stop these evil practices, and that legislation to this end should not be confused with legislation to revise tax schedules. That is a wholly different subject.

In regard to that subject, I have already suggested to the Congress that at this session there should be no new taxes and no changes of rates. And I have indicated to the Congress that the Treasury will be prepared by next November to present to the appropriate committees information on the basis of which the Congress may, if it chooses, undertake revisions of the tax structure.

The long-term problem of tax policy is wholly separate from the immediate problem of glaring evasion and avoidance of existing law.

In this immediate problem the decency of American morals is involved.

The example of successful tax dodging by a minority of very rich individuals breeds efforts by other people to dodge other laws as well as tax laws.

It is also a matter of deep regret to know that lawyers of high standing at the bar not only have advised and are advising their clients to utilize tax-avoidance devices, but are actively using these devices in their own personal affairs. We hear too often from lawyers, as well as from their clients, the sentiment, "It is all right to do it if you can get away with it."

I am confident that the Congress will wish to enact legislation at this session specifically and exclusively aimed at making the present tax structure evasion-proof.

I am confident also that the Congress will give to the Treasury all authority necessary to expand and complete the present preliminary investigation, including, of course, full authority to summon witnesses and compel their testimony. The ramifications and the geographical scope of a complete investigation make it necessary to utilize every power of Government which can contribute to the end desired.

FRANKLIN D. ROOSEVELT.

THE WHITE HOUSE, *June 1, 1937.*

In order to promptly consider and investigate the matters brought to the attention of the Congress by the above message, a joint resolution was introduced providing for the creation of a Joint Committee on Tax Evasion and Avoidance. This joint resolution became law on June 11, 1937. It provided for a joint committee to be composed of six Members of the Senate who are members of the Committee on Finance, and six Members of the House of Representatives who are members of the Committee on Ways and Means. The requisite powers were given the joint committee to hold hearings, to examine documents, and to take testimony. Power was also given the joint committee to examine income-tax returns and related matters. Section 2 of the joint resolution referred to makes it the duty of the joint committee

to investigate the methods of evasion and avoidance of income, estate, and gift taxes, pointed out in the message of the President transmitted to Congress on June 1, 1937, and other methods of tax evasion and avoidance, and to report to the Senate and the House, at the earliest practicable date, and from time to time thereafter, but not later than February 1, 1938, its recommendation as to remedies for the evils disclosed by such investigation.

The joint committee having considered the subject matter submitted to it submits the following report:

The committee has held public hearings, beginning on June 17, 1937. Since that date it has been almost continuously engaged in holding such hearings, or in considering the subject of tax evasion and avoidance in executive session. Because of lack of time, the committee has confined itself for the present to those subjects which may be directly classified under the head of evasion or avoidance, leaving out of account subjects such as community property or percentage depletion which will receive further consideration by the joint committee.

The committee, as a result of its investigations, believes it is imperative at this time that legislation should be enacted in regard to the following subjects, with respect to which it has been shown that certain serious loopholes exist:

1. Domestic personal holding companies.
2. Incorporated yachts, country estates, etc.
3. Incorporated talents.
4. Artificial deductions for losses from sales or exchanges of property.
5. Artificial deductions for interest and business expense.
6. Multiple trusts.
7. Foreign personal holding companies.
8. Nonresident aliens.

Detailed recommendations are made on these subjects in the body of this report. The committee has examined the problem of certain alleged tax-saving devices based on single premium life insurance policies issued by fake foreign insurance companies. The committee believes the existing law is adequate to reach these cases. The subject of pension trusts has been passed over for the present, because it does not appear to have resulted in much loss of revenue to date. However, this matter will be reported on later.

The printed record of the public hearings held by the committee amply sustains the statements made by the President of the United States in his message. The committee strongly urges that legislation along the lines recommended be enacted at the earliest possible moment in order to protect the revenue, and in order that all may bear their fair share of the tax burden. The detailed recommendations of the committee follow.

1. DOMESTIC PERSONAL HOLDING COMPANIES

The problem of the personal holding company has been one requiring the continued attention of the Congress beginning with the Revenue Act of 1913. All of the earlier revenue acts as well as the existing law contain prov sions imposing additional taxes upon corporations organized or availed of for the purpose of preventing the imposition of the surtax upon the shareholders thereof. These provisions have proved difficult of enforcement due to the fact that it is necessary to prove a purpose to avoid the imposition of the surtax upon the shareholders.

In the Revenue Act of 1934 a limited class of companies, known as personal holding companies, were singled out for a special surtax on undistributed profits. Under that act, personal holding companies were defined as corporations, 80 percent of whose gross income for the taxable year was derived from royalties, dividends, interests, annuities, and gains from the sale of stock or securities, and whose stock to the extent of more than 50 percent in value was owned by not more than five individuals during the last half of the taxable year. In computing the number of individuals who owned such majority stock the act counted as one all members of the family in the direct line, as well as the spouse and brothers and sisters. The provisions of the Revenue Act of 1934 were continued in section 351 of the Revenue Act of 1936 with certain changes, the main change being in the rate structure. The advantage of this provision is that it is not necessary to prove a purpose to avoid surtaxes; if a corporation comes within the definition, the surtax automatically applies.

The provisions of section 351 have not entirely closed the loophole of accumulating surplus for the purpose of avoiding surtax. There are still a good many cases in which it is cheaper for an individual to accumulate income in a personal holding company, with no or very little distribution, than to cause a distribution of such income and pay surtaxes upon it. This is due mainly to the graduated rate schedule and the allowance of special cushions not granted to individuals or ordinary corporations. In an analysis of 4,457 personal holding companies' returns filed for the calendar year 1934 and the period from January to June 1935, an aggregate personal holding company net income of $53,000,000 was shown. Of the number of personal holding company returns filed only 374, or less than 9 percent, show taxable income under the surtax provisions of section 351. These 374 returns show a taxable income of only $5,000,000 or less than 10 percent of the total net income of the personal holding company group, and the taxes paid amounted to only $1,695,000, or about 3 percent of their aggregate net income. The remaining 4,083 personal holding companies paid no tax under section 351. However, the Treasury has made the following estimate as to the revenue yield of the present section 351, when dividend distributions are taken into account:

	Calendar year liabilities	
	1934	1935
Personal holding company surtax	$1,800,000	$3,000,000
Estimated individual income-tax liability from extra dividends paid by personal holding companies	33,900,000	46,100,000
Total estimated tax due to sec. 351	35,700,000	49,100,000

In order that individuals may not take advantage of these personal holding company provisions in existing law so as to reduce their taxes, the committee recommends the following changes in section 351 of existing law:

1. It is recommended that the present deduction for taxes imposed by section 102 or a corresponding section of a prior income tax law be eliminated. This deduction is now allowed under section 351 (b) (3) (A). Under existing law a corporate taxpayer may be subject for 1 year to the provisions of section 102 imposing a surtax on corporations improperly accumulating surplus and for another year to the tax on personal holding companies. It seems contrary to public policy to permit the penalty tax imposed by section 102 on undistributed profits to be allowed as a deduction for the purpose of the tax under section 351. Since the tax under section 102 is computed upon undistributed profits for back years, it is believed that it should be paid out of accumulated earnings and profits rather than out of the current earnings and profits of the corporation for the taxable year.

2. It is recommended that the unlimited deduction allowed under section 351 (b) (3) (B) for charitable and other like contributions be

restricted so as not to exceed 15 percent of the net income of the corporation. Under existing law, individuals are entitled to a deduction for charitable contributions only up to 15 percent of their net income and the committee sees no reason why personal holding companies should be treated more favorably than individuals in this respect. However, the committee recommends the retention of the special provision inserted in section 351 (b) (3) (B) of the Revenue Act of 1936 which granted an unlimited deduction, in the case of a corporation organized prior to January 1, 1936, to take over the assets of the estate of a decedent, for amounts paid in liquidation of any liability of the corporation based upon the liability of the decedent to make a contribution or gift to charity, to the extent such liability of the decedent existed prior to January 1, 1934. The committee believes such retention is justified by the fact that this deduction will not inure to the benefit of any private individual.

3. It is recommended that the unlimited deduction for losses from sales or exchanges of capital assets be omitted from section 351. This deduction is contained in section 351 (b) (3) (C). Under existing law personal holding companies may deduct losses from the sale or exchange of capital assets without limitation for purposes of computing the surtax under section 351. If such losses were incurred by an individual they would be allowable under existing law only to the extent of $2,000, plus the gains from such sales or exchanges. In other words, an individual is less favored in this respect than a personal holding company. The effect of this elimination will be to prevent an individual, by transferring his income-producing investments to a personal holding company, from obtaining the benefit of deducting capital net losses denied to him as an individual.

4. It is also recommended that the 20-percent deduction allowed under section 351 (b) (2) (A) of existing law be eliminated. The existing law allows personal holding companies a special deduction of 20 percent of the excess of the adjusted net income over the amount of dividends received from other personal holding companies. For example, if the adjusted net income of a personal holding company in excess of dividends received from other personal holding companies is $20,000,000, 20 percent or one-fifth of this amount, namely $4,000,000, may be accumulated without the payment of any personal holding company surtax whatever. The committee sees no reason for continuing this discrimination in favor of personal holding companies.

5. The committee also recommends the elimination of the deduction allowed personal holding companies for amounts used or set aside to retire indebtedness incurred prior to January 1, 1934. This deduction is contained in section 351 (b) (2) (B) of the Revenue Act of 1936. As a result of this deduction many personal holding companies have been able to escape the surtax under section 351 altogether. The committee is of the opinion that this special relief granted to personal holding corporations and denied to individuals should no longer be continued in the statute.

In referring to the deductions for capital losses, for debt retirement, and the 20-percent exemption mentioned above, the Treasury estimates that these three items alone resulted in a loss of revenue for the year 1936 of $9,237,000.

6. In order for a corporation to be a personal holding company, one of the conditions imposed by existing law is that at least 80 percent of its gross income for the taxable year must be derived from royalties, dividends, interest, annuities, and, except in the case of regular dealers in securities, gains upon the sale of stocks or securities. The existing law excluded from this classification rents, mainly for the reason that it was not desired to interfere with bona-fide and legitimate operating companies whose business consisted of the ownership and operation of office buildings, apartment houses, etc. However, it is believed that the entire exemption of rents from this classification has permitted certain personal holding companies which are not bona-fide operating companies to escape their just share of the tax burden. To prevent certain holding companies which are not bona-fide operating companies from taking advantage of this exception and to protect legitimate operating companies, the committee recommends that rents be included for the purpose of this classification unless they constitute 50 percent or more of the gross income of the corporation. This will prevent a corporation from getting out of section 351 by investing just enough in rents, say 21 percent, and still deriving the remainder of its income from dividends, interest, etc. On the other hand, it will protect the bona-fide real-estate corporation and other corporations renting property and deriving 50 percent or more of their gross income from rents.

7. The next recommendation of the committee is to include in gross income, for the purpose of determining whether a corporation should be classified as a personal holding company, income received by a corporation from an estate or trust, as well as gains from the sale or other disposition of any interest of the corporation in an estate or trust. It is possible that the existing law might be circumvented by interposing trusts between the payor of the investment income and the personal holding company. Under such circumstances, it might be contended that the personal holding company was not receiving income from dividends, interest, etc., but was receiving distributions as the beneficiary of the trust and that such income lost its identity as interest, dividends, etc., in the hands of the corporate beneficiary. The committee, in order to overcome this contention, recommends that such income, including gains from the sale or other disposition of any interest of a corporation in an estate or trust, should be included in determining whether the corporate beneficiary is a personal holding company.

8. The next change suggested by the committee is purely a clarifying one. In classifying the sources of income for the purpose of determining whether a corporation is a personal holding company, the law includes gains from the sale of stocks or securities. It is believed that this provision should be amended so as to make it clear that such language also embraces the gains from the exchange of stocks and securities as well as gains from the sale of stocks and securities.

9. In classifying the sources of income for the purpose of determining whether a corporation is a personal holding company, the committee also believes that there should be included gains from futures transactions in commodities on boards of trade, and exchanges, with an exemption of gains on bona-fide hedging transactions in the case of corporations engaged in good faith in producing, processing, merchandising,

or handling such commodities. In a case brought to the attention of the committee it was shown that a corporation had attempted to avoid this section by deriving 23 percent of its gross income from gains from speculations in commodities and still derive the remainder of its income, namely 77 percent, from investment sources. The recommendation of the committee would remove this loophole.

10. The committee recommends that section 351 be amended to provide that if in any taxable year the gross income derived from interest, dividends, etc., equals 80 percent or more of the total gross income of the personal holding company, the gross income test under section 351 for subsequent years shall be 70 percent of such investment income, instead of 80 percent, until a year for which the stock ownership test does not exist, or until for each of 3 consecutive years, such investment income falls below the 70 percent mark. The reason for this amendment is that it is believed that if a corporation once becomes a personal holding company it should stay in that class until there has been a sufficient change in the sources of its gross income to warrant taking it out or until it ceases to satisfy the stock ownership test.

11. The committee also recommend that convertible securities be included for the purpose of determining whether the stock of a corporation is owned by five or less individuals. It appears that the real owners of certain of these incorporated pocketbooks may own bonds or debentures, which contain provisions under which the obligations may be converted into stock. In such cases, it might be possible for the stock to be held by more than five individuals and at the same time have the interest of the real owner represented by convertible securities. It is believed that this existing loophole in section 351 should be closed in the manner recommended above and that the suggested provision should be applied in such manner as to produce the smallest possible number of individuals owning directly or indirectly more than 50 percent in value of the outstanding stock.

12. A similar situation exists in the case of options. The record ownership of the stock may be split up among more than five individuals but less than five individuals may have an option to acquire the stock at any time they desire. The committee believes that this situation should also be corrected by providing that in the case of an option to acquire stock such stock may be considered as being owned exclusively by the holder of the option or the owner of the stock, and this rule likewise should be applied in such manner as to produce the smallest possible number of individuals owning directly or indirectly more than 50 percent in value of the outstanding stock.

13. The committee also recommend that in determining the ownership of stock by an individual there should be included the stock owned by a partner of such individual. Cases have been presented wherein five individuals may own 46 percent in value of the stock of the corporation and a partner of one of these individuals owns 5 percent. Under existing law, a corporation of this type would not be classed as a personal holding company. The committee believe the close business relationship existing between members of a partnership justifies adding partners to the class of individuals mentioned.

14. The graduated rates of existing law open two serious loopholes. First, the fact that graduated rates are less severe than the graduated rates applicable to wealthy individuals enables such persons to effect substantial savings by use of the personal-holding-company device.

Second, the graduated rates in the low brackets permit further saving through organization of multiple personal-holding companies. The committee believes that the rates should be such as would encourage distribution in all cases. To overcome this tax advantage enjoyed through the formation of multiple personal-holding companies, the committee recommends that the rates under existing law which range from 8 percent on the first $2,000 up to 48 percent be changed so as to provide a 65-percent rate upon the amount of the undistributed adjusted net income not in excess of $2,000 and 75 percent of the amount in excess of $2,000. No low minimum rate can be provided without enabling wealthy individuals to escape substantial taxes through the formation of multiple personal-holding companies.

2. INCORPORATION OF YACHTS, COUNTRY ESTATES, ETC.

Increased use is being made of the device of incorporating yachts, city residences, country estates, etc., in order to avoid taxation of income at the rates prescribed in the higher individual surtax brackets or to obtain the benefit of deducting as corporation expenditures items not allowed to individuals, or both. The cases presented to the committee indicate that the plan in general consists of the transfer of the yacht or the real estate to a corporation for stock, or as paid-in surplus, or the yacht or real estate is purchased with cash provided by the stockholders. Securities, producing sufficient income to absorb corporate expenditures, are then turned over to the corporation for stock or as paid-in surplus. To lend color to the alleged business activity and to bring the corporation's gross income outside of the provisions of section 351 of the existing law, the corporation charges its principal stockholder some rent for the use of the yacht or real estate. The rent paid is usually much below the cost of the operation of the property and much below the amount which would be charged in an arm's length transaction. Since all expenses and losses of the corporation are claimed as deductions in computing the income of the corporation, a large part of the investment income is absorbed by expenses and losses incurred in the operation of the yacht or the real property. Since rents are not now included for the purpose of determining whether or not a corporation is a personal holding company, the taxpayer may also fix the amount of the rent for the yacht or real estate in an amount sufficient to bring his other investment income below the 80-percent test required under section 351 of existing law.

The committee finds no justification for permitting such tax advantage to these self-incorporated individuals. It is, therefore, suggested that the definition of personal holding company be so framed as to include in the 80-percent test the full amount received as rent or other compensation for the use of property by a corporation from any individual (whether a shareholder or not), who, together with his family and partners owns (directly or indirectly) 25 percent or more in the value of the securities which constitute "outstanding stock."

The committee also recommends that there should be disallowed as a deduction from gross income, the expenses of operation and maintenance (including depreciation) of property owned or operated by a personal holding company to the extent that expenses exceed the rent or other compensation for the use of such property, unless it is established to the satisfaction of the Commissioner—

(A) That the rent or other compensation received is the highest obtainable;

(B) That the property was held in the course of business carried on bona fide for profit; and

(C) That there was reasonable expectation that the operation of the property would result in a profit, or that such property was necessary to the conduct of the business.

To prevent a personal holding company from charging expenses in excess of its income for the operation and maintenance of property, such as yachts, city residences, and country estates, etc., against its investment income, such expenses are disallowed unless the corporation can meet the conditions outlined above. This has the effect of placing the personal holding company on the same basis, in this respect, as an individual who cannot offset his personal expenses against his income. If the corporation establishes to the satisfaction of the commissioner that the second test is satisfied and, that the property was necessary to the conduct of such business, it will not be necessary to prove there was reasonable expectation that the operation of the property would result in a profit, in order to obtain a full deduction.

This provision would not apply to a farm or a racing stable operated by the corporation itself where more than 20 percent of the gross income of such corporation came from such operations. This is because the corporation must first be a personal holding company before this provision will apply. Moreover, even if such a corporation is a personal holding company because more than 80 percent of its income comes from investment sources, it will still have the opportunity of escaping this provision by establishing that the property was held in the course of a bona-fide business carried on for profit and that such property was necessary for the conduct of the business. Even where an investment corporation is running a yacht, city residence, or country estate on the side, it is, nevertheless, recognized that certain property may be necessary for the conduct of its investment business, such as typewriters, office furniture, automobiles, and the like. Expenses attributable to such property would satisfy the third test.

8. INCORPORATED TALENTS

Cases presented to the committee showed that individuals organized corporations for the purpose of hiring out their personal services at a substantial increase over the amount of compensation such principal stockholders contracted for with their corporations. Since such corporations do not come within section 351 of the existing law, the excess compensation retained by the corporation is taxed at lower rates than would be applicable to such excess income in the hands of the individuals who performed the services. The committee believes this device constitutes a serious loophole in the existing law and recommends that the definition of "personal holding company" in section 351 of the existing law be amended so as to include, in applying the 80-percent test, the full amount received by the corporation from contracts for personal services (including gain from the sale or other disposition thereof) of any individual (whether or not a shareholder), who, together with his family and partner, owns (directly or indirectly) 25 percent or more in value of the securities which constitute "outstanding stock." The definition of the term "contract for personal services" should include the condition that a party other than the personal corporation has the right to designate the individual who is to perform the services. Someone, for example, such as an actor or artist, with more or less unique talents, incorporates himself and draws a salary from the corporation. The corporation contracts out his service with a third party and the difference between the amount paid to the individual as salary and the amount received from the third party is accumulated by the corporation.

Because of the condition in the contract for personal services that a party other than the corporation must have the right to designate the individual who is to perform the services, in order for this provision to apply, it would not apply to all cases where the corporation is hiring out its employees to third parties. Its application would be limited to cases in which such other party has the right under the contract to designate the individual who is to perform the service and where the individual so designated, with members of his family, owns 25 percent or more in value of the securities which constitute "outstanding stock."

4. ARTIFICIAL DEDUCTIONS FOR LOSSES FROM SALES OR EXCHANGES OF PROPERTY, SECTION 24 (A) (6)

(*a*) There is a provision in existing law which denies losses in the case of sales or exchanges of property between members of a family or between a shareholder and a corporation in which such shareholder owns more than 50 percent in value of the outstanding stock. However, the existing law permits losses to be established through the sale or exchange of capital assets between a personal holding corporation and another corporation, even where both corporations are under common control thereby permitting an advantage to be taken of any adverse change in the market price without an actual transfer of the assets into other hands. To correct this situation the committee recommends that losses be disallowed between two corporations if more than 50 percent in value of the outstanding stock of both is owned by the same individual (or members of his family) and if either one of the corporations for the preceding taxable year met the gross income test of a domestic personal holding company and during the last half of such taxable year met the stock ownership test of a domestic personal holding company, or either one of the corporations for the preceding taxable year met the gross income test of a foreign personal holding company and at any time during such year met the stock ownership test of a foreign personal holding company.

(*b*) Under existing law losses on sales and exchanges between an individual and his partner's corporation are allowed as deductions even though the individual himself may own some stock in the corporation. Because of the close relationship existing between partners, your committee recommends that losses should be disallowed between an individual and his partner's corporation if such individual owns stock in such corporation.

(*c*) The committee recommends that the existing law be clarified to confirm the Treasury's position that losses, for example, between a husband and his wife's corporation, or vice versa, whether or not he owns any stock in such corporation should not be deductible.

(*d*) The committee also recommends that losses between the settlor of a trust and the fiduciary of any trust created by the settlor should be disallowed. It has been the practice even in the case of irrevocable trusts for settlors of the trusts to shuffle back and forth between himself and the trustees, securities to establish losses even though they retained practical control over the trust.

(*e*) For the same reasons, the committee also recommends that losses should be disallowed between fiduciaries of any trusts, created by a common settlor.

(*f*) The committee also recommends that losses should be disallowed between a fiduciary of a trust and any beneficiary thereof. In some cases it has developed that the trustee has sold securities to the beneficiary at a loss. The trustee has then taken advantage of this loss to offset the gain from other securities which has resulted to the direct benefit of the beneficiary, notwithstanding the fact that he still retains the securities in his possession.

(*g*) The committee also recommends that an individual owning stock in a corporation should be considered as owning, to the exclusion of any other individual, the stock owned by his partner for the purpose of denying losses from sales or exchanges of property. For instance, A may own 45 percent of the stock of a corporation and his partner own 6 percent of that stock. Although together they own more than 50 percent of the stock of the corporation, the existing law would permit A to take a loss for the securities transferred to the corporation. The committee's recommendation would prevent the deduction of a loss in such a case.

(*h*) The committee also recommends that section 24 (a) (6) of existing law be amended to include a provision similar to that contained in section 351 providing that the stock owned by a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or other beneficiaries. For example, A, who owns 45 percent of the stock of corporation X, may also own 50 percent of the stock of corporation Y, which in turn owns 25 percent of the stock of corporation X. If you look through corporation Y, you find that A, through his ownership of stock in corporation Y, really owns indirectly 12½ percent of the stock of corporation X, in addition to his direct ownership of 45 percent of stock in corporation X. Adding A's direct as well as his indirect ownership in corporation X together, we find that he owns more than 51 percent of the stock of corporation X. Therefore, under the committee's recommendation, A would not be allowed to deduct a loss on the sale or exchange of property to corporation X.

5. ARTIFICIAL DEDUCTIONS FOR INTEREST AND BUSINESS EXPENSE

The committee had presented to it certain cases wherein individuals were indebted to each other or corporations were indebted to the principal stockholders. In fact it was pointed out that personal holding companies were being utilized for the purpose of establishing artificial deductions. The sole stockholder (or a member of his family) of a personal holding corporation borrowed all or a major part of its annual net income and paid interest thereon. In such cases the debtor kept his books and tax returns on the accrual basis and claimed as deductions the accrued interest. On the other hand, the creditor who was entitled to such payments, if he were on the cash receipts basis, would not be required to report for income tax purposes, the amount owing to him until actual receipt of the money. Under such circumstances the discharge of the debt may be postponed for an unreasonable length of time with the result that the Government is delayed in getting its tax and in many cases the payments fall in a year of no income with the result that little or no tax is paid. The committee believes that such practices between individuals of a family or between corporations under common control should be dealt with in such a manner as to encourage reasonably prompt discharge of such obligations.

It is, therefore, recommended that in the case of a transaction between persons, who under section 24 (a) (6) are not permitted a deduction for loss from sale or exchange of property, where the debtor makes his return on the accrual basis and the creditor makes his return on the cash basis, deductions—under section 23 (a), Expenses and under section 23 (b), Interest—accrued by the debtor within the taxable year but not paid within 2½ months after the close of the taxable year should be disallowed.

This proposal should serve to stimulate reasonably prompt payment of such accrued expenses in order that the debtor may secure the allowance of the deduction. No hardship should result from the requirement that the amount be paid within 2½ months after the close of the year of accrual since expenses of this nature usually should be paid within that time in the ordinary course of business. While this restriction would be applicable only to individuals and corporations in relationships covered by section 24 (a) (6), this class represents the worst offenders in the use of this loophole.

6. MULTIPLE TRUSTS

The committee has given careful consideration to the question of avoidance of taxes through the use of multiple trusts to accumulate income. It is recommended that in the case of all trusts for accumulation, the $1,000 exemption granted under existing law be repealed. This will prevent many of these trusts from escaping tax entirely. For example, if an individual forms 50 trusts each of which has an income of $1,000 a year to be accumulated, under existing law no income tax is paid. Under the committee's proposal, the whole $50,000 would be subject to some tax. This may not be the best remedy for the situation and this question will receive further consideration by the committee. It should be noted that the elimination of the $1,000 exemption would not affect trusts which distribute their income, since such trusts are not taxable and the beneficiaries have the right to a personal exemption under existing law.

7. FOREIGN PERSONAL HOLDING COMPANIES

The testimony taken by the committee has shown that foreign personal holding companies are being utilized by citizens and residents of the United States as a device for tax-avoidance purposes. Income which otherwise would be subjected to the Federal income taxes is being diverted to, and accumulated by, such companies in order that the American shareholders may escape being taxed thereon. Because of the jurisdictional difficulties and the difficulties of collection of taxes involved in reaching these foreign entities, they present a distinct problem. While the provisions of sections 351 and 102 of the present law, which impose surtaxes on the undistributed profits of corporations, by their terms apply to foreign as well as to domestic corporations, it appears necessary for the protection of the revenue that a separate method of taxation be provided for with respect to certain types of foreign personal holding companies.

Although in most cases the foreign personal holding company is effectively beyond the jurisdiction of the United States, the shareholders of such corporation who are American citizens or residents are generally within such jurisdiction. Consequently it has been concluded by the committee that a method of handling this situation should be devised whereby the income of foreign personal holding companies might be taxed to the shareholders pro rata whether such income was actually distributed to them or not. The fiscal authorities in other countries where income taxes are imposed have been faced with a similar problem as to the taxation of foreign personal holding companies and Canada has now in effect a provision which in principle accords with the committee's proposal.

The committee's recommendation in general is that the undistributed part of a foreign personal holding company's net income should be included in the gross income of the American citizen or resident just as if such undistributed income had actually been distributed. Provision has been made so that such income would not be again subject to tax when actually distributed.

This proposal recommends a method of taxation which is a departure from any previously used with respect to corporate income. The committee feel, however, that this innovation is necessary to protect the revenue and prevent further use of one of the most glaring loopholes now existing. The proposal would affect only foreign corporations which are owned 50 percent or more by five American citizens or residents (including members of their families) and which have the same type of investment income which makes a domestic corporation subject to tax as a personal holding company. Real foreign operating companies or widely held holding companies are not included. However, it should be observed that a few foreign corporations, not subject to these recommendations in respect to foreign personal holding companies, may fall under section 102 or section 351. The committee believes that the recommendation is not any more drastic than the situation requires. The detailed recommendations of the committee follow:

1. The undistributed adjusted net income of the foreign personal holding company for its entire taxable year should be included in the gross income of the American shareholders (that is, United States citizens, resident aliens, resident estates or trusts, domestic partnerships, and domestic corporations) to the following extent:

(A) If the corporation constitutes a foreign personal holding company on the last day of its taxable year, then each American shareholder should include in his gross income the amount he would have received if the entire undistributed adjusted net income had been distributed by the corporation on such day; but

(B) If the last day on which the corporation constitutes a foreign personal holding company falls within and not at the end of its taxable year, then only that proportion of the undistributed adjusted net income for the entire taxable year equal to the portion of the taxable year up to such last day should be included in their gross income by the American shareholders as though distributed by the corporation on such last day.

In every case, the American shareholder should include his distributive share of the undistributed adjusted net income of the corporation in his gross income for his taxable year in which or with which the taxable year of the corporation ends.

2. The undistributed adjusted net income should be computed by deducting from the adjusted net income the dividends-paid credit allowed under section 27 of the Revenue Act of 1936, computed, however, without the benefit of subsection (b) thereof, which relates to the dividend carry-over.

3. The adjusted net income should be computed by deducting from the net income Federal income taxes paid or accrued under section 231 of the present law with respect to the taxable year.

4. The net income of a foreign personal holding company should be computed, not in the manner provided for in Supplement "I" relating to foreign corporations, but in the same manner, and on the same basis, as the net income of a domestic corporation except that:

(A) The gross income should include the distributive share of the undistributed adjusted net income of any other foreign personal holding company in which the corporation owns stock. This provision is necessary in order to reach income being accumulated by a chain of two or more foreign personal holding companies.

(B) The deductions permitted under section 23 (d) (relating to taxes of a shareholder paid by a corporation) and section 23 (p) (relating to pension trusts) should not apply.

(C) Deductions for the maintenance and operation of yachts, residences and country estates should be limited as proposed in respect to domestic personal holding companies. It should be noted that the effect of this recommendation would be to include in the net income of foreign personal holding companies interest received by them on obligations of the United States.

5. The entire undistributed adjusted net income of a foreign personal holding company for a taxable year with respect to which the American shareholders are required to return their distributive shares should be treated as paid-in surplus of the corporation. This rule is necessary to permit tax-free distribution of amounts returned by the shareholders as constructive dividends. By treating such income as paid-in surplus the subsequent distribution is not made out of earnings and profits so as to constitute a taxable dividend. Since the present law provides that all distributions are made out of earnings and profits to the extent available, the recommended rule would operate to require the corporation to distribute all of its accumulated earnings before it can make a tax-free distribution to the shareholders of the undistributed adjusted net income previously included in their returns.

6. The American shareholders should not be allowed any credit against their Federal income taxes for foreign income taxes, if any, paid by the foreign personal holding company in respect to the undistributed adjusted net income returned by them. The allowance of such credit is not administratively feasible although it might seem equitable under the circumstances. However, it should be noted that in computing the net income of the corporation a deduction for

foreign taxes will be allowed to the same extent as in the case of a domestic corporation which claims no foreign tax credit.

7. It is recommended that a foreign personal holding company be defined in substantially the same manner as a domestic personal holding company is defined in section 351 of the existing law, with the following changes;

(A) Eliminate the exemption of banks, life-insurance companies and surety companies, and provide that the five or less individuals must be American citizens or residents.

(B) In the gross income test: (1) Change the minimum requirement to 60 percent; (2) do not limit gross income to gross income from sources within the United States; (3) include rents the same as proposed in the case of domestic personal holding companies; (4) include the same provisions with respect to incorporated yachts, country estates, etc., and incorporated talent as proposed in the case of domestic personal holding companies; (5) include income from estates or trusts and gains from the exchange of stock or securities the same as proposed in the case of domestic personal holding companies; (6) include gains from future transactions on boards of trade or commodity exchanges as proposed in the case of domestic personal holding companies; (7) include in the gross income of the corporation its pro-rata share of the undistributed net income of any other foreign personal holding company in which it holds stock; (8) provide that, if in any taxable year the gross income from the items mentioned equals 60 percent or more of the total gross income of the corporation, the gross income test for subsequent years should be 50 percent until for each of three consecutive years it falls below 50 percent, or the corporation ceases to qualify under the stock-ownership test.

(C) In the stock-ownership test: (1) Include convertible securities and options the same as proposed in the case of domestic personal holding companies; (2) provide that in determining ownership of stock owned by an individual stock owned by a partner of such individual should be included; (3) make the test apply to any time during the taxable year.

8. It is further recommended that a 7-year statute of limitations on assessment and collection without assessment be provided to apply where the American shareholder fails to include in his gross income his distributive share of the undistributed adjusted net income of the corporation.

OBTAINING INFORMATION RELATING TO FOREIGN PERSONAL HOLDING COMPANIES

It is difficult to secure complete information with respect to foreign personal holding companies formed by American citizens or residents due to the lack of effective jurisdiction over such companies. In order to make the new method of taxation in respect of foreign personal holding companies effective, it is necessary to give the Treasury the power to require certain information from American citizens, residents and other American entities, with respect to the formation, organization, or reorganization of foreign corporations generally and also information as to the income, stockholdings, etc., of foreign corporations which are personal holding companies. It is the understanding of the committee that under the authority contained in sections 51, 52, 142, and 187 of the Revenue Act of 1936 the Treasury will require each person filing income-tax returns to set forth his ownership of stock in foreign corporations. Additional statutory authority is believed necessary and the committee makes the following recommendations:

1. It is recommended that every person who, on or after the enactment of the act, is an officer or director of a foreign personal holding company and every American shareholder who owns 50 percent or more of its stock, directly or indirectly (including, in the case of an individual, the members of his family), should, under regulations prescribed by the Commissioner with the approval of the Secretary, and with respect to the period he holds such office, or retains such ownership, be required to file returns under oath monthly or at such other times as may be required by regulations, showing the name and address of each shareholder and class and number of shares held by each in such foreign personal holding company, together with any changes in stock holdings during such period, and the name and address of each holder of a security convertible into stock of such company, which the Commissioner under regulations approved by the Secretary of the Treasury prescribes as necessary for carrying out the provisions of the proposed legislation. It is recommended that this information be required if the company would have been a foreign personal holding company for the preceding year or for the taxable year beginning in 1936, if this act has then been in force and effect, or if such person has reason to believe it will be a foreign personal holding company at any time during the current taxable year.

2. It is recommended that criminal penalties be imposed for willful failure to file the statement required in the preceding paragraph, of a fine of $2,000 or imprisonment for 1 year or both.

3. It is recommended that an American shareholder owning 5 percent or more of the stock of a foreign personal holding company be required to set forth in complete detail in his tax return the gross income, deductions and credits, net income, adjusted net income and undistributed adjusted net income of such company.

4. It is recommended that, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, returns under oath be required to be filed by any persons who, after the enactment of the proposed act, aid, assist, counsel, or advise in, or with respect to, the formation, organization, or reorganization of any foreign corporation, which returns should contain such information as the Commissioner with the approval of the Secretary by rules and regulations prescribes as necessary for carrying out the provisions of the act. Such returns should be required to be filed monthly or at such other times as the Commissioner with the approval of the Secretary may by rules and regulations prescribe. This information is essential in order to ascertain those persons seeking to utilize the device of the foreign personal holding company. For obvious reasons, however, the requirement should not be limited to cases of foreign personal holding companies.

5. It is recommended that, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, a return under oath be required to be filed within 90 days after the enactment of the proposed act by every person who, since January 1, 1934, and prior to 90 days after the enactment of the act, has aided, assisted, counseled, or advised in the formation, organization, or reorganization

of a foreign corporation, which return should contain such information as the Commissioner with the approval of the Secretary, by rules and regulations, prescribes as necessary for carrying out the provisions of the act.

This information is necessary to ascertain those persons who have actually utilized the device of the foreign personal holding company. For obvious reasons, however, it should not be limited to the case of foreign personal holding companies. The date of January 1, 1934, is taken because it coincides with the effective date of the original provision imposing a surtax on personal holding companies.

6. It is recommended that criminal penalties be imposed for willful failure to file complete and accurate returns required by the two preceding paragraphs of a fine of $2,000 or imprisonment for 1 year or both.

ADDITIONAL LEGISLATION RELATING TO FOREIGN PERSONAL HOLDING COMPANIES

There appears to be no justification for the continued existence of foreign personal holding companies owned by American citizens or residents and it is believed that practically all of such companies have been created with the sole purpose of avoiding or evading the imposition of the surtax on their shareholders. It is believed as a matter of fiscal policy that the dissolution of such companies should be effected as promptly as possible and the committee accordingly makes the following additional recommendations to encourage such dissolution:

1. It is recommended that in the case of liquidation of any foreign personal holding company wherein the distribution of assets and dissolution of the corporation is not completed on or before December 31, 1937, notwithstanding the provisions of section 117 (a), 100 percent of the gains recognized on such liquidation should be taken into account in computing net income except that if evidence is submitted to the Commissioner prior to January 1, 1938, which establishes to his satisfaction that due to the laws of the foreign country in which it is incorporated, or for other reason, it is impossible to distribute the assets and complete the dissolution on or before December 31, 1937, the Commissioner should be authorized to extend such period to not later than June 30, 1938. Under existing law it is possible for as little as 30 percent of the gain to be taken into account in computing net income.

2. It is recommended that in the case of any person dying after the enactment of this act owning stock or securities of any corporation which for its taxable year preceding his death met the gross-income test of a foreign personal holding company and at any time during such year met the stock-ownership test of a foreign personal holding company, the basis of the stock or securities acquired by the decedent's estate from the decedent or acquired by others from the decedent by bequest, devise, or inheritance should, notwithstanding the provisions of section 113 (a), be (1) the fair market value of such stock or securities at the time of such acquisition or (2) the same as it would be in the hands of the decedent, whichever is lower.

3. It is the intention of the committee to consider measures for the treatment in the case of sale or exchange after December 31, 1937, of stock or securities of such corporations as foreign personal holding

companies in such manner as to obviate the possibility of such sale or exchange under such circumstances or through such devices as to obtain the advantage of section 117 (a), and to recommend thereon at a later date.

4. The committee has made the recommendations above for additional legislation to prevent the use of foreign personal holding companies by American citizens and residents as devices for the evasion and avoidance of Federal income taxes and to encourage the prompt dissolution of existing companies of this type. The committee believes that these recommendations, if adopted, will contribute greatly to the attainment of these ends. It also recognizes the complex character of the problem and the difficulty of framing a tax law which is proof against all the varied and complicated devices involving the use of foreign entities which legal ingenuity may evolve in the future. The committee is therefore of the view that it should continue its study of this problem and should consider other and additional measures which may be feasible for preventing the use of spurious foreign entities to thwart the intent and purposes of the revenue laws. Accordingly, it is the intention of the committee to consider possible measures for the creation of administrative and judicial procedure, including criminal penalties, to prevent the formation and compel the dissolution of artificial foreign entities availed of by American citizens or residents to evade or avoid Federal income taxes, and to make recommendations at a later date with respect thereto.

NONRESIDENT ALIENS

Section 211 (a) of the Revenue Act of 1936 imposes a tax on nonresident aliens not engaged in trade or business in the United States and not having an office or place of business therein at the rate of 10 percent upon their income from interest, dividends, rents, wages and salaries, and other fixed and determinable income from sources within the United States with no allowance for the deductions from gross income and credits against net income allowed to individuals subject to normal and surtax on net income. In the case of a resident of a contiguous country, the existing law provides that such rate may be reduced to not less than 5 percent as may be provided by treaty with such country. This flat tax, which is in effect imposed upon gross income, is in the usual case collected at the source by means of withholding, and has worked well both from an administrative and revenue standpoint. The additional revenue derived is estimated to be not less than $15,000,000 per annum. However, evidence presented to the committee discloses that certain wealthy nonresident aliens have had their Federal income taxes substantially reduced by this new system. In fact, it has permitted certain former citizens of the United States who have now become citizens of other countries but who derive a large amount of income from American sources within the United States, either directly or through an American trust, greatly to reduce their taxes. This is due in the main to the fact that if these individuals were subject to both normal and surtaxes, the effective rate of tax on their income from American sources would be much higher than the 10-percent rate applicable to such income under existing law. To remedy this situation the committee makes the following recommendations:

1. Subject to the normal and surtax on net incomes from the sources mentioned in section 211 (a) of existing law, nonresident aliens (now taxable under that section) whose net income from such sources is more than $21,600, which is the approximate point at which the effective rate becomes 10 percent. It may be possible that some nonresident aliens may pay less tax under this proposal than they do under existing law. To remedy this the committee recommends that the tax under the proposal shall not be less than the tax which would be payable under existing law on the gross income from such sources. In order that this new rule may not unduly increase the tax on nonresident aliens whose net income is just sufficient to bring them within this proposal, the committee also recommends that the tax shall not be increased by more than the amount of net income in excess of $21,600. Nonresident aliens subject to this proposal will still be subject to the withholding provisions at the rates imposed under existing law but they will be entitled to a credit for the amount of tax which has been withheld at the source on such income in computing their tax on the income from the sources specified in section 211 (a). They will be entitled to the same deductions and credits applicable to such income as in the case of nonresident aliens taxable under section 211 (b) of existing law, that is, nonresident aliens engaged in trade or business in the United States or having an office or place of business therein.

2. For the purpose of administering this proposal, the committee recommends that all nonresident aliens whose gross income from the sources specified amounts in the aggregate to $21,600 or more be required to file annual returns with the collector at Baltimore, Md.

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