TECHNICAL AMENDMENTS ACT OF 1958

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HEARINGS

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

EIGHTY-FIFTH CONGRESS

SECOND SESSION

ON

H. R. 8381

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

FEBRUARY 25–28, 1958

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ADDITIONAL INFORMATION

TECHNICAL AMENDMENTS ACT OF 1958

TUESDAY, FEBRUARY 25, 1958

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met, pursuant to call, at 10:10 a. m., in room 312, Senate Office Building, Senator Robert S. Kerr presiding.

Present: Senators Kerr, Frear, Long, Douglas, Gore, Martin, Williams, Flanders, Carlson, Malone, Bennett, and Jenner.

Also present: Elizabeth B. Springer, Chief Clerk.

Senator KERR (presiding). I submit for the record the text of H. R. 8381 which we are about to consider.

(H. R. 8381 is as follows:)

[H. R. 8381, 85th Cong., 2d sess.]

AN ACT To amend the Internal Revenue Code of 1954 to correct unintended benefits and hardships and to make technical amendments, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This Act may be cited as the "Technical Amendments Act of 1958".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, wherever in this Act an amendment or repeal is expressed in terms of an amendment to or a repeal of a section or other provision, the reference shall be considered to be made to a provision of the Internal Revenue Code of 1954.

(c) EFFECTIVE DATE.—Except as otherwise expressly provided—

(1) amendments made by this Act to subtitle A of the Internal Revenue Code of 1954 (relating to income taxes) shall apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954; and

(2) amendments made by this Act to subtitle F of such Code (relating to procedure and administration) shall take effect as of August 17, 1954, and such subtitle, as so amended, shall apply as provided in section 7851 of the Internal Revenue Code of 1954.

SEC. 2. RETIREMENT INCOME CREDIT.

(a) COMPUTATION IN CASE OF INDIVIDUALS WHO ARE MARRIED.—

(1) DEFINITION OF RETIREMENT INCOME.—Section 37 (c) (defining the term "retirement income") is amended by adding at the end thereof the following new sentences: "In applying paragraphs (1) (A) and (2) in the case of individuals who are married, any pension or annuity attributable to services rendered by either spouse shall be treated as received by the spouse who rendered the services. For purposes of the preceding sentence, determination of marital status shall be made under section 143."

(2) LIMITATION ON AMOUNT.—Section 37 (d) (1) (relating to limitation on retirement income for purposes of retirement income credit) is amended by striking out "any amount received by the individual as a pension or annuity" and inserting in lieu thereof "any amount received by the individual (determined without regard to community property laws) as a pension or annuity".

(3) DEFINITION OF EARNED INCOME.—Section 37 (g) (relating to definition of earned income for purposes of retirement income credit) is amended by adding at the end thereof the following new sentence: "For purposes of the

preceding sentence, if income attributable to services rendered by a husband or wife is community income under community property laws applicable to such income, such income shall be treated as the income of the individual who rendered such services."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply only with respect to credits under section 37 of the Internal Revenue Code of 1954 for taxable years beginning after December 31, 1956.

SEC. 3. DEALERS IN TAX-EXEMPT SECURITIES.

(a) MUNICIPAL BONDS.—Section 75 (relating to dealers in tax-exempt securities) is amended—

(1) by striking out paragraph (1) of subsection (b) and inserting in lieu thereof the following:

"(1) The term 'municipal bond' means any obligation issued by a government or political subdivision thereof if the interest on such obligation is excludable from gross income; but such term does not include such an obligation if—

"(A) it is sold or otherwise disposed of by the taxpayer within 30 days after the date of its acquisition by him, and

"(B) in the case of a sale, the amount realized (or in the case of any other disposition, the fair market value of the obligation at the time of such disposition) is higher than its adjusted basis (computed without regard to this section).

Determinations under subparagraph (B) shall be exclusive of interest."; and

(2) by striking out "short-term" each place it appears in subsection (a).

(b) CONFORMING AMENDMENT.—Section 1016 (a) (6) (relating to adjustments to basis) is amended by striking out "short-term".

(c) EFFECTIVE DATE.—The amendments made by subsections (a) and (b) shall apply with respect to taxable years ending after November 7, 1956, but only with respect to obligations acquired after such date.

SEC. 4. STATUTORY SUBSISTENCE ALLOWANCE RECEIVED BY POLICE.

(a) REPEAL.—Section 120 (relating to statutory subsistence allowance received by police) is hereby repealed.

(b) CONFORMING AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 is amended by striking out

"Sec. 120. Statutory subsistence allowance received by police."

(c) EFFECTIVE DATE.—The amendments made by subsections (a) and (b) shall apply with respect to taxable years beginning after December 31, 1956.

SEC. 5. DEFINITION OF DEPENDENT.

(a) SPOUSE.—Paragraph (9) of section 152 (a) (relating to definition of dependent) is amended to read as follows:

"(9) An individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to section 153, of the taxpayer) who, for the taxable year of the taxpayer, has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household, or".

(b) MEMBER OF HOUSEHOLD.—Section 152 (b) (relating to definition of dependent) is amended by adding at the end thereof the following new paragraph:

"(5) An individual is not a member of the taxpayer's house if at any time during the taxable year of the taxpayer the relationship between such individual and the taxpayer is in violation of local law."

SEC. 6. PAYMENTS FOR MUNICIPAL SERVICES IN ATOMIC ENERGY COMMUNITIES.

(a) TREATMENT AS TAX PAYMENTS.—Section 164 (relating to deduction for taxes) is amended by relettering subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) PAYMENTS FOR MUNICIPAL SERVICES IN ATOMIC ENERGY COMMUNITIES.—For purposes of this section, amounts paid or accrued, to compensate the Atomic Energy Commission for municipal-type services, by any owner of real property within any community (within the meaning of section 21 b of the Atomic Energy Community Act of 1955) shall be treated as real property taxes paid or accrued. For purposes of this subsection, the term 'owner' includes a person who holds the real property under a leasehold of 40 or more years and a person who has entered into a contract to purchase under section 61 of the Atomic Energy Community Act of 1955. Subsection (d) of this section shall not apply to a sale by the United States of property with respect to which this subsection applies."

(b) The amendments made by subsection (a) shall apply with respect to taxable years beginning after December 31, 1956.

SEC. 7. WORTHLESS SECURITIES IN AFFILIATED CORPORATIONS.

Section 165 (g) (3) (B) (relating to worthless securities in affiliated corporations) is amended by striking out "rental from" and inserting in lieu thereof "rental of".

SEC. 8. NONBUSINESS BAD DEBTS.

Section 166 (d) (2) (A) (relating to definition of nonbusiness debt) is amended by striking out "a taxpayer's trade or business" and inserting in lieu thereof "a trade or business of the taxpayer".

SEC. 9. REMAINDERS TO RELATED PERSONS IN THE CASE OF CERTAIN CHARITABLE TRUSTS.

(a) DENIAL OF DEDUCTION.—Section 170 (b) (1) (relating to limitations on charitable deductions) is amended by adding at the end thereof the following new subparagraph:

"(E) SPECIAL RULES FOR APPLICATION OF SUBPARAGRAPH (D).—In the case of any transfer to a trust after December 31, 1956, for purposes of subparagraph (D)—

"(i) the term 'grantor' includes any person who bears a relationship to the grantor of the kind specified in any of the paragraphs of section 267 (b); except that, in applying section 267 (b) and (c) for purposes of this subparagraph, paragraph (4) of section 267 (c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants;

"(ii) the term 'reversionary interest' includes a remainder interest; and

"(iii) a power to revest includes the power to vest."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years ending after December 31, 1956, but only with respect to transfers to trusts after such date.

SEC. 10. CHARITABLE CONTRIBUTION CARRYOVER FOR CORPORATIONS.

Section 170 (b) relating to limitations on charitable contribution deduction) is amended by adding at the end thereof the following new paragraph:

"(3) SPECIAL RULE FOR CORPORATIONS HAVING NET OPERATING LOSS CARRYOVERS.—In applying the second sentence of paragraph (2) of this subsection, the excess of—

"(A) the contributions made by a corporation in a taxable year to which this section applies, over

"(B) the amount deductible in such year under the limitation in the first sentence of such paragraph (2),

shall be reduced to the extent that such excess reduces taxable income (as computed for purposes of the second sentence of section 172 (b) (2)) and increases a net operating loss carryover under section 172 to a succeeding taxable year."

SEC. 11. LIMITATIONS ON CHARITABLE CONTRIBUTION DEDUCTION.

(a) REDUCTION FOR CERTAIN INTEREST.—Section 170 (b) (relating to limitations on deduction for charitable, etc., contributions and gifts) is amended by adding after paragraph (3) (added by section 10 of this Act) the following new paragraph:

"(4) REDUCTION FOR CERTAIN INTEREST.—If, in connection with any charitable contribution, a liability is assumed by the receipient or by any other person, or if a charitable contribution is of property which is subject to a liability, then, to the extent necessary to avoid the duplication of amounts, the amount taken into account for purposes of this section as the amount of the charitable contribution—

"(A) shall be reduced for interest (i) which has been paid (or is to be paid) by the taxpayer, (ii) which is attributable to the liability, and (iii) which is attributable to any period after the making of the contribution, and

"(B) in the case of a bond, shall be further reduced for interest (i) which has been paid (or is to be paid) by the taxpayer on indebtedness incurred or continued to purchase or carry such bond, and (ii) which is attributable to any period before the making of the contribution.

The reduction pursuant to subparagraph (B) shall not exceed the interest (including interest equivalent) on the bond which is attributable to any period before the making of the contribution and which is not (under the taxpayer's method of accounting) includible in the gross income of the taxpayer for any taxable year. For purposes of this paragraph, the term 'bond' means any bond, debenture, note, or certificate or other evidence of indebtedness."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years ending after November 7, 1956, but only with respect to charitable contributions made after such date.

SEC. 12. AMORTIZABLE BOND PREMIUM.

(a) AMORTIZATION OF PREMIUMS WITH CALL DATES.—Section 171 (b) (relating to amortizable bond premium) is amended—

(1) by striking out subparagraph (B) of paragraph (1) and inserting in lieu thereof the following:

"(B) (i) with reference to the amount payable on maturity or on earlier call date, in the case of any bond other than a bond to which clause (ii) or (iii) applies,

"(ii) with reference to the amount payable on maturity (or if it results in a smaller bond premium for the period to earlier call date, with reference to the amount payable on earlier call date), in the case of any bond described in subsection (c) (1) (B) which is required after November 7, 1956, or

"(iii) with reference to the amount payable on maturity, in the case of any bond described in subsection (c) (1) (B) which was acquired after January 22, 1954, and before November 8, 1956, but only if such bond was issued after January 22, 1951, and has a call date not more than 3 years after the date of such issue, and"; and

(2) by striking out, in the second sentence of paragraph (2), the phrase "In the case of a bond described in subsection (c) (1) (B) issued after January 22, 1951, and acquired after January 22, 1954, which has a call date not more than 3 years after the date of such issue," and inserting in lieu thereof the following: "In the case of a bond to which paragraph (1) (B) (ii) or (iii) applies and which has a call date,".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply with respect to taxable years ending after November 7, 1956.

SEC. 13. NET OPERATING LOSS DEDUCTION.

(a) TAXABLE YEARS BEGINNING IN 1953 AND ENDING IN 1954.—Section 172 (f) (relating to net operating loss provisions for taxable years beginning in 1953 and ending in 1954) is amended by adding at the end thereof the following new paragraphs:

"(3) The net operating loss deduction for such year shall be, in lieu of the amount specified in section 122 (c) of the Internal Revenue Code of 1939, the sum of—

"(A) that portion of the net operating loss deduction for such year, computed as if subsection (a) of this section were applicable to the taxable year, which the number of days in such year after December 31, 1953, bears to the total number of days in such year, and

"(B) that portion of the net operating loss deduction for such year, computed under section 122 (c) of the Internal Revenue Code of 1939 as if this paragraph had not been enacted, which the number of days in such year before January 1, 1954, bears to the total number of days in such year.

"(4) For purposes of the second sentence of subsection (b) (2), the taxable income for such year shall be the sum of—

"(A) that portion of the net income for such year, computed without regard to this paragraph, which the number of days in such year before January 1, 1954, bears to the total number of days in such year, and

"(B) that portion of the net income for such year, computed—

"(i) without regard to paragraphs (1) and (2) of section 122 (d) of the Internal Revenue Code of 1939, and "(ii) by allowing as a deduction an amount equal to the sum of the credits provided in subsections (b) and (h) of section 26 of such Code,

which the number of days in such year after December 31, 1953, bears to the total number of days in such year."

(b) SHORT TAXABLE YEARS BEGINNING IN 1954.—Section 172 (g) (relating to special transitional rules for net operating loss provisions) is amended by redesignating paragraph (3) as paragraph (4) and by inserting after paragraph (2) the following new paragraph:

"(3) TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953, AND ENDING BEFORE AUGUST 17, 1954.—In the case of a taxable year which begins after December 31, 1953, and ends before August 17, 1954—

"(A) the net operating loss deduction for such year shall be computed as if subsection (a) of this section applied to such taxable year, and

"(B) for purposes of the second sentence of subsection (b) (2), the taxable income for such taxable year shall be the net income for such taxable year, computed—

"(i) without regard to paragraphs (1) and (2) of section 122 (d) of the Internal Revenue Code of 1939, and

"(ii) by allowing as a deduction an amount equal to the sum of the credits provided in subsections (b) and (h) of section 26 of such Code."

SEC. 14. IMPROVEMENTS ON LEASED PROPERTY.

(a) DEDUCTION BY LESSEE FOR DEPRECIATION, ETC.—Part VI of subchapter B of chapter 1 (itemized deductions for individuals and corporations) is amended by adding at the end thereof the following new section:

"SEC. 178. DEPRECIATION OR AMORTIZATION OF IMPROVEMENTS MADE BY LESSEE ON LESSOR'S PROPERTY.

"(a) GENERAL RULE.—Except as provided in subsection (b), in determining the amount allowable to a lesee as a deduction for any taxable year for exhaustion, wear and tear, obsolescence, or amortization—

"(1) in respect of any building erected (or other improvent made) on the leased property, or

"(2) in respect of any cost of acquiring the lease, the term of the lease shall be treated as including any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee, unless the lessee establishes that (as of the close of the taxable year) it is more probable that the lease will not be renewed, extended, or continued for such period than that the lease will be so renewed, extended, or continued.

"(b) RELATED LESSEE AND LESSOR.—

"(1) GENERAL RULE.—If a lessee and lessor are related persons (as determined under paragraph (2)) at any time during the taxable year then, in determining the amount allowable to the lessee as a deduction for such taxable year for exhaustion, wear and tear, obsolescence, or amortization in respect of any building erected (or other improvement made) on the leased property, the lease shall be treated as including a period of not less duration than the remaining useful life of such improvement.

"(2) RELATED PERSONS DEFINED.—In determining for purposes of paragraph (1) whether a lessee and lessor are related persons, the rules of subsections (b) and (c) of section 267 shall apply, except that—

"(A) the family of an individual shall include only his spouse, ancestors, and lineal descendants; and

"(B) the phrase '80 percent or more' shall be substituted for the phrase 'more than 50 percent' each place it appears therein."

(b) TECHNICAL AMENDMENT.—The table of sections for such part VI is amended by adding at the end thereof the following:

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to improvements begun after December 31, 1956 (other than improvements which, on December 31, 1956, and at all times thereafter, the lessee was under a binding legal obligation to make).

SEC. 15. MEDICAL, DENTAL, ETC., EXPENSES IN CASE OF DECEDENTS.

Section 213 (d) (2) (A) (relating to medical, dental, etc., expenses in the case of decedents) is amended by striking out "claimed or".

SEC. 16. DEDUCTIONS BY CORPORATIONS FOR DIVIDENDS RECEIVED.

(a) EXCLUSION OF CERTAIN DIVIDENDS.—Section 246 (relating to rules applying to deductions by corporations for dividends received) is amended by adding at the end thereof the following new subsection:

"(c) EXCLUSION OF CERTAIN DIVIDENDS.—

"(1) IN GENERAL.—No deduction shall be allowed under section 243, 244, or 245, in respect of any dividend on any share of stock—

"(A) which is sold or otherwise disposed of in any case in which the taxpayer has held such share for 10 days or less, or

"(B) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make corresponding payments with respect to substantially identical stock or securities.

"(2) 90-DAY RULE IN THE CASE OF CERTAIN PREFERENCE DIVIDENDS.—In the case of any stock having preference in dividends, the holding period specified in paragraph (1) (A) shall be 90 days in lieu of 10 days if the taxpayer receives dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days.

"(3) DETERMINATION OF HOLDING PERIODS.—For the purposes of this subsection, in determining the period for which the taxpayer has held any share of stock—

"(A) the day of disposition, but not the day of acquisition, shall be taken into account,

"(B) there shall not be taken into account any day which is more than 10 days (or 90 days in the case of stock to which paragraph (2) applies) after the date on which such share becomes ex-dividend, and

"(C) paragraph (4) (of section 1223) shall not apply.

The holding periods determined under the preceding provisions of this paragraph shall be appropriately reduced (in the manner provided in regulations prescribed by the Secretary or his delegate) for any period (during such holding periods) in which the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially identical stock or securities."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to taxable years ending after November 7, 1956, but only with respect to shares of stock acquired after November 7, 1956.

SEC. 17. PROPERTY RECEIVED IN CERTAIN CORPORATE ORGANIZATIONS AND REORGANIZATIONS.

(a) BASIS.—Section 358 (a) (1) (A) (relating to decrease in basis to distributees of property received in certain corporate organizations and reorganizations) is amended by striking out "and" at the end of clause (i), and by adding after clause (ii) the following new clause:

"(iii) the amount of loss to the taxpayer which was recognized on such exchange, and".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply as provided in section 393 of the Internal Revenue Code of 1954 as if the clause (iii) added by such amendment had been included in such Code at the time of its enactment.

SEC. 18. CERTAIN ACQUISITIONS OF STOCK.

(a) TRANSITIONAL RULES.—Section 391 (relating to effective date of certain provisions of the Internal Revenue Code of 1954 relating to distributions by corporations) is amended by adding at the end thereof the following new sentence: "In the case of—

"(1) any acquisition of stock described in section 304 which occurred before June 22, 1954, and

"(2) any acquisition of stock described in such section which occurred on or after June 22, 1954, and on or before December 31, 1957, pursuant to a contract entered into before June 22, 1954,

the extent to which the property received in return for such acquisition shall be treated as a dividend shall be determined as if the Internal Revenue Code of 1939 continued to apply in respect of such acquisition and as if this Code had not been enacted."

(b) EFFECTIVE DATE.—The third sentence of section 391 of the Internal Revenue Code of 1954, as added by subsection (a) of this section, shall apply as if included in such section on the date of the enactment of such Code.

SEC. 19. TAXATION OF EMPLOYEE ANNUITIES.

(a) ANNUITY CONTRACTS PURCHASED BY CERTAIN TAX-EXEMPT ORGANIZATIONS.—Section 403 (relating to taxation of employee annuities) is amended by redesignating subsection (b) as subsection (c), and by inserting after subsection (a) the following new subsection:

"(b) TAXABILITY OF BENEFICIARY UNDER ANNUITY PURCHASED BY SECTION 501 (c) (3) ORGANIZATION.—

"(1) GENERAL RULE.—If—

"(A) an annuity contract is purchased for an employee by an employer described in section 501 (c) (3) which is exempt from tax under section 501 (a),

"(B) such annuity contract is not subject to subsection (a), and

"(C) the employee's rights under the contract are nonforfeitable, except for failure to pay future premiums,

then amounts contributed by such employer for such annuity contract on or after such rights become nonforfeitable shall be excluded from the gross income of the employee for the taxable year to the extent that the aggregate of such amounts does not exceed the exclusion allowance for such taxable year. The employee shall include in his gross income the amounts received under such contract for the year received as provided in section 72 (relating to annuities) except that section 72 (e) (3) shall not apply.

"(2) EXCLUSION ALLOWANCE.—For purposes of this subsection, the exclusion allowance for any employee for the taxable year is an amount equal to the excess, if any, of—

"(A) the amount determined by multiplying (i) 20 percent of his includible compensation, by (ii) the number of years of service, over

"(B) the aggregate of the amounts contributed by the employer for annuity contracts and excludable from the gross income of the employee for any prior taxable year.

"(3) INCLUDIBLE COMPENSATION.—For purposes of this subsection, the term 'includible compensation' means, in the case of any employee, the amount of compensation which is received from the employer described in section 501 (c) (3) and exempt from tax under section 501 (a), and which is includible in gross income (computed without regard to sections 105 (d) and 911) for the most recent period (ending not later than the close of the taxable year) which under paragraph (4) may be counted as one year of service. Such term does not include any amount contributed by the employer for any annuity contract to which this subsection applies.

"(4) YEARS OF SERVICE.—In determining the number of years of service for purposes of this subsection, there shall be included—

"(A) one year for each full year during which the individual was a full-time employee of the organization purchasing the annuity for him, and

"(B) a fraction of a year (determined in accordance with regulations prescribed by the Secretary or his delegate) for each full year during which such individual was a part-time employee of such organization and for each part of a year during which such individual was a full-time or part-time employee of such organization.

In one case shall the number of years of service be less than one.

"(5) APPLICATION TO MORE THAN ONE ANNUITY CONTRACT.—If for any taxable year of the employee this subsection applies to 2 or more annuity contracts purchased by the employer, such contracts shall be treated as one contract.

"(6) FORFEITABLE RIGHTS WHICH BECOME NONFORFEITABLE.—For purposes of this subsection and section 72 (f) (relating to special rules for computing employees' contributions to annuity contracts), if rights of the employee under an annuity contract described in subparagraphs (A) and (B) of paragraph (1) change from forfeitable to nonforfeitable rights, then the amount (determined without regard to this subsection) includible in gross income by reason of such change shall be treated as an amount contributed by the employer for such annuity contract as of the time such rights become nonforfeitable."

(b) QUALIFIED PLANS.—Section 403 (a) (1) (relating to taxability of beneficiary under a qualified annuity plan) is amended to read as follows:

"(1) GENERAL RULE.—Except as provided in paragraph (2), if an annuity contract is purchased by an employer for an employee under a plan which meets the requirements of section 404 (a) (2) (whether or not the employer deducts the amounts paid for the contract under such section), the employee shall include in his gross income the amounts received under such contract for the year received as provided in section 72 (relating to annuities) except that section 72 (e) (3) shall not apply."

(c) CERTAIN FORFEITABLE CONTRACTS PURCHASED BY EXEMPT ORGANIZATIONS.—Section 403 (c) (as redesignated by subsection (a) of this section) is amended by adding at the end thereof the following new sentence: "This subsection shall not apply in respect of an annuity contract purchased by an employer which is exempt from tax under section 501 or 521."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1956.

SEC. 20. CONTRIBUTIONS OF EMPLOYER TO EMPLOYEES' TRUST OR ANNUITY PLAN.

So much of section 404 (a) (relating to deduction for contributions of an employer to an employees' trust or annuity plan, etc.) as precedes paragraph (1) thereof is amended by striking out "income) but if" and inserting in lieu thereof "income); but, if".

SEC. 21. EMPLOYEE STOCK OPTIONS GRANTED BY PARENT OR SUBSIDIARY CORPORATION.

Section 421 (a) (relating to employee stock options) is amended by adding at the end thereof the following new sentence: "In applying paragraphs (2) and (3) of subsection (d) for purposes of the preceding sentence, there shall be substituted for the term 'employer corporation' wherever it appears in such paragraphs the term 'grantor corporation', or the term 'corporation issuing or assuming a stock option in a transaction to which subsection (g) is applicable', as the case may be."

SEC. 22. VARIABLE PRICE RESTRICTED STOCK OPTIONS.

(a) DEFINITION OF RESTRICTED STOCK OPTIONS.—Section 421 (d) (relating to definitions for purposes of employee stock options) is amended—

(1) by striking out clause (ii) of paragraph (1) (A) and inserting in lieu thereof the following:

"(ii) in the case of a variable price option, the option price (computed as if the option had been exercised when granted) is at least 85 percent of the fair market value of the stock at the time such option is granted; and"; and

(2) by adding at the end thereof the following new paragraph:

"(7) VARIABLE PRICE OPTION.—The term 'variable price option' means an option under which the purchase price of the stock is fixed or determinable under a formula in which the only variable is the fair market value of the stock at any time during a period of 6 months which includes the time the option is exercised; except that in the case of options granted after November 7, 1956, such term does not include any such option in which such formula provides for determining such price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply with respect to taxable years ending after November 7, 1956.

SEC. 23. TRANSFERS OF INSTALLMENT OBLIGATIONS TO CONTROLLED INSURANCE COMPANIES.

(a) EFFECT OF TRANSFER.—Section 453 (d) (relating to gain or loss on disposition of installment obligations) is amended by adding at the end thereof the following new paragraph:

"(5) LIFE INSURANCE COMPANIES.—In the case of a disposition of an installment obligation by any person other than a life insurance company (as defined in section 801 (a)) to such an insurance company or to a partnership of which such an insurance company is a partner, no provision of this subtitle providing for the nonrecognition of gain shall apply with respect to any gain resulting under paragraph (1). If a corporation which is a life insurance company for the taxable year was (for the preceding taxable year) a corporation which was not a life insurance company, such corporation shall, for purposes of this paragraph and paragraph (1), be treated as having transferred to a life insurance company, on the last day of the preceding taxable year, all installment obligations which it held on such last day. A partnership of which a life insurance company becomes a partner shall, for purposes of this paragraph and paragraph (1), be treated as having transferred to a life insurance company, on the last day of the preceding taxable year of such partnership, all installment obligations which it holds at the time such insurance company becomes a partner."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years ending after November 7, 1956, but only as to transfers or other dispositions of installment obligations occurring after such date.

SEC. 24. ADJUSTMENTS REQUIRED BY CHANGES IN METHOD OF ACCOUNTING.

(a) ADJUSTMENTS FOR 1939 CODE YEARS.—

(1) ADJUSTMENTS TAKEN INTO ACCOUNT.—Paragraph (2) of section 481 (a) (relating to adjustments required by changes in method of accounting) is amended to read as follows:

"(2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer."

(2) SPECIAL RULE WHERE ADJUSTMENTS ARE SUBSTANTIAL.—Section 481 (b) (relating to limitation on tax where adjustments are substantial) is amended by adding at the end therof the following new paragraphs:

"(4) SPECIAL RULE FOR PRE-1954 ADJUSTMENTS GENERALLY.—Except as provided in paragraph (5)—

"(A) AMOUNT OF ADJUSTMENTS TO WHICH PARAGRAPH APPLIES.—The net amount of the adjustments required by subsection (a), to the extent that such amount does not exceed th net amount of adjustments which would have been required if the change in method of accounting had been made in the first taxable year beginning after December 31, 1953, and ending after August 16, 1954, shall be taken into account by the taxpayer in computing taxable income in the manner provided in subparagraph (B), but only if such net amount of such adjustment would increase the taxable income of such taxpayer by more than $3,000.

"(B) YEARS IN WHICH AMOUNTS ARE TO BE TAKEN INTO ACCOUNT.—The net amount of the adjustments described in subparagraph (A) shall be taken into account ratably (except as provided in subparagraph (C)) in the year of the change and in so many of the taxable years immediately following such year as are the lesser of—

"(i) 9 years, or

"(ii) the number of taxable years beginning before January 1, 1954, and ending before August 17, 1954, in which the taxpayer was engaged in the same trade or business as that in which the amount of adjustments under subparagraph (A) arose.

"(C) LIMITATION ON YEARS IN WHICH ADJUSTMENTS CAN BE TAKEN INTO ACCOUNT.—The net amount of any adjustments described in subparagraph (A), to the extent not taken into account in prior taxable years under subparagraph (B)—

"(i) in the case of a taxpayer who is an individual, shall be taken into account in the taxable year in which he dies or ceases to engage in a trade or business,

"(ii) in the case of a taxpayer who is a partner, his distributive share of such net amount shall be taken into account in the taxable year in which the partnership terminates, or in which the entire interest of such partner is transferred or liquidated, or

"(iii) in the case of a taxpayer who is a corporation, shall be taken into account in the taxable year in which such corporation ceases to engage in a trade or business unless such net amount of such adjustment is required to be taken into account by the acquiring corporation under section 381 (c) (21).

"(D) TERMINATION OF APPLICATION OF PARAGRAPH.—The provisions of this paragraph shall not apply with respect to changes in methods of accounting made in taxable years beginning after December 31, 1963.

"(5) SPECIAL RULE FOR PRE-1954 ADJUSTMENTS IN CASE OF CERTAIN DECEDENTS.—A change from the cash receipts and disbursements method to the accrual method in any case involving the use of inventories, made on or after August 16, 1954, and before November 7, 1956, for a taxable year to which this section applies, by the executor or administrator of a decedent's estate in the first return filed by such executor or administrator on behalf of the decedent, shall be given effect in determining taxable income (other than for the purpose of computing a net operating loss carryback to any prior taxable year of the decedent), and, if the net amount of any adjustments required by subsection (a) in respect of taxable years to which this section does not apply would increase the taxable income of the decedent by more than $3,000, then the tax attributable to such net adjustments shall not exceed an amount equal to the tax that would have been payable on the cash receipts and disbursements method for the years for which the executor or administrator filed returns on behalf of the decedent, computed for each such year as though a ratable portion of the taxable income for such year had been received in each of 10 taxable years beginning and ending on the same dates as the taxable year for which the tax is being computed."

(b) TECHNICAL AMENDMENTS.—Section 481 (b) (relating to limitation on tax where adjustments are substantial) is amended

(1) By inserting after "subsection (a) (2)" each place it appears in paragraph (1) or (2) the following: ", other than the amount of such adjustments to which paragraph (4) or (5) applies,".

(2) By striking out "the aggregate of the taxes in paragraph (1) and inserting in lieu thereof "the aggregate increase in the taxes".

(3) By striking out "which would result if one-third of such increase" in paragraph (1) and inserting in lieu thereof "which would result if one-third of such increase in taxable income".

(4) By striking out "paragraph (2)" each place it appears in paragraph (3) (A) and inserting in lieu thereof "paragraph (1) or (2)".

(c) AMENDMENT OF SECTION 381 (c).—Section 381 (c) (relating to items of distributor or transferor corporation in certain corporate acquisitions) is amended by adding at the end thereof the following new paragraph:

"(21) PRE-1954 ADJUSTMENTS RESULTING FROM CHANGE IN METHOD OF ACCOUNTING.—The acquiring corporation shall take into account any net amount of any adjustment described in section 481 (b) (4) of the distributor or transferor corporation—

"(A) to the extent such net amount of such adjustment has not been taken into account by the distributor or transferor corporation, and

"(B) in the same manner and at the same time as such net amount would have been taken into account by the distributor or transferor corporation."

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply with respect to any change in a method of accounting where the year of the change (within the meaning of section 481 of the Internal Revenue Code of 1954) is is a taxable year beginning after December 31, 1953, and ending after August 16, 1954.

(2) EXCEPTION FOR CERTAIN AGREEMENTS.—The amendments made by subsections (a), (b) (1), and (c) shall not apply if before the date of the enactment of this Act—

(A) the taxpayer applied for a change in the method of accounting in the manner provided by regulations prescribed by the Secretary of the Treasury or his delegate, and

(B) the taxpayer and the Secretary of the Treasury or his delegate agreed to the terms and conditions for making the change.

SEC. 25. DENIAL OF EXEMPTION TO ORGANIZATIONS ENGAGED IN PROHIBITED TRANSACTIONS.

(a) LENDING TO CERTAIN PERSONS.—Section 503 (relating to requirements for exemption in the case of exempt organizations) is amended by adding at the end thereof the following new subsection:

"(h) SPECIAL RULES RELATING TO LENDING BY SECTION 401 (a) TRUSTS TO CERTAIN PERSONS.—For purposes of subsection (c) (1), a bond, debenture, note or certificate or other evidence of indebtedness (hereinafter in this subsection referred to as 'obligation') acquired by a trust described in section 401 (a) shall not be treated as a loan made without the receipt of adequate security if—

"(1) such obligation is acquired

"(A) on the market, either (i) at the price of the obligation prevailing on a national securities exchange which is registered with the Securities and Exchange Commission, or (ii) if the obligation is not traded on such a national securities exchange, at a price not less favorable to the trust than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer;

"(B) from an underwriter, at a price (i) not in excess of the public offering price for the obligation set forth in a prospectus or offering circular filed with the Securities and Exchange Commission and (ii) at which a substantial portion of the same issue is acquired by persons independent of the issuer; or

"(C) directly from the issuer, at a price not less favorable to the trust than the price paid currently for a substantial portion of the same issue by persons independent of the issuer;

"(2) immediately following acquisition of such obligation—

"(A) not more than 25 percent of the aggregate amount of obligations issued in such issue and outstanding at the time of acquisition is held by the trust, and

"(B) at least 50 percent of the aggregate amount referred to in subparagraph (A) is held by persons independent of the issuer;

"(3) immediately following acquisition of the obligation, not more than 25 percent of the assets of the trust is invested in obligations of persons described in subsection (c); and

"(4) in the case of an obligation acquired after November 8, 1956, such obligation is issued pursuant to an indenture or other written agreement which provides that, if the issuer mortgages (or otherwise subjects to lien) substantially all of its property after the issuance of such obligation, such obligation will be secured by a preference no less adequate than that afforded by such mortgage (or lien)."

(b) Effective Date.—

(1) In general.—Except as provided in paragraph (2), the amendment made by subsection (a) shall apply with respect to taxable years ending after March 15, 1956.

(2) Exceptions.—Nothing in this section shall be construed to make any transaction a prohibited transaction which, under announcements of the Internal Revenue Service made with respect to section 503 (c) (1) of the Internal Revenue Code of 1954 before the date of the enactment of this Act, would not constitute a prohibited transaction. In the case of any bond, debenture, note, or certificate or other evidence of indebtedness acquired before the date of the enactment of this Act by a trust described in section 401 (a) of such Code which is held on such date, paragraphs (2) and (3) of section 503 (h) of such Code shall be treated as satisfied if such requirements would have been satisfied if such obligation had been acquired on such date of enactment.

(c) Correction of Cross References.—Sections 2055 (e), 2106 (a) (2) (E), and 2522 (c) are each amended by striking out "sections 504" and inserting in lieu thereof "sections 503."

SEC. 26. CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) Adjustments to Taxable Income for Charitable Contributions.—Section 535 (b) (2) (relating to adjustments to taxable income to determine accumulated taxable income for purposes of the tax on corporations improperly accumulating surplus) is amended by striking out the limitation in."

(b) Adjustments to Taxable Income for Long-Term Capital Gains.—Section 535 (b) (6) (B) (relating to determination of accumulated taxable income) is amended to read as follows:

"(B) such taxes computed for such year without including in taxable income the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined with regard to the capital loss carryover provided in section 1212)."

SEC. 27. UNDISTRIBUTED PERSONAL HOLDING COMPANY INCOME.

(a) CHARITABLE CONTRIBUTIONS.—Section 545 (b) (2) (relating to adjustments to taxable income to determine undistributed personal holding company income) is amended to read as follows:

"(2) CHARITABLE CONTRIBUTIONS.—The deduction for charitable contributions provided under section 170 shall be allowed, but in computing such deduction the limitations in section 170 (b) (1) (A) and (B) shall apply, and section 170 (b) (2) shall not apply. For purposes of this paragraph, the term 'adjusted gross income' when used in section 170 (b) (1) means the taxable income computed with the adjustments (other than the 5-percent limitation) provided in the first sentence of section 170 (b) (2) and without deduction of the amount disallowed under paragraph (8) of this subsection."

(b) NET OPERATING LOSS.—Section 545 (b) (4) (relating to adjustments to taxable income to determine undistributed personal holding company income) is amended by inserting before the period at the end thereof "computed without the deductions provided in part VIII (except section 248) of subchapter B".

(c) EFFECTIVE DATE FOR SUBSECTION (b).—The amendment made by subsection (b) of this section shall apply with respect to adjustments under section 545 (b) (4) of the Internal Revenue Code of 1954 for taxable years beginning after December 31, 1956.

SEC. 28. FOREIGN PERSONAL HOLDING COMPANIES.

(a) ADJUSTMENTS TO TAXABLE INCOME FOR CHARITABLE CONTRIBUTIONS.—

(1) The first sentence of section 556 (b) (2) (relating to adjustments to taxable income to determine undistributed foreign personal holding company income) is amended to read as follows: "The deduction for charitable contributions provided under section 170 shall be allowed, but in computing such deduction the limitations in section 170 (b) (1) (A) and (B) shall apply, and section 170 (b) (2) shall not apply."

(2) The second sentence of section 556 (b) (2) is amended by striking out "the taxable income computed with the adjustments provided in section 170 (b) (2)" and inserting in lieu thereof "the taxable income computed with the adjustments (other than the 5-percent limitation) provided in the first sentence of section 170 (b) (2)".

(b) SPECIAL DEDUCTIONS DISALLOWED.—

(1) Section 556 (b) (3) (relating to adjustments to taxable income to determine undistributed foreign personal holding company income) is amended by striking out "sections 242 and 248" and inserting in lieu thereof "section 248".

(2) The amendment made by paragraph (1) shall apply only with respect to taxable years ending after October 31, 1956.

(c) NET OPERATING LOSS.—

(1) Section 556 (b) (4) (relating to adjustments to taxable income to determine undistributed foreign personal holding company income) is amended by inserting before the period at the end thereof "computed without the deductions provided in part VIII (except section 248) of subchapter B".

(2) The amendment made by paragraph (1) shall apply with respect to adjustments under section 556 (b) (4) of the Internal Revenue Code of 1954 for taxable years ending after October 31, 1956.

(d) CROSS REFERENCE.—

(1) Part III of subchapter G of chapter 1 (relating to foreign personal holding companies) is amended by adding at the end thereof the following new section:

"SEC. 558. RETURNS OF OFFICERS, DIRECTORS, AND SHAREHOLDERS OF FOREIGN PERSONAL HOLDING COMPANIES.

"For provisions relating to returns of officers, directors, and shareholders of foreign personal holding companies, see section 6035."

(2) The table of sections for such part III is amended by adding at the end thereof the following:

"Sec. 558. Returns of officers, directors, and shareholders of foreign personal holding companies."

SEC. 29. BOND, ETC., LOSSES OF BANKS.

Section 582 (c) (relating to losses of banks from sales or exchanges of evidences of indebtedness) is amended by striking out "with interest coupons or in registered form,".

SEC. 30. DEPLETION ALLOWANCE IN CASE OF ESTATES.

Section 611 (b) (4) (relating to allowance of deduction for depletion in the case of estates) is amended by striking out "devises" and inserting in lieu thereof "devisees".

SEC. 31. PERCENTAGE DEPLETION RATES FOR CERTAIN TAXABLE YEARS ENDING IN 1954.

(a) APPLICABLE RATES. Section 613 (relating to percentage depletion) is amended by adding at the end thereof the following new subsection:

"(d) APPLICATION OF PERCENTAGE DEPLETION RATES TO CERTAIN TAXABLE YEARS ENDING IN 1954.—

"(1) GENERAL RULE.—At the election of the taxpayer in respect to any property (within the meaning of the Internal Revenue Code of 1939), the percentage specified in subsection (b) in the case of any mine, well, or other natural deposit listed in such subsection shall apply to a taxpable year ending after December 31, 1953, to which the Internal Revenue Code of 1939 applies.

"(2) METHOD OF COMPUTATION.—The allowance for depletion, in respect of any property for which an election is made under paragraph (1) for any taxable year, shall be an amount equal to the sum of—

"(A) that portion of a tentative allowance, computed under the Internal Revenue Code of 1939 without regard to paragraph (1) of this subsection, which the number of days in such taxable year before January 1, 1954, bears to the total number of days in such taxable year; plus

"(B) that portion of a tentative allowance, computed under the Internal Revenue Code of 1939 (as modified solely by the application of paragraph (1) of this subsection), which the number of days in such taxable year after December 31, 1953, bears to the total number of days in such taxable year."

(b) STATUTE OF LIMITATIONS, ETC.; INTEREST.—If refund or credit of any overpayment resulting from the application of the amendment made by subsection (a) of this section is prevented on the date of the enactment of this Act, or within 6 months from such date, by the operation of any law or rule of law (other than section 3761 of the Internal Revenue Code of 1939 and section 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within 6 months from such date. No interest shall be paid on any overpayment resulting from the application of the amendment made by subsection (a) of this section.

SEC. 32. RETENTION OF 1939 CODE RIGHTS WITH RESPECT TO TREATMENT OF MINERAL INTERESTS.

Section 614 (definition of property) is amended by adding at the end thereof the following new subsection:

"(d) 1939 CODE TREATMENT.—Any taxpayer may treat any property (determined as if the Internal Revenue Code of 1939 continued to apply) as if subsections (a), (b), and (c) had not been enacted. If any such treatment would constitute an aggregation under subsection (b) or (c), such treatment shall be taken into account in applying subsections (b) and (c) to other property of the taxpayer."

SEC. 33. INVESTMENT COMPANIES FURNISHING CAPITAL TO DEVELOPMENT CORPORATIONS.

(a) TIME FOR CERTIFICATION.—The first sentence of section 851 (e) (1) (relating to regulated investment companies furnishing capital to development corporations) is amended by striking out "not less than 60 days" and inserting in lieu thereof "not earlier than 60 days".

(b) CLERICAL AMENDMENT.—Section 851 (e) (2) (relating to limitation with respect to regulated investment companies furnishing capital to development corporations) is amended by striking out "issues" and inserting in lieu thereof "issuer".

SEC. 34. TRANSACTIONS IN REGULATED INVESTMENT COMPANY SHARES AROUND TIME OF DISTRIBUTING CAPITAL GAIN DIVIDENDS.

(a) LOSS ON STOCK HELD LESS THAN 31 DAYS.—Section 852 (b) (relating to taxation of regulated investment companies and their shareholders) is amended by adding at the end thereof the following new paragraph:

"(4) LOSS ON SALE OR EXCHANGE OF STOCK HELD LESS THAN 31 DAYS.—If—

"(A) under subparagraph (B) or (D) of paragraph (3) a shareholder of a regulated investment company is required, with respect to any share, to treat any amount as a long-term capital gain, and

"(B) such share is held by the taxpayer for less than 31 days,

then any loss on the sale or exchange of such share shall, to the extent of the amount described in subparagraph (A) of this paragraph, be treated as loss from the sale or exchange of a capital asset held for more than 6 months. For purposes of this paragraph, the rules of section 246 (c) (3) shall apply in determining whether any share of stock has been held for less than 31 days; except that '30 days' shall be substituted for the number of days specified in subparagraph (B) of section 246 (c) (3)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to taxable years ending after November 7, 1956, but only with respect to shares of stock acquired after November 7, 1956.

SEC. 35. TAX ON NONRESIDENT ALIENS.

(a) EMPLOYEE ANNUITIES.—Section 871 (a) (1) (relating to 30 percent tax in case of nonresident aliens) is amended by inserting "section 403 (a) (2)," after "section 402 (a) (2),".

(b) CONFORMING AMENDMENT.—Subsections (b) and (c) (5) section 1441 (relating to withholding of tax on nonresident aliens) are each amended by inserting "section 403 (a) (2)," after "section 402 (a) (2),".

(c) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply only with respect to taxable years ending after the date of the enactment of this Act. The amendments made by subsection (b) shall take effect on the day following the date of the enactment of this Act.

SEC. 36. CREDITS FOR DIVIDENDS RECEIVED AND FOR PARTIALLY TAX-EXEMPT INTEREST IN CASE OF NONRESIDENT ALIENS.

(a) MINIMUM TAX.—Section 871 (b) (relating to tax on certain nonresident alien individuals) is amended—

(1) by striking out the semicolon at the end of paragraph (2) and inserting in lieu thereof a period;

(2) by striking out paragraph (3); and

(3) by adding at the end thereof the following new sentences:

"If (without regard to this sentence) the amount of the taxes imposed in the case of such an individual under section 1 or under section 1201 (b), minus the sum of the credits under sections 34 and 35, is an amount which is less than 30 percent of the sum of—

"(A) the aggregate amount received from the sources specified in subsection (a) (1), plus

"(B) the amount, determined under subsection (a) (2), by which gains from sales or exchanges of capital assets exceed losses from such sales or exchanges,

then this subsection shall not apply and subsection (a) shall apply. For purposes of this subsection, the term 'aggregate amount received from the sources specified in subsection (a) (1)' shall be applied without any exclusion under section 116."

(b) CREDIT FOR PARTIALLY TAX-EXEMPT INTEREST.—Section 35 (relating to credit for partially tax-exempt interest received by individuals) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) CERTAIN NONRESIDENT ALIENS INELIGIBLE FOR CREDIT.—No credit shall be allowed under subsection (a) to a nonresident alien individual with respect to whom a tax is imposed for the taxable year under section 871 (a)."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply only with respect to taxable years beginning after December 31, 1956.

SEC. 37. CARRYBACK AND CARRYOVER OF FOREIGN TAX CREDIT.

(a) Allowance.—Section 904 (relating to limitation on foreign tax credit) is amended by adding at the end thereof the following new subsection:

"(c) Carryback and Carryover of Excess Tax Paid.—Any amount by which any such tax paid or accrued to any foreign country or possession of the United States for any taxable year beginning after December 31, 1956, for which the taxpayer chooses to have the benefits of this subpart exceeds the limitation under subsection (a) shall be deemed tax paid or accrued to such foreign country or possession of the United States in the second preceding taxable pear, in the first preceding taxable year, and in the first, second, third, fourth, or fifth succeeding taxable years, in that order and to the extent not deemed tax paid or accrued in a prior taxable year, in the amount by which the limitation under subsection (a) for such preceding or succeeding taxable year exceeds the sum of the tax paid or accrued to such foreign country or possession for such preceding or succeeding taxable year and the amount of the tax for any taxable year earlier than the current taxable year which shall be deemed to have been paid or accrued in such preceding or subsequent taxable year (whether or not the taxpayer chooses to have the benefits of this subpart with respect to such earlier taxable year). Such amount deemed paid or accrued in any year may be availed of only as a tax credit and not as a deduction and only if taxpayer for such year chooses to have the benefits of this subpart as to taxes paid or accrued for that year to foreign countries or possessions. For purposes of this subsection, the terms 'second preceding taxable year' and 'first preceding taxable year' do not include any taxable year beginning before January 1, 1957.".

(b) Interest on Overpayments.—Section 6611 (relating to interest on overpayments) is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) Refund of Income Tax Caused by Carryback of Foreign Taxes.—For purposes of subsection (a), if any overpayment of tax results from a carryback of tax paid or accrued to foreign countries or possessions of the United States, such overpayment shall be deemed not to have been paid or accrued prior to the close of the taxable year under this subtitle in which such taxes were in fact paid or accrued.".

(c) Effective Date.—The amendments made by subsections (a) and (b) shall apply only with respect to taxable years beginning after December 31, 1956

SEC. 38. PROPERTY ACQUIRED IN TAX-FREE EXCHANGE.

(a) Basis.—The first sentence of section 1031 (d) (relating to basis of property acquired in certain tax-free exchanges) is amended to read as follows: "If property was acquired on an exchange described in this section, section 1035 (a), or section 1036 (a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange."

(b) Clerical Amendment.—The second sentence of section 1031 (d) is amended by striking out "paragraph" and inserting in lieu thereof "subsection".

SEC. 39. INVOLUNTARY CONVERSIONS.

Section 1033 (a) (2) (relating to involuntary conversions) is amended by adding at the end thereof the following new sentence: "For purposes of this paragraph and paragraph (3), the term 'control' means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

SEC. 40. PROPERTY ACQUIRED BEFORE MARCH 1, 1913.

The first sentence of section 1053 (relating to basis for determining gain in the case of property acquired before March 1, 1913) is amended by striking out "under this part" and inserting in lieu thereof "under this subtitle".

SEC. 41. POSTPONEMENT OF GAIN FROM SALE OR EXCHANGE TO EFFECTUATE FEDERAL COMMUNICATIONS COMMISSION POLICIES.

(a) Requirement of Change in Policy.—Section 1071 (a) (relating to gain from sale or exchange to effectuate policies of Federal Communications Commission) is amended by striking out "necessary or appropriate to effectuate the policies of the Commission" and inserting in lieu thereof "necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the Commission".

(b) Effective Date.—The amendment made by subsection (a) shall apply with respect to any sale or exchange after December 31, 1957. Such amendment shall also apply with respect to any sale or exchange after October 15, 1956, under a contract entered into after such date.

SEC. 42. BONDS ISSUED AT DISCOUNT.

(a) Treatment of Gain.—The first sentence of section 1232 (a) (2) (A) (relating to treatment of gain on sale or exchange of certain bonds and other evidences of indebtedness) is amended by striking out "which does not exceed an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidences of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity," and inserting in lieu thereof "which does not exceed an amount equal to the original issue discount (as defined in subsection (b)),".

(b) Effective Date.—The amendment made by subsection (a) shall apply to taxable years ending after November 7, 1956, but only with respect to dispositions after such date.

SEC. 43. BONDS WITH COUPONS DETACHED.

Section 1232 (c) (relating to bonds with excess number of coupons detached) is amended to read as follows:

"(c) Bond With Unmatured Coupons Detached.—If a bond or other evidence of indebtedness issued at any time with interest coupons—

"(1) is purchased after August 16, 1954, and before November 8, 1956, and the purchaser does not receive all the coupons which first become payable more than 12 months after the date of the purchase, or

"(2) is purchased after November 7, 1956, and the purchaser does not receive all the coupons which first become payable after the date of the purchase,

then the gain on the sale or other disposition of such evidence of indebtedness by such purchaser (or by a person whose basis is determined by reference to the basis in the hands of such purchaser) shall be considered as gain from the sale or exchange of property which is not a capital asset to the extent that the fair market value (determined as of the time of the purchase) of the evidence of indebtedness with coupons attached exceeds the purchase price. If this subsection and subsection (a) (2) (A) apply with respect to gain realized on the sale or exchange of any evidence of indebtedness, then subsection (a) (2) (A) shall apply with respect to that part of the gain to which this subsection does not apply."

SEC. 44. SHORT SALES.

(a) Short Sales Made by Dealers in Securities.—Section 1233 (relating to gains and losses in case of short sales) is amended by adding at the end of subsection (e) thereof the following new paragraph:

"(4) In the case of a taxpayer who is a dealer in securities—

"(A) if, on the date of a short sale of a security, substantially identical property which is a capital asset in the hands of the taxpayer has been held for not more than 6 months, and

"(B) if such short sale is closed more than 20 days after the date on which is was made,

subsection (b) (2) shall apply in respect of the holding period of such substantially identical property. For purposes of this paragraph, the last sentence of subsection (b) applies and the term 'security' has the meaning assigned to such term in section 1236 (c)."

(b) Hedging Transactions.—Section 1233 (a) (relating to gains and losses from short sales) is amended by striking out ", other than a hedging transaction in commodity futures,". Section 1233 is amended by adding after subsection (f) the following new subsection:

"(g) Hedging Transactions.—This section shall not apply in the case of a hedging transaction in commodity futures."

(c) Effective Date.—The amendment made by subsection (a) shall apply with respect to short sales made after October 24, 1956.

SEC. 45. OPTIONS TO BUY OR SELL.

Section 1234 (relating to options to buy or sell) is amended to read as follows:

"SEC. 1234. OPTIONS TO BUY OR SELL.

"(a) Treatment of Gain or Loss.—Gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, a privilege or option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option or privilege relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him).

"(b) Special Rule for Loss Attributable to Failure To Exercise Option.—For purposes of subsection (a), if loss is attributable to failure to exercise a privilege or option, the privilege or option shall be deemed to have been sold or exchanged on the day it expired.

"(c) Non-Application of Section.—This section shall not apply to—

"(1) a privilege or option which constitutes property described in paragraph (1) of section 1221;

"(2) in the case of gain attributable to the sale or exchange of a privilege or option, any income derived in connection with such privilege or option which, without regard to this section, is treated as other than gain from the sale or exchange of a capital asset;

"(3) a loss attributable to failure to exercise an option described in section 1233 (c); or

"(4) gain attributable to the sale or exchange of a privilege or option acquired by the taxpayer before March 1, 1954, if in the hands of the taxpayer such privilege or option is a capital asset."

SEC. 46. SALE OR EXCHANGE OF PATENTS.

(a) Application In Case of Related Persons.—Section 1235 (d) (relating to sale or exchange of patents between related persons) is amended to read as follows:

"(d) Related Persons.—Subsection (a) shall not apply to any transfer, directly or indirectly, between persons specified within any one of the paragraphs of section 267 (b); except that, in applying section 267 (b) and (c) for purposes of this section—

"(1) the phrase '25 percent or more' shall be substituted for the phrase 'more than 50 percent' each place it appears in section 267 (b), and

"(2) paragraph (4) of section 267 (c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants."

(b) Effective Date.—The amendment made by subsection (a) shall apply with respect to taxable years ending after the date of the enactment of this Act, but only with respect to transfers after such date.

SEC. 47. REAL PROPERTY SUBDIVIDED FOR SALE.

Section 1237 (a) (1) (relating to real property subdivided for sale) is amended by striking out "or, in the same taxable year" and inserting in lieu thereof "and, in the same taxable year".

SEC. 48. GAIN FROM SALE OF CERTAIN PROPERTY BETWEEN SPOUSES, ETC.

Section 1239 (relating to gain from sale of certain property between spouses or between an individual and a controlled corporation) is amended by adding at the end thereof the following new subsection:

"(c) Section Not Applicable With Respect to Sales or Exchanges Made on or Before May 3, 1951.—This section shall apply only in the case of a sale or exchange made after May 3, 1951."

SEC. 49. MITIGATION OF EFFECT OF LIMITATIONS.

(a) Adjustments Unaffected by Other Items.—The second sentence of section 1314 (c) (relating to certain adjustments for closed taxable years) is amended by striking out "Other than in the case of an adjustment resulting from a determination under section 1313 (a) (4), the" and inserting in lieu thereof "The".

(b) Effective Date.—The amendment made by subsection (a) shall apply to determinations (as defined in section 1313 (a)) made after November 14, 1954.

SEC. 50. COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT.

Section 1341 (b) (relating to computation of tax where taxpayer restores substantial amount held under claim of right) is amended by adding at the end thereof the following new paragraph:

"(3) If the tax imposed by this chapter for the taxable year is the amount determined under subsection (a) (5), then the deduction referred to in subsection (a) (2) shall not be taken into account for any purpose of this subtitle other than this section."

SEC. 51. CLAIMS AGAINST UNITED STATES INVOLVING ACQUISITIONS OF PROPERTY.

(a) LIMIT ON SURTAX.—Section 1347 (relating to claims against United States involving acquisitions of property) is amended—

(1) by striking out "the tax imposed by section 1" and inserting in lieu thereof "the surtax imposed by section 1"; and

(2) by adding at the end thereof the following new sentence: "This section shall apply only if claim was filed with the United States before January 1, 1957."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) (1) shall apply only with respect to taxable years beginning after December 31, 1956.

SEC. 52. ELECTION PERMITTING CERTAIN PROPRIETORSHIPS AND PARTNERSHIPS TO BE TAXED AS CORPORATIONS.

(a) REPEAL.—Subchapter R of chapter 1 (relating to election of certain partnerships and proprietorships as to taxable status), and section 1504 (b) (7) (relating to definition of includible corporation), are hereby repealed, effective with respect to taxable years beginning after December 31, 1957. No election may be made under section 1361 of the Internal Revenue Code of 1954 for any taxable year ending after June 30, 1957.

(b) REVOCATION OF ELECTION.—If—

(1) a statement of an electon to be taxed as a domestic corporation is heretofore or hereafter filed with respect to any unincorporated business enterprise under section 1361 of the Internal Revenue code of 1954, and

(2) such filing is in accordance with regulations prescribed by the Secretary of the Treasury or his delegate,

then such election shall be treated as a valid election; but such election may be revoked (in accordance with regulations prescribed by the Secretary of the Treasury or his delegate) after the date of the enactment of this section and on or before the last day of the third month following the month in which regulations prescribed under such section 1361 are published in the Federal Register.

(c) TOLLING OF STATUTE OF LIMITATIONS.—In the case of any election referred to in subsection (b) with respect to any unincorporated business enterprise—

(1) The statutory period for the assessment of any deficiency against any taxpayer for any taxable year, to the extent such deficiency is attributable to such enterprise and to the period to which such election applies (or would apply but for a revocation under subsection (b)), shall not expire before the expiration date specified in subsection (d); and such deficiency may be assessed at any time on or before such expiration date, notwithstanding any law or rule of law which would otherwise prevent such assessment.

(2) If credit or refund of the amount of any overpayment is prevented, at any time on or before the expiration date, by the operation of any law or rule of law (other than section 7122 of the Internal Revenue Code of 1954, relating to compromises), credit or refund of such overpayment may, nevertheless, be allowed or made, to the extent such overpayment is attributable to such enterprise and to the period referred to in paragraph (1), if claim therefore is filed on or before the expiration date specified in subsection (d).

(d) EXPIRATION DATE DEFINED.—For purposes of subsection (c), the term "expiration date" means that day which is one year after whichever of the following days is the earlier:

(1) The last day of the third month following the month in which regulations prescribed under section 1361 of the Internal Revenue Code of 1954 are published in the Federal Register; or

(2) if the election is revoked under subsection (b), the day on which such revocation is filed with the Secretary of the Treasury or his delegate.

(e) CLERICAL AMENDMENT.—The table of subchapters for chapter 1 is amended by striking out

"SUBCHAPTER R. Election of certain partnerships and proprietorships as to taxable status."

SEC. 53. PERIOD OF LIMITATION FOR FILING CLAIM FOR CREDIT FOR STATE DEATH TAXES.

(a) PERIOD UNDER 1954 CODE.—Section 2011 (c) (relating to period of limitations on credit for State death taxes) is amended by inserting after paragraph (2) the following new paragraph:

"(3) If a claim for refund or credit of an overpayment of tax imposed by this chapter has been filed within the time prescribed in section 6511, then within such 4-year period or before the expiration of 60 days from the date of mailing by certified mail or registered mail by the Secretary or his delegate to the taxpayer of a notice of the disallowance of any part of such claim, or before the expiration of 60 days after a decision by any court of competent jurisdiction becomes final with respect to a timely suit instituted upon such claim, whichever is later."

(b) PERIOD UNDER 1939 CODE.—Section 813 (b) of the Internal Revenue Code of 1939 (relating to period of limitations on credit for State death taxes) is amended by inserting after paragraph (2) the following new paragraph:

"(3) If a claim for refund or credit of an overpayment of tax imposed by this chapter has been filed within the time prescribed in section 910, then within such 4-year period or before the expiration of 60 days from the date of mailing by certified mail or registered mail by the Secretary or his delegate to the taxpayer of a notice of the disallowance of any part of such claim, or before the expiration of 60 days after a decision by any court of competent jurisdiction becomes final with respect to a timely suit instituted upon such claim, whichever is later."

(c) EFFECTIVE DATES.—The amendment made by subsection (a) shall apply with respect to estates of decedents dying after August 16, 1954. The amendment made by subsection (b) shall apply with respect to estates of decedents dying after February 10, 1939, and on or before August 16, 1954.

SEC. 54. ESTATE TAX IN CASE OF REVERSIONARY OR REMAINDER INTEREST IN PROPERTY.

(a) CREDIT FOR DEATH TAXES.—

(1) CREDIT UNDER 1954 CODE.—Section 2015 (relating to credit for death taxes on remainders) is amended by striking out "60 days after the termination of the precedent interest or interests in the property" and inserting in lieu thereof "the time for payment of the tax imposed by section 2001 or 2101 as postponed and extended under section 6163."

(2) CREDIT UNDER 1939 CODE.—Section 927 of the Internal Revenue Code of 1939 (relating to credit for death taxes) is amended by striking out "60 days after the termination of the precedent interest or interests in the property" and inserting in lieu thereof "the time for payment of the tax imposed by this subchapter as postponed and extended under section 925."

(3) EFFECTIVE DATE.—The amendments made by paragraphs (1) and (2) shall apply in the case of any reversionary or remainder interest in property only if the precedent interest or interests in the property did not terminate before the beginning of the 60-day period which ends on the date of the enactment of this Act.

(b) EXTENSION OF PAYMENT OF ESTATE TAX ATTRIBUTABLE TO FUTURE INTERESTS.—

(1) EXTENSION UNDER 1954 CODE.—Section 6163 (relating to extension of time for paying estate tax on value of reversionary or remainder interest in property) is amended by redesignating subsection (b) as subsection (c), and by inserting after subsection (a) the following new subsection:

"(b) EXTENSION TO PREVENT UNDUE HARDSHIP.—If the Secretary or his delegate finds that the payment of the tax at the expiration of the period of postponement provided for in subsection (a) would result in undue hardship to the estate, he may extend the time for payment for a reasonable period not in excess of 2 years from the expiration of such period of postponement."

(2) EXTENSION UNDER 1939 CODE.—

(A) Section 925 of the Internal Revenue Code of 1939 (relating to period of extension of time for paying estate tax attributable to future interests) is amended by adding at the end thereof the following: "If the Secretary or his delegate finds that the payment of the tax at the expiration of the period of postponement provided for in the preceding sentence would result in undue hardship to the estate, he may extend the time for payment for a reasonable period not in excess of 2 years from the expiration of such period of postponement."

(B) Section 926 of the Internal Revenue Code of 1939 (relating to requirements for postponement) is amended by striking out "interest or interests" and inserting in lieu thereof "interest or interests (or, in the case of an extension under section 925, within the period of such extension)".

(3) EFFECTIVE DATE.—The amendments made by paragraphs (1) and (2) shall apply in the case of any reversionary or remainder interest only if the precedent interest or interests in the property did not terminate before the beginning of the 6-month period which ends on the date of the enactment of this Act.

(c) INTEREST.—Section 6601 (b) (relating to interest in case of extensions of time for payment of estate taxes) is amended by striking out "if postponement of the payment of an amount of such tax is permitted by section 6163 (a)," and inserting in lieu thereof "if the time for payment of an amount of such tax is postponed or extended as provided by section 6163,".

SEC. 55. RETIREMENT ANNUITIES EXCLUDED FROM GROSS ESTATE.

(a) REQUIREMENTS.—Section 2039 (c) (2) (relating to exclusion from gross estate in the case of certain retirement annuity contracts) is amended by striking out "section 401 (a) (3)" and inserting in lieu thereof "section 401 (a) (3), (4), (5), and (6)".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to estates of decedents dying after December 31, 1953.

SEC. 56. GIFT TAX NOT TO APPLY TO ELECTION OF SURVIVOR BENEFITS UNDER CERTAIN QUALIFIED PLANS.

(a) IN GENERAL.—Subchapter B of chapter 12 (relating to gift tax in the case of certain transfers) is amended by adding at the end thereof the following new section:

"SEC. 2517. CERTAIN ANNUITIES UNDER QUALIFIED PLANS.

"(a) GENERAL RULE.—The exercise or nonexercise by an employee of an election or option whereby an annuity or other payment will become payable to any beneficiary at or after the employee's death shall not be considered a transfer for purposes of this chapter if the option or election and annuity or other payment is provided for under—

"(1) an employes' trust (or under a contract purchased by an employees' trust) forming part of a pension, stock bonus, or profit-sharing plan which, at the time of such exercise or nonexercise, or at the time of termination of the plan if earlier, met the requirements of section 401 (a); or

"(2) a retirement annuity contract purchased by an employer (and not by an employees' trust) pursuant to a plan which, at the time of such exercise or nonexercise, or at the time of termination of the plan if earlier, met the requirements of section 401 (a) (3), (4), (5), and (6).

"(b) TRANSFERS ATTRIBUTABLE TO EMPLOYEE CONTRIBUTIONS.—If the annuity or other payment referred to in subsection (a) is attributable to any extent to payments or contributions made by the employee, then subsection (a) shall not apply to that part of the value of such annuity or other payment which bears the same proportion to the total value of the annuity or other payment as the total payments or contributions made by the employee bear to the total payments or contributions made.

"(c) EMPLOYEE DEFINED.—For purposes of this section, the term 'employee' includes a former employee."

(b) CLERICAL AMENDMENT.—The table of sections for subchapter B of chapter 12 is amended by adding at the end thereof the following:

"Sec. 2517. Certain annuities under qualified plans."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to the calendar year 1955 and all calendar years thereafter.

SEC. 57. OASI COVERAGE FOR EMPLOYEES OF FOREIGN SUBSIDIARIES.

The heading of section 3121 (l) (3) (relating to agreements entered into by domestic corporations for the purpose of extending old-age and survivors insurance coverage to service performed by certain employees of foreign subsidiaries) is amended by striking out "BE" and inserting in lieu thereof "BY".

SEC. 58. FEDERAL SERVICE.

The last sentence of section 3122 (relating to collection and payment of employment taxes with respect to Coast Guard Exchanges) is amended by striking out "this subsection" wherever it appears therein and inserting in lieu thereof "this section."

SEC. 59. ACTS TO BE PERFORMED BY AGENTS.

The first sentence of section 3504 (relating to acts to be performed by agents in the case of employment taxes) is amended effective with respect to remuneration paid after December 31, 1954, by striking out "this subtitle" and inserting in lieu thereof "this title".

SEC. 60. PERSONS REQUIRED TO MAKE RETURNS.

(a) EARNED INCOME WITHOUT THE UNITED STATES.—Section 6012 (relating to persons required to make returns of income) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) CERTAIN INCOME EARNED ABROAD.—For purposes of this section, gross income shall be computed without regard to the exclusion provided for in section 911 (relating to earned income from sources without the United States)."

(b) CROSS REFERENCE.—Section 911 (relating to earned income from sources without the United States) is amended by adding at the end thereof the following new subsection:

"(c) CROSS REFERENCE.—

"For administrative and penal provisions relating to the exclusion provided for in this section, see sections 6001, 6011, 6012 (c), and the other provisions of subtitle F."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1956.

SEC. 61. ELECTION TO MAKE JOINT RETURN AFTER FILING SEPARATE RETURN.

Section 6013 (b) (2) (C) (relating to limitation on election to make joint return after filing separate return) is amended by striking out "such section" and inserting in lieu thereof "section 6213".

SEC. 62. RETURNS TREATED AS DECLARATIONS OF ESTIMATED TAX BY INDIVIDUALS.

Section 6015 (f) (relating to returns treated as declarations of estimated income tax by individuals) is amended by adding after paragraph (2) the following: "In the application of this subsection in the case of a taxable year beginning on any date other than January 1, there shall be substituted, for the 15th or last day of the months specified in this subsection, the 15th or last day of the months which correspond thereto."

SEC. 63. PUBLICITY OF EXEMPT ORGANIZATION INFORMATION.

(a) PUBLICITY REQUIRED.—Section 6104 (relating to publicity of information required from certain exempt organizations and certain trusts) is amended—

(1) by striking out "The information" and inserting in lieu thereof:

"(b) INSPECTION OF ANNUAL INFORMATION RETURNS.—The information"; and

(2) by inserting after the heading of such section the following new subsection:

"(a) INSPECTION OF APPLICATIONS FOR TAX EXEMPTION.—

"(1) PUBLIC INSPECTION.—

"(A) IN GENERAL.—If an organization described in section 501 (c) or (d) is exempt from taxation under section 501 (a) for any taxable year, the application filed by the organization with respect to which the Secretary or his delegate made his determination that such organization was entitled to exemption under section 501 (a), together with any papers submitted in support of such application, shall be open to public inspection at the national office of the Internal Revenue Service. In the case of any application filed after the date of the enactment of this subparagraph, a copy of such application shall be open to public inspection at the appropriate field office of the Internal Revenue Service (determined under regulations prescribed by the Secretary or his delegate). Any inspection under this subparagraph may be made at such times, and in such manner, as the Secretary or his delegate shall by regulations prescribe. After the application of any organization has been opened to public inspection under this subparagraph, the Secretary or his delegate shall, on the request of any person with respect to such organization, furnish a statement indicating the subsection and paragraph of section 501 which it has been determined describes such organization.

"(B) WITHHOLDING OF CERTAIN INFORMATION.—Upon request of the organization submitting any supporting papers described in subparagraph (A), the Secretary or his delegate shall withhold from public inspection any information contained therein which he determines relates to any trade secret, patent, process, style of work, or apparatus of the organization, if he determines that public disclosure of such information would adversely affect the organization. The Secretary or his delegate shall withhold from public inspection any information contained in supporting papers described in subparagraph (A) the public disclosure of which he determines would adversely affect the national defense.

"(2) INSPECTION BY COMMITTEES OF CONGRESS.—Section 6103 (d) shall apply with respect to—

"(A) the application for exemption of any organization described in section 501 (c) or (d) which is exempt from taxation under section 501 (a) for any taxable year, and

"(B) any other papers which are in the possession of the Secretary or his delegate and which relate to such application,

as if such papers constituted returns."

(b) ANNUAL INFORMATION WITH RESPECT TO TOTAL CONTRIBUTIONS.—Section 6033 (b) (relating to returns by certain exempt organizations) is amended by striking out "and" at the end of paragraph (6), by striking out the period at the end of paragraph (7) and inserting in lieu thereof a comma and the word "and", and by adding after paragraph (7) the following new paragraph:

"(8) the total of the contributions and gifts received by it during the year."

(c) EFFECTIVE DATE.—The amendments made by subsection (a) shall take effect on the 60th day after the day on which this Act is enacted. The amendments made by subsection (b) shall apply to taxable years ending on or after December 31, 1957.

SEC. 64. ADDRESS FOR NOTICE OF DEFICIENCY.

Section 6212 (b) (1) (relating to address for notice of deficiency in the case of income and gift taxes) is amended by striking out "chapter 1 or 12" and inserting in lieu thereof "subtitle A or chapter 12", and by striking out "such chapter and" and inserting in lieu thereof "subtitle A, chapter 12, and".

SEC. 65. RELEASE OF LIEN OR PARTIAL DISCHARGE OF PROPERTY.

Section 6325 (relating to release of lien or partial discharge of property) is amended—

(1) by striking out paragraph (1) of subsection (a) and inserting in lieu thereof the following:

"(1) LIABILITY SATISFIED OR UNENFORCEABLE.—The Secretary or his delegate finds that the liability for the amount assessed, together with all interest in respect thereof, has been fully satisfied or has become legally unenforceable; or".

(2) by redesigning subsections (c) and (d) as subsections (d) and (e), respectively, and by inserting after subsection (b) the following new subsection:

"(c) ESTATE OR GIFT TAX.—Subject to such rules or regulations as the Secretary or his delegate may prescribe, the Secretary or his delegate may issue a certificate of discharge of any or all of the property subject to any lien imposed by section 6324 if the Secretary or his delegate finds that the liability secured by such lien has been fully satisfied or provided for."

(3) by striking out the word "partial" where it appears in the heading and text of subsection (d) (as redesignated by paragraph (2)).

SEC. 66. CORRECTION OF REFERENCES TO UNITED STATES ATTORNEYS.

Sections 6338 (c) (relating to deeds for real property purchased by the United States), 7324 (3) (relating to special disposition of perishable goods), 7325 (3) (relating to personal property valued at $1,000 or less), and 7422 (f) (2) (cross reference) are each amended by striking out the word "district" each place it appears in the phrases "United States district attorney" and "United States district attorneys".

SEC. 67. CONVEYANCE OF TITLE.

The heading to section 6339 (b) (2) (relating to conveyance of title) is amended by striking out "OF" the first place it appears and inserting in lieu thereof "AS".

SEC. 68. REQUEST FOR PROMPT ASSESSMENT.

(a) SUBSECTION REFERENCES.—The first sentence of section 6501 (d) (relating to request for prompt assessment) is amended by striking out "subsection (c)," and inserting in lieu thereof "subsection (c), (e), or (f),".

(b) CORPORATIONS.—The second sentence of section 6501 (d) (relating to request for prompt assessment) is amended to read as follows: "This subsection shall not apply in the case of a corporation unless—

"(1) (A) such written request notifies the Secretary or his delegate that the corporation contemplates dissolution at or before the expiration of such 18-month period, (B) the dissolution is in good faith begun before the expiration of such 18-month period, and (C) the dissolution is completed;

"(2) (A) such written request notifies the Secretary or his delegate that the dissolution has in good faith been begun, and (B) the dissolution is completed; or

"(3) the dissolution has been completed at the time such written request is made."

SEC. 69. LIMITATIONS ON ASSESSMENT AND COLLECTION.

(a) EXEMPT ORGANIZATIONS.—Section 6501 (g) (2) (relating to returns as exempt organizations) is amended by striking out "corporation" each place it appears and inserting in lieu thereof "organization".

(b) NET OPERATING LOSS CARRYBACKS.—Section 6501 (relating to limitations on assessment and collection) is amended by relettering subsection (h) as subsection (i) and by inserting after subsection (g) the following new subsection:

"(h) NET OPERATING LOSS CARRYBACKS.—In the case of a deficiency attributable to the application to the taxpayer of a net operating loss carryback (including deficiencies which may be assessed pursuant to the provisions of section 6213 (b) (2)), such deficiency may be assessed at any time before the expiration of the period within which a deficiency for the taxable year of the net operating loss which results in such carryback may be assessed."

SEC. 70. LIMITATIONS ON CREDIT OR REFUND.

(a) PERIOD FOR FILING CLAIM.—The first sentence of section 6511 (a) (relating to period of limitation for filing claim for credit or refund) is amended to read as follows: "Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid."

(b) LIMIT ON AMOUNT OF CREDIT OR REFUND.—The heading and the first sentence of subparagraph (A) of section 6511 (b) (2) (relating to limit on amount of credit or refund) are amended to read as follows:

"(A) LIMIT WHERE CLAIM FILED WITHIN 3-YEAR PERIOD.—If the claim was filed by the taxpayer during the 3-year period prescribed in subsection (a), the amount of the credit or refund shall not exceed the portion of the tax paid within the period, immediately preceding the filing of the claim, equal to 3 years plus the period of any extension of time for filing the return."

(c) CORRECTION OF HEADING.—The heading of section 6511 (b) (2) (B) is amended to read as follows:

"(B) LIMIT WHERE CLAIM NOT FILED WITHIN 3-YEAR PERIOD.—".

(d) NET OPERATING LOSS CARRYBACKS.—The first sentence of section 6511 (d) (2) (A) (relating to special period of limitation for credit or refund in case of net operating loss carrybacks) is amended by striking out "15th day of the 39th month" and inserting in lieu thereof "15th day of the 40th month (or 39th month, in the case of a corporation)".

SEC. 71. CORRELATION OF INTEREST WHERE OVERPAYMENT OF TAX IS CREDITED AGAINST UNDERPAYMENT OF TAX.

(a) INTEREST ON UNDERPAYMENT SATISFIED BY CREDIT.—

(1) UNDERPAYMENT UNDER 1954 CODE.—Section 6601 (relating to interest on underpayments, etc.) is amended by redesignating subsections (g) and (h) as subsections (i) and (j), and by inserting after subsection (f) the following new subsection:

"(g) SATISFACTION BY CREDITS.—If any portion of a tax is satisfied by credit of an overpayment, then no interest shall be imposed under this section on the portion of the tax so satisfied for any period during which, if the credit had not been made, interest would have been allowable with respect to such overpayment."

(2) UNDERPAYMENT UNDER 1939 CODE.—Section 3794 of the Internal Revenue Code of 1939 (relating to interest on delinquent taxes) is amended by inserting "(a) General Rule.—" before "Notwithstanding," and by adding at the end of such section the following new subsection:

"(b) INTEREST NOT IMPOSED ON CERTAIN UNDERPAYMENTS.—If any portion of any tax due from the taxpayer under any provision of this title is satisfied by credit of an overpayment, then no interest shall be imposed on the portion of the tax so satisfied for any period during which, if the credit had not been made, interest would have been allowable with respect to such overpayment."

(b) INTEREST ON OVERPAYMENTS CREDITED AGAINST UNDERPAYMENT.—Paragraph (1) of section 6611 (b) of the Internal Revenue Code of 1954 (relating to period for computation of interest on overpayments credited against other taxes), and paragraph (1) of section 3771 (b) of the Internal Revenue Code of 1939, are each amended to read as follows:

"(1) CREDITS.—In the case of a credit, from the date of the overpayment to the due date of the amount against which the credit is taken."

(c) TECHNICAL AMENDMENT.—Subsection (c) of section 6611 (relating to interest on overpayments) is hereby repealed.

(d) EFFECTIVE DATE.—The amendments made by subsections (a), (b), and (c) shall apply only in respect of overpayments credited after the date of enactment of this Act.

(e) INTEREST ATTRIBUTABLE TO NET OPERATING LOSS CARRYBACK FOR CERTAIN TAXABLE YEARS ENDING IN 1954.—If by reason of enactment of section 172 (b) (1) (A) of the Internal Revenue Code of 1954—

(1) a deficiency resulted for the first taxable year preceding a taxable year ending after December 31, 1953, and before August 17, 1954, and

(2) an overpayment resulted for the second preceding taxable year,

no interest shall be payable with respect to any portion of such deficiency for any period during which there existed a corresponding amount of such overpayment with respect to which interest is not payable.

SEC. 72. INTEREST ON UNDERPAYMENTS.

(a) LIMITATION ON ASSESSMENT AND COLLECTION.—Section 6601 (relating to interest on underpayments of tax) is amended by inserting after subsection (g) (added by section 71) the following new subsection:

"(h) LIMITATION ON ASSESSMENT AND COLLECTION.—Interest prescribed under this section on any tax may be assessed and collected at any time during the period within which the tax to which such interest relates may be collected."

(b) CROSS REFERENCE.—Section 6504 (cross references) is amended by adding at the end thereof the following:

"(15) Assessment and collection of interest, see section 6601 (h)."

SEC. 73. FAILURE TO FILE CERTAIN INFORMATION RETURNS.

Subsection (a) of section 6652 (relating to failure to file certain information returns) is amended to read as follows:

"(a) ADDITIONAL AMOUNT.—In case of each failure to file a statement of a payment to another person, required under authority of section 6041 (relating to information at source), section 6042 (1) (relating to payments of corporate dividends), section 6044 (relating at patronage dividends), or section 6051 (d) (relating to information returns with respect to income tax withheld), on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be paid (upon notice and demand by the Secretary or his delegate and in the same manner as tax), by the person failing to so file the statement, $1 for each such statement not so filed, but the total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed $1,000."

SEC. 74. DEFINITION OF UNDERPAYMENT.

Section 6653 (c) (1) (relating to definition of underpayment) is amended by inserting "on or" after "such return was filed".

SEC. 75. TERMINATION OF TAXABLE YEAR IN CASE OF DEPARTING ALIENS.

Subsection (d) of section 6851 (relating to departure of alien) is amended to read as follows:

"(d) DEPARTURE OF ALIEN.—Subject to such exceptions as may, by regulations, be prescribed by the Secretary or his delegate—

"(1) No alien shall depart from the United States unless he first procures from the Secretary or his delegate a certificate that he has complied with all the obligations imposed upon him by the income tax laws.

"(2) Payment of taxes shall not be enforced by any proceedings under the provisions of this section prior to the expiration of the time otherwise allowed for paying such taxes if, in the case of an alien about to depart from the United States, the Secretary or his delegate determines that the collection of the tax will not be jeopardized by the departure of the alien."

SEC. 76. BANKRUPTCY AND RECEIVERSHIP PROCEEDINGS.

(a) IMMEDIATE ASSESSMENT.—Section 6871 (a) (relating to immediate assessment in bankruptcy and receivership proceedings) is amended by striking out "the approval of a petition of, or against, any taxpayer" and inserting in lieu thereof the following: "the filing or (where approval is required by the Bankruptcy Act) the approval of a petition of, or the approval of a petition against, any taxpayer".

(b) CLAIM FILED DESPITE PENDENCY OF TAX COURT PROCEEDINGS.—Section 6871 (b) (relating to claim filed despite pendency of Tax Court proceedings) is amended by striking out "approval of the petition" and inserting in lieu thereof "the filing or (where approval is required by the Bankruptcy Act) the approval of a petition of, or the approval of a petition against, any taxpayer".

SEC. 77. USE OF CERTIFIED MAIL.

(a) TIMELY MAILING TREATED AS TIMELY FILING.—Section 7502 (c) (relating to the timely mailing of registered mail being treated as timely filing) is amended to read as follows:

"(c) REGISTERED AND CERTIFIED MAIL.—

"(1) REGISTERED MAIL.—If any such claim, statement, or other document is sent by United States registered mail, such registration shall be prima facie evidence that the claim, statement, or other document was delivered to the agency, office, or officer to which addressed, and the date of registration shall be deemed the postmark date.

"(2) CERTIFIED MAIL.—The Secretary or his delegate is authorized to provide by regulations the extent to which the provisions of paragraph (1) of this subsection with respect to prima facie evidence of delivery and the postmark date shall apply to certified mail."

(b) OTHER PROVISIONS OF 1954 CODE.—Section 167 (d) (relating to agreement as to useful life on which depreciation rate is based), 534 (b) (relating to notification by Secretary), 6164 (d) (2) (relating to period of extension of time for payment of taxes by corporations expecting carrybacks), 6212 (a) (relating to notice of deficiency), 6212 (b) (2) (relating to address for notice of deficiency in the case of a joint income tax return), 6532 (a) (1) (relating to periods of limitation on suits by taxpayers for refunds), 6532 (a) (4) (relating to reconsideration after mailing of notice), and 7455 (relating to service of process) are each amended by striking out "registered mail" each place it appears and inserting in lieu thereof "certified mail or registered mail".

(c) PROVISIONS OF INTERNAL REVENUE CODE OF 1939.—In applying any provision of the Internal Revenue Code of 1939 which requires, or provides for, the use of registered mail, the reference to registered mail shall be treated as including a reference to certified mail.

(d) EFFECTIVE DATE.—This section shall apply only if the mailing occurs after the date of the enactment of this Act.

SEC. 78. REPRODUCTION OF RETURNS AND OTHER DOCUMENTS.

(a) AUTHORIZATION.—Chapter 77 (miscellaneous provisions) is amended by adding at the end theref the following new section:

"SEC. 7512. REPRODUCTION OF RETURNS AND OTHER DOCUMENTS.

"(a) IN GENERAL.—The Secretary or his delegate is authorized to have any Federal agency or any person process films or other photoimpressions of any return, document, or other matter, and make reproductions from films or photoimpressions of any return, document, or other matter.

"(b) REGULATIONS.—The Secretary or his delegate shall prescribe regulations which shall provide such safeguards as in the opinion of the Secretary or his delegate are necessary or appropriate to protect the film, photoimpressions, and reproductions made therefrom, against any unauthorized use, and to protect the information contained therein against any unauthorized disclosure.

"(c) USE OF REPRODUCTIONS.—Any reproduction of any return, document, or other matter made in accordance with this section shall have the same legal status as the original; and any such reproduction shall, if properly authenticated, be admissible in evidence in any judicial or administrative proceeding, as if it were the original, whether or not the original is in existence.

"(d) PENALTY.—

"For penalty for violation of regulations for safeguarding against unauthorized use of any film or photoimpression, or reproduction made therefrom, and against unauthorized disclosure of information contained therein, see section 7213."

(b) The table of sectons for chapter 77 is amended by adding at the end thereof the following:

"Sec. 7512. Reproduction of returns and other documents."

(c) PENALTY FOR UNAUTHORIZED USE OR DISCLOSURE.—Section 7213 (relating to unauthorized disclosure of information) is amended by redesignating subsection (c) as subsection (d), and by inserting after subsection (b) the following new subsection:

"(c) OFFENSES RELATING TO REPRODUCTION OF DOCUMENTS.—Any person who uses any film or photoimpression, or reproduction therefrom, or who discloses any information contained in any such film, photoimpression, or reproduction, in violation of any provision of the regulations prescribed pursuant to section 7512 (b), shall be fined not more than $1,000, or imprisoned not more than 1 year, or both."

SEC. 79. SEALS FOR OFFICES OF TREASURY DEPARTMENT.

(a) AUTHORITY TO PRESCRIBE SEALS.—Chapter 77 (relating to miscellaneous provisions) is amended by adding after section 7512 (added by section 78 of this Act) the following new section:

"SEC. 7513. AUTHORITY TO PRESCRIBE OR MODIFY SEALS.

"The Secretary or his delegate is authorized to prescribe or modify seals of office for the district directors of internal revenue and other officers or employees of the Treasury Department to whom any of the functions of the Secretary shall have been or may be delegated. Each seal so prescribed shall contain such device as the Secretary or his delegate may select. Each seal shall remain in the custody of any officer or employee whom the Secretary or his delegate may designate, and, in accordance with the regulations approved by the Secretary or his delegate, may be affixed in lieu of the seal of the Treasury Department to any certificate or attestation (except for material to be published in the Federal Register) that may be required of such officer or employee. Judicial notice shall be taken of any seal prescribed in accordance with this authority, a facsimile of which has been published in the Federal Register together with the regulations prescribing such seal and the affixation thereof."

(b) TECHNICAL AMENDMENT.—The table of sections for such chapter is amended by adding at the end thereof the following:

"Sec. 7513. Authority to prescribe or modify seals."

SEC. 80. INCOME TAXES PAID BY LESSEE.

(a) AMENDMENT OF 1939 CODE.—Section 22 of the Internal Revenue Code 1939 is amended by adding after subsection (o) the following new section:

"(p) INCOME TAXES PAID BY LESSEE CORPORATION.—If—

"(1) A lease was entered into before January 1, 1952, "(2) both lessee and lessor are corporations, and

"(3) under the lease, the lessee is obligated to pay, or to reimburse the lessor for, any part of the tax imposed by this chapter on the lessor with respect to the rentals derived by the lessor from the lessee,

then gross income of the lessor shall not include any such payment or reimbursement other than the payment or reimbursement of the tax imposed by this chapter on the lessor with respect to the rentals derived by the lessor from the lessee determined without the inclusion of any such payment or reimbursement in gross income, and a deduction for all such payments or reimbursements shall be allowed to the lessee. For purposes of this subsection, a lease shall be considered to have been entered into before January 1, 1952, if it is a renewal or continuance of a lease entered into before such date and if such renewal or continuance was made in accordance with an option contained in the lease on December 31, 1951.".

(b) EFFECTIVE DATE, ETC.—The amendment made by subsection (a) shall apply with respect to taxable years beginning after December 31, 1951, to which the Internal Revenue Code of 1939 applies. If refund or credit of any overpayment resulting from the application of the amendment made by subsection (a) of this section is prevented on the date of the enactment of this Act, or within 6 months from such date, by the operation of any law or rule of law (other than section 3761 of the Internal Revenue Code of 1939 and section 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within 6 months from such date. No interest shall be paid on any overpayment resulting from the application of the amendment made by subsection (a) of this section.

SEC. 81. CHANGE FROM RETIREMENT TO STRAIGHT LINE METHOD OF COMPUTING DEPRECIATION IN CERTAIN CASES.

(a) SHORT TITLE.—This section may be cited as the "Retirement-Straight Line Adjustment Act of 1958".

(b) MAKING OF ELECTION.—Any taxpayer who held retirement-straight line property on his 1956 adjustment date may elect to have this section apply. Such an election shall be made at such time and in such manner as the Secretary shall prescribe. Any election under this section shall be irrevocable and shall apply to all retirement-straight line property as hereinafter provided in this section (including such property for periods when held by predecessors of the taxpayer).

(c) RETIREMENT-STRAIGHT LINE PROPERTY DEFINED.—For purposes of this section, the term "retirement-straight line property" means any property of a kind or class with respect to which the taxpayer or a predecessor (under the terms and conditions prescribed for him by the Commissioner) for any taxable year beginning after December 31, 1940, and before January 1, 1956, changed from the retirement to the straight line method of computing the allowance of deductions for depreciation.

(d) BASIS ADJUSTMENTS AS OF 1956 ADJUSTMENT DATE.—If the taxpayer has made an election under this section, then in determining the adjusted basis of all retirement-straight line property held by the taxpayer on his 1956 adjustment date, in lieu of the adjustments for depreciation provided in section 1016 (a) (2) and (3) of the Internal Revenue Code of 1954, the following adjustments shall be made (effective as of his 1956 adjustment date) in respect of all periods before the 1956 adjustment date:

(1) DEPRECIATION SUSTAINED BEFORE MARCH 1, 1913.—For depreciation sustained before March 1, 1913, on retirement-straight line property held by the taxpayer or a predecessor on such date for which cost was or is claimed as basis and which either—

(A) RETIRED BEFORE CHANGEOVER.—Was retired by the taxpayer or a predecessor before the changeover date, but only if (i) a deduction was allowed in computing net income by reason of such retirement, and (ii) such deduction was computed on the basis of cost without adjustment for depreciation sustained before March 1, 1913. In the case of any such property retired during any taxable year beginning after December 31, 1929, the adjustment under this subparagraph shall not exceed that portion of the amount attributable to depreciation sustained before March 1, 1913, which resulted (by reason of the deduction so allowed) in a reduction in taxes under the Internal Revenue Code of 1954 or prior income, war-profits, or excess-profits tax laws.

(B) HELD ON CHANGEOVER DATE.—Was held by the taxpayer or a predecessor on the changeover date. This subparagraph shall not apply to property to which paragraph (2) applies.

The adjustment determined under this paragraph shall be allocated (in the manner prescribed by the Secretary) among all retirement-straight line property held by the taxpayer on his 1956 adjustment date.

(2) PROPERTY DISPOSED OF AFTER CHANGEOVER AND BEFORE 1956 ADJUSTMENT DATE.—For that portion of the reserve prescribed by the Commissioner in connection with the changeover which was applicable to property—

(A) sold, or

(B) with respect to which a deduction was allowed for Federal income tax purposes by reason of casualty or "abnormal" retirement in the nature of special obsolescence,

if such sale occurred in, or such deduction was allowed for, a period on or after the changeover date and before the taxpayer's 1956 adjustment date.

(3) DEPRECIATION ALLOWABLE FROM CHANGEOVER TO 1956 ADJUSTMENT DATE.—For depreciation allowable, under the terms and conditions prescribed by the Commissioner in connection with the changeover, for all periods on and after the changeover date and before the taxpayer's 1956 adjustment date.

This subsection shall apply only with respect to taxable years beginning after December 31, 1955.

(e) EFFECT ON PERIOD FROM CHANGEOVER TO 1956 ADJUSTMENT DATE.—If the taxpayer has made an election under this section, then in determining the adjusted basis of any retirement-straight line property as of any time on or after the changeover date and before the taxpayer's 1956 adjustment date, in lieu of the adjustments for depreciation provided in section 1016 (a) (2) and (3) of the Internal Revenue Code of 1954 and the corresponding provisions of prior revenue laws, the following adjustments shall be made:

(1) FOR PRESCRIBED RESERVE.—For the amount of the reserve prescribed by the Commissioner in connection with the changeover.

(2) FOR ALLOWABLE DEPRECIATION.—For the depreciation allowable under the terms and conditions prescribed by the Commissioner in connection with the changeover.

This subsection shall not apply in determining adjusted basis for purposes of section 437 (c) of the Internal Revenue Code of 1939. This subsection shall apply only with respect to taxable years beginning on or after the changeover date and before the taxpayer's 1956 adjustment date.

(f) EQUITY INVESTED CAPITAL, ETC.—If an election is made under this section, then (notwithstanding the terms and conditions prescribed by the Commissioner in connection with the changeover)—

(1) EQUITY INVESTED CAPITAL.—In determining equity invested capital under sections 458 and 718 of the Internal Revenue Code of 1939, accumulated earnings and profits as of the changeover date, and as of the beginning of each taxable year thereafter, shall be reduced by the depreciation sustained before March 1, 1913, as computed under subsection (d) (1) (B); and

(2) DEFINITION OF EQUITY CAPITAL.—In determining the adjusted basis of assets for the purpose of section 437 (c) of the Internal Revenue Code of 1939 (and in addition to any other adjustments required by such Code), the basis shall be reduced by depreciation sustained before March 1, 1913 (as computed under subsection (d)), together with any depreciation allowable under subsection (e) (2) for any period before the year for which the excess profits credit is being computed.

(g) DEFINITIONS.—For purposes of this section—

(1) DEPRECIATION.—The term "depreciation" means exhaustion, wear and tear, and obsolescence.

(2) CHANGEOVER.—The term "changeover" means a change from the retirement to the straight line method of computing the allowance of deductions for depreciation.

(3) CHANGEOVER DATE.—The term "changeover date" means the first day of the first taxable year for which the changeover was effective.

(4) 1956 ADJUSTMENT DATE.—The term "1956 adjustment date" means, in the case of any taxpayer, the first day of his first taxable year beginning after December 31, 1955.

(5) PREDECESSOR.—The term "predecessor" means any person from whom property of a kind or class to which this section refers was acquired, if the basis of such property is determined by reference to its basis in the hands of such person. Where a series of transfers of property has occurred and where in each instance the basis of the property was determined by reference to its basis in the hands of the prior holder, the term includes each such prior holder.

(6) The term "Secretary" means the Secretary of the Treasury or his delegate.

(7) The term "Commissioner" means the Commissioner of Internal Revenue.

SEC. 82. AMENDMENTS TO 1954 CODE WITH RESPECT TO PROPERTY ACQUIRED FROM RETIREMENT METHOD CORPORATION.

(a) GENERAL RULE.—Section 372 of the Internal Revenue Code of 1954 (relating to basis in connection with certain receivership and bankruptcy proceedings) is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) ADJUSTMENT FOR DEPRECIATION SUSTAINED BEFORE MARCH 1, 1913, IN CERTAIN CASES OF PROPERTY ACQUIRED FROM RETIREMENT METHOD CORPORATIONS.—

"(1) IN GENERAL.—If the taxpayer has acquired property in a transaction described in section 373 (b) or 374 (b), and if any such property constitutes retirement-straight line property, then, in determining the adjusted basis of all retirement-straight line property held by the taxpayer on his adjustment date, adjustment shall be made (in lieu of the adjustment provided in section 1016 (a) (3) (A)) for depreciation sustained before March 1, 1913, on retirement-straight line property which was held on such date for which cost was or is claimed as basis, and which either—

"(A) RETIRED BEFORE ACQUISITION BY TAXPAYER.—Was retired before the acquisition of the retirement-straight line property by the taxpayer, but only if a deduction was allowed in computing net income by reason of such retirement, and such deduction was computed on the basis of cost without adjustment for depreciation sustained before March 1, 1913. In the case of any such property retired during any taxable year beginning after December 31, 1929, the adjustment under this subparagraph shall not exceed that portion of the amount attributable to depreciation sustained before March 1, 1913, which resulted (by reason of the deduction so allowed) in a reduction in taxes under the Internal Revenue Code of 1954 or prior income, war-profits, or excess-profits tax laws.

"(B) ACQUIRED BY TAXPAYER.—Was acquired by the taxpayer.

The adjustment determined under this paragraph shall be allocated (in the manner prescribed by the Secretary or his delegate) among all retirement-straight line property held by the taxpayer on his adjustment date. Such adjustment shall apply to all periods on and after the adjustment date.

"(2) RETIREMENT-STRAIGHT LINE PROPERTY DEFINED.—For purposes of this subsection, the term 'retirement-straight line property' means any property of a kind or class with respect to which (A) the corporation transferring such property to the taxpayer was using (at the time of transfer) the retirement method of computing the allowance of deductions for depreciation, and (B) the acquiring corporation has adopted any other method of computing such allowance.

"(3) OTHER DEFINITIONS.—For purposes of this subsection:

"(A) DEPRECIATION.—The term 'depreciation' means exhaustion, wear and tear, and obsolescence.

"(B) ADJUSTMENT DATE.—In the case of any kind or class of property, the term 'adjustment date' means whichever of the following is the later:

"(i) the first day of the taxpayer's first taxable year beginning after December 31, 1955, or

"(ii) the first day of the first taxable year in which the taxpayer uses a method of computing the allowance of deductions for depreciation other than the retirement method."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply only to taxable years beginning after December 31, 1955.

Passed the House of Representatives January 28, 1958.

Attest:

RALPH R. ROBERTS, *Clerk*.

Senator KERR. Our first witness is Mr. Dan Throop Smith, Deputy to the Secretary of the Treasury. Please proceed Mr. Smith.

STATEMENT OF DAN THROOP SMITH, DEPUTY TO THE SECRETARY OF THE TREASURY

Mr. SMITH. Thank you, Senator Kerr.

I have a prepared statement which has been distributed to the members of the committee. It consists of eight pages with an exhibit. If it pleases the committee I should like to go through the eight-page statement and deal with such additional things in the exhibit as may come up with the questioning.

I do not propose unless it is desired to read the entire material including the exhibit.

Senator KERR. All right.

Mr. SMITH. I appreciate the opportunity to appear before this committee for the Treasury Department in support of H. R. 8381. We regard this as very important legislation. As the President stated in his budget message:

> We shall continue our efforts to assure that no one can avoid paying his fair share of the country's total high tax burden. Pending legislation (H. R. 8381) which was developed jointly by the Treasury Department and the House Committee on Ways and Means to remove unintended tax benefits and hardships, should be enacted with a few modifications. The Treasury Department will continue to review the operation of the tax laws and make recommendations for such additional changes as are needed to close loopholes.

This bill is the result of close collaboration between the Ways and Means Committee and the Treasury Department. The Treasury Department staffs had the opportunity to work very closely with the staff of the Joint Committee on Internal Revenue Taxation in preparing original recommendations to the Ways and Means Committee which were made in a joint release on November 7, 1956. Previously, recommendations for clerical and minor technical changes had been developed jointly.

The recommended changes were the subject of hearings——

Senator MALONE. Could I ask one question at this point?

How do these gimmicks get into the tax bill to start with? Doesn't the Treasury study them before they bring them up here?

Mr. SMITH. I would say very largely, Senator Malone, they are provisions—they are gimmicks, to use your word, which have been developed by certain tax specialists to bring within the letter of the law rather abnormal and artificial transactions which had not been thought of previously.

As a matter of fact, I make this point later on in my prepared statement. Almost all of these were provisions that were carried over from the 1939 code, as I indicate in my statement, substantially intact, when the 1954 code was enacted.

Senator MALONE. Now, the 1954 code had a great many pages in it. This one has nearly 100 pages.

Mr. SMITH. Yes.

Senator MALONE. How can you write a bill that long, 100 pages, without including some gimmicks? How do we know there are not a bunch of gimmicks in this one?

Mr. SMITH. Well, since the principal purpose of this bill is to remove gimmicks that we now know exist——

Senator MALONE. Don't you know that when you write a bill? Can't you write a bill that is on principle and not set out special cases?

Mr. SMITH. I am afraid the experience over the last—what is it now, 45 years?—has indicated that the ingenuity of taxpayers and their advisors is such that under any law ways will be found to circumvent the intent but not the letter of the law.

Senator MALONE. I don't know whether that is it or whether it is laxness on the part of the Treasury, and maybe a gentle treatment of certain types of cases by the experts in your Treasury and before our committees.

Mr. SMITH. Well, I can speak only for the last 5½ years, and I can say very emphatically that in that period of time there has been no conscious or intentional laxness, and I presume and I have every reason to think that that has been the attitude of the Treasury indefinitely.

Senator MALONE. Then it is just lack of understanding of how to write a bill?

Mr. SMITH. No, I would not be willing to accept that as a statement, Senator.

Senator MALONE. I know you would not, but we continually have this happen. You know that none of us here can analyze 100 pages in 2 days. You have to trust somebody, and those we can trust are getting scarcer and scarcer around here and in the departments.

Go ahead.

Senator KERR. Very well.

Mr. SMITH. Let me start the paragraph which I was reading.

The recommended changes were the subject of hearings held by the Subcommittee on Internal Revenue Taxation of the Ways and Means Committee in November 1956. The bill was later reviewed and modified by the Ways and Means Committee in executive sessions extending over a considerable period of time.

Most of the unintended benefits for which the Treasury Department recommended corrections arose under the provisions of the 1939 code which had been carried over substantially intact into the 1954 code. A few of them were new problems.

The Treasury Department strongly indorses this bill, with the exception of one section to which I shall refer later. I wish to emphasize here that though this bill does not have a significant immediate revenue effect, it seems to us to be of very great importance in maintaining the fairness of the tax system.

As Secretary Anderson indicated in his recent statement before the Ways and Means Committee, loopholes and unintended benefits, as well as instances of hardship on taxpayers, are always a matter of concern; they are particularly serious when tax rates are at high levels. To maintain respect for our voluntary tax systems, we must maintain fairness and equality in applying the tax burden.

Because of studies still in process by the Committee on Ways and Means, the bill does not deal with three very complex areas; namely, the taxation of corporate distributions and adjustments, the income taxation of estates and trusts, and the tax treatment of partners and partnerships. Advisory groups of distinguished private citizens who are especially qualified in these fields have submitted comprehensive reports for study by the Ways and Means Committee. The Treasury Department has given its wholehearted cooperation to these advisory groups, whose work will be of great assistance in the formulation of appropriate revisions in the tax areas mentioned.

As the report of the Ways and Means Committee has indicated, it is not feasible to provide detailed revenue estimates for this bill. While it is not a revenue-raising measure, as such, the general effect of the bill will be to strengthen the revenue system. An important aspect of this legislation is its preventive function in blocking the growth and spread of known tax avoidance devices which, even where they do not result in substantial revenue losses at present, threaten more widespread abuse and loss of tax receipts in the future.

More than half of the 82 provisions of H. R. 8381 represent technical adjustments. Of the remaining more substantive provisions of the bill, some two-thirds close loopholes or foreclose unintended benefits in the present law. The balance of its provisions relate generally to the removal of hardships.

The provisions which deal with unintended benefits are as follows:

Section 2 of the bill removes several areas of inequality in the application of the retirement income credit as between community-property and noncommunity-property States. A more detailed explanation of this and other specific sections of the bill is presented in an exhibit accompanying this statement.

Section 3 closes a loophole whereby certain dealers in certain tax-exempt securities have been deducting artificial tax losses by taking advantage of special rules for the write-off of premiums on these securities.

Section 4 removes an exemption which permits police officials to exclude a subsistence allowance of up to $5 a day from their taxable income.

Section 5 stops certain abuses of the dependency allowance.

Section 9 makes it impossible to obtain what is in effect a double charitable contribution deduction where the taxpayer sets up a charitable trust with a reversionary interest to a close relative.

Section 10 eliminates a possible double deduction for the same amount due to the interplay of the 2-year charitable contribution carryover and the net operating loss carryovers.

Section 11 makes it impossible to claim a double deduction for both interest and a charitable contribution in certain transactions where property is donated to charity subject to indebtedness.

Section 12 further tightens the 1954 code provisions denying unjustified tax deductions for premiums on short-call bonds.

Section 14 curbs tax avoidance in connection with unrealistic tax writeoffs for improvements on leased property where there is a lease renewal feature.

Section 16 deals with abuses involving purely tax-inspired corporate transactions in stock around dividend dates.

Section 19 is directed at practices whereby certain tax-exempt institutions have been paying tax-deferred compensation to part-time employees in the form of retirement annuities.

Section 22 deals with unwarranted tax advantages in connection with the use of variable price employees' restricted stock options.

Section 23 checks tax avoidance by means of tax-free transfers of installment obligations to controlled life insurance companies.

Section 24 prevents the omission from taxable income of certain proper transitional adjustments where a change of accounting method is initiated by the taxpayer.

Section 34 prevents a tax-avoidance device whereby security dealers and others have been able to claim artificial tax losses on transactions in the stock of regulated investment companies around the time of distributing a capital gain dividend.

Section 41 eliminates the possibility of obtaining unjustified tax-postponement treatment under the involuntary conversion provisions on what are essentially voluntary transactions in broadcasting properties.

Section 42 deals with arrangements designed to convert ordinary interest to investors into capital gains through the redemption of bonds issued at an artificially large discount.

Section 43 further tightens present-law provisions dealing with devices to transform ordinary income into capital gains through the creation of artificial discounts on detached-coupon bonds.

Section 44 provides certain adjustments in the short sale provisions to check conversion of short-term into long-term capital gains by security dealers on their investment accounts.

Section 46 restricts the provisions for capital gain treatment on sales of patents to exclude cases where the inventor sells his patent rights to a corporation in which he has a substantial interest.

Section 51 terminates now obsolete World War I provisions limiting the tax on amounts received from long-standing claims against the United States in connection with property acquisitions by the Government.

Section 52 repeals the present provision allowing certain proprietorships and partnerships the option to be taxed as corporations.

And I would like to interrupt my prepared statement here to indicate that this particular repeal was not a recommendation of the Treasury Department. The Treasury Department recommendation was for an extension of the time during which the option granted under the 1954 code could be exercised, an extension of the time until the regulations are made final so that the individual concerns electing the option will know precisely where they stand.

Senator WILLIAMS. Is that the section as to which the Treasury Department has issued no regulations whereby it could be operated?

Mr. SMITH. That is correct, Senator Williams.

Senator WILLIAMS. And there has been nothing done under that section up to this time?

Mr. SMITH. That is correct. The action of the House was consistent with the action taken in 1954, when, as the members of this committee, I am sure, will recall, the Internal Revenue Code came over to the Senate, there was no provision for either of the options as to whether a partnership was to be taxed as corporation or a corporation taxed as a partnership.

In the Senate the 2 provisions were put in, and in the conference committee 1 of the options was maintained, the 1 which it is now proposed to repeal, the other 1 was dropped.

Nevertheless, it was the Treasury Department's feeling at the time and it has been its feeling since that the option which was dropped was the more significant and useful one; that is, the option for certain corporations to be taxed as partnerships.

We were perfectly agreeable to this in 1954 as part of a consistent pattern to give an option both ways. We do not object to its repeal at the present time. But in doing so we want to make it clear here, as we did in the House Ways and Means Committee, that this is without prejudice to the recommendation of the other option, the option of small corporations, certain small corporations, to be taxed as partnerships.

Senator KERR. Don't you think really that as a matter of effective administration that a corporation should be taxed as a corporation and a partnership should be taxed as a partnership?

Mr. SMITH. That, as a general proposition, is certainly an appealing one. I cannot disagree in general. However, one of the two options, the one that was not adopted in 1954, has been advocated by many people who are experts in the field of small business. And we are sympathetic, as a part of a small business tax relief program, to the other option which, in fact, was recommended by the Cabinet Committee on Small Business and was reendorsed by Secretary Anderson in an appearance before the Ways and Means Committee.

But that is because of other major, you might say, overriding considerations.

Senator KERR. Very well.

Mr. SMITH. Section 60 requires better reporting of income earned abroad to prevent abuse and confusion over the scope of the special treatment of such income.

Section 63 provides greater availability for public inspection of information filed with the Government by tax-exempt organizations.

Provisions of the bill which remove hardships or otherwise benefit taxpayers are as follows:

Section 6 permits residents of certain communities surrounding Government Atomic Energy installations to deduct the payments they make to the Atomic Energy Commission for municipal services in lieu of real-estate taxes.

Section 13 provides for a more equitable proportioning of the 1954 and 1939 code rules for the computation of net operating loss deductions in the case of losses carried to or through certain 1953–54 fiscal years.

Section 25 provides for clear and objective application of the prohibited transactions rules with reasonable qualifying conditions where a pension trust invests in debenture issues of the employer corporation.

Section 31 provides more equal treatment of fiscal year and calendar year taxpayers in certain situations by permitting the fiscal year taxpayer to apply the percentage depletion provisions of the 1954 code to that portion of the fiscal year 1953–54 which falls in the calendar year 1954.

Section 32 provides that the taxpayer may choose between the 1954 code and the 1939 code rules for defining a mining property for purposes of the percentage depletion allowances applicable to coal and other mineral resources.

Section 53 extends the period of limitation for filing claim for credit against the Federal estate tax for death taxes paid to the States, where there was litigation and consequent delay in the final determination of the State tax liability.

Section 54 permits the Treasury in certain hardship cases to extend the present periods for postponement of payment of Federal estate tax on reversionary or remainder interests and for the claiming of credit for State and foreign death taxes in such situations.

Section 56 relieves employees of possible gift tax liability on the mere designation of a survivor beneficiary in a qualified pension plan, to the extent the benefit is attributable to employer contributions.

Section 71 provides for better correlation of interest on overpayments and underpayments of tax so as to eliminate erratic differences which may arise under present law where, even though underpayments and overpayments offset each other, the Internal Revenue Service is required to collect more interest than it pays, or vice versa.

Section 75 provides greater flexibility in the requirement for tax compliance certificates by departing aliens. This will permit certain reasonable exceptions to the certification and tax bonding provisions where the collection of the tax will not be jeopardized.

Section 80 fills a gap between pre-1952 rules and the 1954 code to provide relief from tax pyramiding where the lessee pays the lessor's taxes under certain tax-paid rental contracts.

I shall not attempt to enumerate here the technical provisions of the bill. These technical adjustments include the correction of inadvertent errors in the statute, the removal of inconsistencies and ambiguities, and the clarification of situations where the technical language of the law does not carry out the clear intention of the Congress as expressed in the committee reports. These provisions are listed with a brief explanation in the attached exhibit, to which I have previously referred.

The Treasury Department renews its recommendations for two changes in the code which were contained in its original recommendations but are not included in the bill before you. These relate to the premium payment test for life insurance under the estate tax and the so-called bank-loan plan of life insurance.

Prior to the 1954 code life insurance proceeds were included in decedents' estates to the extent they had paid the premiums, even though they had given away all of the incidents of ownership before death.. The premium payment test was removed in the 1954 code in an attempt to correct a discrimination against life insurance proceeds as compared with other types of property under the estate tax. The Treasury objected to the complete removal of the premium payment test before this committee in 1954, on the grounds that it went too far and introduced a new discrimination, this time in favor of life insurance.

The Ways and Means Committee recognized the existence of this problem and provided for a partial restoration of the premium payment test in its original bill. This provision was thought by many to be inadequate. It was removed by a committee amendment in the House. It was stated that this would leave an opportunity to develop a satisfactory solution.

We urge your committee to consider the approach which the Treasury previously suggested of including in a decedent's estate the difference between the proceeds received upon death and the cash surrender value of the policy at the time of death. We believe that such a solution would place life insurance on essentially the same basis as other property for purposes of estate-tax treatment.

Senator GORE. May I ask a question?

Senator KERR. Yes.

Senator GORE. But the present provision of the law, you will agree, is discriminatory in favor of life insurance policies?

Mr. SMITH. That belief is the basis of our recommendation; yes, Senator Gore.

Senator GORE. Under the present provisions it is possible, is it not, for people with sufficient means to pay large premiums to pass on large estates completely free of either gift or estate taxes.

Mr. SMITH. No; I think there would be gift taxes on the premiums.

Senator GORE. Not if the premiums came within the annual allowance.

Mr. SMITH. Certainly not.

Senator GORE. And it is possible, then, to avoid gift and estate taxes by this method?

Mr. SMITH. Only to the extent that the premiums fall within the gift taxes exclusion.

Senator GORE. Well, that is quite substantial as an insurance premium.

Mr. SMITH. It is a question as to what is meant by large amounts.

Senator GORE. Yes, I agree.

At the time this provision was on the floor of the Senate in 1954, in the course of debate I expressed the view, which was never challenged, that with a wife and two children, where I am able to pay the monthly premiums, I could pass on an estate of $700,000 completely free of gift or estate taxes.

Mr. SMITH. I do not have in mind specific figures, it would of course depend on the type of policy.

I would like to emphasize, as I have already indicated here, that the position that we are now proposing is precisely the position that was taken by the Treasury before this committee in 1954. This is not an afterthought or a new thought on this subject.

Senator FREAR. What was the basis for the House not accepting your recommendation?

Mr. SMITH. I cannot speak for the other legislative body. I say only, Senator Frear, they did not accept it, to our regret.

Senator FREAR. It was just a question of not having enough votes?

Mr. SMITH. I suppose that is one way of describing it.

Senator KERR. Let me see if I understand this, Mr. Smith.

Under the present law a beneficiary is the owner of the life-insurance policy, and when the insured dies there is no inheritance tax, is that generally true?

Mr. SMITH. That is right.

Senator KERR. And under the provisions of the 1954 code, an insured, if he wants his inheritance or his inheritance-tax exemption for any designated beneficiary, can give such beneficiary, such person, up to $3,000 which under the law is free of gift tax, which beneficiary can then use as a premium on the life-insurance policy on the insured which has been designated as the property of the beneficiary, and thereby the insured provides the means of paying the premium, through gift of money equal to premium which may be then used in payment of premium.

Mr. SMITH. The donee is a free agent to use his gift in any way he likes.

Senator KERR. The donee does not have to use it, he can if he wants to. But by the operation of that the insured provides the means for the payment of the policy premiums, the premiums on the policy, and then of course upon the death of the insured the face or the amount of the policy comes to the beneficiary free of inheritance tax—

Senator FREAR. Regardless of the size?

Senator KERR. Regardless of the size—and, of course, for that to be implemented, the insured has to die, is that right?

Mr. SMITH. That is right, though there may be cash surrender values that can be collected in the meantime.

Senator GORE. It is pretty nice for those able to pay the premiums to pass along to their children something that is free of taxation. I would like to pass that along to my children, but I just do not happen to be able to pay that $6,000-a-year premium.

Senator KERR. Well, the Senator could do it for $1,000 a year or whatever the wanted to give his children.

Senator GORE. Yes, again free of taxes.

Senator KERR. Does the Senator propose to change the exemption of the $3,000 gift from the gift tax?

Senator GORE. No, I propose to restore to the law the premium test which was repealed in 1954.

Is that not right, Mr. Smith?

Mr. SMITH. That was repealed.

Now, our proposal, Senator Gore, is not to restore that test. We think that earlier provisions of the law had in fact a discrimination against life insurance. Therefore what we now propose, and what we did propose before this committee in 1954, is a position in between, such that the only amount subject to the estate tax would be the difference between the cash surrender value of the policy and the face value.

Senator KERR. And the amount paid.

Mr. SMITH. And the amount paid. In other words, as these premiums, year after year, are paid, they of course build up the cash surrender value of the insurance policy. If it is an endowment policy, as it approaches maturity the cash surrender value approaches the face value. Our thought is that this position in between the present law and the pre-1954 law will put life insurance in substantially as nearly as possible, the same position as other property. The individual can give money now, subject to the gift tax exemption, he can use the money in any way he chooses. That property which is transferred by gift, whether in the form of a payment on a policy owned by a beneficiary other than the individual or made directly in cash or other property can be used by the individual receiving it to build up a value, and that value is not subject to the estate tax, and I think properly so.

Our thought is that this proposed treatment of life insurance, would, I repeat, as nearly as possible put the person who receives the benefit of having someone else pay premiums on the policy which he owns in substantially the same position as though he had gotten gifts in the form of other property. He will get a gradual buildup.

Senator KERR. That is not necessarily correct, is it?

Mr. SMITH. There cannot be absolute identity.

Senator KERR. Suppose the beneficiary takes the $3,000 given him and invests it, we will say, in that real estate, and that real estate enhances in value. Isn't the proposal that you are making somewhat similar to one that would in effect impose inheritance tax on the increased value of an investment made by the beneficiary of that $3,000 gift?

Mr. SMITH. That argument has been made before. It is our opinion that it is not comparable. I recognize that there is a certain analogy, but it does not seem to us to be as close an analogy as the fact of what you might call the large gain to the holder of the policy arising at the moment of death of the person on whom the policy was issued in the first place.

Senator KERR. Do you give the donee of the annual gifts from the insured the benefit of any return on the gift over the years?

Mr. SMITH. The donee of the ordinary gift of property has the right to use it in any way he chooses, whether it is real estate which goes up in value——

Senator KERR. You are going to limit him if we adopt your recommendation here, are you not?

Mr. SMITH. No, because this does not apply in case the cash is given to the donee, then he as a free agent does whatever he chooses with it. This applies in the case where the individual himself pays the premiums.

Senator KERR. Where the insured pays the premiums?

Mr. SMITH. Where the insured pays the premiums.

Senator FREAR. It can be the same dollars, though.

Senator KERR. Now, the insured can give up to $3,000 to the beneficiary in any form that he wants to and does not even have to make a report of it, does he?

Mr. SMITH. That is right.

Senator KERR. You do not even require a report.

Mr. SMITH. The law does not require a report, and we certainly do not.

Senator KERR. But here you are saying to him that you are going to amend the law so as to restrict the exercise by him of the privilege he now has to make an unrestricted gift.

Mr. SMITH. On the grounds, Senator, that it is death——

Senator KERR. But regardless of what the grounds are, is that not the legal effect of it?

Senator GORE. I do not believe it is.

Mr. SMITH. I do not believe so.

Senator KERR. You are saying to him that he cannot give it to him in the form of a premium receipt on a life-insurance policy which the insured has no interest in or control of.

Mr. SMITH. We are not putting any restriction whatsoever on the form of the gift; we are merely limiting the estate-tax consequences of a gift in a particular, very peculiar form.

Senator KERR. And now you are advising the committee that that does not constitute a legal restriction on the gift?

Mr. SMITH. No; I think it constitutes only—this applies entirely to the measure of the estate of the decedent.

Senator KERR. Let's start over. Under the law—and I do not believe you are seeking to change it—where the beneficiary is the owner of the policy and pays the premiums, there is no inheritance tax.

Mr. SMITH. That is right.

Senator KERR. And that is based on the recognition by the law that the insurance policy is a chosen action that does not belong to the insured, it is not a part of his estate.

Mr. SMITH. That is correct.

Senator KERR. He has no interest in it, he has no control over it, he cannot borrow any money on it, he cannot surrender it for cash-surrender value, it is not his, is that correct?

Mr. SMITH. Yes.

Senator KERR. Now, under the law at this time, he can give to anybody a gift not to exceed $3,000 in any form that he wants to, he can even give them an Angus bull if he wants to.

Senator BENNETT. Could you buy one of those for $3,000?

Senator GORE. I will sell you one.

Senator KERR. Or an automobile, or an amount of stock, or a check, so long as its market value does not exceed $3,000, and there is no gift tax on it.

And this then becomes the property of the donee, and he can do what he wants to with it, is that correct?

Mr. SMITH. That is correct.

Senator KERR. Then I have to disagree with you, that when we fix it so that the donor cannot give a gift consisting of a premium receipt of less than $3,000 without thereby impairing the value of another asset that that donee at that time owns and in which the donor has no interest whatever.

Mr. SMITH. You are not the only one who has disagreed with us, Senator, including, I take it, the majority of the House.

Senator KERR. I am not talking about the advisability of a change of the legal effect of the law. My disagreement with you is as to whether or not that amendment would impair a right which a taxpayer or a person now has.

Mr. SMITH. Well, to me the fact that a particular sort of gift had a different tax consequence under the estate tax arising at some time long after the gift is made is other than a direct limitation on the gift.

Senator KERR. Here is the insurance policy that the insured has no ownership in, it is no part of his estate, it is not subject to estate taxes. And here is the right which that insured has to give his loved one, whether it is his wife or his daughter or his son or his brother, up to $3,000 a year free of gift tax or free of income tax or any other tax.

Yet when he exercises that right which he now has, your recommendation would impair the value of an asset which that donee now has.

Mr. SMITH. Senator, our proposal would not influence the immediate value of the gift, the cash surrended value which is built up under the premiums, we would not impose——

Senator KERR. That is but one element of the value of the asset.

Mr. SMITH. That is but one element. But that element we would leave untouched and not subject to the estate tax. We would include under our proposal only that difference between the face value and the cash surrender value which will be built up as an event arising—and this is the difference between the real estate and the Angus bull and all the other items that have been mentioned—as something arising, a right coming into existence by the death of the individual who himself has paid the premiums on the policy.

That seems to us a very significant distinction.

Senator GORE. Isn't that in that instance testamentary in character?

Mr. SMITH. In a sense it can be so called.

Senator GORE. Testamentary in character, and in this way, and by this device, the Treasury has suffered substantial losses in revenue under the estate tax.

Now, we have been discussing the rights and practices involved in the payment of a premium within the range of gift tax exemption.

Now, have you not had experience with the payment of premiums vastly in excess of the gift tax limitation on which gift taxes have been paid, thus avoiding the estate tax?

Mr. SMITH. Well, I presume there are such policies of this sort. There are also of course transfers of other property by gift in excess of the allowance which in turn gets property out of the estate.

Senator KERR. That does not avoid any estate tax now in effect, does it?

Mr. SMITH. The general type of transfer, no. There is an option of giving and paying the gift tax.

Senator KERR. I say, that does not avoid any estate tax now in effect.

Mr. SMITH. No.

Senator KERR. And if your recommendation is adopted, what it would amount to would be an increase in the inheritance tax.

Mr. SMITH. That is exactly what our recommendation is, to include in the estate——

Senator KERR. But you do not recommend the increase as to anything except this particular form of asset?

Mr. SMITH. That is correct, because we know of no other form of property under gift where a large value comes into existence at the moment of death.

As to the Florida real estate, your Angus bull, and the others, it is transferred, the value builds up, it is in the hands of the donee, it is not influenced by whether the donor died or when he died. The distinctive characteristic of life insurance is that the value comes into being by the death, in this instance, of the donor of the payment of the premium.

Senator GORE. And to that extent it is testamentary in character.

Senator KERR. It cannot be testamentary in character, Senator.

Mr. SMITH. I am not sure what the full legal implications of that are, but perhaps it is the same thing, it is something that comes into existence by reason of the death.

Senator KERR. If there is a lawyer here on the staff he can answer that question if you want it answered?

Senator GORE. I would be glad to have it answered, sir.

Senator KERR. The implementation of the insurance policy cannot be testamentary in character, because it may not even have been given to the beneficiary by the insured.

The beneficiary may have in the inception bought the insurance policy. Your wife could go down with your permission now and buy an insurance policy on you and use her money to pay the premium. And that is not testamentary in character.

Senator GORE. I agree. But that is not the kind we are talking about.

Senator KERR. You can give your wife $3,000 a year free of tax, and the law does not impose upon her any restrictions as to what they can do with that money, and there is nothing testamentary involved whatever.

Senator GORE. Not in that case, no.

Senator BENNETT. I am not a lawyer, Mr. Chairman, but it seems to me in my layman's understanding the word "testamentary" refers to the power of the man who is deceased to control the distribution of the assets.

Senator KERR. Let's get the dictionary, we will see what "testamentary" is. It does not hurt to refer to it once in a while.

Senator BENNETT. It is one of my favorite books.

Senator GORE. Senator Bennett, the instances to which Senator Kerr has just referred were not on all four's with the situation to which you refer. He was speaking of an instance in which a man's wife would buy an insurance policy on her husband's life. That would not be testamentary in character.

Mr. SMITH. I should just like to note, if I may, that we have been impressed in the Treasury——

Senator KERR. Let me read this while we are on the subject:

> Testamentary. Of or pertaining to a will or testament or the admission of a will; bequeathed by a will; given by testament.

There is nothing in this that is connected with a will. And there is nothing in this that relates to the transfer of property by decease or inheritance.

Senator BENNETT. That is my understanding.

Senator KERR. It is an asset that belonged to the beneficiary of ab initio. That is a technical term meaning from the beginning.

Mr. SMITH. I am aware of it.

Senator KERR. And that which the deceased did not own cannot have a testamentary characteristic.

Now, I am charging nothing for that little lecture on basic law, but you can find that on any treatise on the subject.

Senator GORE. Mr. Smith, is it not testamentary in character when the father designates his son as his beneficiary of a policy on which he, the father, retains to the point of his death the right of changing the beneficiary?

Senator KERR. That is not what we are talking about, that is not even affected in this discussion or this amendment or the present reading of the law.

Senator GORE. You do not mind him answering the question?

Senator KERR. Not at all. But I want him to know and the record to show the fact that you have now shifted and are talking about something else other than what we have been talking about.

The amendment you are talking about does not refer to a policy with reference to which the insured can change the beneficiary. Does it?

Mr. SMITH. That is correct, it does not so apply.

Senator GORE. All right. Explain the premium test.

Mr. SMITH. The premium payment test has to do with policies where the so-called incidents of ownership have been transferred to someone else by gift. The incidents of ownership includes such things as the right to change the beneficiary. They include the right to surrender the policy, I believe.

The individual, the insured, has no rights to do anything with the policy.

Now, when such a policy is given, its then value is of course subject to gift tax.

Senator KERR. At the time of the gift?

Mr. SMITH. At the time of the gift.

Now, the premium payment test that existed in the pre-1954 law provided that even though a policy had been given away, with all these incidents of ownership transferred, the fact that the insured paid the premiums brought the entire amount of the policy into his estate. In 1954 that so-called test was wiped out completely.

Senator GORE. Thank you.

Mr. SMITH. And we are now proposing, as we did in 1954, that there be an in-between point. We recognize that the pre-1954 law discriminated against life insurance. We are impressed by the fact that the 1954 law in our opinion discriminates in favor of life insurance, and we noted, shortly after the 1954 Code was adopted, in various solicitations for the purchase of life insurance, statements to the prospective purchaser "do you realize that you can now do things with life insurance that you can do with no other property in the way of transferring property to your deceased?"

Senator GORE. And what have been the estimated losses to the Treasury under this provision as compared with the revenues which would have accrued under the provisions of the law prior to the 1954 act?

Mr. SMITH. We have not been able to make any estimate on that, because it is something that will come into effect over a rather long period of time.

Senator GORE. You have no estimate at all?

Mr. SMITH. I have no dollar figures on it, Senator.

Senator GORE. Is it substantial?

Mr. SMITH. We think it is certainly appreciable—and I do not know whether I use "appreciable" in the same sense as you use "substantial". We think it would run into tens of millions of dollars over the years.

Senator GORE. In the case of a beneficiary who comes into the possession of values by means of a will, and in the case of a beneficiary who comes into possession of values accruing to him as a result of the death of the insured, what are the essential differences?

Mr. SMITH. The estate-tax law provides that dispositions which take effect at death are included in the estate tax, even though it is not subject to will or transferred by will. That, we think, is a precedent, a significant analogy in the present law which reasonably can be applied to this difference between the cash surrender value and the face value of insurance policies.

Senator GORE. Then do I correctly understand your recommendation to be that you wish treated for purposes of estate taxes the values which accrue as a result of the death over and above the surrender values prior to death?

Mr. SMITH. That is it exactly, Senator.

Senator GORE. And is it your view that, to the extent that the values accruing as a result of death are over and beyond the surrender value prior to death, they are in essence testamentary in character?

Mr. SMITH. As a nonlawyer I am not willing to use a word that apparently has legal significance.

I will have to content myself by saying that it seems to us something that is eminently proper to include in an estate subject to an estate tax.

Senator KERR. Are you a lawyer, Mr. Smith?

Mr. SMITH. I am not.

Senator KERR. I want to tell you now it is enlightening to hear you two nonlawyers discussing legal terms with such faculty.

But I would remind you it is not too binding on the lawyers.

Mr. SMITH. My recommendation is based on a policy decision and not legal niceties.

Senator KERR. Haven't the courts held as invalid efforts to have the Treasury, even before the 1954 code, apply the premiums test on insurance which was no part of the assets of the decedent.

Mr. SMITH. I am not aware of that, and I am not sure that there was a precise statutory provision that the Treasury had to rely on.

Senator KERR. It would not have been the first time that the Treasury took action without a precise statutory provision, nor would it have been the first time that a court held an act not only unjustified by the law, but in reality unconstitutional.

I frankly think your recommendation would be unconstitutional. I think you would be depriving an individual of an asset which he has by subjecting it to an estate tax when it was not part of the estate.

Mr. SMITH. That is not our opinion, that it would be unconstitutional, and we think from the standpoint of fairness of policy and—and just one final point on this—this recommendation is made in the light of what seems to us a reasonable balance between the tax treatment of various forms of property at death, and it is not primarily a revenue measure.

We are concerned with the fairness, the neutrality, so far as possible, of the tax law. And our recommendation is made in that spirit.

Senator GORE. And it is the view of the Treasury that it is possible under the present provision of law for vast amounts to be passed on by way of insurance policies and avoid the estate tax.

Mr. SMITH. Well, vast amounts can be transferred subject to the gift tax, and hence not under the estate tax.

Senator KERR. And not subject to the estate tax?

Mr. SMITH. Not subject to the estate tax.

Senator KERR. Nothing can be done under this law that escapes any estate law now in effect.

Mr. SMITH. That is the reason we are recommending it.

Senator GORE. Because the 1954 act amended it.

Senator WILLIAMS. While you are on this section dealing with insurance, would you describe the loan-financed insurance and what recommendations you make.

Mr. SMITH. In my prepared statement that is the very next paragraph, Senator Williams.

Senator WILLIAMS. That is all right.

Mr. SMITH. I believe I completed the statement ending with the estate tax treatment on paragraph 3 of page 6.

There is no new principle involved in the Treasury's suggestion with respect to loan-financed life insurance. Longstanding provisions of the tax law have disallowed the interest deduction where indebtedness is incurred to finance single-premium life insurance contracts. These provisions were further tightened under the 1954 code to deal with similar abuses such as had arisen in connection with annuity plans and plans for advance borrowing for the payment of future premiums. All of these plans were based on the idea of permitting the policyholder to deduct the interest on borrowed funds while there was a simultaneous tax-free buildup of earnings on reserves behind the policy. The increasing use of borrowed funds to carry life insurance, under plans developed to make them substantially self-sustaining after the first 1 or 2 premiums and advertised as being of negligible cost to high-bracket purchasers, seems to constitute a substantially equivalent abuse. We hope that your committee will consider means of dealing with this problem.

We suggest that one approach would be to disallow as a deduction interest on indebtedness incurred to carry a life insurance, endowment, or annuity policy under an arrangement or plan which contemplated that a substantial number of premiums would be paid by means of such indebtedness. I should like to emphasize that this recommendation would have no effect whatsoever on the status of life insurance policies as a basis for loans from any source. The value of life insurance policies as collateral would not be modified in any way; nor would there be any consequences for the policyholder who borrows on his insurance policy in the ordinary course of events to meet particular needs. All that is proposed is a denial of the interest deduction to the purchaser of a policy who buys it under a plan to have it carried largely by special loans made for the purpose. The proposed change in the tax law would not restrict the value of insurance policies as a basis for loans even in these limited cases; it would simply deny an interest deduction to the borrower.

Senator WILLIAMS. Does the Treasury have recommended language to suggest to the committee?

Mr. SMITH. I do not have it today, we have worked on it, and I shall be glad to provide language on that, Senator Williams.

(Mr. Smith did not furnish the language requested by Senator Williams.)

I should like to comment briefly on section 37 of the bill, relating to the carryover of the foreign tax credit, and sections 81 and 82, relating to the depreciation adjustments of railroads shifting from the retirement method.

Section 37 relates to a minor area of treatment of foreign income. It provides special relief in that area by introducing a tax averaging principle with respect to foreign income taxes which does not apply to the income of corporations or individuals from domestic sources. This provision does not deal with an unintended hardship. The Treasury Department has reported adversely to the Ways and Means Committee on separate proposals of similar nature. We believe it has no proper place in this bill.

Section 81 and its companion section 82 deal with a matter now in controversy between the Internal Revenue Service and certain railroads which changed from the retirement method to the straight-line method of depreciation in certain past years. Since this provision was added on the floor of the House, there is no reference to it in the Ways and Means Committee report. A detailed description of the underlying problem and the solution proposed in the bill is presented in the appended exhibit.

Senator MALONE. Mr. Smith, you passed over section 81 very quickly. What does section 81 do?

Mr. SMITH. I am just describing it now. In my succeeding paragraphs I refer to the fact that the exhibit describes it in more detail, I describe it briefly here.

Because of the litigation on this matter—I am referring again to sections 81 and 82—which the Treasury has thus far lost—the present provisions have been developed as a compromise. This provision arises after discussion and consideration over a considerable period by the Treasury and the Ways and Means Committee. We regard the proposal as a reasonable solution of a difficult problem.

In view of Senator Malone's question perhaps I might refer——

Senator MALONE. What is the solution, what does it do?

Mr. SMITH. May I turn to the exhibit and read the statement there.

Prior to 1942, railroads generally used the retirement method of computing depreciation on their roadway assets, which include buildings, bridges, tunnels, water towers, and the like.

Senator MALONE. You speak of depreciation that had been allowed. Does your income-tax law take into account at all the difference in the depreciation allowance, of, say, 10 or 15 years ago, and what it will purchase at this time? In other words, the inability of replacing machinery under any depreciation set several years ago on account of inflation?

Mr. SMITH. No, there is no recognition in the law of the so-called replacement-cost depreciation.

Senator MALONE. You are, I suppose, aware of the fact that due to the inflated cost, nothing can be replaced by the depreciation fixed a few years ago.

Mr. SMITH. I will not agree that nothing can be replaced.

Senator MALONE. Mention something that can be replaced?

Mr. SMITH. In part the cost can be replaced.

Senator MALONE. Ten percent or fifty percent?

Mr. SMITH. I think it is higher than that.

Senator MALONE. But the buying power of the dollar has continually and materially decreased, according to the testimony here only last fall of the Secretary of the Terasury and the Administrator of the Federal Reserve.

According to them the 1948 dollar was worth 47 cents. In other words, of any depreciation allowances that were supposed to replace machinery or any other asset that were set in 1948, at this time only 47 percent of that replacement cost would be available. That is true, is it not?

Mr. SMITH. It would be of that order of magnitude. We should take account, however, of the fact that many of the more costly replacement products now are also more efficient in production in terms of unit capacity, and there has been some compensating offset.

Senator MALONE. Name some. You are an expert.

Mr. SMITH. No, I am not an expert in machine tools, but I am aware of the advertisements that are made by machine tool manufacturers about the larger capacities.

Senator MALONE. Advertisements are one thing and depreciation and replacement are another thing.

Am I right in saying that machinery or any depreciable asset cannot be replaced now by any depreciation items set 10 years ago, on the face of it?

Mr. SMITH. On the face of it it looks as though that is probable. I am sure there must be some exceptions.

Senator MALONE. What they have to do now for replacement is to go into capital investment and get the capital someplace—from the stockholders, or the profits if any. They say now railroads have no profits and I guess they are about two-thirds right.

Mr. SMITH. That is a very important thing, and I agree in general, that typically it takes more dollars of investment to stay even.

Senator MALONE. Where do you get it under your present depreciation and your present taxes?

Mr. SMITH. You do not get it from a tax deduction.

Senator MALONE. In other words, you just cannot replace it unless you can go out and sell more stock in the railroad or whatever outfit it is, or get new money and bring it into the corporation.

Mr. SMITH. Or retained earnings after tax or from other security issues.

Senator MALONE. What retained earnings? I think you will find that we have utterly destroyed small business while giving it lipservice through your income taxes and through free imports without any evening of the difference in the labor and other costs here and in the chief competing country. They are down and they are out.

Mr. SMITH. I thoroughly agree with the proposition that one of the damages of inflation is the great difficulty it imposes upon business of getting the necessary funds to maintain it.

Senator MALONE. Couldn't you, through an amendment, make it possible to make up the difference before taxes?

Mr. SMITH. That is not contemplated in this bill, Senator.

Senator MALONE. I understand you could not possibly give industry a break. Of course, in reviewing your statement as to the magnitude of the bill, it is a mystery to me how you have collected any taxes up to now. But you seem to do it all right. But now you are correcting these things. Why not take into account the fact that no one, no small business and no big business, can replace its equipment under the depreciation as set forth after it is 2 years old.

Mr. SMITH. Well, a change of the sort that is suggested here has very far reaching implications as a matter of tax policy. If one turns to a measure of what might be called real income instead of the monetary measure, there are other elements of the income tax that might properly be considered for adjustment to be put into real rather than monetary terms.

Also, the revenue impact of such an adjustment would be very large. That, I think, is beyond the things that we have contemplated for this bill.

I thoroughly agree that the subject is an extremely important one and worthy of careful consideration by everyone, and I assure you we are giving it careful attention.

But I do not have a recommendation, nor would I——

Senator MALONE. Would that be acceptable to the Treasury, an amendment that would allow for the depreciated purchasing power of the dollar for reserves set aside for depreciation before taxes?

Mr. SMITH. No; it would not be acceptable to the Treasury at this time. I say that without prejudice to the general merits of it.

Senator MALONE. Why?

Mr. SMITH. Because of its far-reaching implications as to what is implied, as I have already said, on other measures of taxable income.

Senator MALONE. What other measures?

Mr. SMITH. Well, if one is going to say that there is no income unless the real value of the capital had been recouped——

Senator MALONE. I did not say that.

Mr. SMITH. That is certainly implicit——

Senator MALONE. No, I am asking you a specific question, and you answered in the negative, and I asked why.

Mr. SMITH. I continue, if I may, to say that in our opinion the use of depreciation based on replacement costs is a modification of the universal concept in the income tax that taxable income is related to the flow of dollars regardless of the purchasing power of those dollars.

If there were to be an adjustment for depreciation, I would suppose that it would also be proposed that there be an adjustment for the tax treatment of, let's say, interest on bonds, in which in some instances for certain periods the declining purchasing power of the dollar had been such that the interest itself, which is subject to tax, has not been sufficient to maintain the real value of the capital invested. That is the sort of thing I have in mind when I say that an adoption of a concept of maintaining the replacement of physical assets through tax-deductible depreciation has far-reaching implications.

Senator MALONE. You are making a great admission there, in case you don't know it. That is that you are deliberately short changing industry. You are admitting that the Government is deliberately short changing government bond holders through inflation.

And, of course, they are stealing the money from the taxpayers through inflation. It is a damaging admission.

But this is a specific request in regard to a thing recognized by everyone. Railroads have been here, and trucklines, and I think all the small business will be on your neck within a year, because you are destroying them, and that is just one way of destruction, so that they cannot replace their equipment any way on earth except to go out and sell more stock, which again is in the hands of the Treasury, and Mr. Martin, the Director or Administrator of the Federal Reserve.

Mr. Martin can say tomorrow that you have to put down 100 percent for margin on stock purchased, or he can say 1 percent. And he has lowered it lately. So he controls the stock that can be sold.

You also have your rediscount rate. It is all in the record of last fall. So that right here in Washington you have the destruction of private business, as such, in your hands and I think you are doing a pretty fair job of it.

Mr. SMITH. I, of course, would not agree with that, Senator.

Senator WILLIAMS. Mr. Smith, while we are on this question of depreciation, it has been called to my attention several times that there seems to be quite a dispute between the Treasury and the taxpayers as to the need of setting up salvage value in establishing depreciation rates. And in reviewing the 1954 act and the law, it appears very clear to me that it was the intention of Congress when they passed the law, wisely or otherwise, that there would not be a salvage value set up. And I understand that in certain areas of the country some agents are enforcing the salvage value and in other areas they are not.

Now, what is the policy and what is the law?

Mr. SMITH. The position of the Treasury—and we think quite clearly that this is the proper, and only proper, interpretation of the law—on the basis of long-standing policies is that property will not be depreciated below its salvage value.

Senator WILLIAMS. When you speak of long standing are you speaking of back beyond the 1954 code?

Mr. SMITH. I am, sir.

Senator WILLIAMS. The 1954 code rewrote the depreciation schedule, did it not?

Mr. SMITH. It introduced certain new elements; it did not rewrite the basic schedule.

Senator WILLIAMS. It repealed the old depreciation schedules.

Mr. SMITH. No, sir; it added two new optional methods without modifying the basic provisions.

Senator WILLIAMS. But in the committee report I notice that they set up—first was the straight line method, and second listed was the digit method, and the third was the accelerated——

Mr. SMITH. That is the traditional one we have always had.

Senator WILLIAMS. That is the traditional one. And the second was the digit method, and the third was the declining balance. But Senator Milliken, in presenting the bill to the floor, made it very clear that it was the intention of the committee that anyone electing either of the latter two choices in which there would definitely be a balance, could during the life of that depreciation schedule change to No. 1, whereby the cost would all be recovered. Now, that is in the committee report, and it is also in the statement by the chairman of the committee, and it was adopted by the conference, in their report. I wish you would furnish for the committee the basis of your reasoning otherwise.

Mr. SMITH. I shall be glad to do so, for the record. And may I just elaborate very slightly with reference to the basic problem with which we are confronted where we think we are——

Senator WILLIAMS. I am not speaking of the merits of whether it should or shouldn't, I am speaking of the law, and it seems to me that the regulations of the Department should be based upon the law and the intent of the law as passed and not based upon what you may think about it, I think you will agree on that.

Mr. SMITH. I assure you to the best of our ability our regulations are always based upon the intent of the law where that is clear and unambiguous. I will be glad to furnish that for the record.

(The information requested follows:)

The depreciation allowance for income tax purposes is based upon the generally accepted accounting principle that the income of each year should bear as a part of the cost of earning that income a proportionate part of the exhaustion of the capital equipment used in the business. There has been long-standing recognition that salvage value is a factor in determining depreciation allowances. The regulations under the Revenue Act of 1921 provided that:

"* * * The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the basis of the property determined in accordance with section 204 and articles 1591–1603." (Art. 161, Regulations 65)

Almost identical words appear in section 1.167 (a)-1 (a) of the present regulations under the 1954 Code.

Salvage value is defined in the present regulations as the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. (Sec. 1.1767 (a)-1 (c), Income Tax Regulations)

EXCERPT FROM THE INTERNAL REVENUE CODE OF 1954, REPORT OF THE COMMITTEE ON FINANCE, UNITED STATES SENATE (83D CONG., 2D SESS., REPT. NO. 1622, PP. 26-28).

An important change made by your committee liberalizes the treatment of unrecovered cost at end of service life. A characteristic feature of the proposal declining-balance method under the House bill is that it leaves an unrecovered portion of some 10 to 13 percent of cost at the end of service life. In computing the deduction under the declining-balance method, the depreciation rate is multiplied by the entire unrecovered cost of the asset. While no specific set-aside is made at the end of useful life, this procedure automatically leaves an unrecovered residual at the end of useful life, which in some cases may represent an unrealistically high estimate of salvage value. Where the asset is a single item the amount unrecovered can be deducted as a loss when the asset is sold or abandoned. With respect to a group of items, such as machines, if a taxpayer maintains records of his depreciable assets by year of acquisition he may deduct the entire remaining unrecovered cost of a given year's acquisitions at the time of retirement of the last surviving unit. If the taxpayer does not avail himself of this procedure, he would recover the 10 to 13 percent residual gradually over a long period of years subsequent to the end of the service life.

The unrealistically high salvage value at end of service life is also reflected in a relatively low level of accumulated allowances during the last third of service life. This limiting feature of the declining-balance method lessens its attractiveness. Moreover, since the accumulated allowances under the declining-balance method limit the amount allowable under other methods, this imposes a straitjacket on the use of other methods such as a combination of different straightline rates at different stages of service life. Such other methods may not provide as much depreciation in the early years as the declining-balance method but will insure the full recovery of cost *above the realistic salvage value at the end of service life.* (Italic supplied.)

It seems unfair to delay the writeoff of a significant portion of cost in the manner prescribed by the House bill. This drag on cost recovery due to the automatic residual under the diminishing-balance system would partially cancel its advantages, make it unattractive to some taxpayers, and weaken its effective stimulus to investment. Since the accumulated allowances under the declining-balance method serve as a standard for other eligible methods, the unrealistically high salvage value may thus restrict the use of otherwise acceptable methods.

To deal with this problem and permit greater flexibility of depreciation, your committee has adopted two specific amendments. One liberalizes the provision of the House bill which limits accumulated allowances under other reasonable and consistent methods to the amount of allowances which would have resulted under the declining-balance method. This is done by applying the limitation only during the first two-thirds of service life. The should permit wider use of other methods which permit the full amortization during the late years of a property's life of the entire cost *above realistic salvage value.* (Italic supplied.)

The other amendment allows taxpayers availing themselves of the declining-balance method an option to switch to straight-line depreciation at any time in the life of a property. The straight-line rate would be based on the realistic estimate of remaining life of the property at the time of the switch. Moreover, the rate would thereafter be applied to the depreciated balance of the account at the time of the switch, *less a realistic estimate of salvage value.* (Italic supplied.)

The House bill does not clearly permit the use of the sum-of-the-years-digits method of depreciation. This method results in approximately the same pattern of depreciation as the double-rate declining-balance method, with some differences which disqualify it under the House bill. This method is difficult to reduce to a brief formula but consists of the application of varying rates of depreciation, which are lower each year, to a constant balance in the property account *reduced by estimated salvage.* * * * (Italic supplied.)

Treasury Income Tax Regulations under the Internal Revenue Code of 1954, section 1.167(e)-1(b), relating to the treatment of estimated salvage in case of a change from the declining balance method to the straight line method of depreciation, provide in part as follows:

"(b) *Declining balance to straight line.*—In the case of an account to which the method described in section 167 (b) (2) is applicable, a taxpayer may change without the consent of the Commissioner, from the declining-balance method of depreciation to the straight-line method at any time during the useful life of the property. * * * When the change is made, the unrecovered cost or other basis (less a reasonable estimate for salvage) shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time. * * *"

Senator WILLIAMS. Would you care to comment on that further at this time?

Mr. SMITH. I would like to just say this, that the matter of salvage value has had a variety of meanings in different people's minds. Some people think of it as the scrap value. Now, as to the provision in the law dealing with declining balance and the reference in the committee reports to salvage, I believe from the discussions we had in the Treasury and with various groups in the Congress, dealt with the sort of situation where under declining balance, the entire cost is never fully written off. You get to a line that approaches the horizontal but never exactly reaches it.

Senator FLANDERS. That is an asymptote, mathematically speaking.

Mr. SMITH. Yes. I didn't know whether to throw that in or not. Thank you for doing so, Senator Flanders.

Senator FREAR. If anyone wants to challenge it we have the dictionary here.

Mr. SMITH. On the basis of that asymptotic result of depreciation, where there is simply scrap value——

Senator WILLIAMS. We can understand why the taxpayers are confused when you use such terms as that to describe it.

Mr. SMITH. We have not used these terms in the regulations. On the basis of this treatment where there is barely scrap value, that approximates the remaining depreciation.

Now, we have also been confronted with situations where property is purchased and used for a period of 1 year, and then been sold while it still has very large secondhand value.

Senator MALONE. Would you call that obsolescence?

Mr. SMITH. No; I would say, in these instances, the value, the market value does not approach zero or anything like it in 1 year.

Senator WILLIAMS. Did we not have a safeguard whereby if the property was sold and was not purchased and used in the line of business, regular line of business, that it could be recovered and it was taxable?

Mr. SMITH. Yes.

Senator WILLIAMS. Straight income?

Mr. SMITH. No; the distinction there is that it is taxable at the capital gains rate. So that there is an advantage of being able to write it off as fast as possible against ordinary income, and then recoup it.

Senator WILLIAMS. I was thinking that there was a provision in the law in regard to some of these rental agencies for cars whereby they could not convert it over to capital gain?

Mr. SMITH. No, it is not. The only place that provision exists for the ordinary income treatment on gains is in connection with the 5-year amortization, the emergency certificates for 5-year amortization. That provision does not exist in the various ordinary methods.

Senator WILLIAMS. And there is no salvage value on the 5-year amortization certificates, is that correct?

Mr. SMITH. I think that is correct, though typically only a certain fraction of the total cost is subject to the 5-year writeoff.

Senator WILLIAMS. But to that extent any percentage of the property is subject to the 5-year writeoff, there was no salvage value established either at the beginning or the end?

Mr. SMITH. That is correct.

Senator WILLIAMS. And the only place salvage value comes in is on the ordinary taxpayer who does not put it under the 5-year amortization formula?

Mr. SMITH. Yes. The Treasury position is that the practice of retirement and replacement of the individual taxpayer should be taken into account in determining the useful life, which in turn determines the rate of depreciation.

We think that is a sound policy. It is, if I may use the phrase, a double-edged sword, it cuts both ways. From the standpoint of most taxpayers, if they use property subject to a high degree of obsolescence, even though the physical life may be 10 years, if they use it in a method or have products requiring a degree of precision such that they replace it at the end of 5 years, they should be entitled to take their depreciation on the basis of 5 years. The experience of the individual taxpayers, we think, is significant.

Senator MALONE. Is that provided for in the law?

Mr. SMITH. That is provided for in the regulations, the law is not specific. The law merely says a reasonable allowance, the regulations provide that the experience of the individual taxpayer will be of significance.

Senator MALONE. Will be of significance, but it is up to the internal revenue agent in that State to determine. Is that it?

Mr. SMITH. It is a question of fact in each instance. Inevitably it is a question of fact.

Senator MALONE. Now, as to the obsolescence, suppose a piece of machinery or equipment is judged to be obsolete for its present use, and is sold for a certain amount of money to another company or another outfit in another area or another individual to whom it should be of some use. Then what do you do with it when this new company or individual gets it?

Mr. SMITH. That is a new purchase, and that new company can take depreciation on the basis of its cost spaced over its second life in its particular use.

Senator MALONE. It is the same piece of machinery?

Mr. SMITH. Yes.

Senator WILLIAMS. Mr. Chairman, I won't pursue this further but I would like for the staff to insert in the record at this point an excerpt from the floor statement of the chairman of the Finance Committee, Senator Eugene D. Millikin, dealing with this particular depreciation schedule in the 1954 conference report.

Mr. SMITH. It is a very important area, Senator Williams, to which we have given and are continuing to give careful thought.

Senator BENNETT. It is not your intention that that would be considered as part of the consideration of this particular bill?

Mr. SMITH. No.

Senator WILLIAMS. But since this question has come up in this colloquy I thought it would be well to have the statement inserted in the record.

(The statement referred to follows:)

Mr. MILLIKIN. Mr. President, I shall now discuss some of these provisions. Others are discussed fully in the report.

DEPRECIATION

An important feature of the bill, which benefits both individuals and corporations, is that relating to depreciation. A great deal of complaint has been received about the difficulty which taxpayers are having with the present depreciation allowances.

The House version of the bill continues all depreciation allowable under present law, and in addition grants taxpayers the right, at their option, to use the diminishing-balance method of depreciation at double the rate available under the straight-line method, or to use any other systematic method which does not give greater aggregate charges than those available under the declining-balance method.

The bill, as it passed the House, applies to all types of tangible depreciable assets, including farm equipment, machinery and buildings, rental housing, and industrial and commercial buildings, as well as machinery and equipment. The total amount of the depreciation cannot exceed, as at present, the actual cost of the property, so that the proposed change merely affects the timing and not the total amount of depreciation deductions.

Under the diminishing-balance method of depreciation, a constant rate is applied each year to the remaining unrecovered cost of property. For example, a machine costing $1,000 with a 10-year life would be depreciated at $100 a year under the existing straight-line method. Under the diminishing-balance method, with a rate double the straight-line rate, the depreciation rate would be 20 percent, and in the first year the charge would be $200. In the second year, the 20-percent rate would be applied to the remaining cost of $800—the original cost of $1,000 less the first year's depreciation of $200—with a depreciation charge of $160. In the third year, the charge would be 20 percent of the remaining cost of $640, or $128, and so forth. In the fifth year, the charge would be $81.92, or $18.08 less than that available under the straight-line depreciation method and would continue to decline in later years.

The committee has accepted the House bill with amendments to make it clear that taxpayers who do not elect the new method may still continue under the straight-line method or any other method now providing a reasonable allowance for depreciation. The committee amendment will also permit a taxpayer to shift from the declining-balance to the straight-line method to insure that the entire asset can be written off during its estimated life. In order to prevent a loophole, the new provision is made to apply only to assets with a useful life of more than 3 years. Other changes of a clarifying nature are fully explained in the report.

The new method for depreciation will be available to all taxpayers with depreciable property. It will help farmers in financing their machinery, equipment, and farm buildings. It will be available to manufacturers for their machinery and buildings, and to store owners for their buildings and equipment. It will be available for all forms of rental property, including housing.

More rapid depreciation will have two advantages for taxpayers and for the country's economy. By permitting capital investments to be recovered more rapidly, while the prospects for income and the risks associated therewith can be more clearly foreseen, the existing tax barriers to new investment will be reduced. Furthermore, the more rapid recovery of the cost of an investment will permit new investments to be financed to a greater extent by relatively short-term loans. This is of special importance to small business which is likely not to be in a position to secure long-term loans.

Senator FREAR (presiding). Mr. Smith, will you proceed.

Mr. SMITH. I turn now to my main statement.

In consultation with the joint committee staff, we have carefully reviewed the effective date provisions of H. R. 8381 in order to be certain that there will be no unjustified retroactive application of the proposed changes in the law. We recommend that the effective date of the substantive provisions of the bill which do not deal with unintended benefits or hardships be moved up 1 year so that they will apply to taxable years beginning after 1957 instead of after 1956.

Under the bill the various provisions which would correct unintended benefits and hardships are generally applicable to transactions occurring after November 7, 1956, the date on which the Ways and Means Subcommittee which prepared the bill released the list of unintended benefits and hardships which it was studying.

We recommend that these provisions be made applicable to transactions occurring after December 31, 1956. Special mention should also be made of the provision relating to remainders to related persons in the case of certain charitable trusts, which presently would apply to transfers to trusts made after 1956. Since this provision was not offered in any formal list or bill before June of 1957, we think it appropriate to apply this amendment only to transfers in trust made after 1957. Of course, the many provisions in the bill which are intended merely to clarify the 1954 code should apply as if they were part of the original 1954 code.

The unintended benefits which have developed under existing law have permitted a few taxpayers to avoid paying their share of the country's total tax burdens which the Congress intended and which we in the Treasury Department believe they properly should pay.

Unusual and often artificial transactions which are developed to come within the letter of the law should not be permitted to continue to give unfair tax advantages. As directed by the President, the Treasury Department will continue to review the operation of the tax laws and make recommendations to the Congress for such additional changes as are needed to close loopholes.

In developing methods to close loopholes, we are always anxious to keep to a minimum the restrictions and recordkeeping for ordinary transactions which do not involve abuses. It is necessary to strike the best balance possible between the prevention of unwarranted advantages and undue complications.

Two committee amendments were developed and made on the floor of the House to H. R. 8381 which minimized recordkeeping for transactions which presented little opportunity for abuse. We shall review with care the testimony to be presented in these hearings of the Senate Finance Committee to see whether we shall have any other recommendations for constructive changes in the provisions of this bill.

(The attachment to the statement is as follows:)

EXHIBIT

PROVISIONS WHICH REMOVE UNINTENDED BENEFITS

Section 2: This section eliminates certain inequalities in the operation of the retirement income credit as between community-property and non-community-property States. The elimination of these inequalities is consistent with the purpose of the retirement income credit which was intended to provide a uniform amount of tax-exempt income for retired persons whether they live in community-property or in non-community-property States. One of the purposes of the retirement income credit was to eliminate the discrimination under prior law which resulted from tax exemption for benefits received under social security and certain other retirement programs of the Federal Government while tax was imposed upon benefits received under private retirement plans, upon benefits received under retirement plans of State and local governments, and upon incomes of persons who provide independently for their old age.

There are several important areas of inequality in the case of the retirement income credit under present law. One of these is the earning test which must be met before retirement. The bill removes this inequality by making the retirement credit available only to spouses who were actually employed.

A second inequality of present law arises from the fact that pension income of the husband in community-property States may in part be attributed to the wife. As a result, it is possible for both spouses to claim a credit each based upon $1,200 of retirement income. In a non-community-property State the husband cannot attribute a work-connected pension to his spouse and as a result in such cases only one retirement income credit may be claimed. The bill provides for this problem by permitting work-connected pension or annuity income to be attributed only to the spouse who was actually employed.

A third area of inequality between community-property and non-community-properties States arises in the case of the application of the work test under the retirement income credit. This test requires the retirement credit to be reduced by the earned income in excess of $1,200 ($900 in the case of those under age 65 and receiving governmental pensions and no limitation for those age 72 or more). In community-property States the earned income of the husband is divided equally between the two spouses while in non-community-property States these earnings are attributed only to the husband. This variation in many cases works to the detriment of couples in community-property States and in other cases to those in non-community-property States. The bill meets this problem by attributing this work income only to the person actually employed and who renders the services.

A fourth area of inequality has to do with the requirement that retirement income eligible for the credit be reduced by any tax-exempt pensions such as social security received by the taxpayer. A husband residing in a community-property State who receives a primary social-security benefit can now attribute half of the pension to his wife, so that a smaller amount of social-security benefit is applied to reduce his retirement income. The bill eliminates this advantage by providing that in determining the amount of social security and other tax-exempt pensions received community-property law shall not be taken into account.

Section 3: Under present law dealers in tax-exempt securities can, in effect, write off premiums on such securities against ordinary income even though they are not subject to tax on the income from such securities, in any case where they dispose of the securities within 30 days of acquisition or where the securities no not mature until 5 years from the date of acquistion. The bill changes this treatment by deleting the 5-year rule and by modifying the 30-day rule so that it will apply only where the bonds are disposed of at a gain.

Section 4: This section removes a provision whereby police officials may in effect exclude a subsistence allowance of up to $5 a day from their taxable income.

Section 5: This section defines a dependent in such a manner as to give assurance that a double exemption may not be claimed for a wife on the ground that she is both a spouse and a dependent. It also excludes from the definition of a dependent those living in the household of the taxpayer if their relationship to the taxpayer is an illegal one.

Section 9: Present law provides that both a charitable contribution deduction and an exclusion may not be claimed if the corpus of a charitable trust reverts to the grantor. Taxpayers have been able to avoid this provision by having the corpus revert to persons closely related to the grantor. The bill would make this impossible by expanding the meaning of the word grantor to include such persons.

Section 10: Present law provides for a 2-year charitable contribution carryover, and a net operating loss carryback of 2 years and carryforward of 5 years. The bill makes it impossible for these two carryovers to interact in such a way as to give rise, to a double deduction with respect to the same amount.

Section 11: The bill makes it impossible to claim both an interest and a charitable contribution deduction with respect to prepaid interest where property is donated to a charity. It also makes it impossible for a taxpayer to receive an interest deduction with respect to money borrowed to purchase bonds which in turn are donated to charity subject to the indebtedness just before a date on which interest income would be received.

Section 12: Under present law premiums on bonds which are callable prior to maturity can be written off ratably against ordinary income over the period up to the earliest call date if this date is more than 3 years from the date the bonds were issued. If these bonds are not actually called at this early call date they can subsequently be sold and any gain realized treated as a capital gain even though deductions with respect to the same amount (the premium) have already been taken against ordinary income. The bill stops this avoidance device by eliminating the 3-year call date exception.

Section 14: Where a lessee makes improvements on property he has rented he generally can write off the cost of the improvements over the initial period of the lease, even though the life of the improvements may be substantially longer than this and although he may have the option to renew the lease. The bill in such a case requires the cost of the improvements to be spread over all of the periods for which the lessee can renew the lease, unless the life of the asset is less than this or unless the lessee can establish that it is more probable that the lease will not be renewed than that it will. An associated problem relating to leases between related parties is also dealt with in the bill.

Section 16: Under present law it is possible for corporations to buy and sell stock in periods around dividend dates and claim an 85-percent intercorporate dividend-received deduction with respect to the dividend income while deducting in full against taxable income corresponding loss on the sale of the stock which results by reason of the drop in value of the stock reflecting the dividend paid. The bill eliminates this special advantage by denying a dividends-received deduction for dividend income where the stock is held for only 10 or fewer days; a 90-day rule is provided for cumulative preferred dividends. Also, this provision stops a similar avoidance device involving the 85-percent dividend-received credit where simultaneous long and short positions are maintained over a dividend date.

Section 19: It has been reported that certain tax-exempt institutions are paying some of their part-time employees all or almost all of their compensation in the form of annuities. This would give these employees a special advantage if the tax on this full amount could thereby be deferred until they begin receiving their pensions. The bill limits to 20 percent the portion of the compensation, which, for tax purposes, can be treated as deferred income. It also deals with a similar problem relating to forfeitable annuities of tax-exempt organizations where the employee at some later time prior to retirement obtains a nonforfeitable right to these amounts, by providing for a tax when the right to the annuity becomes nonforfeitable.

Section 22: Present law provides capital-gains treatment and tax deferment for employees restricted stock options where the option price is within 85 percent—or 95 percent—of the value of the stock at the time the option is granted. So-called variable price options have unintentionally been given more favorable treatment. The bill denies this capital gains and deferred tax treatment to variable price options in which the price may be determined by reference to the value of the stock before the option is exercised when such value is higher than the average value of the stock during the month the option is exercised.

Section 23: Under present law income from installment obligations generally may be deferred for tax purposes until the obligations are collected. Usually where these installment obligations are transferred before collection, the unpaid balance is taxable at the time of this transfer. However, in limited situations, such as where these obligations are transferred to corporations controlled by the person making the transfer, the tax is further postponed until the transferee collects the installment obligations. Where the transferee is a life-insurance company no tax is collected because this is a type of income not taxable to life-insurance companies. The bill removes this unintended benefit by providing that where installment obligations are transferred to life-insurance companies, gain on the obligations is to be recognized. Related problems are also dealt with involving transfers of these obligations to partnerships of which a life-insurance company is a member and involving their transfer to companies which in the next year become life-insurance companies.

Section 24: If taxpayers change their method of accounting, present law generally provides that certain adjustments must be made in the year of transition to prevent certain income from being taxed twice and other income from being omitted from tax entirely. However, it appears that under the 1954 Code, to the extent these adjustments relate back to years before 1954, these adjustments are not to be made. The bill requires these adjustments, attributable to years before 1954, to be made if the change in method of accounting is initiated by the taxpayer. However, these adjustments if they require an increase in income may, for tax purposes, be spread out over a period of as much as 10 years.

Section 34: Because capital-gain income of regulated investment companies can be passed on down to the stockholders and taxed only to them, it is possible for dealers in these securities to purchase stock of regulated investment companies just before a capital-gain dividend becomes payable. They then may treat the dividend received as a capital gain while receiving ordinary loss treatment on any loss resulting from the sale of this stock. The bill provides that where a taxpayer holds such stock for no more than 30 days, instead of receiving ordinary loss treatment in the case of the sale of the stock, such a loss is to be treated as a long-term capital loss. A somewhat similar problem is also dealt with in the case of taxpayers other than dealers.

Section 41: If the sale of broadcasting property is certified by the Federal Communications Commission as being necessary or appropriate to carry out its policies, present law provides for deferral of tax on any gain upon appropriate reinvestment of the proceeds, or permits the taxpayer to reduce the basis of other property by the amount of gain. On occasion, taxpayers have purchased additional facilities knowing that they will have violated the FCC rules fixing a limit on the number of facilities they may own. By so doing it was possible for them to obtain a tax deferment on the sale of an old and unwanted facility. FCC by administrative action taken in 1956 restricted its certifications to those cases where the disposition of the property is required because of a change in FCC policy or rules. The bill changes the present law to accord with this administrative action taken by FCC.

Section 42: Where bonds are issued with an artificially large discount and then redeemed at par, or a call price before their maturity date, the entire difference between the issue price and redemption price can be claimed by the corporation issuing the bond as a deduction against ordinary income, although the bondholder obtains capital-gains treatment with respect to has gain in excess of the portion of the discount attributable to the period up to the time of the redemption—or sale prior to redemption. Since one taxpayer in this case receives a deduction against ordinary income, the bill provides that any gain, to the extent of the original issue discount, is to be treated as ordinary income at the time of the sale or redemption of such a bond.

Section 43: Cases have arisen where taxpayers create artificial capital gains by buying bonds with detached interest coupons which are payable within 12 months from the date of purchase. Present law in such cases provides capital-gains treatment with respect to the rise in the value of the bond which is caused by the passing of the period to which the detached interest coupons relate. The bill prevents this conversion or ordinary income into capital gains by providing ordinary income treatment for gains attributable to discounts arising from detached interest coupons whether or not the detached coupons are attributable to the period of 12 months or less after purchase of the bond.

Section 44: Section 1233 of the 1954 Code prevents taxpayers from using the device of short sales as a means of converting what are really short-term gains into long-term capital gains. One of the rules by which this is accomplished is the rule that if at the time of a short sale the taxpayer has held for less than 6 months property substantially identical to that sold short, the holding period of the substantially identical property will start anew at the time the short sale is closed. However, this rule applies only if the property used to close the short sale is a capital asset in the taxpayer's hands, and dealers in securities have been able to avoid this holding period rule by closing a short sale with property held for sale to customers instead of property held in their investment account. Section 44 of the bill will make the holding period rule apply in the case of a short sale by a dealer who has held similar investment securities for less than 6 months but only if the short sale is not closed for more than 20 days after it was made. This section of the bill also adds a new subsection to exclude hedging operations in commodity futures from the operation of the short sales provision.

Section 46: Present law provides capital-gains treatment for an inventor who sells his patent to a corporation, if he—or a closely related person—does not own more than 50 percent of the stock of the corporation and otherwise qualifies for the special captal-gains treatment for patents. The bill reduces the area in which the capital-gains treatment is to be available by restricting it to those cases where the inventor sells his rights to a patent to a corporation in which he does not own as much as 25 percent of the stock. Other technical changes are also made in this provision.

Section 51: Present law provides that where taxpayers have received amounts from the United States with respect to claims against the Government which have remained unpaid for more than 15 years and which involve acquisitions of property by the Government, the tax is not to exceed 30 percent of the amount received. The bill makes this provision inapplicable with respect to claims filed after December 31, 1956, and makes the 30-percent limitation apply only in the case of the surtax with respect to amounts paid by the Government in 1957 and futrue years with respect to claims filed before 1957.

Section 52: Present law provides proprietorships and partnerships under certain conditions with the option to be taxed as corporations. The bill repeals this provision. It also provides flexible rules to provide that elections under this provision will not be binding for past periods.

Section 60: The bill, in order to obtain better reporting of taxable income with respect to income earned abroad, requires that in determining whether a taxpayer has the $600 or more of gross income which would necessitate his filing a return, income earned abroad is to be taken into account, even though this income may be excludable income for tax purposes.

Section 63: This provision in general provides that more of the information which is presently filed by tax-exempt organizations is to be made available for public inspection. Subject to limitations as to the disclosure of information which might be harmful to the organization or national defense, the bill provides that the applications for exemption of educational, charitable, and religious organizations and other exempt organizations described in section 501 (c) and (d) are to be made available for public inspection along with supporting data presented by the organizations. The bill also provides that the annual information returns now filed by certain educational and charitable organizations, in the portion available for public inspection, shall show the total contributions and gifts received during the year.

PROVISIONS WHICH REMOVE UNINTENDED HARDSHIPS AND WHICH GRANT BENEFITS

Section 6: In Oak Ridge, Tenn., and Richland, Wash., where practically all of the real estate was either purchased or leased from the Atomic Energy Commission, the persons so acquiring real estate are required to pay the Commission or its agents for services usually rendered by a municipality. These payments are not taxes, however, and, therefore, are not deductible for income tax purposes by the persons living in these communities. The bill treats payments of this type as if they were taxes and thus makes it possible for the residents of these communities to deduct these amounts in computing their income taxes.

Section 13: The net operating loss deduction under the 1954 code more nearly follows what has been referred to as the statutory income concept rather than the economic income concept of the 1939 code. Present law provides that where a year begins in 1953 and ends in 1954 the allowable loss consists of a portion of a loss computed under the 1939 code rules, and a portion computed under the 1954 code rules, depending on the portion of the fiscal year falling in each of these 2 calendar years. This rule of proportion works under present law where the loss originates in 1 of these 1953–54 years, but it does not provide for a proportioning between the 1939 code and the 1954 code rules where a loss is carried to, or through, 1 of these 1953–54 fiscal years. The bill extends this treatment to losses carried to, or through, these years.

Section 25: Present law provides that where a pension trust and certain other tax-exempt organizations makes loans without adequate security to the creator of the organization, such as an employer corporation, a prohibited transaction is deemed to have occurred and the organization loses its tax-exempt status. The purchase of debentures of the employer by a pension trust constitutes a prohibited transaction because debentures are not secured. The bill provides that the purchase of a debenture of an employer corporation by a pension trust is not to be deemed to be a prohibited transaction if certain specified conditions are met. Certain of these conditions are designed to give assurance that the purchase was made in an arm's length transaction at a fair market price. Other conditions that must be met are that not more than a quarter of the assets of the pension trust are invested in the bonds of the employer; that the trust purchases not more than 25 percent of any debenture issue of the employer; and that loans subsequently made by the employer will not be given more favorable treatment from the standpoint of collateral.

Section 31: Changes made in percentage depletion rates by the 1954 code were effective, in the case of fiscal year taxpayers, with respect to years beginning after January 1, 1954. The bill permits fiscal year taxpayers to apply the percentage depletion rates specified in the 1954 code to that portion of a 1953-54 fiscal year which follows December 31, 1953.

Section 32: The 1954 code defines the word "property" for purposes of computing the percentage depletion allowance in the case of coal and other mineral resources. Taxpayers have contended that this definition is more restrictive than the definition of property followed by the courts under the 1939 code and have urged that the rights which they claim to have had under the 1939 code be restored. The bill, therefore, provides that a taxpayer may, if he chooses, elect to determine what constitutes a "property" as if the 1954 code definition had not been enacted and as if the 1939 code rules still applied.

Section 37: Present law limits on a country by country basis the credit which may be claimed for foreign taxes to the same proportion of the United States tax—before the credit—which the income in the foreign country represents of the total income from all sources. The bill provides a 2-year carryback and 5-year carryforward for foreign taxes which cannot be claimed as credits against the United States tax because of the per country limitation.

Section 53: Under present law the time allowed for claiming a credit against the Federal estate tax for death taxes paid to States varies in certain cases according to whether a disputed amount of Federal estate tax was initially paid and then a claim for refund filed, or whether the case was taken directly to the courts without paying the disputed amount. The bill amends the statute to provide that credits for State death taxes can still be claimed if these taxes are paid within 60 days after the Treasury has notified the taxpayer of the disallowance of his claim for refund or within 60 days after a final decision by the court acting on such a claim.

Section 54: Present law provides for the postponement of the payment of Federal estate tax on reversionary or remainder interests until 6 months after the termination of any prior interest. State and foreign death taxes in such cases are allowed as credits if they are paid and credits are claimed for them within 60 days after the termination of the prior interest in the property. The bill permits the Secretary of the Treasury to extend the 6 month period for as much as 2 additional years, and to allow the payment of State and foreign death taxes and the claiming of credit therefor in the extension period.

Section 56: The bill provides that the mere designation of a survivor beneficiary in the case of qualified pension, profit-sharing, and stock-bonus plans is not to result in the imposition of a gift tax if the survivor benefits are of such a nature as not to be includible in the employees gross estate for estate-tax purposes. Thus, the gift tax will not apply in such cases to the extent an annuity or pension under a qualified plan is attributable to contributions made by the employer. It will continue to apply, however, to the extent the annuity is attribuable to contributions of the employee.

Section 71: Under present law situations can arise where, even though underpayments and overpayments of tax offset each other, the Internal Revenue Service collects more interest than it pays, or vice versa. With appropriate limitations where no interest is payable, the bill eliminates these erratic differences by terminating interest both as to overpayments and underpayments during any period of time to the extent these payments offset each other. This provision also provides for similar situations arising with respect to net operating loss carrybacks in transition years affected by the 1954 code.

Section 75: Existing law provides that no alien may leave the United States until he has procured a certificate indicating that he has complied with all the obligations imposed upon him by the income-tax laws. The bill provides that the Secretary may by regulations make exceptions to this rule. In addition, the bill provides that the payment of taxes not yet due, or furnishing of a bond with respect to these taxes, by a departing alien will not be required if the Secretary determines that the collection of tax is not jeopardized.

Section 80: For taxable years prior to 1952, the Internal Revenue Service provided that where lessees contracted to pay a rental to a lessor, plus any Federal income taxes of the lessor attributable to this rental income, only the rent plus the initial tax on the rent was includible in the lessor's income. Any additional tax of the lessor (attributable to the initial tax on the rental income) paid by the lessee was not to be included in the lessor's income. However, for the period from 1952 until the adoption of the 1954 code, a pyramiding of the lessor's taxes was required in such cases. The 1954 code provided a new rule to the effect that the lessor is not to include in his income any income taxes paid on his behalf by the lessee but that these taxes also are not to be deductible to the lessee. The bill does not affect the 1954 code rule but extends the pre-1952 rule to all years coming under the 1939 code; that is, it extends it to the years 1952 and 1953.

Sections 81 and 82: Prior to 1942 railroads generally used the retirement method of computing depreciation on their roadway assets, which include buildings, bridges, tunnels, water towers, and the like, but not rolling stock or roadbed or track. Under the retirement method the cost of an asset, less salvage value, is charged against income at the time of its retirement. Since 1942 most railroads have been permitted to change to the straight line method of computing depreciation provided they established a reserve based on depreciation they would have sustained under the straight line method prior to the date of changeover. Generally, this was 30 percent of the cost of roadway assets. The effect of requiring a 30 percent reserve was to permit depreciation on a straight line basis over the remaining life of the property equal to 70 percent of the cost of the assets. Section 81 of the bill provides the following tax consequences for taxpayers who changed from the retirement method to the straight line method for any taxable year beginning after December 31, 1940, and before January 1, 1956, if they elect to be governed by the amendment:

With respect to taxable years beginning after December 31, 1955, in lieu of a depreciation reserve of 30 percent the reserve will be based on depreciation sustained before March 1, 1913, plus depreciation computed on the basis of the 30 percent reserve requirement for the years after the changeover to straight line depreciation and before the first taxable year beginning after December 31, 1955.

With respect to the period between the taxpayer's changeover to straight line depreciation and his first taxable year beginning after December 31, 1955, the computation of depreciation on the basis of a 30 percent reserve is binding. No refunds for that prior period.

The 30 percent reserve can be adjusted, however, for prior years for purposes of computations under the World War II excess-profits tax. The adjustments permitted will increase the excess profits tax credit and decrease the income subject to the excess profits tax.

Section 82 of the bill a companion section which I would like to refer to at the same time, which is not elective, applies to any taxpayer who has acquired property of a railroad corporation in a receivership or bankruptcy proceeding if the corporation transferring the property to the taxpayer used the retirement method of computing depreciation and the acquiring corporation, the taxpayer, adopts any other method of computing depreciation. The tax consequences of the application of this section are substantially the same as those described in connection with section 81.

TECHNICAL PROVISIONS

Section 7: This provision deals with worthless securities and affiliated corporations and corrects a grammatical error.

Section 8: This provision deals with the scope of nonbusiness bad debts. It makes it clear that a business bad-debt deduction cannot be claimed for a debt which was not originally created or acquired in connection with a trade or business of the taxpayer claiming the deduction.

Section 15: This provision relates to the income-tax deduction in a decedent's last return for medical, dental, etc., expenses which are paid out of his estate in the year following death. However, to obtain this deduction a statement must be filed indicating that this amount was neither claimed nor allowed as a deduction for estate-tax purposes. The bill allows the income-tax deduction for these expenses so long as the statement filed indicates the deduction was not allowed for estate-tax purposes regardless of whether such a deduction was claimed, and thus conforms this provision with the provision allowing such expenses to be deducted, as an alternative, in computing the income of the decedent's estate.

Section 17: This provision relates to property received in a transaction described in section 358 where the transaction may be regarded as two separate exchanges. The bill provides that in such cases there is to be a reduction in the basis of the property received, to the extent of the amount of any loss recognized to the taxpayer upon the exchange.

Section 18: This section deals with the 1954 code rules relating to sales of stock to related corporations. These rules became effective as of June 22, 1954. The bill makes it clear that the 1939 code provisions are applicable in determining the extent to which property received on an acquisition of stock is to be treated as a dividend in the case of any acquisition of stock involving redemption through the use of related corporations if this occurred before June 22, 1954. The 1939 code provisions are also to apply to acquisitions of stock which occurred between June 22, 1954, and December 31, 1957, if the taxpayer was under a contract entered into before June 22, 1954.

Section 20: This provision relates to contributions of employers to employees trusts or annuity plan, and corrects an error in punctuation.

Section 21: This section relates to employee stock options granted by parent or subsidiary corporations. It provides that for the purpose of determining whether an individual is, or has been, an employee of a parent or subsidiary corporation of the corporation which granted an option—or issued or assumed such an option—the term "employer corporation" is to be treated as if it were the "grantor corporation"—or corporation issuing or assuming the stock option.

Section 26: This provision relates to the tax on corporations improperly accumulating surplus. It eliminates the possibility of any double deduction through a charitable contribution carryover for purposes of the accumulated earnings tax (an unlimited charitable contribution deduction is allowed in computing accumulated taxable income and so no carryover is needed), and also eliminates the possibility of any excessive deduction with respect to capital gains and the taxes on these gains.

Section 27: This section relates to the tax on personal holding companies. It makes it clear that for purposes of the personal holding company tax no carryover of charitable contributions is to be allowed. It also provides that the net operating loss deduction for personal holding companies is not to take into account the dividends-received deduction and other deductions provided for corporations generally but not allowed in computing personal holding company income.

Section 28: This provision makes three changes in the tax on foreign personal holding companies. In general, foreign personal holding company income is included in the gross income of the United States stockholders. This provision, first, makes it clear that in computing this income no carryover of charitable contributions is to be allowed; second, prevents a double deduction for partially tax-exempt interest; and, third, provides that the net operating loss deduction available in the case of foreign personal holding company income is not to take into account the dividends-received deduction and other special deductions provided for corporations generally but which are not allowed in computing foreign personal holding company income.

Section 29: This provision relates to losses of banks with respect to bonds and other evidences of indebtedness. It corrects an inadvertent error in the 1954 code by which ordinary loss treatment may be denied with respect to retirements on mortgages and other evidences of indebtedness issued by corporations or governmental units without interest coupons and not in registered form.

Section 30: This provision relates to the depletion allowance in the case of estates and corrects the misspelling of the word "devisees."

Section 33: This section is concerned with the qualifications which must be met by investment companies furnishing capital to development corporations if these investment companies are to obtain regulated investment company treatment. This provision corrects a reference in the present code to "not earlier than 60 days" to "not less than 60 days." This language restores the 1939 code rule which was inadvertently changed. A typographical error is also corrected in this provision.

Section 35: Under present law lump-sum distributions under "trusteed" employee pension plans are subject to a 30-percent tax when received by a nonresident alien not engaged in a trade or business within the United States. Such payments also are subject to a withholding tax at their source. However, neither the 30-percent tax nor the withholding at source are applicable if the lump-sum payments are made under an "insured" employee pension plan. The bill provides the same treatment for payments made under an "insured" employee pension plan, as present law already provides in the case of lump-sum payments made under "trusteed" employee pension plans.

Section 36: Section 871 (a) of the code imposes a tax of 30 percent of the gross amount of certain items of income received by nonresident aliens not engaged in trade or business in the United States. However, if the individual's income from these sources exceeds $15,400, section 871 (b) provides that the alien is to pay the regular income tax if this is more than 30 percent of the gross amount received from the specified income sources. However, the 30-percent tax imposed by section 871 (a) is not reduced by the 4-percent dividends-received credit or the $50 dividend exclusion, but this credit and exclusion are available where a 30-percent tax is applicable under section 871 (b). Thus, a lower tax may be achieved under subsection (b) than under subsection (a). The bill prevents the use of the credit and exclusion to reduce the tax under subsection (b) below the 30-percent tax under subsection (a). An amendment is also made to deny the credit for partially tax-exempt interest in computing the taxes imposed under sections 871 (a) and 871 (b).

Section 38: In connection with an exchange of property described in section 1031—property held for productive use, section 1035—insurance policies, or section 1036—stock for stock of the same corporations, a taxpayer, in addition to transferring property of the type permitted to be exchanged free of tax, may also exchange other property with respect to which the taxpayer will be able to claim a loss. The bill makes it clear that there is to be a decrease in the basis of the property received to reflect any such loss.

Section 39: In connection with the involuntary conversion provision, reference is made to the acquisition of control of a corporation holding property similar to that which was compulsorily or involuntarily converted into money. The 1954 code contains no definition of control of a corporation for this purpose. The bill restores the 1939 code definition which defines control as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Section 40: The section of present law providing that property acquired before March 1, 1913, is to have a basis at least equal to its fair market value as of March 1, 1913, inadvertently refers to only one part in subtitle A relating to income taxes. The bill corrects this reference so that it refers to the entire income-tax subtitle.

Section 45: This provision rearranges and clarifies the existing tax treatment provided with respect to options to buy or sell. The bill provides that the gain or loss arising from an option to buy or sell property is to be considered gain or loss arising from property which has the same character as the property underlying the option. The section also adds certain clarifying exceptions with respect to the general rule for options: First, it is made clear that capital-gains treatment will not apply to dealers in options where the options are a part of their inventory; second, it is made clear that the section does not apply to gains on the sale of an option in any case in which the income derived in connection with the option would, without regard to this section, be treated as ordinary income; and, third, it is made clear that the section does not apply to gain attributable to the sale of options acquired before March 1, 1954.

Section 47: Present law provides that under certain conditions real property which has been subdivided in order to be sold in separate tracts will not be considered property held for sale to customers, with the result that these sales will be eligible for capital-gains treatment. The bill makes it clear that this treatment is not to be available in the case of property previously held for sale to customers by the taxpayer nor is it to apply in the case of property sold in the same year in which the taxpayer is a dealer in real estate, whether or not the particular property in question was held for sale to customers.

Section 48: Under the 1939 code the provision relating to gains from the sales of certain property between spouses or between an individual and a controlled corporation did not apply to sales or exchanges made on or before May 3, 1951. This date which was unintentionally omitted from the 1954 code is restored by the bill.

Section 49: This section relates to certain adjustments to be made for closed taxable years. The bill makes it clear that after a refund or deficiency has been paid with respect to an adjustment in a closed year where the same item has been adjusted by agreement between the Government and the taxpayer in an open year, neither the Government nor the taxpayer may later raise any unrelated adjustment in the closed year.

Section 50: In connection with the provision of present law relating to the computation of tax where a taxpayer restores a substantial amount held under claim of right it is not clear that if the tax for the year of restoration is computed by reducing it by the tax attributable to the item in a prior year, the deduction, which is not taken into account, is not to have any effect for purposes of the net operating loss carryback or carryforward. The bill makes it clear that the deduction is not to be taken into account in computing income except for the computations under the claim of right provision itself.

Section 55: This section relates to the exemption under the estate tax for the value of an annuity or other payment receivable by a beneficiary under an employee's trust or a retirement annuity contract. In the case of retirement annuity contracts reference is made only to those purchased by an employer under a nontrusteed plan which "meet the requirements of section 401 (a) (3)." However, a qualified nontrusteed employee annuity plan must for income-tax purposes also meet the requirements of section 401 (a) (4), (5), and (6). The bill makes these qualifications also applicable in the case of section 2039 (c).

Section 57: This section relates to agreements entered into by domestic corporations for the purpose of extending old-age and survivors insurance coverage to service performed for certain employees of foreign subsidiaries. The bill corrects a typographical error in the heading of this provision.

Section 58: This section relates to the collection and payment of employment taxes with respect to Coast Guard exchanges. The bill corrects an erroneous reference.

Section 59: This section relates to acts to be performed by agents in the case of employment taxes. The bill corrects an erroneous reference.

Section 61: This provision relates to the limitation on the election to make a joint return after filing a separate return. The bill corrects an erroneous cross-reference.

Section 62.: Present law provides that if an individual files his tax return on January 31—or February 15 in the case of farmers—of the succeeding taxable year the return will serve as a substitute for a declaration or an amended declaration required to be filed on January 15. The bill makes it clear that where the individual makes his return on a fiscal-year basis, appropriate dates having the same relationship to his taxable year are to be substituted for the reference to January 31, or February 15, as the case may be.

Section 64: This provision relates to address for notice of deficiency in the case of income and gift taxes. The bill corrects an erroneous reference.

Section 65: This provision amends the code to make it clear that the Secretary may release property subject to special liens for estate- and gift-tax purposes if the liability with respect to these taxes has been fully provided for. This restores the 1939 code rule which was inadvertently omitted from the 1954 code.

Section 66: This provision corrects certain sections of the code by changing reference to "United States district attorney" to "United States attorney" to conform with presently established nomenclature.

Section 67: This provision amends a section of the code relating to the conveyance of title to correct a grammatical error in the heading of the provision.

Section 68: Present law provides that executors and corporations contemplating dissolution may request prompt assessment of any income tax due from a decedent or the corporation. Such assessment must be made within 18 months except in case of fraud, willful evasion, or failure to file a return. The bill will permit a later assessment also where the assessment is based upon the omission of amounts representing 25 percent or more of gross income or upon a failure to file a personal holding company information schedule. The bill also makes it clear that a request for prompt assessment may be made not only by a corporation contemplating dissolution, but also by one in the process of dissolution or one which is already dissolved.

Section 69: The bill makes it clear that, where an organization in good faith determines that it is an exempt organization and files an information return, this return is to be deemed its return for purposes of the running of the period of limitation on assessments and collections not only where the organization is technically a corporation but also where it is a trust. This section of the bill also amends the code to assure the continuation of the 1939 code rule that a tax deficiency attributable to the application of a net operating loss carryback may be assessed at any time prior to expiration of the assessment period for the year in which the loss was sustained.

Section 70: This section provides that the period for filing a claim for refund is to be 3 years from the time the return was actually filed rather than 3 years from the due date of the return, as presently provided. This section also provides that, where a return was filed after the due date, under an extension of time for filing, and a claim is filed within 3 years after the return was filed, amounts to be refunded include not only payments made within the 3 years preceding the date of the claim but also those made within 3 years plus the period of extension for filing the return. This section further provides that the special period of limitation for filing a claim for credit or refund with respect to net operating loss carrybacks in the case of individuals is to be extended from the 15th day of the 39th month after the end of the loss year to the 15th day of the 40th month after the end of such year.

Section 72: This section provides expressly that interest may be assessed and collected at any time during the period within which the tax to which it relates may be collected. This removes any basis for contending that interest, to be collectible, must be assessed within the limitation period for the assessment of the tax on which the interest has accrued.

Section 73: This provision amends the code to remove any basis for contending that the penalty for failure to file information returns can be avoided by filing these returns after the due date. The application of this section has been limited to information returns for which a fixed due date is prescribed by regulations.

Section 74: This section makes it clear that in the case of income, estate, and gift taxes, for purposes of measuring a deficiency in tax, the tax shown on a return is to be taken into account if the return was filed on the last day prescribed for filing, as well as in cases where it was filed before such date.

Section 76: This section makes it clear that the Government may make immediate assessment of a deficiency upon the filing of a petition by the taxpayer in a proceeding under the Bankruptcy Act even though approval of the petition is not required by that act. This provision also makes it clear that a petition for redetermination of a deficiency by the Tax Court is not to be filed after the filing of a petition by the taxpayer in a proceeding under the Bankruptcy Act where approval of the petition is not required by the act.

Section 77: This section amends the code to provide that wherever the use of registered mail is presently required, either certified or registered mail may be used. In addition, the Secretary is authorized to prescribe by regulations the extent to which the provisions of the code requiring prima facie evidence of delivery and regarding the postmark date, now applicable to registered mail, are also to apply in the case of certified mail.

Section 78: This section grants the Secretary the authority to utilize the service of Federal agencies and commercial organizations for the processing of microfilm and other reproducing materials. The actual photographing of the returns and other records will be performed only by Government employees. The Secretary in this connection will issue regulations providing safeguards against unauthorized use of microfilm or other reproductions and unauthorized disclosure of information contained in these films or reproductions. The provision also provides that the microfilm and other reproductions are to have the same legal status as the original documents, and if properly authenticated are to be admissible in evidence as if they were the originals.

Section 79: The bill adds a new section to the code authorizing the Secretary to prescribe individual seals for district directors of internal revenue and for other officers and employees of the Department to whom functions of the Secretary are delegated. It also provides that judicial notice is to be taken of these seals if facsimilies are published in the Federal Register.

Mr. SMITH. That concludes my prepared statement, Senator Frear. I should just like to note that the exhibit which is attached has a description section by section which was very largely adopted, in fact, to a very considerable extent it is a verbatim reproduction of, the statement made on the floor, or rather the material inserted into the record on the floor, by the chairman of the Ways and Means Committee in explanation of the bill. We have worked closely with the Joint Staff and with the Ways and Means Committee on this, and this represents a combined statement and explanation.

Senator FREAR. Did you say you had a couple of reservations? Do you want to identify those reservations?

Mr. SMITH. The only reservation I had was with reference to 37 which I have already referred to.

Senator CARLSON. Mr. Chairman.

Senator FREAR. Senator Carlson.

Senator CARLSON. Dr. Smith, I would like to have you discuss section 42 in your prepared statement. I am not sure I understand what you want to do there.

Mr. SMITH. Might I refer you, Senator, to the exhibit. I would like to read that one paragraph statement, and then elaborate on it.

Section 42. Where bonds are issued with an artificially large discount and then redeemed at par, or a call price before their maturity date, the entire difference between the issued price and redemption price can be claimed by the corporation using the bond as a deduction against ordinary income, although the bondholder obtains capital gains treatment with respect to his gain in excess of the portion of the discount attributable to the period up to the time of the redemption or sale prior to redemption. Since one taxpayer in this case receives a deduction against ordinary income, the bill provides that any gain, to the extent of the original issue discount, is to be treated as ordinary income at the time of the sale or redemption of such bond.

Let me try to elaborate that with the action that was taken in the 1954 code, when we dealt with the problem as we then saw it.

We had become aware by 1954 of a practice by which bonds were sold at an artificially large discount. For example, if the going market rate were 3 percent, a 2 percent coupon bond of course, would sell at very considerably less than par at a price which, with the interest and the appreciation to maturity, would be the given market rate, the 3 percent rate.

Senator CARLSON. You are referring to corporation bonds?

Mr. SMITH. I am referring to corporation bonds, or mortgage bonds, or any sort of private transaction bonds.

Now, it was our feeling, then, that that made it possible under the then law to bring under the capital gains element of the law income which really was interest, compound interest.

Therefore, we recommended in the House that there be a limit put upon the amount of original issue discount which could be permitted without having part of the discount brought into ordinary income rather than capital gains. As I recall the figure, it was one-quarter of 1 percent per year, which for a 20-year bond permitted issuance at 95.

Now, because coupons cannot always be carried out to the exact fraction representing the going market rate of interest, it is the practice in issuing bonds to have a coupon rounded usually to the nearest quarter of 1 percent, and then sold either at a premium or a discount below that.

That sort of ordinary market practice we did not feel should be interfered with; there was no significant abuse. So our recommendation was designed to the then abuse situation.

Senator FREAR. The Chair very much dislikes to interrupt the speech by the representative of the Treasury, but you may have noticed that the chairman of the committee is absent, and I am sure you will be interested in an important announcement that has just been made, it is over on the ticker. Senator Byrd has announced that he will be a candidate for reelection.

Senator MARTIN. May I break in a moment, Mr. Chairman?

Senator FREAR. You surely may.

Senator MARTIN. Mr. Chairman, from an American standpoint that is wonderful news. I am going to talk a little franker with the Senator not being present.

Senator Byrd was on this committee when I first came here over 11 years ago. He has been one of the most tireless workers on this important committee. Senator Byrd and I have not always agreed, but I have appreciated the soundness of his position, even if it was contrary to my own.

I do not think there is a man in Congress that has as full a knowledge of the tax laws of this Nation and the general economic condition of our country and the things that affect the general economy of the Nation as Senator Harry Byrd.

I have been talking to him ever since he made his announcement, and his reasons for not being a candidate were very good indeed. But I am so glad that he has reconsidered. And when you consider that the legislature of the great Commonwealth of Virginia unanimously requested that he be a candidate, I think it is one of the finest compliments that any American has received in a long while.

Senator FREAR. I am sure the chairman of the committee will appreciate those gracious remarks by the ranking minority member, and I know they are sincere.

The acting chairman of the committee will also say for the record that it has been a great pleasure, as well as an education to him, to have served under such a great statesman and one who has protected the interests of all Americans.

Senator Williams?

Senator WILLIAMS. I was just going to add, Mr. Chairman, that the decision of Senator Byrd to remain in the Senate is far more important to the country than any action we may take on the pending legislation, so I think we can afford to take some time out to pay our compliments.

Senator CARLSON. I will continue. We were in a discussion on this section 42 which deals with the taxation of bonds, corporation bonds, that have had a great appreciation in value.

Now, if the doctor has another statement to make on it, then I want to lead off somewhere else.

Mr. SMITH. I have not quite completed my statement, Senator Carlson. The action that was taken in 1954 dealt with situations where bonds were issued with artificially large discounts and built up value with the passage of time, as they inevitably would when they have a low coupon at the time the market rates are higher and were carried to maturity.

Now a new practice has developed. This is of very, very limited application. I know of no major corporation that has done anything of this sort. It is what you might call a closely controlled internal financing type of situation where the bonds are issued at a very large discount, perhaps a $1,000 bond issued for $600 or $700 bearing only nominal interest, and then a year or two later is redeemed at par.

Now, under the letter of the law as it stands, that is treated as capital gain. It seems to us that that should not be capital gain. That is completely, in our opinion, an artificial, abnormal transaction designed to come within the letter of the law but to fall outside of the spirit of the law.

Senator CARLSON. Doctor, if you do not mind, I want to give you a case that is pending right now in the State of Kansas. A taxpayer writes me that some years ago he purchased a few shares of preferred stock in a corporation. They transferred this preferred stock to bonds within the last 2 or 3 or 4 years. The Treasury is holding that, although the preferred stock was transferred at the same dollar value—in other words, the preferred stock had a dollar value when the transfer was made, the bonds have the present value today of the preferred stock—that the taxpayer should pay a capital gains tax on the amount of the difference between the amount that he purchased these preferred stocks for which have been transferred to bonds, although there has been and is not today any change in value.

Mr. SMITH. That, I think, is correct, Senator Carlson. I might add that that has no bearing whatsoever on this. This would not influence it.

Senator CARLSON. I understand that.

Mr. SMITH. That provision arises out of a very long-standing provision of the law that where an equity interest in a company is converted into a cerditor interest in a company, where there has been a stepping up from equity owner to creditor, that that is a realization of gain.

I think that that basic provision is a necessary one to prevent what has been referred to in the street as a bail-out type of situation.

You will recall that in the 1954 code one of the main loopholes closed was the preferred stock bail-out whereby a preferred stock dividend was issued tax-free on common stock and shortly thereafter redeemed, the stockholders staying in the same position as they had been previously as regards the full ownership of the common stock, but money had come out of the corporation from earnings, had gotten into the hands of the individuals, and they had gotten that out on a capital gains basis.

There is already a provision in the law, and has been for a long time, to prevent that sort of situation in connection with conversion from stock to bonds. The generalized type of abuse that might develop in the absence of such a situation would be to exchange part of the stock for bonds and then have those bonds paid off, the net consequence being that the stockholder still holds his common stock while he has gotten cash from the corporation which, if it had been distributed in the ordinary course of events, would have been taxable as dividend income, but because they went around in a roundabout way, it got out as capital gains, and we would regard that as an abuse.

Senator CARLSON. This happen to be preferred common stock in a corporation. There have been some important decisions contrary to what you have stated, is that not correct, in regard to the taxing of these preferred stocks which have been transferred into bonds?

Mr. SMITH. I am not aware of that.

Let me consult. I will be glad to check it for the record.

Senator CARLSON. I bring this up because it is a very recent letter that I have had and I want to get it clarified, and here is the place to do it.

Mr. SMITH. My answer, subject to check, is that when anyone goes from a stock to a creditor position, and obtains bonds worth more than the basis of his stock he has taxable gain.

(The information requested follows:)

Section 354 of the 1954 Code in terms covers such an exchange of preferred stock for "securities," i. e., bonds. An exchange in order to be tax-free must be within subsection (a) (1) but subsection (a) (2) (B) states that subsection

(a) (1) will not apply if "any such securities are received and no such securities are surrendered." (Regs. § 1.354-1 (b); S. Rept. 1622, p. 265; see also example (3) of regs. § 1.354-1 (d).) The word "securities" has been defined to include bonds and not to include stock whether it be preferred or common. See, for example, regs. § 1.305-2 (b).

Since the exchange does not come within the non-recognition principle of section 354 (a), the difference between the basis of the stock surrendered and the fair market value of bonds received by the taxpayer is taxable. See sections 302 and 356 (a) of the 1954 code. The fact that the preferred stock has the same fair market value as the bonds received in exchange is, of course, the business reason for the exchange but has no relevancy with respect to the measure of taxable gain.

Senator WILLIAMS. One item which was not mentioned in your report but one which I have corresponded with the Treasury on was in connection with a situation where the Treasury had decided under existing law that you would have to allow as an "ordinary and necessary" business expense the payment of bribes or kickbacks that were being made by American corporations to officials of foreign governments.

I would like for you to comment upon that, and also to express your position on the pending amendment to correct that situation.

Mr. SMITH. As you indicate, Senator Williams, we have had correspondence on that, and at your request we have given you the draft of an amendment which would have the effect of denying the deductibility of payments made abroad that would be illegal if made in this country under the laws and customs of this country.

While we recognize that this raises certain problems and difficulties in trying to enforce our high standards on countries where the standards may be somewhat different, the public policy issue is such that we would support the amendment.

Senator WILLIAMS. You would support the amendment. Thank you.

There is one other question in connection with another loophole, that I do not see dealt with here. In the 1951 Code, Congress dealt with the question of taxing cooperatives. At that time there was a difference of opinion by some of us on the committee, but that is beside the point. It is my understanding that in all the court decisions which have arisen under existing law—and there have been several court decisions—the Treasury Department has been overruled, and as it stands now, you cannot tax either the cooperative or the farmer on the allocation of any of the earnings of this cooperative which are not made in cash or its equivalent.

Now, am I not correct in my understanding that all the court decisions have been against the Treasury Department's position in trying to tax the farmers on these allocations?

Mr. SMITH. We have lost a series of cases and have acquiesced in them, including very recently a case that arose from facts subsequent to the 1951 legislation.

Senator WILLIAMS. And you have not won any court decision: is that correct?

Mr. SMITH. We have lost them all.

Senator WILLIAMS. You have lost all decisions. Does the Treasury not recognize, then, that under the existing law you have no authority whatever to tax the farmer on any allocated fund which he is not actually receiving during the calendar year?

Mr. SMITH. I think that is perhaps a little bit further than the position we are actually in, Senator Williams. The cases we have lost have been ones where the allocation certificates were held by the courts not to have fair market value.

Senator WILLIAMS. That is the type I am speaking about.

Mr. SMITH. In that case we have no basis for taxing. There are still some allocation certificates that are made where there is interest and a due date. Those we can still tax.

Senator WILLIAMS. Where there is a bond payable at a certain date or a note or tax, those are taxable?

Mr. SMITH. Yes.

Senator WILLIAMS. I understood that. But as to those allocations on which there are no due dates, that are payable only at the decision of the organization itself, as I understand it, it is now the position of the Treasury Department that there is no tax due on the recipient?

Mr. SMITH. No tax due until the cash is paid at such time in the future as it may be paid.

Senator WILLIAMS. Is the Treasury acquiescing in that position, that the farmers do not even have to report it?

Senator FREAR. It is not limited to farmers, is it?

Senator WILLIAMS. Farmers or anybody, any beneficiary.

Mr. SMITH. The corollary of not having to pay is not having to report.

Senator WILLIAMS. Not having to report.

Mr. SMITH. And under the existing law, it would be, as it is now interpreted, it would be possible for any cooperative to allocate 100 percent of their earnings under these allocation certificates and thereby be completely exempt themselves, and the recipient likewise would not be taxable, and there would be no current tax whatever.

Senator WILLIAMS. In other words, here is a complete tax avoidance possibility as far as cooperatives are concerned, is that correct?

Mr. SMITH. I see no reason for limitation under the cases we have lost.

Senator WILLIAMS. 100 percent. And how long has it been recognized by the Department that this situation existed?

Mr. SMITH. It is only very recently, within the last few weeks, that we lost the case under the post-1951 legislation. The earlier cases had arisen prior to 1951. The Treasury in acquiescing in those cases held that the intent of the 1951 legislation was such that we thought we had a very reasonable basis to carry through the courts again on the post-1951 situation.

The case was made on that basis. The courts did not recognize it, and so it is very recently that we have, shall I say, been completely defeated.

Senator WILLIAMS. As I understand it, it is only recently that you have admitted it, but it is not recently that it happened, because I have a letter dated July 26, 1955, from the Treasury Department signed by Mr. Humphrey, and it is a copy of a letter addressed to the chairman of the House Ways and Means Committee.

Mr. SMITH. We knew the situation was bad as early as 1955, and advised the Ways and Means Committee as to it.

Senator WILLIAMS. And I would like to read from that letter. I am reading from page 2:

Cooperatives thereby may retain earnings for indefinite periods of time with no liability for income tax by either the cooperative or its members.

So it has been for a substantial period of time that you have recognized that as far as the courts' interpretations of our existing laws were concerned, you had no legal basis to collect this tax; is that not true?

Mr. SMITH. Well, we have attempted to litigate, in the absence of legislation, on a succession of instances that we thought we might win on.

Senator WILLIAMS. But what taxes have been collected since 1955 have been, in effect, collected on a basis of voluntary payment method, or on the basis of Treasury regulations and not backed up by law?

Mr. SMITH. The way the final litigation turned out, that is a correct statement of fact.

Senator WILLIAMS. Now, do you have a solution to the problem, or is it the position of the Treasury to leave it open whereby there would have to be no tax paid at all in this particular field?

Mr. SMITH. Going back to the letter from the former Secretary which you have read, which was followed up by a later letter from Senator Humphrey, and in turn, followed up by a statement of Secretary Anderson before the Ways and Means Committee earlier this session, we have advised that we think legislation is necessary.

And we are working closely with the Ways and Means Committee, and we hope that this will be legislation in the near future.

Senator WILLIAMS. But pending the time of recommending such legislation, is it your clear understanding that this particular group has no taxes whatever to pay unless they just voluntarily decide as a matter of charity to send it in to the Government?

Mr. SMITH. Under the facts of the cases as they have been decided. And it is still a matter of fact as to whether a certificate does or does not have fair market value.

Senator WILLIAMS. What is the definition of a fair market value? If X individual gets this certificate and he does not have the authority to sell it to John Doe on a voluntary basis, he cannot transfer it, nor can he have it redeemed except at the discretion of the organization; is that a modified payment?

Mr. SMITH. I am not in a position today, Senator Williams, to try to give a legal opinion on exactly what these cases mean. We have acquiesced in the cases that we have lost, but acquiescence means that we are limited to that particular set of facts.

Senator WILLIAMS. I realize that. But I would like to get this point clear, because I do not think we should put all of the farmers of this country into the position of having to go to court to get justice on a claim by the Treasury Department when you admit that under the law you have no authority to collect such a tax.

I think it is up to us to correct the law. Personally, I think the tax should be paid at one source or the other, and I have my own opinions as to where it should be paid. I have always felt that the one who kept the money should pay the tax. The cooperatives should have exemption on all bona fide distributions but on that which they keep they should pay the tax and not tax the farmer on something he has not received and may never receive.

Mr. SMITH. The press release indicating that we were acquiescing in cases indicated further that we would as soon as possible revise the regulations in line with those court decisions. In other words, we would attempt to draw the line as we saw it on the basis of what the court decisions have been. It would be premature for me to try to pass judgment on where that line is drawn now.

Senator WILLIAMS. Could you furnish for the record a copy of that regulation recently in which you have acquiesced?

Mr. SMITH. I would be glad to furnish a copy of the press release. The revised regulation is something which a very considerable number of experts in the field are working on. That is not ready now. I cannot put it in until it is ready.

(The press release requested follows:)

UNITED STATES TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
February 14, 1958.

TIR 69

TECHNICAL INFORMATION RELEASE

The Internal Revenue Service announced today that it will follow the decisions in *Long Poultry Farms, Inc.* v. *Commissioner* (249 F. 2d 726 (C. A. 4, 1957)), and *Commissioner* v. *B. A. Carpenter* (219 F. 2d 635 (C. A. 5, 1955)) in connection with the tax treatment of allocations of patronage dividends by cooperative associations to its patrons. Accordingly, steps will be taken to dispose of pending litigation and claims involving this issue in conformity with the principle enunciated in these decisions and to conform Treasury regulations and outstanding rulings to these decisions at the earliest practicable date.

Senator WILLIAMS. Do you not think that it is a situation which should be dealt with rather promptly? Certainly, it is a wide-open case now, more so that it has ever been in the history of our tax structure; is that not true?

Mr. SMITH. That is correct.

Senator WILLIAMS. And it is generally admitted that, under the existing interpretation, no tax whatever has to be paid at all in this particular field?

Mr. SMITH. On particular types of certificates.

Senator WILLIAMS. Well, it would be possible for them to allocate 100-percent of their earnings in this particular type of certificate, would it not?

Mr. SMITH. If that is acceptable to the members, it is a matter of relationships within the cooperative.

Senator WILLIAMS. That is true?

Mr. SMITH. I cannot pass on that.

Senator WILLIAMS. One other question, and then I will pass. There is another amendment pending before the committee, dealing with the existing rate on depreciation of oil, 27½ percent, and proposing to reduce it to 15. Now, that question has been under study by the Treasury Department for the past several years. What are your recommendations?

Mr. SMITH. We have no position on this at this time. That is somewhat beyond the scope of H. R. 8381, on which I am testifying.

Senator WILLIAMS. I do not think so. The question of depletion is mentioned under one of the sections here, in that we carry back certain retroactive features.

Mr. SMITH. It is a fiscal-year adjustment.

Senator WILLIAMS. Nevertheless, this question is before the committee. What is the position of the Department or does the Department have a position?

Mr. SMITH. I have no position at this time on that.

Senator WILLIAMS. Could you furnish the committee an estimate as to the amount of revenue that would be involved in a change from the 27½ to 15 level?

Mr. SMITH. I shall undertake to do so; yes.

(The information was not furnished by Mr. Smith.)

Senator FREAR. Has the Senator from Delaware finished?

Senator WILLIAMS. Yes. I understand that the committee has filed with you a request for a report on this amendment, and I assume we can expect such a report.

Mr. SMITH. I recognize the additional request.

Senator FREAR. The Senator from Illinois.

Senator DOUGLAS. As I understand it, the deputy to the Secretary says that he will furnish for the committee the information on revenue gain by diminishing the oil-depletion allowance from 27½ to 15 percent.

Mr. SMITH. I just told Senator Williams I would undertake to get that on a statistical basis.

Senator DOUGLAS. I wonder if, at the same time, you would present information as to revenue gain if the depletion allowance were allowed to continue at 27½ percent for individuals or enterprises with a gross income of less than a million, and were reduced to 21¼ percent for enterprises with gross incomes of between $1 million and $5 million, and 15 percent for enterprises or individuals with incomes of over $5 million? In other words, a sliding scale.

Mr. SMITH. Yes; I am aware of the Senator's suggestion along those lines. I do not know that figures have been prepared on that. It obviously would be a considerably more difficult thing to do. I am not sure whether the returns are based on that, but I will say that we will, of course, undertake to do what we can on that.

Senator DOUGLAS. Would you prepare a report on this, too?

Mr. SMITH. Yes; I will undertake to do this.

Senator MALONE. Mr. Chairman.

(The information was not furnished by Mr. Smith.)

Senator FREAR. The Senator from Nevada.

Senator MALONE. First, I am very interested in the matter of farmers' welfare. Do you intend to keep trying to collect this tax, regardless of what the law says, just keep hammering at it?

Mr. SMITH. No, Senator Malone. We have acquiesced in the cases, and, as I have indicated, we are modifying our regulations accordingly.

Senator MALONE. There will be no litigation now?

Mr. SMITH. That is the whole point and purpose of the regulation.

Senator MALONE. I just wanted to make sure. Now, in the case of a depletion, the House Ways and Means Committee has studied that situation for many years, and it has been before this committee once or twice. The depletion allowance is the gambling money in the oil business. That is well recognized. It will be remembered that, all through Mr. Ickes' administration as Secretary of the Interior, he claimed we were out of oil, we had no critical materials such as tungsten, that we must save what we have and import the oil and minerals.

He was always for repeal of the depletion allowance, which then would have put the country in the position that he claimed it was already in. That is, no oil, no minerals. That, of course, when it comes before this committee, will be thoroughly discussed. But, as a result of continuing the depletion allowance, it is the gambling money that the so-called wildcatter or the established company can go out and spend, and have the money to prospect new fields. If they fail, they can write it off to that extent.

Now, would you in your investigation add this information—it would be very interesting to this committee. What is the amount that the depletion allowance, if eliminated, would mean in taxes, domestic and foreign? And separate the two. Foreign would mean in any other nation outside of the United States and its possessions. Would you do that?

Mr. SMITH. I shall undertake to get that information.

(The information was not furnished by Mr. Smith.)

Senator MALONE. Now, at the same time—and I suppose this was included in the original request—divide the foreign and domestic revenue that would be saved to the Government if it were cut from 27½ to 15 percent.

Mr. SMITH. The more subdivisions that are requested, the more difficult it is to get answers and to be sure of them. I can only say, Senator, we shall do the best we can.

Senator MALONE. The more important it is?

Mr. SMITH. Yes.

(The information was not furnished by Mr. Smith.)

Senator MALONE. Now, is it not possible that you have already studied this question, because it has been before Congress for some years? I myself have appeared before the Ways and Means Committee several times in support of depletion, and on every occasion when Mr. Ickes suggested that we were out of oil and minerals and he would do away with the depletion allowance.

I showed that that was the gambling money enabling exploration in Nevada where there was no known oil at the time, or in Utah where there was little oil at the time.

Now, every year we are discovering new oilfields. We have more known reserves of oil today in the United States than we have ever had in the history of the world, probably 3 or 4 times as much as we had when Mr. Ickes said we were out of oil and also was against the depletion allowance.

So there is a definite relation in the discovery of new oilfields in the United States and the depletion allowance.

Then I think it is important to know what revenue the Government is losing by that particular question that Senator Williams referred to. It is very important that a division between the foreign depletion allowance, foreign production of oil, and the domestic production be made. That you understand?

Mr. SMITH. I understand the request, and we will do what we can on it.

(The information was not furnished by Mr. Smith.)

Senator MALONE. One more question, I think you are through explaining the sections, are you not?

Mr. SMITH. Yes, I am.

Senator MALONE. Section 4 refers particularly to policemen. Would you explain why you are cutting out that particular reference in section 120?

You will find that on page 7 of the House report on H. R. 8381:

Statutory subsistence allowance received by policemen.

Would you explain in your own words why you want to cut section 120 of the code out?

Mr. SMITH. That is section 4 of the bill. It is an amendment to section 120 of the code.

Senator MALONE. Will you explain just how you do that and why?

Mr. SMITH. The $5 a day subsistence allowance was added to the code in 1954.

Senator MALONE. There was no allowance prior to that time?

Mr. SMITH. There was no prior allowance. This was added, I believe, in the House. The Treasury did not support the amendment at the time.

Senator MALONE. Why was it allowed then?

Mr. SMITH. It was allowed on the ground that this was a payment that in a very few jurisdictions was made that was in effect—those who argued for it contended it was made—for a reimbursement of expenses. The Treasury did not at that time consider that a persuasive argument. We were concerned that something would develop, as it has since developed.

What has developed is that in a great many places changes have been made in the method of compensation reducing salaries and substituting therefor subsistence allowances of $5 a day.

Senator MALONE. Do you have documentary evidence that this has been done anywhere?

Mr. SMITH. I do.

Senator MALONE. Will you submit it for the record?

Mr. SMITH. I shall.

(The material referred to follows:)

REDESIGNATION OF STATE AND LOCAL POLICE PAY AS SUBSISTENCE ALLOWANCES TO TAKE ADVANTAGE OF THE EXCLUSION UNDER SECTION 120

The State of South Carolina in 1955 enacted a law which provided that of the amount appropriated by the general assembly for salaries of police officials and all commissioned law enforcement officers, $5 a day (or $30 a week) is designated a subsistence allowance. South Carolina officials were already reimbursed for actual subsistence expenses when on duty away from their station in an amount not to exceed $7.50 a day while in the State or $10 when outside the State.

The City Councils of Columbia and Sumter, S. C. redesignated as a subsistence allowance $5 per day of the policeman's pay. The ordinance adopted on August 17, 1955 by the City Council of Columbia, S. C., provided as follows:

"Beginning with the fiscal year 1955–56, of the amounts appropriated by the City Council of Columbia, S. C. for police officials, the sum of five ($5.00) dollars per day for each work day shall be designated as and shall constitute a statutory subsistence allowance. The purpose of this section is to give the police officials employed by the said city the tax benefits provided for by section 120 of the 1954 Internal Revenue Code."

In case of City Policeman W. J. Shirah of Columbia, S. C., the Internal Revenue Service held that the so-called subsistence allowance which he had received was not a statutory subsistence allowance within the meaning of section 120 of the 1954 code but constituted compensation for services and was includible in gross income. The district court, however, held in favor of the taxpayer that the subsistence allowance was properly granted by the city ordinance and was the type specifically authorized by section 120 of the 1954 code and, therefore, was not taxable.

The 1956 session of the Georgia Legislature empowered governing authorities of political subdivisions to set apart a portion of the compensation, whether payable on a salary or a fee basis, to sheriffs, deputy sheriffs, patrolmen, policemen, and other law-enforcement officers, as a subsistence allowance which was not to exceed $5 a day for each day on duty. (Georgia Laws, 1956 session No. 450, H. B. 336). Section 2 of this act provided that the purpose of the law was to enable law enforcement officers to take advantage of section 120 of the 1954 code. Section 3 provided in effect that amounts which are redesignated as subsistence allowances for purposes of tax benefits under section 120 are to continue to be considered as compensation for purposes of pension rights. The provisions of the law are as follows:

SUBSISTENCE ALLOWANCE FOR LAW ENFORCEMENT OFFICERS, GEORGIA LAWS, 1956 SESSION, NO. 450 (HOUSE BILL NO. 336)

Be it enacted by the General Assembly of Georgia:

SECTION 1. The governing authorities of the several counties, municipal corporations, and other political subdivisions of this State are hereby authorized to designate and set apart a portion of the compensation, whether payable on a salary or fee basis, to sheriffs, deputy sheriffs, partolmen, policemen and other law enforcement officers, as a subsistence allowance, which shall not exceed five dollars ($5.00) for each day actually spent by such sheriff or other law enforcement officers in the performance of his duties.

SEC. 2. It is the purpose of this Act to enable such sheriffs and other law enforcement officers to receive for income tax purposes, the benefits of the non-inclusion in gross income of subsistence allowances, as authorized in the Internal Revenue Code of 1954, Title 26, Section 120, and to this end, the General Assembly recognizes that such sheriffs and police officers are required by virtue of their duties to incur expenses not generaly incurred by other officials and professions.

SEC. 3. Nothing in this Act shall affect any present pension system of any county, municipal corporation or political subdivision of the State of Georgia or any rights of any person under any present pension system of any county, municipal corporation or political subdivision.

SEC. 4. All laws and parts of laws in conflict with this Act are hereby repealed.

Approved March 9, 1956.

Several Georgia cities, and at least one county, have taken advantage of this authorization and have redesignated a portion of city (or county) police salaries as subsistence allowances. These include Atlanta, Savannah (and Chatham County), Albany, and Marietta.

Two cities in North Carolina, Mount Airy and Gastonia, have redesignated a portion of city police salaries as subsistence allowances. Several other cities in North Carolina have requested information from the office of the district director of internal revenue relative to the adoption of such a plan.

The city of Houma, La. has pased an ordinance, effective January 1, 1958, permitting policemen to exclude $5 a day from taxable income.

The following bill was introduced in the City Council of Pittsburgh, Pa., on October 21, 1957:

FILE OF COUNCIL, CITY OF PITTSBURGH. SERIES 1957

File No. 1997
Bill No. 3561

Presented by Mr. Oblum, October 21, 1957. In Committee on Finance, October 22, 1957. Affirmatively Recommended

An Ordinance designating Five Dollars ($5.00) for each workday of police officials as a statutory subsistence allowance

The Council of the City Of Pittsburgh hereby enacts as follows:

SECTION 1. Effective immediately, of the amounts appropriated by City Council for police officials, the sum of five dollars ($5.00) per day for each work day shall be designated as and shall constitute a statutory subsistence allowance. The purpose of this section is to give police officials employed by the City the tax benefits provided for by Section 120 of the 1954 Internal Revenue Code.

SEC. 2. The statutory subsistence allowance hereby provided shall continue in effect until this ordinance is repealed.

SEC. 3. That any ordinance or part of ordinance, conflicting with the provisions of this ordinance, be and the same is hereby repealed so far as the same affects this ordinance.

This bill was not passed.

Revenue agents in certain districts have found that local police were deducting $1,500 from their salary as subsistence allowance although there was no statute or ordinance designating part of their compensation as subsistence allowances.

TYPES OF OFFICERS WHO QUALIFY AS "POLICE OFFICIALS" UNDER SECTION 120

The Internal Revenue Service has received numerous inquiries as to whether certain types of officers would qualify as "police officials" under section 120. Specifically mentioned in inquiries are: sanitary and building inspectors who carry police badges and are given certain police powers, guards or wardens of prisons or public works camps operated under the State Board of Correction who have all powers of a police officer in the State including but not limited to making arrests under criminal law, sheriffs of civil courts of records, bailiffs of the several courts, probation officers and other workers in juvenile and superior courts, and rangers of State fish and wildlife divisions.

Might I just add on the revenue impact of this, as is indicated in the House committee report, thus far the amount of revenue concerned, according to our best estmate, is that it would be about $300,000 a year. But if it goes all the way, it would be $50 million a year.

We also are aware not only of changing the method of compensation for police officers, those at present qualified as police officers, but there have been attempts to have other employees, State and municipal, qualified as police officers. I have in mind such things as building inspectors and other inspectors that come under this provision.

Senator MALONE. Does the Treasury Department take the position that a building inspector is subject to call like a police officer any time of day or night?

Mr. SMITH. You are getting into details there that I am not familiar with, Senator Malone.

Senator MALONE. Well, I do not think you are either. But it is obvious to anyone that they are not, nevertheless, the Treasury always has opposed it, and now it is an outright repeal, with no attempt to amend it to prevent such abuses as you have outlined.

Mr. SMITH. All individuals would still be subject to the rules existing for all employees as to the deductibility of their expenses. All that we object to is a general statutory provision that authorizes a favored treatment for a group of citizens, many of whom have no additional expenses, no reimbursement. We think all citizens should be treated exactly the same under the law as to the extent to which they are permitted to take deductions for their business and professional expenses.

Senator MALONE. In other words, a peace officer that is subject to call 24 hours a day should not have any advantages that would not accrue to a regular 8-hour-day man?

Mr. SMITH. I did not say that, Senator. I said that he should not by statute have any different treatment than anybody else that might be subject to 24-hour-a-day call.

Senator MALONE. You are saying in effect, that he should not have any statutory advantages.

Mr. SMITH. As compared to anybody else who is subject to call 24 hours a day.

Senator MALONE. We could go into that. You mentioned a building inspector. You do not generally consider a building inspector on a 24-hour call?

Mr. SMITH. Many police officers are not.

Senator MALONE. Most of them are, I think we will agree. But I do not want to argue with you. I would like to ask permission to put in the record a letter addressed to me dated February 27 by Robert J. Galli, Sparks, Nev., a letter addressed to Senator Bible dated February 7, signed by Robert J. Galli, chief of police of Sparks, Nev., and a letter from William Lovejoy, secretary of the welfare association of the Oakland Police Department.

Senator FREAR. Is there objection? Without objection, these letters will be admitted.

(The letters referred to are as follows.)

CITY OF SPARKS,
DEPARTMENT OF POLICE,
Sparks, Nev., February 18, 1958.

Refer: 104.7.

Hon. GEORGE W. MALONE,
United States Senate, Washington, D. C.

DEAR SENATOR MALONE: May I invite your attention to pages 4, 5, and 6 of the Police Chief. Also I am enclosing a copy of my letter to Senator Bible for your information.

To repeal section 120 will defeat the purpose of fair legislation. However, if section 120 were amended to prevent any abuse of the law, this action would maintain the original interest of section 120. I'm sure your decision and actions in this matter will be wise and just.

Respectfully yours,

ROBERT J. GALLI, *Chief of Police.*

CITY OF SPARKS,
DEPARTMENT OF POLICE,
Sparks, Nev., February 7, 1958.

Hon. ALAN BIBLE,
Committee on Interstate and Foreign Commerce,
United States Senate, Washington, D. C.

DEAR SENATOR BIBLE: Reference to your letter dated January 15, 1958, regarding section 4 of H. R. 8381. I do agree that the subsistence allowance section is being abused; however, I also feel that the fault is in part due to section 120 in its original form.

Perhaps the solution to this situation is not to repeal section 120 but to amend the section in a manner that no allowance can be attached to a salary. It may be possible to establish a subsistence allowance form, similar to the W-2 form, which all political subdivisions could present at the end of each calendar year. The form could be attached to the income tax return form same as the W-2.

I have discussed this problem with an accountant and it is agreed that an amendment to section 120 could be devised to eliminate any unjust claims. However, it is felt that a city, county or State should show ample evidence and justification for any subsistance allowances, which under section 120 is not necessary.

It is my firm belief that an officer's subsistence allowance should be deductible to a maximum of $5 per day. However, I do agree and believe that the "allowance" should not be part of a salary and a penalty provided for any violations.

Thank you for your consideration and I know whatever action you will take in this matter will be fair and just for all concerned.

Respectfully yours,

ROBERT J. GALLI,
Chief of Police.

WELFARE ASSOCIATION,
OAKLAND POLICE DEPARTMENT,
Oakland, Calif., February 12, 1958.

Hon. GEORGE W. MALONE,
United States Senate, Washington, D. C.

DEAR SIR: It is our understanding that H. R. 8381, an internal revenue measure, has been reported out of the House of Representatives, 85th Congress, on January 28, 1958. This bill has been referred to the Senate Finance Committee.

The policemen and firemen of California are striving to achieve professional status and are extending every effort to have for our State the most proficient and effective law enforcement and fire-fighting agencies in the Nation. A logical objective in our efforts to raise our standards is to guarantee an adequate and certain retirement income. H. R. 8381, by eliminating the community property benefits allowed us by California law, will depreciate the value of our earned retirement.

We are certain that the income accruing to the Federal Government from the provisions covering community property States in H. R. 8381, are not sufficient to merit the unhappy effect of the bill on all retired persons now residing in California and on all police and firemen of the State.

Our membership is greatly concerned with this issue and we ask that you eliminate that section dealing with community property States, from H. R. 8381, so that we may continue to enjoy the present coverage under the Internal Revenue Code.

Very truly yours,

WILLIAM LOVEJOY, *Secretary*.

Senator MALONE. And also a description and a discussion of this particular legislation found on pages 4, 5 and 6 of the Police Chief of February 1958.

Senator FREAR. Without objection, it will also be admitted and made part of the record. At the request of Senator Bible, I submit for the record several letters he received opposing section 4.

Senator MALONE. Thank you.

(The article and letters referred to are as follows:)

[From the Police Chief, February 1958]

H. R. 8381 WOULD REPEAL POLICE SUBSISTENCE PAYMENTS

Now before the United States House of Representatives is a bill, H. R. 8381, amending the Internal Revenue Code of 1954 "to correct unintended benefits and hardships and to make technical amendments, and for other purposes. It is known as the Technical Amendments Act of 1957.

Introduced in the first session of the 85th Congress by Congressman Wilbur D. Mills, of Arkansas, chairman of the subcommittee studying amendments to the Internal Revenue Code, H. R. 8381 was reported out of the Ways and Means Committee and is pending on the House Calendar. It was not called up for debate at the first session, due to intervention of the year-end recess, but may be brought before the House at any time during its current session. Since it has been approved by the House Committee on Ways and Means, no further hearings will be scheduled and it may be amended on the floor only by a committee member.

WHAT H. R. 8381 WOULD DO

H. R. 8381 contains 81 sections repealing, clarifying or amending various provisions of the Internal Revenue Code of 1954, ranging from denying a taxpayer dependency exemption for a member of his household if the relationship between them is in violation of local law, to the more complex facets of corporate and estate taxes, etc.

However, section 4, titled "Statutory Subsistence Allowance Received by Police," provides that section 120 (of the Internal Revenue Code of 1954), relating to statutory subsistence allowance received by police, is hereby repealed.

Section 120 of the Code permits police officials of State and local governments to exclude from taxable income subsistence allowances not in excess of $5 a day.

Enactment of H. R. 8381 simply removes this exclusion from taxable income of police officers. The Treasury Department made the proposal to the House subcommittee, together with other recommendations, because "this provision was originally designed to cover subsistence allowances of police only because it was thought that they generally were required to make more trips away from posts of duty than was true in other cases."

"However," says the report of the House Rules Committee on Ways and Means, "since the adoption of this provision in 1954, amounts which in fact constitute ordinary police salaries have been designated as subsistence allowances in some cases to obtain the benefits of this exclusion. In addition, your committee believes that this exclusion is inequitable since there are many other individual taxpayers whose duties also require them to incur subsistence expenditures regardless of the tax effect. Thus, it appears that certain police officials by reason of this exclusion are placed in a more favorable position taxwise than other individual income taxpayers who incur the same types of expense. Moreover, subsistence expenses incurred by taxpayers generally in the performance of service as employees while away from home in any case are deductible.

"Therefore, to bring the tax treatment of subsistence allowances for police officials into line with the treatment of such allowances in the case of other taxpayers, your committee's bill repeals section 120 of present law which provides this special allowance. This change is made effective with respect to taxable years beginning after December 31, 1956.

"Available information indicates that at the present time at least two States, Georgia and Indiana, have State police who qualify for this exclusion. If the revenue gain from repealing this provision is limited to the police of these two States, it is estimated that it would amount to about $300,000 a year. However, should all State and local governments change their pay classifications for police so as to allow the maximum daily subsistence allowance under this provision, the ultimate revenue which the repeal of this provision would entail could amount to as much as $50 million a year."

COURT DECISION IN SOUTH CAROLINA

Proposal of the Treasury Department to include in H. R. 8381 provision for repeal of section 120 of the Revenue Code was sparked by a decision of the United States District court in South Carolina.

In 1955 the Legislature of South Carolina enacted Act 234, titled "An Act to Provide for a Subsistence Allowance from the Amounts Appropriated by Acts of the General Assembly for Police Officials and All Commissioned Law Enforcement Officers." Act 234 was approved by the Governor of South Carolina May 25, 1955. In effect, the act provided that beginning with the fiscal year 1955-56, of the amounts appropriated by the State for police officials and all commissioned law enforcement officers, the sum of $5 a day for each regular workday was designated as a "statutory subsistence allowance." Since such subsistence allowance was excludable from taxable income, it had the practical effect of giving such police and law enforcement officers an increase in take-home pay.

The city of Columbia, S. C., had enacted an ordinace on August 17, 1955, providing that of the amounts appropriated by the city council for police officials, the sum of $5 per day for each work day "shall be designated as, and shall constitute a statutory subsistence allowance." The purpose of the ordinance was spelled out: "to give police officials employed by the said city the tax benefits provided for by section 120 of the 1954 Internal Revenue Code."

The $5 per day tax exemption was subsequently claimed by Police Officer J. W. Shirah, of Columbia, and his wife on their 1955 tax return. The exemption was denied by the Internal Revenue Service. Officer Shirah instituted suit in the District Court of the United States for the Eastern District of South Carolina, Columbia division. The court handed down opinion (C/A 5816, October 4, 1957) in favor of the plaintiff.

In his decision, Judge George Bell Timmerman said: "The main contention of the defendant is that the ordinance of the city of Columbia did not, under its Treasury Regulation, section 1. 120 (a), grant or give a statutory subsistence allowance to its policemen. Even conceding that the Treasury Department has the power to enact supplemental legislation affecting the subject matter of the congressional act, it hardly can be aid that the Treasury Department has the power to change either the meaning or the intent of the congressional enactment. Assuming the correctness of what is last stated, it is appropriate to turn to what Congress had to say about the intended meaning of section 120 of the Internal Revenue Code of 1954.

"By turning to pages 4176 and 4826 of volume 3, United States Code, Congressional and Administrative News, 83d Congress, 2d session, 1954, it will be seen how both the House and the Senate regarded section 120. . . . From the foregoing (House report), it is manifest that the Congress of the United States had some feeling for federally overtaxed police officers, who night and day are on duty to protect the lives and property of individual citizens and who run great risks in doing so. As there stated, section 120 was new and it was intended to grant a new, not an old exclusion from gross income. Plainly what Congress intended was to reduce taxes to be levied on the meager incomes of police officers * * *."

The decision concluded "that the amount of $540 receivd by the plaintiff W. J. Shirah as a statutory subsistence allowance during the calendar year 1955, after August 17, and thus paid to him as a member of the police deparement of the city of Columbia is not taxable as part of his gross income."

Meanwhile, the Internal Revenue Service announced its position relative to the excludability of subsistence allowances to police officers in its ruling 57-46. This ruling read: * * * "The amount of $5 per workday designated as a 'subsistence allowance' for police officials and all commissioned law enforcement officers under Act 234, Acts of South Carolina, 1955, is not a 'statutory subsistence allowance' within the meaning of section 120 of the 1954 code but constitutes compensation for services rendered and is includible in gross income under section 61 (a) of the code."

The ruling further stated: "Pursuant to the South Carolina law, highway patrolmen are assigned territories which allow them to live at home to the extent that they eat all three meals at home each day. No expenses are incurred while on duty, as State-owned automobiles are furnished, together with all gas, oil, and repairs. If, at any time, a particular patrolman is assigned temporary duty away from his station, such patrolman is reimbursed for actual subsistence in an amount not to exceed $7.50 per day while in the State or $10 when outside the State. Act 234, supra, does not provide for any kind of expenses incident to the performance of police duty, the travel allowance for expenses up to $7.50 or $10 per day for temporary duty assignments away from an official station having been provided for in earlier legislation. Act 234 has not affected the amount of money received by patrolmen. It merely designates that, of the amount appropriated for a patrolman's salary, the amount of $5 a day for each regular workday or $30 each week represents a statutory subsistence allowance. No concurrent laws have been enacted to specifically increase or decrease the rates of pay of highway patrolmen * * *.

"The term 'statutory subsistence allowance' as used in section 120 of the code is an established amount, apart from salary or other compensation, which is authorized to be paid to an individual who is employed as a police official for meals and other incidental expenses in connection with his duties, and must accordingly be designated to provide for the cost of subsistence expenses incident to the performance of police duties. The allowance under Act 234, supra, does not satisfy such a test. The mere designation of an amount paid to a police officer as a subsistence allowance will not serve to exclude such amount within the meaning of section 120 of the code.

"Accordingly, it is held that the so-called subsistence allowance of $5 per day payable under Act 234, Act of South Carolina, 1955, is not a 'statutory subsistence allowance' within the meaning of section 120 of the code but constitutes compensation for services rendered and is includible in gross income under section 61 (a) of the code."

The Internal Revenue Service, noting the United States district court decision in the case of *W. J. Shirah and Cleopatra Shirah v. The United States of America*, therefore proposed repeal of section 120 as one of the provisions in H. R. 8381 "to correct unintended benefits" and the House Ways and Means Committee accepted the proposal.

ACTION BY POLICE GROUPS

Many police groups and organizations throughout the United States have taken action to protest the provision for repeal of section 120. Last month the Police Chief published appeal of President Martin O. Betz, New Hampshire Association of Chiefs of Police (Portsmouth, N. H.) for concerted effort in protesting to members of the House of Representatives such repeal.

In the majority of police jurisdictions section 120 of the Internal Revenue Service affords justified relief from taxation on moneys spent for subsistence. While the Congress is concerned with eliminating income tax relief preference to any special group, it would not seem that undue advantage has been taken of section 120 to justify its outright repeal.

Col. W. C. Dominy, directory of the Georgia State Patrol, has widely circulated letter from Attorney Frank Edwards, of the Peace Officers' Association of Georgia, summarizing the effect and present status of H. R. 8381.

Secretary-Treasurer Royce L. Givens, of the National Conference of Police Associations, has also issued bulletin to members of that organization giving complete information on section 4, H. R. 8381 and suggesting that individual Congressmen be advised of the objection to it; and, further, if H. R. 8381 is enacted by the House, that no time be lost in contacting members of the Senate, expressing opposition to the repeal of section 120, Internal Revenue Code of 1954.

Chief Herbert T. Jenkins, of Atlanta, Ga., sergeant-at-arms of the IACP, supports the position of the Georgia Peace Officers Association and asks that the IACP, through an appeal to members, give all possible assistance. "The bill * * * will disallow any future deductions from gross income," he points out, "of any statutory subsistence allowances, to be effective December 31, 1956. If this becomes law, no deduction will be possible beginning January 1, 1957 and for and after the taxable year 1957. Insofar as the taxable year 1956 is concerned, that is the subject of the litigation we are about to begin."

Chief Robert V. Murray, Metropolitan Police, Washington, D. C., third vice president of IACP, addressed a query to the Internal Revenue Service regarding the matter. The reply stated, "You ask two specific questions: (1) a hypothetical question as to the effect on a statutory subsistence allowance of reductions for pension contributions; (2) whether it is anticipated that the Service will seek the repeal of section 120. It is the stated policy of the Service to refrain from issuing a ruling on a hypothetical set of facts. Consequently, it is not possible for us to give an opinion in this situation you present." Chief Murray was referred to H. R. 8381, the report of the Committee on Ways and Means accompanying the bill, and to Internal Revenue Ruling 57-46.

Other police organizations and associations are urgently requested to consider sending immediate protests to section 4 of H. R. 8381 to the Congressmen of their State. Individual members are also asked to contact their Congressmen expressing the view that section 120 of the 1954 Internal Revenue Code should not be repealed, and, if some change is needed, that it be made without repealing the statute or placing a restrictive date on its operation as proposed by the Internal Revenue Service.

STATE OF NEVADA,
DEPARTMENT OF MOTOR VEHICLES,
NEVADA HIGHWAY PATROL DIVISION,
Carson City, Nev., January 2, 1958.

Hon. ALAN BIBLE,
United State Senate, Washington, D. C.

MY DEAR SENATOR: Enclosed find verifax copies of correspondence directed to our attention by Col. W. C. Dominy of the Georgia State Patrol, regarding H. R. 8381, section 4, which proposes to repeal in its entirety section 120 of the 1954 code having to do with subsistence allowances for police officers of State and local governments. That particular section (120) of law, grants relief from taxation covering legal subsistence allowance to police officers, while on official duty for their department.

This legislation directly affects the Nevada highway patrol and listed below are our objections to this bill, and we ask you to strenuously voice our opposition to this legislation.

1. Because of our small organization in personnel numbers, and because of the great expanse of area in our State, the officers in our department must be flexible to move at any time anywhere in our State.

2. Our officers are allowed by State statute, per diem to defray the actual expenses involved ($10 in State; $15 out of State) by the officers while on assignment away from his home base of operation.

3. If this legislation is passed it will seriously affect the operation of our department, because the salary scale of enforcement agencies is not of sufficient stature for any officer to be able to maintain his own family obligations, and also have to be subjected to taxation on legal subsistence, which is provided for by the State legislature.

4. This proposed legislation will also affect local and county police officers, who may be away from their departments on criminal matters, or in other States on matters of extradition.

These basic objections are listed to bring forth the seriousness of this proposed legislation and to the ramifications to the enforcement agencies in our State that will be affected, if it is passed by the Congress.

I earnestly solicit your aid in bringing this matter to the attention of the Members of the Congress, and to urge them to leave the statute as it is in its original form, as passed in 1954.

Anything that you can do to assist in this matter will be greatly appreciated.

Very truly yours,

ROBERT J. CLARK, *Director.*

SHERIFF OF LYON COUNTY,
Yerington, Nev., January 8, 1958.

Hon. ALAN BIBLE,
Senate Office Building, Washington, D. C.:

DEAR SENATOR: This letter is written relative to H. R. 8381, section 4, which proposes to repeal in its entirety section 120 of the 1954 code, having to do with subsistence allowances for police officers, section 120 covers relief from taxation on legal subsistence allowance to police officers while on official duty for their department.

Obviously my department which consists normally of about nine men objects to this repeal. We find it necessary throughout a year's time to do considerable traveling in the conduct of our normal police work. We do not believe that we should be taxed on an allowance which is made to us while we are away from home. No subsistence we could conceivably receive would actually pay the expense of these trips, and we do not wish to be taxed on top of it.

We would appreciate your efforts in this regard. We know that we are joined in this thinking by all others in our line of endeavor, and most particularly the officers of the Yerington City Police.

Cordially yours,

CLAUDE L. KEEMA, *Sheriff.*

ELY, NEV., *January 16, 1958.*

Hon. ALAN BIBLE,
United States Senate, Washington D. C.:

Eastern Nevada Peace Officers Association go on record as opposed to repeal of H. R. 8381, section 120.

EASTERN NEVADA PEACE OFFICERS ASSOCIATION,
CHRISTINE RUSSELL, *Secretary.*

Senator FREAR. Senator Long.

Senator LONG. I just want to ask a few questions here. Section 2 of this bill would increase the taxes on the retired persons in community property States by denying them what has always been the right under the community property law of dividing the income equally between husband and wife. I thought, Mr. Smith, that that thing had been settled long before I came to Congress; that the nature of community property income was well recognized and that had been thought out in Congress. It will be recognized that the answer to that issue was not to deny people in community property States the right of regarding that income as being equally that of husband and wife, but instead to amend the law as it was done to permit husbands and wives in noncommunity property States to split their income the same way they did in other States.

Now, why did the Treasury want to go back and start that fight all over again? I just do not understand it.

Mr. SMITH. The Treasury is very sympathetic to this amendment. We think it is necessary to carry out the intent of the 1954 legislation, which was to provide through the retirement income credit a treatment substantially similar to that available under social security.

Senator LONG. Let me just tell you about this social security. In the first place, no one particularly noticed that under social security. As far as the tax was concerned the fact that you treated community property income as being the income of the husband alone, made no particular difference as far as the tax was concerned.

Suppose you had a man working for $4,200. If you regard his wife as earning half that income to make it $2,100 and $2,100, you still have a 3-percent tax on $4,200, and so the tax collection would be exactly the same in either event. And that being the case, it was a distinction without a difference as far as the tax was concerned. But that should certainly be no precedent.

Mr. SMITH. But, Senator Long, this deals with benefits. We were frankly amazed and perturbed in the preparation of regulations under this because it turned out, as we regarded it for the first time, that a new discrimination or distinction between community property and noncommunity property States had arisen under the letter of the retirement income provision. We had a uniform treatment under split income for income tax purposes in general. We had a substantially uniform provision under the marital deduction under the estate tax. We had a uniform provision under the social-security tax. And then it suddenly turned out that there were differences here. This was a surprise—because in the discussions in the House where this was first processed, and to the best of my recollection in the discussions here, the presumption all along was that this was to be analogous to, as nearly as possible, comparable to social- security benefits.

Senator LONG. If someone would, after the long experience in these noncommunity property States, introduce a proper amendment, to let them split their retirement income the same as they do in property States, I submit that would be more important than what you are trying to do by raising the tax on our old folks. How much would it cost to do what I am suggesting, letting the folks in the noncommunity property States split their income?

Mr. SMITH. I do not have a figure on it. I have not even thought of it. It seems to us clear that the 1954 intent was to have the retirement income provision conform to the social-security provision. This in the most literal sense of the term comes within our concept of an unintended benefit.

Senator LONG. Let me tell you, Mr. Smith. I was on the committee, and we usually look to the intent of the legislator rather than the intent of the Executive.

Mr. SMITH. I fully appreciate that, Senator.

Senator LONG. And I will guarantee that it is my intent that those old folks would get that benefit as far as the other members of the committee were concerned at that time. And my information is that it would only cost $15 million to let the aged people in all the other States have the same benefit that people have in community property States.

Mr. SMITH. Including social security?

Senator LONG. Not including social security, leaving social security out of the picture.

Mr. SMITH. Then the retirement incomes does not conform to the social-security treatment, and that would be——

Senator LONG. And so what? Does your life insurance policy conform to social security?

Mr. SMITH. No. But the difference between the community property States and noncommunity property States, I thought, with this one exception which now it develops exists, had been conformed under the income tax law.

Senator LONG. There is never any exception as far as the taxation of community property income, the tax treatment was uniform, that was always regarded as being equally the income of husband and wife and taxed accordingly.

Now, it has been urged many times that this tended to discriminate in favor of community property States. And that was resolved and settled by saying, all right, let those people in noncommunity property States split their income the same as they do in community property States. And that is the only sensible way to do it, not to take something away from the community property State, but just give the people in the other States the same break.

And I submit that that is the answer to this one. Now, so far as trying to violate that principle, I know none of us who voted for social security had any idea of destroying the principle of taxation in community property States. And so far as being willing to let the other States have the same tax treatment, we are certainly in the minority in community property States, we are not trying to take anything from them, but we do not want them to take anything from us, it is just about that simple.

I would appreciate it if you would check to see what the cost would be as far as your tax retirement income benefit, that is, to permit the other States to have the same tax treatment of retirement income.

Mr. SMITH. We shall have to get a figure on that, Senator Long.

(The information requested follows:)

The figure of $15 million used by Senator Long is consistent with a Treasury estimate.

Senator LONG. I notice in the discussion of section 37, which relates to the foreign tax credit, you oppose that section, and I believe the Ways and Means Committee agreed unanimously to that provision, did they not?

Mr. SMITH. I do not know whether it was unanimous or not. I cannot speak for that committee.

Senator LONG. It was my understanding that that was unanimously agreed to.

Let me ask you this: If a company is trying to do business, let us say, in Pakistan, and you make an installment sale on which they have got a profit of $100,000, and Pakistan has a tax of about 60 percent on that profit, and we have a tax of 52 percent ,if that company is doing business on the installment basis and Pakistan insisted that they tax them on the accrual basis, the credit would fall in 1 year at 60 percent. In the next year you would have a tax, the United States tax, of 52 percent, because the company is doing business on the installment basis.

And, that being the case, that is a total tax of 112 percent. If these people were permitted to average across their overall business, they could perhaps take their foreign tax credits to get their profit in some other country; but they cannot do it, they have got to take it by a country-by-country basis.

That would be a tax of 112 percent on profit, would it not?

Mr. SMITH. I do not believe they are additive in that sense. My mental arithmetic is not too quick on that. My first observation was that a company is doing——

Senator LONG. Sixty and fifty-two is a hundred and twelve.

Mr. SMITH. I understand the two add up to that amount. But I doubt whether the net effect is that tax on the total; I think there may be some consequences of deductions.

But my main observation on that is that if a company is doing business continuously and consistently, these deductions would tend to wash out.

Senator LONG. But suppose Pakistan 1 year had plenty of dollars, so 1 year they can trade with us; and the next year they cannot. So a person makes a transaction where in 1 year he has got a profit of $100,000 on which he is taxed 60 percent in Pakistan for $60,000; the next year he has got a tax of 52 percent, or $52,000, on profit on the same transaction. And that adds up to 112 percent on profit.

Now, if he were in position to take his tax credit, he would not be particularly upset about that. He could take his $60,000 credit for what he paid in Pakistan against the $52,000, and he would not owe any tax beyond that, and that is the way Congress intended it would work.

But if we insist on making them keep their books one way and the foreign country makes them keep their books a different way, why should we not make some allowance for the fact that the income falls in two different years?

Mr. SMITH. Senator, there are many different problems in the taxation of foreign income. There are many very fundamental problems which need consideration and determination. It is our impression, our strong impression——

Senator LONG. My general impression is, Mr. Smith, that if they sit around and wait until the Treasury brings relief to the people, about half the time it never happens.

Mr. SMITH. This particular provision, which costs, according to our best estimates, $5 million a year, is a very limited application special relief type provision, which does not get at the very basic problem of the taxation of foreign income with reference to the development of foreign private investment abroad, and as I said in my statement, we are opposed to this special relief provision, and we oppose it as being included in this bill.

Senator JENNER. I have a short question I think would fit right in this, if the Senator would yield.

In answer to Senator Williams a while ago, you said that the corollary of not having to pay is not having to report, referring to the co-ops and so forth.

Mr. SMITH. Yes.

Senator JENNER. This bill requires United States citizens resident abroad to report their earned income, which is excluded from the United States tax. Why this distinction?

Mr. SMITH. This is an entirely different point, Senator Jenner, from what Senator Long is raising.

Senator JENNER. It is a different point?

Mr. SMITH. Yes.

Senator JENNER. Why the difference, then?

Mr. SMITH. Shall I complete my statement on Senator Long's question?

I do have one additional point, if I may, and then I can deal with your point.

Senator LONG. Let me say, Mr. Smith, I do not regard anybody paying 112 percent on income as being a special interest.

Mr. SMITH. I now have the point I thought was wrong on adding it up. Taxpayers always have the option of taking the foreign tax as a deduction and paying the United States tax on the amount of foreign income after the foreign tax, so the two do not, if the taxpayer conducts his affairs in what would seem a reasonable manner, add up to 100 percent. There is first the deduction of the foreign tax; then there is the United States tax on the rest of it. It is somewhat analogous to the system that some merchants have of discounts, 50 percent, plus 25, plus 25, plus 10, and so forth, and it looks as if they pay you 10 percent to take it away.

The foreign tax deductions work in that manner, but it does not add up to 112 percent.

Senator LONG. You feel that he is adequately cared for and he could take a 60-percent deduction on his $100,000, and he could pay 52 percent tax on what was left over, so he could wind up with about——

Mr. SMITH. I did not mean to say that there is not a problem there. I merely say that the magnitude of the problem is not as indicated by the proposition that the tax would exceed 100 percent. That is my point.

Senator LONG. If a person were not subjecting himself directly to the jurisdiction of his country but doing business as a foreign subsidiary, he would not have these problems. He would be able to avoid that type of taxation, would he not?

Mr. SMITH. I think the same type of problem would apply in connection with dividends from a foreign subsidiary. There is more latitude on timing their payments.

Senator LONG. He would get 85 percent—he would only pay tax on 15 percent.

Mr. SMITH. No. From foreign corporations you do not get the intercorporate dividend credits, because the foreign subsidiary itself was not subject to United States tax, so there is no multiple tax. Dividends from foreign subsidiaries are brought in subject to the full United States tax.

May I turn to Senator Jenner's point.

This is an entirely different point, Senator Jenner. You will recall that income earned abroad by two categories of United States citizens, those who have bona fide residences abroad, and also those who are in foreign countries for 17 out of 18 months, even though they do not have foreign residences, are not subject to United States tax.

In the first instance, it applies without limit. And in the second instance, it applies with the ceiling of $20,000.

There is considerable uncertainty, in some instances, I am quite sure, honest uncertainty, as to what is earned income and what is not earned income. There is also uncertainty as to where income is earned.

If an American resident abroad is handling a legal case which involves his presence in some foreign courts, and also in some American courts, or if he comes to this country to get material or to discuss it with his client, there are obviously problems of allocation of income as to where it is earned.

There is also the question as to whether income is attributable to effort or to capital. If you have a business proprietorship or partnership, which has capital invested, and there are certain total earnings, is that earned income or is it attributable to the fact that you have capital investments? Is it investment income?

Now, under the present law, the Internal Revenue Service is under a very great handicap in getting information that is appropriate, that is necessary, to make the factual determinations as to the validity of the presumptions on the part of taxpayers that their income is not subject to tax because, in their opinion, it is earned income.

This is something we have been concerned with in the Treasury as well as the Internal Revenue Service for some time. It happens to be one that I have had occasion to look into myself in some of the foreign internal revenue offices, and there are some specific examples of situations that have run along at times for many years where they had no basis for computing a tax for an individual. They did not get a tax return, and it turns out that sometimes there are hundreds of thousands of dollars, in some instances millions of dollars, of back taxes due, simply because there was no basis of making a tax audit in the first instance.

Now, all that is proposed here is that the individual report his income. He will take a deduction for it, if it is his belief that it is income earned abroad. This will not affect by one cent anybody's bona fide tax liability. It merely will provide a basis for the Internal Revenue Service to know who is abroad, who is getting what sort of income, so that the citizens where they are resident will be under the same obligation of making information available for investigation to determine their true and proper tax liability.

We feel this is a very important——

Senator JENNER. Why do the co-ops not do the same thing? Why do they not report what they——

Mr. SMITH. The co-ops do report their distribution, I believe.

Senator WILLIAMS. But if they do not, what can you do about it? Is not the penalty on the tax, and when there is no tax due, there would be no penalty due. Is that not correct? Is not the penalty for not reporting a penalty on the tax?

Mr. SMITH. I am referring to getting information on audit.

Senator WILLIAMS. That is your tax returns, but if a co-op does not file any return, what is the penalty? No information return when there is no tax due.

Mr. SMITH. We can require information returns.

Senator WILLIAMS. You can require, but what do you do if you do not get it?

Mr. SMITH. We can have a penalty for not putting in a required information return.

Senator WILLIAMS. What is the penalty?

Mr. SMITH. It comes under the misdemeanor provisions.

Senator WILLIAMS. It is my understanding that the penalty was a percentage of the tax that was found to be due.

Mr. SMITH. That is for filing a wrong return.

Senator FREAR. Still, what is the penalty?

Mr. SMITH. It is a misdemeanor penalty. I am having it checked. Just a moment.

Senator WILLIAMS. In other words, they do have to file?

Mr. SMITH. We require them to file, as compared to this foreign proposition where, under the statute, it is excluded income, and we have no basis for even requiring a filing.

Senator WILLIAMS. It is my understanding that there were several of these organizations which were not filing because they did not owe a tax, and all you could do was fine them a percentage of the tax, and if they owed no tax there would be no penalty.

Mr. SMITH. This is section 6652 of the code:

Failure to file certain information returns. Additional amount. In case of each failure to file a statement of a payment to another person, required under authority of section 6042 (relating to payment of corporate dividends at the source—that is the co-op paying to its members.

Senator WILLIAMS. That is right, to its members. And you have been collecting from its members on that basis when, under the law, you had no right to collect. We have got it straight at that point. But I am speaking in line with Senator Jenner's question.

Suppose the co-op itself does not file any return at all, as far as it is concerned, as a co-op. That is the penalty? When it does not file any information return as to the distribution.

Mr. SMITH. There would be no penalty in that case. This is on the information return, what they have paid.

Senator WILLIAMS. Then under the existing law the co-operatives of this country do not have to file any information returns or any returns at all, as far as the Government is concerned. They can allocate it.

Mr. SMITH. I have had called to my attention 7203—

Willful failure to file return or supply information, or to pay tax—

which gives a criminal penalty for misdemeanor, $5,000 or 1 year.

Senator WILLIAMS. Would that be effective under the situation?

Mr. SMITH. I should like to examine this more fully and elaborate in the record, if I may.

The point you have raised is, I think, a significant one which should be taken into account in this whole matter of the taxation of co-ops and their members.

Senator WILLIAMS. We are not suggesting that they are not. They may all be filing. But it is my understanding that the penalty for nonfiling is a penalty on the tax.

Mr. SMITH. I think there are additional penalties, but I should like to go through this with care and supply it for the record.

Senator WILLIAMS. The information return they filed would include the cash refunds as well as allocated refunds, and the Treasury Department is now recognizing that you have no right under the law to collect any tax from the individual receiving that allocation when it is not a bona fide payment.

Mr. SMITH. Well, if it is one of those specific forms which do not have fair market value——

Senator WILLIAMS. Yes. And it is not transferable.

Mr. SMITH. I still do not want to pass judgment on exactly what determines fair market value.

Senator WILLIAMS. Before we get through, we are going to pass judgment. And I would like a definite letter from the Department. I will not ask you to do it here. But I wish you would furnish to the committee an exact definition of what is taxable and what is not taxable so that we can have it in the record.

Frankly, I would like to have it for the committee, and also incorporated in the Congressional Record. I do not think the Treasury Department should be in the position of collecting a tax from individuals on the basis of the threat of taking them in to court if they do not pay it, when the Treasury Department knows that it cannot win the case when you go to court, and then you have no substance of law to support your assessment. If there is a loophole in the law let's recognize it and make that correction.

Mr. SMITH. As I have already indicated, Senator Williams, we are working out a revision in the regulation to conform to the cases in which we have acquiesced. That will be the document which will indicate our best interpretation of what the court rulings are as to what is fair market value.

Senator WILLIAMS. Will you be able to furnish that to the committee for the hearings on this bill, for our record?

Mr. SMITH. I very much doubt it. These are things we must do with great care and accuracy. I literally do not know how far along that is.

Senator WILLIAMS. I have corresponded with the Department for the last 3 years on this one subject, and I would feel constrained, if you do not, to suggest that maybe it would be well for Congress to put an amendment to this bill which would provide you could not collect a tax on something when you have no basic law to support the assessment. You should refund to these people what you have collected erroneously.

Mr. SMITH. We will proceed as far as we can on the basis of the litigation, including a very recent case—it is the only recent case we have had—under the post-1951 situation. And I think it is important that this thing be done correctly and done promptly.

(The information requested follows:)

An exempt cooperative association is required to file Form 990-C, United States Exempt Cooperative Association income tax return, on or before the 15th day of the 9th month following the close of its taxable year. If such a return is taxable and is delinquent, the association is subject to the addition to the tax for failure to file a tax return under section 6651. If the return is nontaxable, the addition to the tax under section 6651 would not apply.

An exempt cooperative association required to file Form 990-C may be liable for the criminal penalties imposed by section 7201, relating to attempt to evade or defeat tax, by section 7203, relating to willful failure to file return, supply information, or pay tax, by section 7206 (1), relating to fraud and false statements under the penalties of perjury, and by section 7207, relating to fraudulent returns, statements, or other documents.

Under section 6041, relating to information at source, section 6042, relating to returns regarding corporate dividends, earnings, and profits, and section 6044, relating to returns regarding patronage dividends, exempt cooperative associations are required to file returns on Forms 1096 and 1099. Under section 6652, relating to failure to file certain information returns, additional amounts are imposed on exempt cooperative associations which fail to file such returns. Moreover, exempt cooperative associations which fail to file information returns may be liable for the criminal penalty under section 7203 for willful failure to file a return.

The additions to the tax provided in subsections (a) and (b) of section 6653, relating to failure to pay tax, and provided in section 6655, relating to failure by corporation to pay estimated income tax, are also applicable to exempt cooperatives taxable as provided in section 522.

Senator MALONE. Mr. Chairman——

Senator JENNER. Senator Long yielded to me.

Senator LONG. That is perfectly all right. Go ahead. We are getting some good Republican questions. It is perfectly all right with me.

Senator MALONE. First I want to join with the Senator from Louisiana on this question of community property tax. When the question of community property tax was thoroughly discussed here, I was a member of the committee. We have a community property tax in our State. There was no objection at that time from any community property tax State to recognizing the same privilege in every other State, regardless of their State law.

But it was thoroughly understood—and I think if you dig up the debates in this committee you will find that all of us expressed the opinion that we should not be penalized by adopting the pattern for all of the States.

It was well accepted by our State, and it was recognized in other States, that it was only a fair thing to do, but with no penalty for the original community property States.

What you are suggesting here—I agree with the Senator from Louisiana—is a penalty on some of the community property States and I think it is a wrong approach.

In this question of the foreign tax that has been raised by Senator Jenner and Senator Williams, I remember that was also discussed thoroughly here, and in most instances of the foreign corporations we found—it was just as a coincidence, no doubt—that their foreign tax always equaled the amount we would have collected here. Therefore, we collect practically no tax.

Is that about right?

Mr. SMITH. That is not always the result. Where the foreign taxes are as high, that is the result. But there are many areas where they are less.

Senator MALONE. It is no doubt just a coincidence, they estimate what our tax will be and simply appropriate it. Therefore the corporations pay it to the foreign government and not to us.

Mr. SMITH. We still get a substantial amount of revenue after all the foreign tax credits, approaching $200 million.

Senator MALONE. If you will read the debate at that time, I think your conclusion will be different. You would find that most of these corporations, especially the foreign oil corporations, always pay, in Saudi Arabia and other places approximately what would have been collected here.

Mr. SMITH. In many industries and many geographic areas, that is correct. But I still submit that we get a substantial net revenue.

Senator MALONE. If you review the testimony in that debate, I think you will be enlightened.

Now, one other question——

Senator LONG. Might I just interrupt to ask that you supply to us for the record how much revenue you do get from the taxation of American corporations on their overseas activities. I would be curious to know. What is that figure?

Mr. SMITH. May I say, Senator——

Senator MALONE. By corporations.

Mr. SMITH. By corporations.

We have had underway for some months a very detailed examination, calling in from the field the tax returns of corporations in order to have a figure which we think is more solid to stand upon than the estimates we have had in the past. That particular study has not quite been completed yet. Rather than try to get it into this record at this time, I would merely reaffirm the earlier estimates.

Senator LONG. I would be curious to know what they are. What do you estimate we are getting from the taxation of American corporations on their overseas activities?

Mr. SMITH. The figure we used in 1954, which would be perhaps somewhat larger now, for the then recommendations for the branch income and the deduction of the tax rate at the 14 percentage point, as I recall it, the estimate of revenue loss was $147 million, and we thought that those two together would pretty well wipe out the remaining net tax.

Senator LONG. So your estimate would be that you are getting about $147 million?

Mr. SMITH. That was our 1954 estimate. Since we are in the process of getting a solider estimate based upon the actual investigation of the returns of the principal companies doing business abroad, I would like to stand merely on that until we get a more accurate figure. I do not have it now.

Senator LONG. I hope the Senator from Nevada will pardon the interruption, but I do think we ought to get that information.

Mr. SMITH. We are very much interested in that. That is the reason we started in this elaborate investigation to get it.

Senator WILLIAMS. That $147 million would not include the tax that must be collected by the Government in the distribution of dividends on that portion which should be brought back into the country; is that not correct?

Mr. SMITH. Well, the foreign tax is allowed as a credit against the United States tax on the dividends.

Senator WILLIAMS. I appreciate that. But I am speaking about the portion of the foreign tax——

Senator KERR. Would you clarify that statement?

Mr. SMITH. If a company operates through a foreign subsidiary, when it receives the dividends in this country from its foreign subsidiary, it includes those dividends, as I indicated to Senator Long a while ago, in full with no corporate dividend credit. It applies the regular United States tax. Then it applies against that, as a credit against the United States tax, the foreign tax paid by the subsidiary on its earnings out of which the dividends in turn have been paid.

Senator KERR. But that credit is one taken by the parent company, which in turn pays dividends to American stockholders, and they get no credit?

Mr. SMITH. No, there is no pass-through to the stockholders.

Senator KERR. The credit coming to, let us say, the American company, is applied against its revenue from the foreign operation, whether it comes to it by reason of its direct operation or its operation through its subsidiary, the profit on which returns to the parent in the form of dividends.

Mr. SMITH. Exactly so.

Senator WILLIAMS. And in the ultimate redistribution of those retained earnings by the American corporations to their stockholders here in this country, there would be some additional tax over and above this $147 million.

Mr. SMITH. Of course, that is just like any other dividend, taxed in the ordinary way.

Senator WILLIAMS. That is the point I was making, it does not include that later revenue.

Senator MALONE. Most of the time this tax which they pay to the foreign governments just about equals, as a coincidence no doubt, what they would have paid to this Government. I think you will find that a very general rule. Is that not right?

Mr. SMITH. It comes pretty close to it. There are instances above and instances below.

Senator MALONE. In other words, they might miss the estimate a little, just because they would not know a year ahead, but they make it as close as possible.

We have been talking about some pretty big people. Now to get some smaller people such as waitresses. In my State the internal revenue office requires waitresses and people in many other occupations to report their tips as well as their salary. It has come to the point where, regardless of what the girls and boys who are employed as waitresses and bartenders and all have reported, the internal revenue offices make estimates of the probable percentage of tips at certain tables and locations in the hotels and various business places and send them a bill for that amount.

But I want to ask you if this method of determining tips, et cetera, upon which the tax is fixed for waitresses and bartenders is sanctioned by the home office here in Washington.

Mr. SMITH. I, of course, do not know the exact practice in Nevada, other than I have just heard it from you for the first time.

Senator MALONE. I do not think it is confined to Nevada.

Mr. SMITH. I do know there have been instances, there has been litigation where very substantial back taxes were collected on unreported tips running into the tens of thousands of dollars a year in some of the larger hotels. I think there is a general practice, and I think we would sanction it, a general practice of attempting to include a reasonable amount for tips. But that should always be done on a basis such that there should not be undue harassment on small amounts. Where to strike the balance is a matter of practice.

Senator MALONE. If we could pay their way I could bring witnesses. They do not have the money to pay their own way here, especially after they get through with your income-tax people. These people have a very reasonable salary and work their 8 hours a day and do get a certain amount in tips.

But your Internal Revenue Service in many cases sends them a bill of what they consider a table in a certain location is worth in tips, or a table in another location, or a table in another hotel; and, as I said before, these girls and boys cannot stand to have a suit in court. The hotel would simply terminate their employment, and they know that.

So it is blackmail that works. Do you sanction that procedure?

Mr. SMITH. Under the connotations that you have, of course I do not sanction it.

Senator MALONE. You are doing it now.

Mr. SMITH. As I say, I have heard of it for the first time today. I should be glad to check into it.

Senator MALONE. I should be glad for you to do that. Do you sanction it for the ordinary employee—I am not talking about the chef or the headwaiter at the Waldorf. I am talking about the ordinary restaurants and hotels in States like my State of Nevada, where you are now following the practice.

Mr. SMITH. I shall take it up with the Commissioner of Internal Revenue to determine what the practice is and what the policy is, Senator Malone.

Senator MALONE. And put it in this record.

Mr. SMITH. I shall undertake to do so.

(The information requested follows:)

Prior to 1953 voluntary compliance by some taxpayers receiving tip income left much to be desired. Because of the seriousness of this situation, where the problem was significant, district directors initiated an enforcement program consisting primarily of widespread publicity and extensive audit classification of returns of taxpayers occupying positions where substantial tipping is customary.

The tip income audit program has generally been directed to returns filed by personnel of establishments where food and liquor handlers receive very substantial amounts of tip income.

Since it is common knowledge that these taxpayers receive tip income, the question facing the Service is how much income was received. In view of the absence of adequate records maintained by some taxpayers, the Service is forced to resort to other methods of determining the amount of such income.

In all cases the taxpayer is afforded the opportunity to show that the examining officer's preliminary determination is in error. Of course, when this is done, appropriate adjustments are made.

Senator LONG. May I ask another question, Mr. Chairman?

You made the statement, as to this foreign-tax provision for special-interest legislation, that you thought a person ought to feel lucky to be taxed at 80.8 percent where other people would be taxed at 52 percent for the same type of transaction.

If this person should then take this opportunity to be taxed at only 80.8 percent, but elects not to take the foreign-tax credit or take it as a deducion, is it not true that he would have to give up his credit in every other country where he is dealing?

Mr. SMITH. I think that probably would be the practice.

Senator LONG. So he could then elect to be taxed by the United States Government as well as the foreign government, and not get the credit but just the deduction, with the result that he pays anywhere from 80.8 to 60 percent in all the different countries where he is dealing, on income as far as this country is concerned. As far as he is concerned, he is paying 80.8 on the transaction in Pakistan if he takes the deduction, but he has to elect to pay more taxes in every other country where he is dealing in the event he elects to take that deduction.

Mr. SMITH. He also has some option as to how he elects to report his United States income.

Senator LONG. If he is doing business in this country and in several other countries, he might elect to report his income one way in this country, and it might be to his advantage as far as his overall activity is concerned. But that throws him right in a trap where he cannot do business in some other country where they make him report a different way; is that not correct?

Mr. SMITH. There are various things in which, once a person exercises an option, they have to take all the consequences of the option. There are not many options where you can take the best of all possibilities under alternative options. If you have one, you take it and stick with it.

Senator LONG. But the point is that, applied to the example that I gave you, if the man managed to get out with just being taxed 80.8 percent with regard to his profit in what is made by dealing in Pakistan, he also has to agree to make an election that would cause him to be taxed at a higher rate in all the other countries where he is doing business, has he not?

Mr. SMITH. That might have that consequence.

Senator LONG. It would, would it not?

Mr. SMITH. It usually would.

Senator LONG. Now, we discussed this matter for a moment on the basis that this person was doing business as a corporation through an affiliate. If he were doing business through a foreign affiliate, for 10 years in a foreign country, and in 10 years he accumulated his profits, when he brought them back into this country he could take all the foreign-tax credits that he had accumulated for the entire 10-year period against the tax that he would owe this country?

Mr. SMITH. That is correct.

Senator LONG. Now, all these people are asking for in this particular section that you say is special-interest legislation is just to do the same thing for 5 years, if they are doing business directly as American corporations; that is what it amounts to, does it not?

Mr. SMITH. But this would be an additional thing available for subsidiaries as well as branch operations, as I understand it.

Senator LONG. Why would the subsidiary need it, if he can accumulate all of his credits for years and take it in 1 year when he pays his dividends, which is, in some instances, as much as 10 years after the credit accrued to him?

Mr. SMITH. Simply because he may choose to do that at the time of withdrawal; there are various business decisions that are made as to when they are going to withdraw the funds.

Senator LONG. If it is fair and it is right that an affiliate could have the benefit of all his tax credits, why should not an American company who takes the American flag abroad have the same opportunity? Why should not he have a right to take his tax credit? You are perfectly content with his right to take his credit?

Mr. SMITH. I would like to——

Senator LONG. What is immoral about a person doing business as an American corporation where he is just directly subject to the jurisdiction of this country rather than getting away from the jurisdiction of this country by dealing through an affiliate?

Mr. SMITH. There is, of course, nothing immoral about it whatsoever. The question is as to whether there should be in the very difficult, the very complex area of the taxation of foreign income, a fundamental change which permits the averaging of credits which does not now exist in any fields of the income-tax law.

Now, it is our feeling that this is a significant departure from the general provisions of law. We think it is a thing of significant revenue impact, $5 million a year. It is not related to the fundamental problem, the very important problem of developing American investment abroad in connection with economic development there. It seems to us it is an inappropriate item, on its merits in this case.

Senator LONG. I gave you a case—that is why I want to talk about the merits—I gave you a case where a man would be taxed at 112 percent.

Mr. SMITH. I disagreed with that.

Senator LONG. You came back, and you told me that that man could make an election which would permit him to be taxed at 80.8 percent while the others would be taxed at 52. But, in connection with that, you concede that by making an election he might have to pay a lot more taxes even then he would have to pay if he just elected to pay the rate of 112 percent on his income. In other words, dollarwise, to make the election that you say might be to his advantage, might cost him a lot more in terms of dollars to be taxed at 80 percent in Pakistan because he has to be taxed more with relation to all the transactions in other countries.

Mr. SMITH. Let me note, Senator, that, in your assumed situation, where the tax is of the order of 80 percent, that is based upon a foreign tax of 60 percent, I believe was the figure used, which is already above the United States 52-percent rate, so the comparison between 80 and the 52 is not a significant one; it is a comparison between 60 and 80.

Senator LONG. By the time you put the two together—in other words, what you are advocating is a business with a right to a foreign tax credit should not be able to take it?

Mr. SMITH. No; I am not.

Senator LONG. You are advocating a situation where a man has got a right without a remedy, that is what it amounts to. You are advocating a type of situation where a man can be taxed at 112 percent on his income, and where the only alternative that he has would be to make an election that might cost him a lot more than that.

Mr. SMITH. I am advocating very simply that the carry forward and carryback of tax credits is something for which there is no precedent, it is a fundamental departure from the law, it is a special relief departure that we think is not meritorious.

Senator LONG. If an affiliate does business for 10 years and accumulates tax credits, and he declares a dividend and puts that money in his parent corporation, at that point he gets the benefit of all the tax credits that he has accumulated over 10 years, so he does carry it forward, does he not, as a practical matter?

Mr. SMITH. As a practical matter it may approach the same result, but there are many practical differences between the operations of the——

Senator LONG. If he is not carrying those tax credits forward——

Senator KERR. Would the Senator yield?

Senator LONG. Yes, sir.

Senator KERR. He can carry them forward only to the extent that he owes taxes here on that income.

Senator LONG. That is right.

Senator KERR. Now, when you go beyond that, you might get into the situation where you would be letting him have a credit on the taxes he owes for the income he made in this country by reason of his having paid a higher rate of tax to a foreign country on the money he made on his income in that country.

Senator LONG. My understanding is that you could only take your foreign tax credit on a country-by-country basis, and you could only take it up to your 52 percent corporate tax. And I do not understand it, and I believe that there is no way where, if he paid 60 percent tax, that he can ever get the other 8 percent.

Senator KERR. There would be if you let him carry it forward far enough.

Senator LONG. He could carry forward the 52 percent, but not anything beyond the 52 percent, not the extra 8. And that is not in here, and not intended to be in here.

This is intended to take care of the kind of situation I am talking to you about. I do not believe that is here, and if it were here, I would be glad to support an amendment and see that that would not happen.

But as far as taxing a man at 112 percent, where the only thing you can do is to help him to make an election that will cost him even more in terms of dollars by denying him tax credit in another country where he is trading, that to me is so completely unfair, when you look at what he could do if he had an affiliate. He could simply carry his credits forward for 10 years, and to say that this person would be permitted to carry his forward by 5, as this provision would say, I think is completely fair and reasonable.

Mr. SMITH. I would simply say that there are a variety of differences between operating through the subsidiary and through the branch. There is, for instance, the difference in the treatment of percentage depletion. In one case if you take the foreign subsidiary you have the advantage of postponing the taxability of the income, but you do not get percentage depletion.

Now, this is another one of the differences. The options exist under the law. And to think that under each option they should have all the advantages of the other option just seems to us in the Treasury to be going too far, especially where it involves adoption of a completely new concept, a carryover of a credit.

Senator KERR. If the Congress, however, decided to change it, it would be abided by?

Mr. SMITH. We would certainly administer the law if it passes. We have recommended against this earlier, and we still recommend against it.

Senator KERR. We will recess until 10 o'clock tomorrow.

Thank you very much. You have been a very good witness. I appreciate your being frank.

Mr. SMITH. Thank you, Senator Kerr. It is always a pleasure to be here.

(By direction of the chairman, the following is made a part of the record.)

STATEMENT SUBMITTED BY THE AMERICAN LIFE CONVENTION AND LIFE INSURANCE ASSOCIATION OF AMERICA

The American Life Convention and the Life Insurance Association of America are two life insurance company organizations with a combined membership of 260 life insurance companies domiciled in the United States and Canada, having in force over 90 percent of all legal reserve life insurance in the United States.

Our two associations oppose the recommendations made by the Treasury Department that H. R. 8381 be amended to include a premium payment test for the estate tax on life insurance and to disallow the income tax deduction for interest on indebtedness incurred to pay life insurance premiums on an annual basis.

These two proposals were presented by the Treasury Deparment as a part of the list of unintended benefits and hardships which provided a basis for the hearings during November of 1956 conducted by the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee. The staff of the Joint Committee on Internal Revenue Taxation considered these proposals and they were the subject of extensive hearings by the Subcommittee of the House Ways and Means Committee. Neither proposal was adopted.

I. PREMIUM PAYMENT TEST

Originally, the premium payment test, which was first adopted in 1942, required the inclusion in gross estate of the proceeds of life insurance without reference to the ownership of the policy, if the insured had paid the premiums. This test was removed by congressional action in 1954, and since that time life insurance had been included in gross estate according to principles applicable to other types of property; that is, the proceeds have been included in the gross estate of the insured if at the time of his death, the insured had any rights of ownership in the policy. The Treasury proposal is the same as the original premium payment test, except that it excludes from the operation of the test the amount of the cash surrender value of the policy at death. In principle it does not differ from the original premium payment test. The only difference is in the degree of its impact.

The position of the two life insurance company associations on the Treasury proposals was set out in testimony before the Subcommittee on Internal Revenue Taxation and appears in a statement on page 95 of hearings before a Subcommittee of the Committee on Ways and Means, House of Representatives, 84th Congress, 2d session, November, 1956. At that time, the two associations expressed outright opposition to the premium payment test. That opposition remains unchanged.

The Treasury Department apparently bases its recommendation on the theory that life insurance is essentially testamentary in nature, and that transfers of the life insurance policies during lifetime have no meaning.

During the life of the insured, the policy may be pledged for a loan, it may be sold outright for a valuable consideration, and it may be the subject of a gift. In addition, a policy has a cash surrender or loan value option and other rights which may be exercised. It may provide an endowment benefit which may be realized upon the maturity date. It includes a right to dispose of the death proceeds through the designation of a beneficiary which is likewise a valuable right. When the policy is unconditionally transferred, all of these rights are enjoyed by the transferee and no interest remains in the transferor. Under the premium payment test, even though all rights in a policy are transferred unconditionally leaving no incidents of ownership in the transferor, the policy proceeds would nevertheless be subject to the estate tax.

A life insurance policy is property which is freely transferable during the life of the insured. There are many reasons for the transfer of life insurance policies during lifetime, among them exchanges of policies under buy and sell agreements entered into by partners or by shareholders in small corporations, property settlements, assignments to creditors, and small employer pension plans, to mention only a few. Once the policy is transferred, the transferor cannot recall his assignment, and the transferee can treat the contract as he pleases. He may surrender it for cash or hold it until maturity of the policy or death of the assignor, or exercise other rights. If he waits for the death of the assignor, nothing passes from the assignor. The beneficiary merely collects a fixed sum of money under a contract with a third party. Consequently, the transfer of a life insurance policy and the continued payment of premiums through gifts by the assignor is no more testamentary in nature than gifts of money, securities or other property.

Where incidents of ownership are retained by the insured, the proceeds are clearly includible in his taxable estate just as is the case with other types of property. However, the premium payment test singles out life insurance for unique and discriminatory treatment under the estate tax. No other form of property is subjected to the estate tax when the decedent has transferred such property prior to his death and not in contemplation thereof, as that term is defined in the code.

Reliance upon the theory that there is nothing to be subject to an inter vivos transfer and that the transfer is testamentary overlooks the fact that when a policy has been unconditionally transferred there is nothing left to pass from the decedent at death. In such a case the policy in no sense serves as a will. A will can be revoked at any time up to death. Upon death it effects the transfer of property from the decedent. Neither of these characteristics is present where an insurance policy has been unconditionally assigned to another.

This discrimination against life insurance companies is not just a matter of theory. For example, a father may purchase a single premium policy on his life and give it to his son for educatonal use. The son, grown up, uses the loan value for his education, and later repays the amount to the insurance company.

Many years later the father dies. The absolute gift he completed perhaps 50 years earlier is, under the premium payment test, included in his gross estate. Even more pointed is the case in which someone other than the insured takes out insurance on his life and the insured then or later pays some of the premiums. Under the premium payment test an allocable portion of the proceeds would be included in the gross estate of the insured even though he never owned the policy and never had any power of disposition over it.

The premium payment test discriminates against the small and moderate estate, as the very wealthy can avoid the effect of the test by transferring along with a policy of life insurance sufficient income producing property to cover the premium payments so that the donee can himself pay the premiums.

The implications of this discrimination are broad. One of the most significant would be the effect on small business. The importance of life insurance in small business cannot be overemphasized. The fortunes of small business cannot be so readily divorced from the personal needs of its managers and owners as can those of big business. Life insurance owned by members of the small-business man's family or by his associates often provides part of the basic financial planning he must make.

The owner of a small business seldom has sufficient liquid assets to provide for the continued operation of his business after the imposition of taxes and other expenses arising at death. He strives for expansion and plows back into the business any surplus he may have. At the time of his death, there is a need for liquid assets to provide for additional management costs made necessary by his loss and to pay succession taxes. Without such assets there is forced liquidation of the small business in many cases; in others the only solution is the merger of the small business with other businesses, with the consequent concentration of industrial power, and the loss to the economy of the initiative and imagination produced by small business.

The provision for this needed supply of liquid funds is normally impossible if done through ordinary savings. Life insurance owned by the family of the businessman is the most practical and feasible means of meeting this need.

The problems in this area do not, however, await the death of the small-business man. The mere uncertainties of future instability of the business should the businessman die is a major obstacle to the financing of small business. The small-business man often has trouble obtaining credit because of the possibility that his death, and the costs attendant thereto, would undermine the solvency of the business. This was pointed out time after time at hearings before the House Ways and Means Committee during January of this year.

If the premium payment test should be restored, the use of life insurance by the small-business man for the continuation of his business would involve substantial additional expense. This is so because the small-business man, who usually is without securities or other property, cannot arrange for the acquisition by his family of insurance on his life without subjecting it to taxation in his estate. For example, in the case of a small business with a taxable value of $200,000, under the premium payment test the heirs would be required to purchase approximately $20,000 more life insurance to provide for estate taxes.

It was for these reasons that the Senate Special Committee to Study Problems of Small Business made these recommendations to the 81st Congress:

"Give life insurance the same estate tax treatment as any other form of property. If the owner of a business provides for payment of estate tax on his death by giving his son $3,000 a year, there is no estate tax. However, if the son is given $3,000 a year to pay premiums on a life insurance policy covering the father's life, the insurance proceeds are piled on top of the father's other property and subject to estate tax. Removal of this discrimination against one type of property, life insurance, would facilitate putting the heirs of owners of independent businesses in a position to meet estate tax obligations and to carry on the business free of extraordinary obligations."

The Senate Select Committee on Small Business again this year called attention to the deterrent effect of the estate tax on small business. (See S. Rept. 1237, 85th Cong., 2d sess., p. 11.) The Treasury proposal to impose greater estate tax burdens therefore runs directly counter to the interests of small business.

In addition to its unfairness, the premium payment test is of questionable legality. If applied retroactively to past transfers, it would appear to be clearly violative of due process.[1] If confined to future transfers it would still be subject to attack as a direct tax.

The recent and well-reasoned opinion of the Court of Appeals for the Seventh Circuit in *Kohl* v. *United States*[2] squarely holds that an estate tax on proceeds of an insurance policy unconditionally transferred before death is unconstitutional as a direct tax. No Supreme Court case indicates otherwise. On the contrary, in every case in which the Supreme Court has sustained an estate tax it has carefully pointed out that some incident of ownership remained in the decedent which passed upon death.[3] This consistent reliance upon the incidents of ownership test strongly suggests that in the absence of such facts the tax would not have been upheld.

More recently there has been a lower court decision holding that the premium payment test is constitutional, the case of *Estate of Clarence H. Loeb* (29TC—No. 4, October 11, 1957). The case is now on appeal to the second circuit. Even in this opinion, however, the court admitted that the statute was imposing an estate tax not on the transmission of property at death, as is usually the case of property subject to estate tax, but on an inter vivos gift. The court said:

"Section 811 (g) (2) (A) taxes life insurance to the estate of a decedent, even though he possessed no incidents of ownership in the insurance at his death, to the extent that he paid premiums for the insurance. Therefore, we think it is clear that the subject of the tax under that section is the *inter vivos* transfer of that part of the insurance purchased by the decedent and thus the conclusion in the *Kohl* case, that section 811 (g) (2) (A) imposes a direct tax upon insurance proceeds, is erroneous."

Thus the court seems to say that if the premium payment test is constitutional it must be as a tax on a transfer during lifetime. This concept is obviously inconsistent with the overall purposes of a tax designed to reach transfers at death.

The premium payment test clearly imposes a special burden on life insurance inconsistent with the original purposes of the estate tax and with the treatment of any other type of property. Its harshest impact is upon the estate of moderate size, not just because life insurance is the traditional backbone of the savings of the moderate and small property owner but also because the very wealthy person is able to avoid the maximum impact of the test. The usefulness of insurance, in family planning and for business purposes, would be impaired by this discriminatory treatment. The premium payment test should not be again imposed.

II. BANK FINANCED LIFE INSURANCE

At the time the Treasury Department presented its proposal on bank-financed life insurance to the Subcommittee on Internal Revenue Taxation of the Ways and Means Committee, the life insurance business pointed out its lack of objective tests for compliance. The same comment must again be made, since the proposal is the same.

Under present law interest paid on indebtedness incurred or continued to purchase a single premium life insurance endowment or annuity contract is not deductible for income tax purposes. The Treasury now proposes that the present law be extended to cover the case where the policy or annuity is purchased in pursuance of a plan which contemplates that a substantial number of premiums would be paid with borrowed funds.

Life insurance companies take the position that no proposal should be adopted which would impair the normal use of borrowed funds by those in need of such credit to carry their insurance protection. Any legislation on this subject must be administratively feasible and any test of compliance should be objective and practicable. The Treasury proposal has no such objective test for compliance. Its application seems to depend on the intent of the purchaser to pay a substantial number of premiums from borrowed funds.

It may be that some reasonable extension of the single premium concept now embodied in the law can be worked out. The proposal of the Treasury Department, which so far has not been publicly reduced to statutory language, would

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[1] *Nichols* v. *Coolidge*, 274 U. S. 531 (1927); *Lewellyn* v. *Frick*, 268 U. S. 238 (1925); *Kohl* v. *United States*, 226 F. 2d 381 (C. A. 7, 1955).

[2] 226 F. 2d 381.

[3] See, for example, *Chase National Bank* v. *United States*, 278 U. S. 327 (1929); *Bromley* v. *McCaughn*, 280 U. S. 124 (1929); *Tyler* v. *United States*, 281 U. S. 497 (1930); *Helvering* v. *Hallock*, 309 U. S. 106 (1940); *Fernandes* v. *Wiener*, 326 U. S. 340 (1945).

prove unacceptable in the long run, and chiefly, it would seem, to those in the Treasury who would have to administer the law.

Previous legislation to deny interest on amounts borrowed to pay premiums has been directed against the single large amount borrowed to pay premiums in a single sum or over a short period of time. In such cases, there are special considerations, such as single premium discounts and larger amounts of interest. The single premium policy was looked upon as a device which could be used for tax avoidance purposes and is not comparable to the situation involving a policy under which premiums are payable annually over a long period of time.

We must also take issue with the inference in the Treasury proposal that life insurance is a tax exempt investment. Life insurance does not fall into this class of property. In the case of life insurance, all gain arising from a life insurance or annuity contract is taxed to the policyholder as ordinary income as soon as the gain becomes the property of the policyholder, just as is the case with income from other sources. Under section 72 of the Internal Revenue Code, the insured is taxed upon all of the gain he receives under the contract, during his lifetime, whether the contract is one of life insurance, endowment, or annuity, and whether he surrenders the contract for cash value or retains it until maturity and collects the proceeds as an annuity. The only exemption in the code is applicable to the death benefit under life insurance and here the exemption is based upon social principles.

Although the Treasury Department shares our concern with the burden of disallowing the deduction in the case of the policyholder who borrows from necessity, we do not see how he can be given adequate protection under the indefinite test proposed. Certainly this is true in cases in which the insured is required to borrow for two or more years in succession.

At best, denial of interest deductions for any amounts borrowed is difficult of enforcement because it necessarily involves a test of intent which cannot be consistently applied. Thus the penalty would attach to some amounts borrowed to pay premiums, but not to others. No test is satisfactory unless it is at the same time objective and fair.

CHAMBER OF COMMERCE OF THE UNITED STATES,
Washington, D. C., March 3, 1958.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: The Chamber of Commerce of the United States strongly supports H. R. 8381, the technical amendments bill now before your committee.

In view of the long period which has been required for preparation and consideration of the measure it is obvious that certain effective dates established by the bill as passed by the House of Representatives should be changed in order that there may be no additional hardship cases created through unjustified retroactive application of these provisions.

Provisions of the bill which would effect clarification of the Internal Revenue Code of 1954 should by all means apply as of the effective date of that act.

Merely because the list of unintended benefits and hardships under study by a subcommittee of the Committee on Ways and Means was released on November 7, 1956, most provisions of this bill dealing with these problems use this as an effective date. Release of the list of problems under study did serve as an effective deterrent and tended to stop transactions in these areas. The intent of these provisions would be accomplished in all but a few isolated instances by an effective date coinciding with the date of passage of the bill, or, at least, with the calendar year in which adoption is completed. Adoption of such effective dates would preclude the possibility of creating a new unintended hardship for those who conducted their affairs scrupulously within the framework of existing law.

The national chamber urges that appropriate adjustments be made in these effective dates of H. R. 8381, and asks that this statement be made a part of the record of your committee hearings on the bill.

Cordially yours,

CLARENCE R. MILES.

(Whereupon at 12:55 p. m., the committee recessed to reconvene at 10:15 a. m., Wednesday, February 26, 1958.)

TECHNICAL AMENDMENTS ACT OF 1958

WEDNESDAY, FEBRUARY 26, 1958

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met, pursuant to recess, at 10:15 a. m. in room 312, Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd (presiding), Kerr, Frear, Long, Douglas, Gore, Smathers, Martin, Williams, Carlson, Bennett, and Jenner.

Also present: Elizabeth B. Springer, chief clerk, and Colin Stam, chief of staff, Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The committee will come to order.

STATEMENT OF HON. FRANCIS CASE, UNITED STATES SENATOR FROM THE STATE OF SOUTH DAKOTA, ACCOMPANIED BY KENNETH KELLER, GENERAL COUNSEL, HOMESTAKE MINING CO.

The CHAIRMAN. Senator Case, we are honored to have you before our committee. Thank you for coming.

Senator CASE. Mr. Chairman, I count it an unusual privilege to appear before this committee this morning. And if the Chair will not rule me out of order, I should like to say that this privilege is not merely a privilege of appearing before the Committee on Finance but it is a privilege to appear before a committee chairmaned by yourself, and be able to say I freely express the feeling of millions of Americans when I say I am very happy that the prospects are that you will continue to be chairman of this very important committee.

The CHAIRMAN. Thank you, Senator Case.

Senator CASE. It is heartfelt as far as I am concerned. I have had the privilege of serving with the distinguished Senator from Virginia on another committee, the Committee on Armed Services, and I know from personal experience the value of the counsel of the Senator from Virginia.

It is a real privilege to appear before you.

Mr. Chairman, I come here this morning on official business to support an amendment which I have introduced which is designated as amendment 2-24-58-C to H. R. 8381.

(A letter from Senator Case of South Dakota enclosing the amendment to H. R. 8381 follows:)

UNITED STATES SENATE,
COMMITTEE ON PUBLIC WORKS,
Washington, D. C., February 26, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR MR. CHAIRMAN: I have submitted to the Senate an amendment intended to be proposed to the bill H. R. 8381 which would provide a depletion rate for gold of 23 percent instead of the present rate of 15 percent.

My amendment would provide for gold the same depletion rate that is now provided for such metals as lead, zinc, tantalum, tungsten, antimony, platinum, and others.

The gold-mining industry is operating under very unfavorable conditions. The price of gold was fixed at $35 per ounce in 1934 and has not been increased since. In the meantime, the operating costs for wages and equipment have steadily increased, the same as they have in other industries. The gold-mining operator is placed in the position of receiving a 1934 income for his product while paying steadily increasing operating costs. As a result, most of our gold mines have closed. An incentive is needed to make new discoveries.

Gold is, of course, an important commodity in the economy of this Nation. Our Federal Reserve notes are backed 25 percent with gold, and the mineral retains its historic position in the realm of international finance. The current rate of our domestic consumption of gold is substantially in excess of our annual production and new industrial uses are being made of it, such as in atomic reactors, coating for satellites, etc.

It seems to me that one way in which the Congress should recognize its responsibility to the gold-mining industry is to place this metal on a more equitable basis with other minerals and provide a 23-percent depletion rate. I hope your committee will consider my amendment favorably.

With best wishes,

Sincerely yours,

FRANCIS CASE, *United States Senate.*

[H. R. 8381, 85th Cong., 2d sess.]

AMENDMENT

Intended to be proposed by Mr. CASE of South Dakota (for himself, Mr. MARTIN of Pennsylvania, Mr. MALONE, Mr. MUNDT, Mr. BENNETT, and Mr. FLANDERS) to the bill (H. R. 8381) to amend the Internal Revenue Code of 1954 to correct unintended benefits and hardships and to make technical amendments, and for other purposes, viz: At the end of the bill add a new section as follows:

SEC. 83. RATE OF PERCENTAGE DEPLETION FOR GOLD.

(a) GOLD MINED IN THE UNITED STATES.—Section 613 (b) (2) (B) (relating to percentage depletion rates) is amended by inserting "gold," after "columbium,".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years ending after the date of the enactment of this act.

Senator CASE. My amendment would include gold in the other minerals which are accorded the 23-percent depletion under section 613 (b) (2) (B) of the code. At the present time, as the committee knows, gold falls among the minerals or ores that are given a 15-percent depletion rate under subparagraph 6 as one of all the other minerals. But we seek to have it placed in the paragraph under the 23-percent classification which presently includes such things as sulfur and uranium and a group of nonmetallic elements, and then says "and ores of the following metals: antimony, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, nickel, platinum and the platinum group metals, tantalum, thorium, tin, titanium, tungsten, vanadium, and zinc." I invite the committee's attention to the fact that all of these ores of these metals listed involve more complicated mining processes than do the clays and things of that sort which are given the 15-percent depletion rate.

Gold mining today is almost extinct in the United States. There are very, very few mines still able to operate. The price of gold was fixed in 1934, and I certainly need not present any statistics to this committee to say that the cost of powder, machinery, steel, labor, and all other costs that go into this mining operation have greatly increased since 1934. It has practically liquidated the gold mines of the country.

There is in South Dakota one outstanding exception, the Homestake Gold Mining Co., which is operating, but which has been able to operate only by an extremely good management and by instituting various methods of cutting costs. One of those is very uneconomic as far as the country's reserves are concerned. And that is that the mine is obliged to work its highest-grade ores and to bypass the lower-grade veins which ordinarily would be worked if it could be done at a profit. Actually, I think that this relief that we are stressing here will not cost the Treasury anything because the operation is on such a level that the depletion rate under the 50-percent rule won't amount to much; but as a matter of justice, it ought to be done and the time might come when it would be helpful.

Mr. Chairman, I should like to place here a statement by John W. Hamilton, secretary-treasurer of the Homestake Mining Co.

(The statement referred to follows:)

ILLUSTRATIVE EXAMPLES OF UNINTENDED INEQUITY IN UNRELATED TAX LAWS

By John W. Hamilton, Secretary-Treasurer, Homestake Mining Co.

Homestake Mining Co. is experiencing ever-diminishing profit margins. Its costs mounted steadily as worldwide inflation has become more extreme yet it has not had the privilege of increasing the price of its product commensurate with the increase in costs. Efficiency in operation has improved and partially offset the cost-price squeeze. However, through statute it has not had the only effective weapon employed by all other producers to prevent loss of profits—freedom to increase the price of its product commensurate with the increase in cost of production.

This has caused hardship in another area, an area in which it is safe to assume none was intended. Homestake, as a result of the cost-price squeeze caused by an unchanged fixed price in time of inflation, is deprived of a portion of the deduction for percentage depletion that it would otherwise enjoy.

PERCENTAGE DEPLETION

Section 613 (a), Internal Revenue Code, provides that there shall be allowed as a deduction in computing taxable income in the case of mines a specified percentage of gross income from the property not to exceed 50 percent of the taxable income from the property. In the case of gold, the specified percentage is 15 percent of gross income.

Using roughly equivalent magnitudes, the present situation is such that the deduction for percentage depletion is limited to 50 percent of our taxable income. Homestake spends some $9 per ton to recover slightly less than one-third of an ounce of gold from each ton of ore mined. At $35 per ounce of gold, Homestake's gross income is $12 per ton of ore mined. The deduction for percentage depletion equivalent to 15 percent of gross income is $1.80 while 50 percent of taxable income is only $1.50 or a loss of 30 cents per ton. The additional Federal income tax due to this loss of depletion is 16 cents.

Gross income	$12.00	$12.00
Operating costs	9.00	9.00
Net operating income	3.00	3.00
Depletion:		
15 percent of gross income	1.80	
50 percent of taxable income		1.50
Total	1.20	1.50
Federal income tax, 52 percent	.62	.78
Total	.58	.72
Add, depletion	1.80	1.50
Net cash available for dividends	2.38	2.22

If inflation continues and the price of gold remains unchanged, then the second penalty of a fixed price, loss in depletion and the consequent additional tax, will continue in a direct ratio. Abolishment of the limitation of percentage depletion to 50 percent of net income for mining products with a price fixed by statute would relieve the inadvertent inequity created by the interaction of unrelated laws.

Due to the effect of the above limitation, an increase in percentage depletion on gold from 15 to 23 percent of gross income would have no effect on Homestake's gold mining operations. The increase would, however, serve to stimulate exploration for deposits of a higher grade, or which could be mined at lower costs. Examples below compare amounts per ton of ore that would be available if the grade of ore, or low operating costs permitted depletion equivalent to percentages of gross income.

	Depletion rate	
	23 percent	15 percent
Gross income	$24.00	$24.00
Operating costs	9.00	9.00
Net operating income	15.00	15.00
Percentage depletion	5.52	3.60
Total	9.48	11.40
Federal income tax, 52 percent	4.93	5.93
Total	4.55	5.47
Add, depletion	5.52	3.60
Net case available for dividends	10.07	9.07
Gross income	12.00	12.00
Operating costs	5.00	5.00
Net operating income	7.00	7.00
Percentage depletion	2.76	1.80
Total	4.24	5.20
Federal income tax, 52 percent	2.20	2.70
Total	2.04	2.50
Add, depletion	2.76	1.80
Net cash available for dividends	4.80	4.30

Senator CASE. Mr. Chairman, there is with me this morning Mr. Kenneth Keller, who is the general counsel for the Homestake Mining Co. I think if the committee would permit, I would like to have him supplement my statement, and then either he or I would be available to answer questions if you have them.

The CHAIRMAN. Mr. Keller, we will be very glad to hear from you.

STATEMENT OF KENNETH KELLER, GENERAL COUNSEL, HOMESTAKE MINING CO.

Mr. KELLER. Mr. Chairman and members of the committee, I would like to very briefly corroborate the statement of Senator Case with reference to this problem. The Senator is a good student of mining.

The CHAIRMAN. He is a good student of most everything.

Mr. KELLER. Yes, indeed, sir.

We feel in the gold industry that this amendment should be adopted to remove any existing inequity in the tax law. We see no reason why the metal gold should be placed in any different category than tin, lead, zinc, antimony, and the metals mentioned by Senator Case.

As you gentlemen are doubtless aware, the gold industry is in a very bad plight in this country by virtue of the fact that we have a fixed-price product, the price having been fixed since 1934, and the cost and increases in inflationary costs such as wages and material are having a very detrimental effect upon the profit picture in our industry. In fact, insofar as my own company is concerned, our net profits have been steadily declining year by year. And if the present trend continues unabated, the existing gold mines that are now operating, are facing the threat of extinction. We believe that it is only just and equitable that this new metal, which is certainly of importance to the economy of this Nation, be placed in a more favorable depletion category along with these other metals.

The members of this committee realize, I am sure, that gold is important to the economy of this Nation, since 25 percent of Federal Reserve notes are backed in gold, and the metal still occupies its historic and traditional place in the field of international finance.

I am not sure but that possibly the members of this committee may not be aware of this fact that annual consumption of gold in industry in this Nation is considerably in excess of our present current annual production.

The important thing, I think, to emphasize at this meeting is that in relation to Federal tax receipts, the adoption of this amendment will at the present time have no effect, because, my company being the sole major producer, we are now up against the 50-percent limitation provision of the depletion law. In other words, your depletion rate, 15 percent, or even of 23 percent, as we are suggesting, will bump head on into the 50-percent limitation.

So that actually it will not give us any tax benefit as of now. As the Senator says, however, we think that as a matter of equity and fairness, this amendment should be made at this time, and in the future it may be of some benefit to us, particularly in the event, and when, I should say, the price of the metal is raised.

Furthermore, it has, and will have, I think, an incentive effect, looking toward the discovery of future ore bodies, when a new mine might be developed and the 23-percent depletion rate might be of some substantial benefit.

Thank you, gentlemen.

The CHAIRMAN. Thank you very much, sir.

Senator CARLSON. May I inquire if this is the only operating mine for gold in the Nation today?

Mr. KELLER. It is the only major operating mine, sir. The Cripple Creek area is shut down—the mother lode in California—a considerable amount of gold is produced in Utah as a by-product of the copper operation.

The CHAIRMAN. Any other questions?

Mr. Case, we thank you very much.

The Chair wishes to insert in the record at this point letters he received from Mr. Herman M. Magnus, of Magnus & Co., Cincinnati, Ohio, and Mr. Weldon Doe, Jr., Sellers, Doe & Bonham, Montgomery, Ala., who address themselves to section 3 of H. R. 8381, the section on which the next two witnesses will testify.

(The letters referred to follow:)

MAGNUS & CO.,
Cincinnati, February 3, 1958.

Senator HARRY F. BYRD,
Washington, D. C.

DEAR SENATOR BYRD: We understand that the House passed on January 28, 1958, H. R. 8381 and that section 3 of this was amended to provide that a dealer is not required to amortize premium on tax-exempt bonds if, (*a*) he disposes of the bond within 30 days after acquisition and, (*b*) the amount realized is higher than the adjusted basis of the bond. We understand the effective date of this goes back to November 7, 1956, and that the bill is now before the Senate Finance Committee.

As a dealer exclusively in the sale of tax-exempt securities and as such for almost 33 years, we wish to call your attention to the fact that if this bill is passed and becomes law in the form that it passed the House, it will work untold hardships on the small municipal dealer who tries to conduct his business in a legitimate and proper way and at the same time will be the means of municipal subdivisions having to pay higher prices for their bonds.

As an example of what we mean by the foregoing, if this bill passes and becames law it would add greatly to our bookkeeping requirements and general overhead and we are in no different position than the ordinary dealer in tax exempts. There may be some cases that this law is designed for, but certainly not for the vast majority of dealers and we believe it would be unfair to impose hardships on the large majority of the municipal dealers to correct any loopholes that a few may be taking advantage of.

Here in Ohio, tax bonds must be sold at a single rate of interest. They cannot be sold at a split rate and the interest cost thus determined. The only way they can be sold is with one rate of interest in multiples of one-fourth percent and the premium determines the best bid. To force dealers to have to amortize premiums as per the House-adopted bill would, in our opinion, cause for lower premiums to be bid by the dealers for Ohio bonds, and, of course, this is also true in other States.

We respectfully request your consideration to the foregoing and hope that the bill will not pass the Senate.

Respectfully yours,

HERMAN M. MAGNUS.

SELLERS, DOE & BONHAM,
Montgomery, Ala., February 27, 1958.

Senator HARRY F. BYRD,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: It has come to our attention that you, as a member of the Senate Finance Committee, are now considering H. R. 8381.

As a relatively small firm dealing in municipal bonds, we are quite upset by the proposed section 3 of this bill for the following reasons.

First and foremost is the great amount of added work that would be required by our bookkeeper and accountant in order to comply. Already these people are kept extremely busy in order to comply with existing regulations of the Securities and Exchange Commission and the Internal Revenue Service. To require us to amortize the premium on practically every bond we handle (nearly all of our purchases from municipalities are at a premium) would place an unbearable burden on an already overworked staff, which could only lead to either (1) higher interest costs to the selling municipality because of an increased cost of doing business, or (2) a freezing out of the small investment banker by the large houses who are better staffed and can better withstand the added load.

Secondly, in no matter what form this bill may eventually be passed, it would seem entirely unfair to us to make its provisions retroactive. Certainly, you would not penalize every bond dealer in this country of ours because of the transgressions of a relative few.

We therefore would strongly urge that—

(1) No dealer be required to amortize the premium on a tax-exempt bond sold at a profit, no matter how long he has to hold it.

(2) The effective date for this bill to go into effect be a reasonable time after its final adoption.

Very truly yours,

WELDON DOE, Jr.

The CHAIRMAN. The next in turn is M. W. Wright Harrison, President of the Peoples National Bank of Charlottesville, Va. Mr. Harrison, have a seat.

STATEMENT OF W. WRIGHT HARRISON, PRESIDENT OF THE PEOPLES NATIONAL BANK OF CHARLOTTESVILLE, VA.

Mr. HARRISON. Senator Byrd, as one of your constituents, that certainly was good news that you will be leading the Commonwealth of Virginia for a long time to come.

The CHAIRMAN. I want to present Mr. W. Wright Harrison, president of the Peoples National Bank of Charlottesville, Va., one of the leading banks of the South.

You may proceed, Mr. Harrison.

Mr. HARRISON. My name is W. Wright Harrison. I am president of the Peoples National Bank, a dealer bank which underwrites and deals in State and Government bonds. Our main office is in Charlottesville, Va. I am appearing today in the place of Mr. W. S. Hildreth on account of his illness. Mr. Hildreth is chairman of the board of our bank.

We specialize in municipal undewritings in the South Atlantic area, particularly in Virginia, West Virginia, Maryland, Delaware, and the Carolinas. We have been underwriters in many millions of bonds, particularly school bonds, in the Washington suburban area, at times when these bonds were very difficult to sell. We participated in bids of $64,141,000 bonds and bought $8,500,000 in Arlington County, Va.; Alexandria, Va.; Fairfax County, Va.; and Montgomery County, Md., in the last 3 years.

I wish to speak particularly on H. R. 8381, section 3, concerning dealers in tax-exempt securities, first in regard to the legislation, and second in regard to the effective date.

In regard to the legislation, there is no royal road to riches even for the Treasury Department. Perhaps this amendment may bring a little more revenue to the United States Government. We are convinced, however, that what revenue does come in this way will be offset almost exactly by higher interest paid by the counties, by the cities, and by the States. You are all familiar with the recent difficulties in marketing over a long period of years. We believe the effects of this change will be so far-reaching, particularly in the case of local school issues, that the harm done to the localities will be much more serious than any slight increase in revenue to the Internal Revenue Department.

However, should any legislation be passed affecting this section of the law we are convinced that the effective date should be a date subsequent to final adoption of the bill or at least some definite future date such as July 1, 1958, September 1, 1958, or some later date when it is certain that Congress will be adjourned and when the bill may have passed. I should like to emphasize to you gentlemen the great difficulty in bookkeeping and accounting and the very considerable expense imposed on dealers by requiring them to amortize premiums.

I should like to point out that this requirement would be imposed on an inventory which is the stock in trade of dealers so that each dealer carrying an inventory in issues of municipal bonds with 10 or even 40 maturities would have to make a separate computation of the amortization on each sale of each maturity. This would necessitate a burden and an expense which, in the final analysis, must be passed on to the borrowing municipality and if it were imposed retroactively, it would create a terrible problem to the dealers. As things stand now, we have no idea what amortization requirements will be included in the final bill and it would appear highly unusual to require us to compute our income retroactively on the basis on an unknown new provision in this law. We, therefore, strongly urge that should section 3 be enacted the effective date be made subsequent to the date of the final adoption of the bill.

CONCLUSIONS

Briefly we have two recommendations.

1. Section 3 of H. R. 8381 be eliminated completely.
2. Should any part of this section be enacted that the effective date be subsequent to the date on which the bill is adopted.

We appreciate the opportunity of submitting these recommendations to the committee.

The CHAIRMAN. Mr. Harrison, we appreciate your appearance very much.

Are there any questions?

Senator WILLIAMS. Mr. Harrison, you were speaking in regard to the effective date. Assuming that this section was enacted, you would have no objection to its being made January 1 of this year, would you? I mean, it would not necessitate retroactive amended returns?

Mr. HARRISON. It would not make necessary amended returns; no, sir. It would mean that—we are well into the year 1958, and we have not started making the necessary computations during this period of the year. It could be done. It would be much simpler if it were a date when we could begin making the necessary bookkeeping for the transactions at the time when this particular section became effective.

Senator WILLIAMS. I see, thank you.

The CHAIRMAN. You stated that any additional revenue that might come to the Federal Government would be offset by high interest rates paid by the cities and States; is that right?

Mr. HARRISON. That is right.

The CHAIRMAN. Would you submit a further memorandum, elaborating on that a little more?

Mr. HARRISON. Yes, sir; we would be glad to submit one to the committee, particularly on the subject of how the cost would be carried on to the borrowing municipalities.

The CHAIRMAN. And in that memorandum, would you give some concrete illustrations. We would like to put it in the record.

Mr. HARRISON. Would you like me to attempt to do this at this time, or do you want the memorandum?

The CHAIRMAN. No; submit a memorandum.

Mr. HARRISON. All right, sir. I would be glad to.

The CHAIRMAN. Mr. Stam says this is only done in the event of a loss, not in the event of a gain. Do you understand that?

Mr. HARRISON. Yes, sir. I understand that the present deal which you are considering would only require this computation in case of a loss. That is true. We feel that the effect would still be the same in the case of securities on which we did take a loss, that it would be a burden which would have to be passed on to the borrowing municipalities.

The CHAIRMAN. If you will furnish that memorandum, Mr. Harrison, we would appreciate it. Thank you very much for your appearance.

(The following was subsequently received for the record:)

MEMORANDUM TO THE SENATE COMMITTEE ON FINANCE RE SECTION 3, H. R. 8381

By W. Wright Harrison, president, the Peoples National Bank, of Charlottesville, Va.

Gentlemen, after completing my testimony before your committee on February 24, 1958, your chairman, Senator Byrd, asked for a memorandum elaborating further on my statement that any additional revenues that may come to the Federal Government as a result of the proposed change in section 3, H. R. 8381 would be offset by higher interest rates paid by the cities and States. Senator Byrd asked for concrete illustrations. I would like to give two such illustrations: the first, a municipal issue bought by this bank in its capacity as a municipal dealer in which the bank made a profit, and the second, an example wherein it sustained a market loss. In each case I have shown the net results after taxes and after interest income under the present law and also the results under the changes proposed by section 3, H. R. 8381.

EXAMPLE NO. 1—(A PROFIT)

We purchase $100,000 city of Charlottesville, Va., bonds due 7 years after date bearing interest at 5 percent. We bid a net interest cost to the city of 2.50 percent on these bonds. We finally sell the bonds to a permanent investor 90 days later at a 2.40 percent interest return. Under the present law, we would have a net income after 52 percent corporate taxes on our profit and our nontaxable income on our investment for the 90-day period of $1,320.27. Under the proposed section 3, H. R. 8381, we would have a net profit after taxes and nontaxable income on the investment of $1,024.03. This means that the transaction would result in $296.24 less net income after taxes to this bank and would result in the United States Treasury receiving an equal amount in additional revenue. Since the bidding on municipal issues is a highly competitive market, one must assume that in bidding 2.50 percent for the above-mentioned Charlottesville bonds that we felt that a possible profit after taxes of $1,320.27 was the minimum amount of anticipated profit to which we were entitled after considering the risk involved and the money-market conditions at the time of sale. In order to obtain this $1,320.27 profit under the proposed amendments to the law, we could bid the city of Charlottesville only 2.60 percent rather than 2.50 percent as bid in the example under the old law. Therefore, the city of Charlottesville would pay one-tenth of 1 percent more interest for 7 years on $100,000, or $700, in order that the Treasury could collect $296.24 more taxes from this bank on its small profit at the time the bonds were sold.

EXAMPLE NO. 2 (A LOSS)

We purchase $100,000 City of Charlottesville bonds due 3 years after date bearing interest at 5 percent. We bid a net interest cost to the city of 2.25 percent. Because of a drop in bond prices, we must sell these bonds 30 days later to an investor at 2.30 percent. Under the present law, we would have a net loss after 52 percent tax credit combined with our nontaxable interest income during the 30 days our money was invested of $242.90 income. Under the proposed section 3, H. R. 8381, we would have a net loss after tax adjustment combined with our nontaxable interest income of $128.24 income. This means that the transaction would result in $114.08 less net income after taxes to this bank on the transaction and would result in the Treasury receiving an equal amount in additional revenue. Once again it must be assumed that our bid of 2.25 percent was fair and that we are entitled to $242.90 net income for the risk involved in underwriting these bonds and for the use of our money for 30 days. In order to obtain this $242.90 under the proposed changes in section 3, H. R. 8381, we could bid only 2.33 percent rather than 2.25 percent as we bid in the example under the old law. Therefore, the City of Charlottesville would pay 8/100 of 1 percent more interest for 3 years, or $240, in order that the United States Treasury could collect $114.08 more taxes from this bank on its income from this transaction at the time the bonds were sold.

These two examples prove conclusively that section 3, H. R. 8381 might raise small amounts of additional tax income for the Treasury but the cities and States would pay much more than the amount received by the Treasury in increased interest cost in issuing new bonds. The mathematical computations in the two examples outlined above have been carefully made by our accounting department. Should the members of the committee or the staff of the Internal Revenue Department be interested in the detailed computations, we would be glad to supply them.

The other matter of expense which must eventually be passed along to the municipalities is the matter of bookkeeping costs. The computations of amortization is a time-consuming process which does not lend itself to automation. In our municipal department, an additional clerk would be needed to make the thousands of amortization calculations necessary and to keep records on these for income-tax purposes. The net result would be a few dollars in additional revenue to the Government in income taxes, but the salary of this additional clerk must be borne by the cities and towns issuing municipal bonds.

We appreciate the opportunity of submitting this supplemental memorandum.

W. WRIGHT HARRISON,
President, The Peoples National Bank of Charlottesville, Va.

The CHAIRMAN. The next witness is Mr. William M. Adams, vice president of the Investment Bankers Association of America.

STATEMENT OF WILLIAM M. ADAMS, VICE PRESIDENT OF THE INVESTMENT BANKERS ASSOCIATION OF AMERICA

The CHAIRMAN. Mr. Adams, we are glad to have you, sir. You may proceed.

Mr. ADAMS. Senator Byrd, and members of the Finance Committee, my name is William M. Adams. I am president of Braun, Bosworth & Co., an investment banking firm which underwrites and deals in State and municipal bonds. My office is in Detroit but my firm also has offices in other States. I am appearing today as a vice president of the Investment Bankers Association of America.

The Investment Bankers Association of America is a voluntary unincorporated trade association of investment banking firms and security dealers who underwrite and deal in all types of securities. Our Association has over 800 member firms engaged in one phase or another of the securities business in the United States and Canada, including about 100 commercial banks. Our members have, in addition to their main offices, over 1,300 registered branch offices. Many of these firms underwrite and deal in State and municipal bonds and in the aggregate do a large percentage of the underwriting, distribution, and trading of State and municipal bonds.

Since our recommendations are directed solely to section 3 of H. R. 8381, regarding amortization of premium on tax-exempt bonds by dealers, it may simplify understanding of the problem to summarize briefly the function of dealers in marketing municipal bonds, the pricing of municipal bonds, and the effect of amortization by dealers.

Senator KERR. Just a moment, Mr. Adams. Would you give the committee your interpretation of what section 3 would do?

Mr. ADAMS. It is my understanding that section 3 would require dealers to amortize premiums on all tax-exempt bonds held by them, unless, first, a bond is disposed of by the dealer within 30 days after the date of its acquisition by him; and (*b*) the amount realized is higher than the adjusted basis of the bond. Section 3 would apply to all tax-exempt bonds acquired by dealers after November 7, 1956.

Senator KERR. After November 7, 1956. Now, are you opposed to it at all or are you opposed to the retroactive feature of it, or what is your position?

Mr. ADAMS. I am opposed to two things, Senator, which I have included in this statement. Would you prefer that I state them now, or as they come into the statement?

Senator KERR. Well, I thought that for my own benefit, the best way to get rid of ignorance is to expose it. If I knew to start with what you were addressing yourself to I might better understand what you say as you address yourself to it.

Mr. ADAMS. We are opposed to the 30-day limitation in connection with this section, and also the date of its taking effect.

Senator KERR. Now, if the effective date would change it to that of the passage of the act, how would you feel about the bill?

Mr. ADAMS. I think, sir, that we would be very happy to see it at a date that was definitely set in the future on which we could begin to function on that basis. And the date of the act, of course, would be presumably some later date, would it not?

Senator KERR. I said if the effective date of the provision were made the same as the passage of the act.

Mr. ADAMS. That would be quite agreeable.

Senator KERR. Then if that were done, would that cure all of your opposition to the section?

Mr. ADAMS. No. The 30 days. It is the other portion of it that we are opposed to.

Senator KERR. What phase of that are you opposed to? The 30-day clause on sale or disposal of a tax-exempt bond is in the existing law, isn't it?

Mr. ADAMS. But that existing law applies only to bonds 5 years and under. Under the new section it would apply to any maturity of bonds sold at a loss or held over 30 days and sold at a profit.

Senator KERR. All right. Then you helped me some. Now, go ahead, maybe I will catch up with you before you get through.

FUNCTION OF DEALERS

Mr. ADAMS. Most issues of municipal bonds are offered by the issuing municipality at competitive bidding and are sold to the syndicate of dealers which bids the price that provides the lowest net interest cost to the issuer. The dealers reoffer the bonds to investors at a price slightly higher than the price paid to the issuer, the markup in price representing the dealer's profit. The dealer is a merchant of bonds, the bonds held by the dealer constitute his stock in trade for sale to customers, and the primary objective of the dealer is to resell the bonds as quickly as possible at a profit.

PRICING OF BONDS

Most issues of municipal bonds are serial issues, that is some of the bonds mature each year to the final maturity date. The price varies for bonds of different maturities in the same issue, so that each maturity of bonds in a single issue may for bookkeeping purposes constitute a separate item of stock in trade. If a dealer on a single day buys and offers for resale 3 or 4 issues of bonds and each issue has 20 separately priced maturities in it, the dealer may have 60 or 80 separately priced new items of stock in trade, plus his accumulated inventory of bonds previously purchased.

A bond is priced at a "premium" when its dollar price is higher than its face value (ordinarily $1,000).

Senator KERR. Now, would you say its dollar price is higher when its market value is higher?

Mr. ADAMS. A bond is priced at a premium when its dollar price is higher than its face value, face value ordinarily being $1,000.

Senator KERR. The face value is the par value, isn't it?

Mr. ADAMS. That is correct.

Senator KERR. Then your term here "dollar price" is synonymous to dollar price?

Mr. ADAMS. That would be the market price.

Senator KERR. All right.

Mr. ADAMS. A bond is priced at a "discount" when its dollar price is lower than its face value. Practically all new issues of municipal bonds are purchased by dealers at a small premium because (1) laws in many States require that the issuing municipality receive at least the face value of the bonds and (2) the bidding by dealers on the bonds usually results in a price above the face value.

Senator KERR. Is that because of the advice of counsel or others to the issuer as to what interest rate will enable the bidders to pay par or a little better?

Mr. ADAMS. Yes, that is correct. Of course, the dealers set the coupon rate, and as I say here, the law in most States requires that you must set a coupon rate at which you will purchase from the municipality originally the bonds at their face value or higher.

Senator KERR. Now, the law doesn't require the setting of the coupon rate at any specified figure; does it?

Mr. ADAMS. No.

Senator KERR. Doesn't the law just require that the issuer receive at least par or what you refer to as the face value for the bond?

Mr. ADAMS. That is correct, sir.

Senator KERR. And in fixing it so that that can be done, then you get into the matter of fixing the coupon?

Mr. ADAMS. That is correct.

Senator KERR. Which is the same as the interest rate?

Mr. ADAMS. That is correct.

Senator KERR. All right.

Mr. ADAMS. However, bonds which were originally sold at a premium may subsequently be resold at a discount if (a) money rates go up so that investors demand a higher yield than the interest rate provided on the bond or (*b*) adverse developments in the credit of the issuer increase the risk in the bonds. Thus, in the latter part of 1956 when money rates went up many issues of bonds which had been sold previously at a premium were then sold at a discount.

Senator KERR. And when the interest rates came down in the latter part of 1957, then the dealer that had a very high inventory of bonds which they had either held because they couldn't get cost out of them or because they felt they would have a chance by holding them to do better on them, made more money than the combined group of them had made in any similar period in the memory of most dealers; didn't they?

Mr. ADAMS. I don't know that I would go quite that far although——

Senator KERR. How near would you come to it?

Mr. ADAMS. Well, there are other periods, Senator, when we have had rather quick rises in the market which would have occasioned your receiving a quick rise in inventory.

Senator KERR. You know I have enough trouble listening to the spoken word without trying to correlate it with visual education. I wish you would tell me, if you can, a period in our history similar to November and December 1957, when the dealers with a big inventory of bonds with medium- and high-interest rates enjoyed as much of an increase in value of inventory as quickly as they did in that 60-day period, when you take into account both the amount of the inventory and the increase in value of it.

Mr. ADAMS. I don't have the figures on the amount of inventory in 1953, but I can give you the rapidity of the increase.

Senator KERR. Now, the Treasury sold its 90-day bills 2 days ago for 1.21; didn't they?

Mr. ADAMS. That is correct.

Senator KERR. The first of November they were selling them at what, 3.75, 3.74?

Mr. ADAMS. 3.6, something, I believe, was the highest yield on which they sold their bills.

Senator KERR. And that was in late October or early November of 1957?

Mr. ADAMS. That is approximately correct.

Senator KERR. Now, from November to February 15 is how long?

Mr. ADAMS. Three months.

Senator KERR. Will you tell me, show me any other period in our history when the interest rate on a 90-day bill decreased to that extent?

Mr. ADAMS. Senator, I am not a dealer in United States Government bonds.

Senator KERR. You have a chart there, which you offered us as an exhibit.

Mr. ADAMS. Yes.

Senator KERR. I presumed you understood it, and I was quite sure that I might not.

Now, referring to that chart, will you tell me if it discloses any period in our history when that much of a change took place in that short a time?

Mr. ADAMS. You asked me to confine it to Government bills, and I do not have those figures here.

Senator KERR. Do they fix the market or follow the market?

Mr. ADAMS. I would say that nothing would be quite so responsive to general interest rates as the Government bills.

Senator KERR. Well, then, I just referred to them because it happens that I know something about them, and you being in the position you are, not only a dealer but the vice president of the Investment Bankers Association of America, I am sure you would either have in your mind, or within your reach information on other inventory, that is, other bonds or debentures or interest bank securities. And there would be a pretty close relationship between any of them and the interest rate on Government bills; wouldn't there?

Mr. ADAMS. May I speak on municipal bonds, which is what we deal in, Senator?

Senator KERR. Well, I would be glad if you would answer my question. You said that there is nothing that more nearly reflects fluctuations in the market than Government bills. Did you make that statement?

Mr. ADAMS. I think that is correct.

Senator KERR. That was the statement you made; wasn't it?

Mr. ADAMS. Yes.

Senator KERR. Well, now, do you still think it is correct? You thought it was correct when you made it.

Mr. ADAMS. I still think it is correct.

Senator KERR. That is the assumption I am indulging here.

Mr. ADAMS. We are dealing with municipal bonds and in connection with this bill, it applies to municipal bond dealers, and I would like to give you some figures on the change in the market for municipal bonds in similar periods. May I do so?

Senator KERR. Well, if you do, I want you to distinctly understand that I understand that you are giving that on your own initiative rather than in response to my question.

Mr. ADAMS. Not being a dealer in Government bonds, we are interested from the standpoint of our inventory only in connection with the handling of municipal bonds. In other words, we do not stock or deal in Government bonds.

Senator KERR. I understand.

Mr. ADAMS. And I am only interested in the movements of Government bond rates as they relate to municipal prices.

Senator KERR. And whether one causes the other, that is, whether Government bills make the market or follow the market, the rate at which they sell certainly reflects the market as at the time they are sold?

Mr. ADAMS. Definitely.

Senator KERR. Either by reason of the market being that or by reason of their selling so that the market then becomes that?

Mr. ADAMS. Definitely.

Senator KERR. Then let me get the answer to my question. If you don't know, just say so. Do you know of any other period of 90 days or thereabouts, maybe 105, if you went from October 31 to February 15, do you know of any other comparable period in our history when the interest rates on 90-day Government bills had that wide a fluctuation and that much of a decline?

Mr. ADAMS. May I say to you that Government bills, 60- to 90-day bills alone, would not be indicative of the entire interest rate market.

Senator KERR. Surely you may, you can say anything you want to, you have got the right of freedom of speech, you have got the right to answer my question or say you don't want to, or say you don't know, or filibuster. And since that seems to be what you want to do, why, you go ahead and make your statement.

I am not adverse to your position. The fact about the business is, I think you are justified in opposing at least the retroactive features of this section. But it just happens that I was interested in another phase, and here you are, the representative of a great segment of this Nation, the Investment Bankers Association of America, and you come here occupying that position, and it enables you to speak with some authority, and I had hoped that you and I might indulge here in a colloquy that would evince some information. And I assure you, as far as I am concerned, you wouldn't damage your position any by giving me the benefit of any information which you must have.

The CHAIRMAN. The Chair would suggest that you answer Senator Kerr to the best of your ability. If you feel that you are not competent to answer the question——

Mr. ADAMS. I would be very happy to answer the question. But when I answer a question like that, I would like to say that the level of such and such on a certain date, and I cannot do that from memory on Government bills.

To answer your question, Senator, I do not think there is any question but what this was probably the most rapid change and most drastic change in a similar period of time that we have ever had in our history. The reason I hesitated at all was that there was a period there in 1953 when we had a most rapid change and a very drastic change, and it would come somewhere near the similar change that we now have experienced. And I am reluctant to say yes or no without having the date and the figures in front of me. That was the only reason for my reluctance.

Senator KERR. I understand that. And I asked you if you could remember any other period.

Mr. ADAMS. I could not from memory, and so I hesitate.

Senator KERR. I appreciate what you say because with the limited acquaintance I have with the situation, I don't remember any other period, and I say to you quite frankly, if between us we could find another period for the sake both of information and accuracy, I would like you to identify it, and say when it was.

Mr. ADAMS. I can give you figures——

Senator KERR. Let me see if we can agree on this, that there have been a few such periods, and if there are any others at the moment, neither of us can think of them.

Mr. ADAMS. That I would agree with; yes.

Senator KERR. Now on that basis, is that not indicative of the foundation for what I just asked you about, if the period of November and December wasn't one in which, let us say, there was one of the most rapid accelerations in value of inventory that either of us can remember, and it was at that time when the investment dealers had very large inventories?

Mr. ADAMS. That is true.

Senator KERR. I appreciate your letting me get that information into the record.

Mr. ADAMS. The effect of amortization. If a dealer buys a 10-year $1,000 bond with a 3½ percent interest coupon for $1,021.20 (to yield 3¼ percent to maturity) and sells the bond in 30 days for $1,021.02 (to yield 3¼ percent to maturity), if not required to amortize premium, he would have a loss of 18 cents.

Senator KERR. What is the meaning of the term "to amortize a premium"?

Mr. ADAMS. Let us take a 1-year 6 percent bond, and assume that you bought it to yield——

Senator KERR. A 1-year 6 percent bond dated January 1, 1958.

Mr. ADAMS. All right.

Senator KERR. Now, that gives you the rate, the term, and the date of issuance.

Mr. ADAMS. Right.

Senator KERR. Now, when did you buy it?

Mr. ADAMS. Let's say that we bought it on January 1, 1958, and that we sold it on July 1.

Senator KERR. What do you assume you paid for it? It is a $1,000 bond.

Mr. ADAMS. Let's assume that we paid $103 for it.

Senator KERR. Then that would be $1030?

Mr. ADAMS. Yes.

Now, if we have to amortize this bond——

Senator KERR. Now, you didn't say you amortized the bond, what you said was you amortized the premiums.

Mr. ADAMS. Amortized the premiums.

Senator KERR. The premium there is $30.

Mr. ADAMS. That is correct.

Senator KERR. When you amortize that, what do you do?

Mr. ADAMS. We wouud divide it up into the number of 6-month periods between the date of the bond and the date of maturity.

Senator KERR. Does that mean then that in amortizing that premium, and it being a 1-year period, you would by amortizing charge as an item of expense one-fourth of it in each of the 3 months of 1958, since it was a 1-year bond?

Mr. ADAMS. That is correct, except that the amount of amortized premium is not deductible and cannot be charged as an item of expense.

Senator KERR. Now, if it were a 2-year period, and you were going to pay a 3 percent premium on it, then you would pay $1,060, wouldn't you?

Mr. ADAMS. That is approximately correct.

Senator KERR. And then if you were permitted to amortize that premium, and since it is a 2-year bond, you would first charge off half of that premium each of the 2 years for which the bond was issued?

Mr. ADAMS. A fourth each 6 months, but the amortized premium on tax-exempt bonds cannot be charged as an item of expense.

Senator WILLIAMS. When you sell this bond, if you sold it at a price higher, how would you figure your amortization?

Senator KERR. You sure left me suspended in mid air up there, Senator. That is all right. You go ahead, and I hope that I am still hanging up there.

Senator WILLIAMS. I was just lost because I thought at some time you were selling this bond.

Senator KERR. If it is a 2-year bond and you pay a 3 percent premium, then you have paid $1,060 for it, approximately?

Mr. ADAMS. That is correct.

Senator KERR. In other words, the $60 is a premium?

Mr. ADAMS. Well, you would be paying a 6 percent premium, then.

Senator KERR. But it is $60?

Mr. ADAMS. That is correct.

Senator KERR. And 6 percent for 1 year is nearly the same as 3 percent for 2 years?

Mr. ADAMS. You mean the other way around, don't you? 3 percent for 1 year is the same as 6 percent for 2 years.

Senator KERR. No, 6 percent for 1 year, I believe, is the same as 3 percent for 2 years.

Mr. ADAMS. I understand now what you mean. You are correct.

Senator KERR. But whether you call it a 3 percent premium for 2 years or a 6 percent premium for 1 year, the $60 is the premium?

Mr. ADAMS. That is correct.

Senator KERR. And if you are permitted to amortize it, that means that if you keep your books and pay your taxes on an annual basis, you charge $30 each of those 2 years, or $15 each 6 months of the 2 years.

Mr. ADAMS. That is correct, but amortized premiums cannot be deducted in the case of tax-exempt bonds.

Senator KERR. Now, then, Senator Williams, I was getting around to your question.

Senator WILLIAMS. All right.

Senator KERR. Now, then, by amortizing the premium, we have got that on the debit side of your books taxwise, haven't we?

Mr. ADAMS. Yes.

Senator KERR. Now, then, does this still prevent you from doing that? Would this section prevent you from charging that premium off as an expense? Under the present law you amortize that premium, don't you?

Mr. ADAMS. On any bond over 5 years held—under 5 years, if they are held longer than 30 days, we must amortize it. Over 5 years, we don't have to amortize it.

Senator KERR. Well, now, do you want to amortize it, or don't you want to amortize it? Which is your position before this committee?

Mr. ADAMS. Well, the position we are taking here, Senator, is that we are—we prefer to require as little unusual bookkeeping as possible.

Senator KERR. You mean you prefer to have as little of it required of you?

Mr. ADAMS. That is correct.

Senator KERR. You prefer that the Government require as little of it as possible?

Mr. ADAMS. To amortize all items that we handle, which is what would be required, that is, to at least check every item to see if it required amortization, would be required under this bill as it is set up.

Senator KERR. Would be required?

Mr. ADAMS. Yes, sir.

Senator KERR. And that would be a rather large bookkeeping job?

Mr. ADAMS. That would be a tremendous bookkeeping item. I have brought along figures from my own books to show you what is involved.

Senator KERR. You are getting ahead of me. I will be glad to look at that. But I am trying to go ahead with you and understand it, and since you understand it and I don't, I will tell you frankly that you have got the advantage of me here. And if you can help me to understand it as well as you do, we will be able to talk about it on an equal basis, won't we?

Now, let's say you pay $1,060 for this bond, and you keep it for 30 days and you get $1,100 for it. That means you have made $40, doesn't it?

Mr. ADAMS. That is correct.

Senator KERR. Now, what do you pay taxes on under those circumstances? And what do you charge off under those circumstances?

Mr. ADAMS. You would pay taxes on $40, and you would not charge off against your income any of the amortization that would have prevailed over that period of 30 days on that bond.

Senator KERR. In other words, one twenty-fourth in this event of the $60, since it is a 2-year bond, and since you pay the $60 premium.

Mr. ADAMS. One twenty-fourth.

Senator KERR. Is that correct?

Mr. ADAMS. That would be one twenty-fourth; yes.

Senator KERR. But you still made $40, didn't you?

Mr. ADAMS. Yes, sir, according to your figuring.

Senator FREAR. May I inquire what kind of bond this is, whether it is municipal or Government?

Senator KERR. Well, my question was addressed to any bond.

Senator FREAR. Any bond. Well, I think there is a difference, isn't there?

Mr. ADAMS. Yes. If these are municipal bonds that we have been talking about under my interpretation only.

Senator KERR. Why do you talk about municipal bonds only? Is that because that is all you handle, or because they are tax exempt?

Mr. ADAMS. Because they are tax exempt.

Senator KERR. In other words, whatever interest would be collected in that time by you or anyone else that collects it, is tax exempt?

Mr. ADAMS. That is correct.

Senator KERR. But your profit on this transaction is $40. I want to tell you I can figure that out, if you pay $1,060 for it this week and sell it a month from now at $1,100, in my country that is $40 profit. And until you begin to put things on the debit side, you owe tax on $40, don't you? Now, what is it that you now can do in the matter of offsetting a part of that $40 profit under the existing law?

Mr. ADAMS. For bonds that are under 5 years maturity——

Senator KERR. Well, this is a 2-year bond?

Mr. ADAMS. It is a 2-year bond. If that bond were held less than 30 days——

Senator KERR. But you hold it for 30 days.

Mr. ADAMS. Then if we hold it over 30 days we must amortize this bond, and therefore get no benefit—well, if we have held it exactly 30 days——

Senator KERR. Let's say 31 days.

Mr. ADAMS. If we have held it 31 days, then we must amortize that bond, and we get no benefit of the writeoff of it at all.

Senator KERR. Well, if you must amortize it, don't you then get the benefit of what you have done because you must?

Mr. ADAMS. Senator Kerr, let me just back up for a minute here and try to make it clear if I can. Now, if you hold this bond for the 31 days, which goes over the period, then any amortization, this one twenty-fourth that you mention of the premium, must be as far as we are concerned from a tax point of view, be deducted from the cost of the bond, so that there is no advantage in it. Now, if you hold the bond under 30 days under the present law, you are not required to amortize and are able to get the advantage and you have received in the meantime tax exempt income.

Senator KERR. No, you haven't selected any income, because I assumed that if this bond were issued on January 1, 1958, there wouldn't be a coupon that anybody would collect before February 1.

Mr. ADAMS. But all bonds, Senator Kerr, are traded on an interest-accrued basis, so that——

Senator KERR. I had assumed that that was included in the $1,100. Now, if you had sold that $1,100, would you get in addition to that the interest for that period of time?

Mr. ADAMS. Correct.

Senator KERR. Now, you have helped me a whole lot with that one statement, so that if you sold the bond for $1,100 you would sell it for $1,100 plus the 31 days interest?

Mr. ADAMS. That is correct.

Senator KERR. Then you still wouldn't owe, would you, any tax on that 30-day interest, because that is a tax-exempt bond?

Mr. ADAMS. No, there would be no tax on it.

Senator KERR. Well, then, you wouldn't want to charge that off against the $40 profit, in addition to this, would you?

Mr. ADAMS. No, there is no chargeoff there.

Senator KERR. Well, I thought you said that if you had held it more than 31 days you had to make a chargeoff.

Mr. ADAMS. Well, you do get the benefit of the amortization against your interest income.

Senator WILLIAMS. Who gets it? Does it pass on to the purchaser of the bond or is it lost?

Mr. ADAMS. No, this is a matter of bookkeeping as far as your profit or loss is concerned.

Senator Kerr, may I make a suggestion, that if I go through the remainder of this amortization that we might clear up a part of it, and then we can see if there are any questions that I can answer for you.

Senator KERR. That will be fine. I used to teach school and I found out that I did better when I operated on the basis of the ability of the students to understand rather than a feeling that you ought to operate on the basis of my ability to explain.

Mr. ADAMS. I think that is probably a very good system.

Senator GORE. Could I ask one question now?

The CHAIRMAN. Senator Gore.

Senator GORE. What tax rate would you pay on the $40 profit, assuming the case which Senator Kerr states?

Mr. ADAMS. 52 percent. That is, if you were in a high enough income level so that your profit could be in the 52 percent bracket as a corporation.

Senator GORE. Ordinary income and not capital gains?

Mr. ADAMS. That is correct. As a dealer we would operate only on that basis.

Senator FREAR. That is not for a municipal bond?

Mr. ADAMS. I beg your pardon?

Senator FREAR. If it were a municipal bond it is tax exempt.

Senator KERR. That would be for the amount of the sale price above the $1,100, and therefore that would be in addition to the $40 that was identified.

Senator FREAR. That is a profit and not interest, then?

Mr. ADAMS. That is correct.

Senator GORE. And is this because you are a dealer?

Senator KERR. No, anybody that is a dealer, anybody that is a dealer in bonds takes in to profit what he earns when he sells it for more than he pays for it, and puts into the loss any amount he sells for less than what he paid for it.

Mr. ADAMS. That is right.

Senator KERR. And that is one item of income, and that is kept just like a merchant that sells canned peas or catsup or steak.

Senator GORE. That is what I am asking.

Senator KERR. But the other item of income that he had was whatever amount of interest there was accumulated on the bonds from date of issuance to date of sale, and which was included in the sale price over and above the $1,100. And on that you pay no tax.

Mr. ADAMS. That is correct.

Here is the point at which I am doing a very poor job of explaining, I think, and that is right here in this one statement that we have made there and possibly I assumed it is too simple. But in this instance here, if a dealer buys a 10-year $1,000 bond with a 3½ percent interest coupon for $1,021.20, to yield 3¼ percent maturity, the dollar price would have changed, it would come to $1,021.02, because of this amortization. Now, if we are not required to amortize the premium, we would have the loss of 18 cents, but if we are required to amortize premium, we would have no loss or gain. Now, the whole gist of this thing revolves around the question of the 18 cents whether it is loss or whether it is income, tax-free income.

Senator KERR. How would it be tax-free income, now, if actually you wrote a check for $1,021.20 when you bought it and you only got a check for $1,021.02 when you sold it.

Mr. ADAMS. Because you have received the accrual of the coupon at 3½ percent as tax-exempt income while you held it.

Senator KERR. How can you receive it?

Mr. ADAMS. You must, when you buy bonds you pay accrued interest to the date you pay for them.

Senator KERR. Don't you put that into the check?

Mr. ADAMS. Yes.

Senator KERR. What I asked you was if you wrote a check for $1,021.20 when you bought it and you got a check for $1,021.02 when you sold it, how do you have an 18-cent profit?

Mr. ADAMS. I am sorry, Senator, but in this figure we have not included accrued interest, because that is simply something that always goes with every bond transaction and this is only principal.

Senator KERR. You referred there to the fact that you were going to have to make this simple for simple-minded people, and I want to say that you are exactly right. And I am simple-minded enough to think of you wrote a check for $1,021.20 for the bond and then you sold it and got a check for $1,021.02, you lost 18 cents.

Mr. ADAMS. That is principal, it has nothing to do with the income you held from the bond.

Senator KERR. What would you write a check for when you bought it and what would you get a check for when you sold it?

Mr. ADAMS. If you were to purchase that bond on January 1, 1958, and that was the date of the bond, then you would pay——

Senator KERR. I am getting back to these figures here. Instead of $1,021.20 on the basis I have outlined, what would the check be? Since that was the date of the issuance of the bond, I presume it would be for $1,021.20.

Mr. ADAMS. If that was the date of the issue, that is exactly correct. There would be no accrued interest at all.

Senator KERR. All right.

Senator GORE. What was that figure?

Senator KERR. $1,021.20. It is in the second paragraph on page 2 of his prepared statement.

Mr. ADAMS. Now, if you were to hold that bond for 30 days and then turn it in——

Senator KERR. No, you sell it to somebody.

Mr. ADAMS. All right, sell it to somebody—there would be accrued interest per thousand of $2.92.

Senator KERR. Then you would get a check for that, wouldn't you?

Mr. ADAMS. Yes.

Senator KERR. Plus $1,021.20.

Mr. ADAMS. Correct—wait a minute.

Senator KERR. Plus $1,021.20.

Mr. ADAMS. Now at the end of the 30 days, at the end of 30 days you would get $1,021.02.

Senator KERR. $1,021.02, plus $2.92?

Mr. ADAMS. That is correct.

Senator KERR. Plus $2.92—which would be $1,023.94?

Mr. ADAMS. I didn't figure it, but that would sound correct.

Senator KERR. You can validly assume it. Now, then, on the present basis you would have a $2.92 tax-free income?

Mr. ADAMS. That is correct.

Senator KERR. But under the present law you have an 18-cent loss.

Mr. ADAMS. If you held a bond——

Senator KERR. If you got $1,021.02.

Mr. ADAMS. Yes, if you held it 31 days.

Senator KERR. No. You told me you sold it in 30 days.

Mr. ADAMS. That is correct. I am sorry. We said 31 days at one time. You would have a loss of 18 cents if it was sold in 30 days, that is correct.

Senator KERR. But if you sold it in 31 days, and those same figures happened to apply, you would have a $2.92 profit on which there was no tax?

Mr. ADAMS. Correct.

Senator KERR. But you would have an 18-cent loss that was a deductible item was a loss?

Mr. ADAMS. Not in 31 days.

Senator KERR. Well, I thought you said you would.

Mr. ADAMS. No, 30 days.

Senator GORE. You had it the other way around just now.

Senator KERR. If not required to amortize, say, he would have a loss of 18 cents, that is right here in the statement.

Mr. ADAMS. Yes, but he would not be required to amortize if he held the bond 30 days or less, but if he held it 31 days, then he must amortize it.

Senator KERR. Then we have held it 31 days, and I am asking you to assume that these figures apply to the 31-day transaction.

Mr. ADAMS. If he held it 31 days he would not be able to take any loss. That figure would then have to be amortized, that is right.

Senator KERR. Well, then when you amortize, doesn't that just direct how you charge it off as a loss?

Mr. ADAMS. There is no loss. There is a bookkeeping item permitted if you hold that bond over 30 days, that item is then deducted from your tax-exempt income. In other words, it is amortized.

Senator KERR. In other words, the effect then of requiring you to amortize it is the same as saying you cannot deduct whatever the figure may be that you have got to amortize as a loss.

Mr. ADAMS. Yes, that is right.

Mr. STAM. Against the taxable income.

Senator KERR. But if you sell it in 30 days or less at these figures, then you would get $2.92 tax-free income?

Mr. ADAMS. Right.

Senator KERR. And having an 18-cent loss on the face——

Mr. ADAMS. Right.

Senator KERR. Of the bonds, which I don't understand, but which I will in a minute—you would be permitted to show an 18-cent loss.

Mr. ADAMS. That is right.

Mr. STAM. That is existing law.

Senator KERR. That is existing law, and is the way you want to keep it.

Mr. ADAMS. Senator Kerr, it is rather difficult to go back into history without taking a lot of time. We are willing, let's put it this way, we are willing to cooperate to the fullest extent in trying to close a loophole which obviously is a loophole. We are willing to accept a certain amount of what we feel is an inequity in order to do that. Now, what we are proposing is—and what this section 3 proposes—is that any bonds——

Senator KERR. Now, are you for section 3 or against it?

Mr. ADAMS. The only thing I am against in section 3 is requiring this 30-day provision which means that we must then go over every transaction that we have in any maturity of bonds in order to establish what bonds will have been sold at less than acquisition cost, and therefore subject to this bill. Is that fairly stated?

Senator KERR. Yes. But I understood that there was the 30-day provision in existing law.

Mr. ADAMS. But it applies only to the 5 year maturity.

Senator KERR. You mean it applies only to bonds that mature in 5 years or less?

Mr. ADAMS. Within five years, correct.

Senator KERR. And under section 3 written, existing law will be made applicable to any bonds?

Mr. ADAMS. To all maturities, correct.

Senator KERR. And that is the feature in it that you object to?

Mr. ADAMS. I am not objecting to it applying to all bonds, I am objecting to the fact that you are arbitrarily saying that the end of 30 days any bonds you have held you must amortize.

Senator KERR. Well, now, at the present time, if it is 5 years or less, you must, mustn't you?

Mr. ADAMS. Under 5 years, yes.

Senator KERR. Well, then it looks to me like what you are saying adds up to the position that you are against any change in the present law, since the only thing that this section does, as I understand it retroactively changes the application of the present law to any bond instead of just those that mature in 5 years or less.

Mr. ADAMS. The very fact that it applies to all maturities of all bonds, whether sold at a profit or a loss after 30 days is the thing that we are objecting to.

Senator KERR. Now does the present law not apply to any bonds with less than a 5-year maturity, whether it is a profit or a loss?

Mr. ADAMS. Within the 5-year maturity, whether profit or loss, yes.

Senator KERR. Well, then, isn't the only difference in the section here that it would apply to any bond regardless of maturity?

Mr. ADAMS. It amounts to this, that in the months of December and January, in what we feel is a relatively small firm in this business, that we had 281 items that were 1 to 5 years, and we had 1,020 items of all maturities which went through our books in those 2 months.

Senator KERR. Well, then, doesn't your position add up to one of being against any change in existing law?

Mr. ADAMS. No, that isn't true. We are trying to propose something, Senator Kerr, that would do away with the existing inequities, that would close the loophole.

Senator KERR. What are the existing inequities? Now, the Treasury tells us that all they are trying to do is close the loophole.

Mr. ADAMS. And I am sure that is correct, sir.

Senator KERR. And I am trying to find out what the loophole is.

Mr. ADAMS. Here is the loophole [indicating statement].

Senator KERR. Why don't you just break down and tell me what the loophole is.

Senator BENNETT. Near the bottom of page 2 there is a paragraph which is headed "The 'loophole.'"

Senator KERR. Well, if he is able to write it down on a piece of paper, he ought to be able to say it. Go ahead, Mr. Adams.

Mr. ADAMS. Effect of amortization. If a dealer buys a 10-year \$1,000 bond with a 3½ interest coupon for \$1,021.20 (to yield 3¼ percent to maturity) and sells the bond in 30 days for \$1,021.02 (to yield 3¼ percent to maturity), if not required to amortize premium, he would have a "loss" of 18 cents. If the dealer is required to amortize premium in this transaction, he must for tax purposes reduce his cost of the bond by the amount of premium attributable to the period which he held the bond (since the dealer held the bond 1/120th of the 10 years to maturity, the premium attributable to that period would be 1/120th of the full premium of $21.20), which would be 18 cents; his cost for tax purposes would be reduced by 18 cents to $1,021.02 so that he would have no tax "loss" on the transaction; and the amortized bond premium on tax-exempt bonds is not deductible. The bookkeeping burden and expense for a dealer in making this computation for each transaction is apparent.

If the dealer at the same time buys another 10-year $1,000 bond with a 3-percent-interest coupon at a discount for $978.80 (also to yield 3¼ percent to maturity) and sold it in 30 days for $978.99, the discount attributable to the period he held the bond (18 cents) would be fully taxable to the dealer as ordinary income.

PRESENT LAW

Section 75 of the Internal Revenue Code of 1954 requires a dealer to amortize premium on a tax-exempt bond held by him unless (*a*) the bond is sold or otherwise disposed of by the dealer within 30 days after the date of acquisition by him or (*b*) the earliest maturity or call date of the bond is a date more than 5 years from the date on which it was acquired by the dealer.

THE "LOOPHOLE"

It has been reported that a few dealers are taking advantage of the exceptions under section 75 of the code by holding premium bonds so that they can establish losses from the reduction of premium attributable to the period the bonds are held by the dealer, while collecting tax-exempt interest on the bonds during the same period. Section 3 of H. R. 8381 is designed to close this "loophole."

The "loophole" involves only the sale of premium bonds at a loss and the loophole is not involved where premium bonds are sold at a profit.

Section 3 would require dealers to amortize premium on all tax-exempt bonds held by them unless (*a*) a bond is disposed of by the dealer within 30 days after the date of its acquisition by him and (*b*) the amount realized is higher than the adjusted basis of the bond. Section 3 would apply to all tax-exempt bonds acquired by dealers after November 7, 1956.

This provision would require dealers to amortize premium on all tax-exempt bonds sold at a loss; and that closes the loophole.

However, this provision would also require dealers to amortize premium on tax-exempt bonds sold at a profit if the dealer holds the bonds more than 30 days; and that is unfair and unnecessary to close the loophole.

We recommend that two changes be made in section 3:

(1) The exception from amortization for bonds sold by a dealer at a profit should not be limited to bonds disposed of within 30 days.

The exception from amortization for bonds sold by a dealer at a profit should not be limited to bonds disposed of within 30 days because:

(*a*) A requirement that dealers amortize premium on all tax-exempt bonds sold at a loss completely closes the loophole. The loophole is not involved when dealers sell tax-exempt bonds at a profit.

(*b*) It is unfair to require dealers to amortize premium when they are not permitted to amortize discount. Any artificial "profit" from discount attributable to the period which a dealer holds a discount bond is taxed fully as ordinary income of the dealer. If, for the purpose of closing a loophole involving the sale of premium bonds at a loss, a degree of inequity is to be accepted in requiring dealers to amortize premium when bonds are sold at a loss, the inequity should not be extended to situations not involving the loophole. Accordingly, amortization of premium should not be required when bonds are sold by dealers at a profit.

(*c*) A 30-day limitation on the exception for bonds sold by a dealer at a profit complicates the simple and direct closing of the loophole, imposes an arbitrary time limit upon the sale of inventory, and imposes on dealers the burden and expense of computing amortization in transactions not involving the loophole. The dealer's added expense must be reflected in the cost to the borrowing municipality.

(*d*) Finally, the point which we want to emphasize is that dealers, in the normal conduct of their business and with no consideration of tax aspects, frequently are unable to dispose of bonds at a profit within 30 days after the date of acquisition, but could dispose of the bonds at a profit if they held the bonds for a more favorable market. In many issues in the past year it has taken dealers several months to dispose of long-term bonds.

Since the loophole is closed by requiring amortization of premium on bonds sold at a loss, and since a tax inequity and a bookkeeping burden is imposed on dealers in requiring amortization of premium, there is no justification for requiring a dealer to amortize premium on a bond sold at a profit, regardless of how long the bond is held by the dealer.

Consequently, we urge that subdivision (1) of subsection (a) of section 3 (on p. 4 of H. R. 8381) be changed to eliminate the provision requiring a dealer to amortize premium on a bond sold at a profit if he holds the bond more than 30 days and to read as follows:

> (1) The term "municipal bond" means any obligation issued by a government or political subdivision thereof if the interest on such obligation is excludable from gross income; but such term does not include such an obligation if in the case of a sale, the amount realized (or in the case of any other disposition, the fair market value of the obligation at the time of such disposition) is higher than its cost (computed without regard to this section). Determinations under this subdivision shall be exclusive of interest.

In the provision quoted above we have substituted the word "cost" for "adjusted basis" because "cost" is a simpler, better understood and less technical term.

(2) The effective date of section 3 should be subsequent to adoption of H. R. 8381.

Subsection (c) of section 3 provides that the provisions of the section shall apply—

> with respect to taxable years ending after November 7, 1956, but only with respect to obligations acquired after such date.

With this effective date each dealer would have to:

(*a*) Check every transaction in premium bonds since November 7, 1956, to determine which transactions are affected;

(*b*) Make the necessary computations and adjustments for every transaction in premium bonds (i) sold at a loss or (ii) sold at a profit more than 30 days after the date of acquisition; and

(*c*) File amended tax returns for 1956 and 1957.

We emphasize that this burden would be imposed, not only on the few transactions where the loophole was utilized by a few dealers, but on all transactions by all dealers in the tax-exempt bonds which constitute their stock-in-trade.

We are distressed at a proposal that dealers should be required retroactively to make the necessary computations and tax adjustments with respect to transactions in their stock-in-trade. Some dealers even today may be unaware of the proposed change in the tax law. Dealers who are aware of the change proposed in section 3 certainly cannot be expected to revise their accounting procedures and their computation of taxable income on the basis of proposals pending in Congress. As of today, dealers have no way of knowing for certain what amortization requirement will be included in the final bill.

It will be a substantial burden and expense for dealers to set up the necessary bookkeeping and accounting procedures to amortize premium on future issues of bonds, but we cannot emphasize too strongly the terrific burden that would be imposed by requiring dealers retroactively to amortize premium. Consequently, we urge that the effective date of section 3 be a date subsequent to final adoption of the bill.

We appreciate the opportunity to submit these recommendations to the committee.

The CHAIRMAN. Thank you, Mr. Adams.

Are there any further questions of the witness?

Senator KERR. Yes.

Now, Mr. Adams, I would like to ask you again to explain to me in language that would make it understandable to you if you didn't know what happens when you amortize a premium on a bond.

Mr. ADAMS. Let's take this illustration that we used here on page 2 and the 18 cents that is above it.

Senator KERR. I understand that 18 cents. That occurs because of the difference in the premium at which the bond was bought and the premium at which it was sold.

Mr. ADAMS. That is correct.

Senator KERR. That is, the amount of money above the par or face value of the bond. Now, when you put the phrase in there "to yield 3¼ percent to maturity" after each one of them, you fixed it so that I don't understand it.

Now, I am not fussing with you about that, because you fixed this on the basis that a man would fix it that knows what he is putting down here. You don't put in here, if I read it accurately, whether that is a difference in the purchase price and the sale price occurs by the passage of time. I presume that it must be that.

Mr. ADAMS. That is correct.

Senator KERR. Well, it must be an awfully short time, because it is only 18 cents.

Mr. ADAMS. It is 30 days.

Senator KERR. Now, at what rate of interest would 18 cents accrue on $1,000 in 30 days?

Mr. ADAMS. Well, it is approximately a quarter of 1 percent, because it is the difference between the 3½ coupon on the bond and the 3¼ percent yield that the bond bears at the premium paid.

Senator KERR. But it had the same coupon on it when it was sold as it did when it was bought. It was still a 3½-percent coupon when you sold it, wasn't it?

Mr. ADAMS. It certainly was.

Senator KERR. Well, you bought it on a basis that yields 3¼?

Mr. ADAMS. Yes, sir.

Senator KERR. Frankly, what I can't understand to begin with is how a bond with a 3½-percent coupon——

Mr. ADAMS. May I try to explain, Senator——

Senator KERR. Sold to yield 3¼ percent to maturity would bring $1,021.20, and then the same bond sold to yield 3¼ percent at maturity would bring $1,021.02.

Mr. ADAMS. Senator Kerr, when you buy that bond——

Senator KERR. It has to be a difference in time, but this doesn't tell—where does it say in here how long you held that?

Mr. ADAMS. If a dealer buys a 10-year bond—let me see here, right there on the third line—and sells the bond in 30 days.

Senator KERR. Yes; but did you sell it in 1 day or 29 days.

Mr. ADAMS. We sold it on the 30th day. Possibly that English is not good, but that is the intention.

Senator KERR. I am not complaining about it, I am just trying to understand it.

Then give me the interest rate that you figured there. Is 18 cents a quarter of a percent on $1,000 for 30 days? I can figure that.

Mr. ADAMS. Well, now, may I try to explain this again——

Senator KERR. $1,000 at one quarter of a percent per year is how much? Can you and I figure that up here right quick?

Mr. ADAMS. I think I could clarify this easier if you would permit me to make one statement regarding it.

Senator KERR. It is $2.50, isn't it?

Mr. ADAMS. But we become involved, immediately, Senator Kerr, with the procedure in figuring a present worth of a dollar over a period of years in which the papers are figured, and my brain is not keen enough to take that formula right here and figure it up for you.

Senator KERR. Then you can understand the difficulty that I am having.

Mr. ADAMS. Senator Kerr, I am most sympathetic, because this is the deplorable thing about my business that I wished the answer to——

Senator KERR. It just happens that I think I am for your position. But I am trying to be sure that I understand it so that I can assure myself that I am arriving at the right conclusion in being for it.

Mr. ADAMS. May I try once again to explain this?

Senator KERR. I wish you would; yes.

Mr. ADAMS. We will have to accept this fact to begin with, if you will——

Senator KERR. I would either like for you to tell me to forget this example or make me understand it.

Mr. ADAMS. I would like to try with this example to tell you. This is a 10-year bond to begin with, and we have got to accept one feature of it, you will get it out of this book if you want to get into that, and that is that this 10-year bond bearing a 3½ percent coupon figured to yield 3¼ percent to——

Senator KERR. Is going to bring a premium?

Mr. ADAMS. Yes. And the premium is $21.20. Now, what we must do is this, the $21.20 is going to disappear if you hold that bond for the full 10 years.

Senator KERR. That is, because if you hold it for the full 10 years, then you get the base value of the bond.

Mr. ADAMS. That is correct.

Now, then, it is going to disappear at a certain amount daily.

Senator KERR. Yes.

Mr. ADAMS. And actually, the daily amount is six-tenths of a cent.

Senator KERR. The daily amount for 30 days is 18 cents?

Mr. ADAMS. That is correct.

And for a day it is six-tenths of a cent. Now, that is over the entire life of that bond.

Now, the man that buys that bond is going to collect the face value of the bond at maturity and every year 3½ percent of tax-exempt income.

Senator GORE. What else is he supposed to get back?

Mr. ADAMS. Nothing.

Senator GORE. All right. Excuse me, Senator Kerr.

Mr. ADAMS. So that this 18-cent figure which either becomes a so-called loss in one event, an amortized deduction from the cost price in the other event——

Sentor KERR. Is there some other word that you could give me for "amortize" that would explain what happens?

Mr. ADAMS. The daily erosion of that $21.20 is the only word I know, because that $21.20 is going to disappear between the date you bought the bond and its final maturity 10 years hence.

Senator KERR. Let's say you paid $1,021.20 for a bond, now, that is $21.20 premium; isn't it?

Mr. ADAMS. That is correct.

Senator KERR. And let's say you kept it for a year.

Mr. ADAMS. Yes, sir.

Senator KERR. And you collect on it 3½ percent of $1,000 for a year, that is $35.

Mr. ADAMS. That is correct.

Senator KERR. Now, you don't pay any tax on that $35?

Mr. ADAMS. No, sir.

Senator KERR. And then you sell the bond after you have held it for a year, and you get that coupon, since it is a 10-year bond, and since the $21.20 was the premium for the 10 years at a quarter of a cent, that is $2.12 a year?

Mr. ADAMS. Well, it fiures out at the rate of 18 cents a month a year, if you went on a 12 months' basis, $1.92.

Senator KERR. Let's say $1.92. I just want to get the figure.

Mr. ADAMS. You are more correct, I think.

Senator KERR. Then the $1.92 off the $21.20 is $19.28, that is what you get on that premium; isn't it?

Mr. ADAMS. You mean at the end of 10 years?

Senator KERR. No; you have kept it for a year.

Mr. ADAMS. You're right.

Senator KERR. You kept it for a year and you have collected $35 tax free income, and then you sell the bond for $1,019.28.

Mr. ADAMS. That is right.

Senator KERR. Now, insofar as the purchase price of the bond is concerned, you have lost $1.92?

Mr. ADAMS. That is right.

Senator KERR. Insofar as income on the bond, you have got $35?

Mr. ADAMS. That is correct.

Senator KERR. Now, under the present law, can you take that $1.92 as a loss?

Mr. ADAMS. That is a 10-year bond; yes.

Senator KERR. Now, under this amendment, could you take it as a loss?

Mr. ADAMS. No; there would no loss there.

Senator KERR. Now, is that one of the things that you feel is inequitous about the amendment? You say the loophole involves only the sale of premium bonds at a loss.

Mr. ADAMS. That is correct.

Senator KERR. And is the situation here, where you have sold it for $1.92 less than you paid for it, the one that put it in the category of a bond that is sold at a loss?

Mr. ADAMS. Yes; that would be in the category of a bond that was sold at a loss.

Senator KERR. Well, if I understand your statement, you say that the loophole involves only the sale of premium bonds at a loss.

Mr. ADAMS. That is right.

Senator KERR. And I thought you said that you were willing to close that loophole.

Mr. ADAMS. I am trying to be sure that my terms are in the same words as yours.

Senator KERR. I want them to be, because they have to be for us to understand each other.

Mr. ADAMS. We have no objection whatsoever to amortizing any bonds on which we show a loss. We feel that it is an inequity in our business. But, to close this loophole, we are willing to accept that inequity.

Now, we feel, as I said in my statement here, that if we are going to force the amortization of all premium bonds in our business, then in turn we should then force the amortization of all discount bonds, because if I go out and buy a 1½-discount bond at 18 cents on the dollar——

Senator KERR. Now, a discount bond is a bond——

Mr. ADAMS. Under 100.

Senator KERR. Is the bond that you buy at less than its face value?

Mr. ADAMS. That is correct. The prime rate today is 4 percent. We are going to get during the holding period on that bond 1½ percent of $15 a year on income. Now, any appreciation in that bond or any profit in that bond above our acquisition cost——

Senator KERR. That is about the $80?

Mr. ADAMS. That is right—we are going to pay at the rate of the 52-percent corporate tax. We are paying at 4 percent, the prime rate today——

Senator KERR. That is, if you borrowed the money to buy it?

Mr. ADAMS. Practically every dealer in our business would be doing so.

Senator KERR. Most of us do.

Mr. ADAMS. That is correct. We would then be suffering an inequity, which we are continuously, of paying a profit and not being able to deduct the difference between the borrowing cost and the income from the bond.

Senator KERR. Don't you charge off that 4-percent interest?

Mr. ADAMS. We can't.

Senator KERR. You mean if a bond dealer has to borrow money to carry inventory, the interest he pays to the lender is not an item of expense?

Mr. ADAMS. If you are a municipal bond dealer.

Senator KERR. It is not?

Mr. ADAMS. Correct.

Senator KERR. And that, then, is the reason for your position here?

Mr. ADAMS. That is pretty hard to say that that is the reason for it.

Senator KERR. That is one of the reasons?

Mr. ADAMS. Well, we feel that is a definite inequity as far as our business is concerned, and if you are going to say to us, "we are going to burden you with amortizing all premium bonds," then in turn you ought to give us the privilege of amortizing all discount bonds, so that we wouldn't have our throats cut on the one side and take it away on the other.

Senator KERR. Mr. Adams, I want to thank you for your very patient, and I want to say, effective explanation of this matter. You have helped me a great deal, and I appreciate it.

Senator FREAR. May I ask two questions?

Mr. Adams, why do you say that if a bond is sold at a profit there is no need to amortize the premium?

Mr. ADAMS. This loophole of which we speak—if I can interject something here that we haven't discussed at all——

Senator FREAR. If it isn't lengthy.

Mr. ADAMS. No; it comes in largely as a result years ago when interest rates were low of dealers buying high coupon bonds, let's say 6 percent, for the sake of argument, on a 2-percent basis, and holding those bonds and getting the benefit of that amortization, if that word means anything to you, so that they could charge off the amortization agains their profits from other sources and save the 52 percent, where they were receiving the 6-percent tax-exempt income while they held this bond, so that there was no objection on that, and as a result of which there was money being made constantly in there by that operator on that basis, and that was the loophole toward which this has been directed, as I understand it.

Senator FREAR. I think you are right. If you held the bond, the bond you referred to here for 6 months, the amortization would be 6 times 18, or 72 cents.

Mr. ADAMS. Yes.

Senator FREAR. Would not your normal dealers' profit be much more than that?

Mr. ADAMS. Oh, yes.

Senator FREAR. Thank you.

The CHAIRMAN. Are there any other questions?

Thank you very much, Mr. Adams.

(Subsequently Mr. Adams submitted for the record the following supplementary memorandum regarding amortization of premium on tax-exempt bonds held by dealers, particularly with respect to sec. 3 of H. R. 8381:)

SUPPLEMENTARY MEMORANDUM REGARDING AMORTIZATION OF PREMIUM ON TAX-EXEMPT BONDS HELD BY DEALERS PARTICULARLY WITH RESPECT TO SECTION 3 OF H. R. 8381, SUBMITTED BY THE INVESTMENT BANKERS ASSOCIATION OF AMERICA [1]

"Premium" and "discount" on tax-exempt bonds.—A bond is priced at a "premium" when its dollar price is higher than its face value (ordinarily $1,000). The premium on a bond disappears over the period of time to the maturity of the bond, because at maturity only the face value will be paid to the holder of the bond. If a $1,000 bond maturing in 10 years is purchased for $1,021.20, the premium of $21.20 will disappear over the 10-year period at the rate of $2.12 each year (18 cents per month), and the value of the bond (assuming that all other factors affecting price remain the same) will decrease at that rate.

A bond is priced at a "discount" when its dollar price is lower than its face value. The discount on a discount bond disappears over the period of time to maturity of a bond, because at maturity the face value will be paid to the holder. If a $1,000 bond maturing in 10 years is purchased for $978.80 the discount of $21.20 will disappear at the rate of $2.12 each year (18 cents each month) and the value of the bond (assuming that all other factors affecting price remain the same) will increase at that rate.

Mechanics of amortization.—In general, to amortize, means to eliminate gradually. To amortize premium on a tax-exempt bond for tax purposes the taxpayer must, in computing taxable profit or loss in a transaction in a tax-exempt premium bond, eliminate the amount of premium attributable to the period which he held the bond by reducing his "cost" of the bond by that amount. The effect of reducing "cost" in computing taxable gain or loss obviously is to decrease deductible loss by the amount of the eliminated premium or to increase taxable gain by the amount of the eliminated premium.

Section 171 (a) (2) of the Internal Revenue Code provides that no deduction against income shall be allowed for amortized bond premium on tax-exempt bonds. Most taxpayers find amortization advantageous for tax purposes because they obtain a deduction in the amount of the amortization; but dealers in tax-exempt bonds are penalized when they must amortize premium because the amortized (or eliminated) premium decreases deductible loss or increases taxable gain, and no deduction against income is allowed for the eliminated premium. For example:

(1) If a dealer buys for $1,021.20 a bond maturing in 10 years and sells the bond 30 days later (in which case the amount of premium attributable to the 30-day period the dealer held the bond is 18 cents) for $1,021.02, which is 18 cents less than he paid for the bond:

(*a*) If the dealer is required to amortize premium, he would for tax purposes reduce his "cost" of the bond by 18 cents (the amount of the amortized premium) to $1,021.02 in computing taxable gain or loss. He would have no tax loss on the transaction and no deduction is permitted for the amortized premium.

(*b*) If the dealer were not required to amortize premium, he would have a loss of 18 cents on the transaction which would be deductible.

(2) If a dealer buys for $1,021.20 a bond maturing in 10 years and sells the bond 30 days later (in which case the amount of premium attributable to the

[1] This supplementary memorandum is submitted in response to a request for a brief explanation of the mechanics and effect of amortization of the premium on tax-exempt bonds held by dealers.

We have used throughout this memorandum as examples a $1,000 bond maturing in 10 years priced to yield 3¼ percent to maturity (1) for a premium bond with a 3½-percent interest coupon and (2) for a discount bond with a 3-percent interest coupon. There is no special reason for using these particular bonds as examples. In order to simplify consideration of changes in the value of a bond resulting from the elimination of the premium or discount, we have assumed in all of the examples, except example (2) where we assumed a $5 profit, that all other factors affecting price of the bond remain the same.

30-day period the bond was held by the dealer would be 18 cents) for $1,026.20 which is $5 more than he paid for the bond:

(a) If the dealer is required to amortize premium, he would have to reduce his "cost" of the bond in computing taxable gain or loss in the transaction by 18 cents to $1,021.02. He would then have a taxable profit in the transaction of $5.18, although he received for the bond only $5 more than he paid for it, and no deduction is permitted for the amortized premium.

(b) If the dealer were not required to amortize premium, he would have a taxable profit of $5 in the transaction.

A dealer is not permitted to amortize discount on tax-exempt bonds.—If a dealer buys for $978.80 a $1,000 bond maturing in 10 years and sells it 30 days later for $978.98, the 18-cent appreciation in value would represent discount attributable to the 30-day period he held the bond but that discount is fully taxable to the dealer as ordinary income.

It is inequitable to require a dealer to amortize premium (thereby reducing his deductible loss or increasing his taxable profit for tax purposes by the amount of the amortized premium) while taxing fully as ordinary income any discount received by the dealer for the period he held a discount bond. Furthermore, the difficulty in presenting a simple explanation of the mechanics and effect of amortization makes apparent the bookkeeping and accounting burden and expense that is imposed on dealers in requiring amortization in transactions in the bonds which constitute their stock in trade for sale to customers.

Interest on tax-exempt bonds.—Interest on tax-exempt bonds obviously is exempt from Federal income tax. The interest is ordinarily payable semiannually and the holder of the bond on the payment dates will receive the full amount of the interest. However, it is the practice of the business that each purchaser of a tax-exempt bond pays to the seller, in addition to the purchase price, the accrued interest on the bond for the period which it was held by the seller. On a tax-exempt bond with a 3½-percent interest coupon, dated January 1, 1958, and purchased by a dealer on that date, with interest payable on July 1, and January 1 of each year, the semiannual interest payment would be $17.50. If the dealer sold the bond 30 days after his purchase, the purchaser would pay to the dealer the accrued interest on the bond for 1 month which would be $2.92, and the purchaser on July 1 would receive the full semiannual interest payment of $17.50. Most dealers (except dealer banks) borrow money to pay for and carry their inventory but the interest paid by the dealers to borrow this money is not a deductible expense because section 265 of the Internal Revenue Code provides that interest on indebtedness incurred to purchase or carry tax-exempt obligations is not deductible. Even when the amount of interest paid by a dealer on indebtedness incurred to purchase or carry his inventory of tax-exempt bonds exceeds the amount of tax-exempt interest received on those bonds, the dealer cannot deduct even the amount by which interest paid exceeds the tax-exempt interest received.

The law and the "loophole."—Section 75 of the Internal Revenue Code of 1954 requires a dealer to amortize premium on a tax-exempt bond held by him unless (a) the bond is sold or otherwise disposed of by the dealer within 30 days after the date of acquisition by him or (b) the earliest maturity or call date of the bond is a date more than 5 years from the date on which it was acquired by the dealer. It has been reported that a few dealers are taking advantage of the exceptions under section 75 of the code by holding premium bonds so that they can establish losses from the reduction of premium attributable to the period the bonds are held by the dealer, while collecting tax-exempt interest on the bonds during the same period. Section 3 of H. R. 8381 is designed to close this loophole. The loophole involves only the sale of premium bonds at a loss and the loophole is not involved where premium bonds are sold at a profit.

Section 3 of H. R. 8381.—Section 3 would require dealers to amortize premium on all tax-exempt bonds held by them unless (A) a bond is disposed of by the dealer within 30 days after the date of its acquisition by him and (B) the amount realized is higher than the adjusted basis of the bond. Section 3 would apply to all tax-exempt bonds acquired by dealers after November 7, 1956.

This provision would require dealers to amortize premium on all tax-exempt bonds sold at a loss; and that closes the loophole.

However, this provision would also require dealers to amortize premium on tax-exempt bonds sold at a profit if the dealer holds the bonds more than 30 days; and that is unfair and unnecessary to close the loophole.

Recommendations.—If, for the purpose of closing a loophole involving the sale of premium bonds at a loss, a degree of inequity is to be accepted in requiring dealers to amortize premium when bonds are sold at a loss, the inequity should not be extended to situations not involving the loophole. We recommend that two changes be made in section 3:

(1) Subdivision (1) of subsection (a) of section 3 (on p. 4 of H. R. 8381) be changed to eliminate the provision requiring a dealer to amortize premium on a bond sold at a profit if he holds the bond more than 30 days and to read as follows:

"(1) The term 'municipal bond' means any obligation issued by a government or political subdivision thereof if the interest on such obligation is excludable from gross income; but such term does not include such an obligation if in the case of a sale, the amount realized (or in the case of any other disposition, the fair market value of the obligation at the time of such disposition) is higher than its cost (computed without regard to this section). Determinations under this subdivision shall be exclusive of interest."

(2) The effective date of section 3 should be subsequent to adoption of H. R. 8381.

Senator GORE. Mr. Chairman, I would like to take a minute to return a favor of yesterday. My friend, Senator Kerr, gave me a little lecture on whether or not life insurance was testamentary in character.

Senator KERR. No; the Senator from Oklahoma said that the life-insurance policy which a deceased did not own was not testamentary in character when it became a collectible item to the beneficiary.

Senator GORE. I would like to read from the decision entitled "*Bailey et al.* v. *United States*."

Life insurance is inherently testamentary in character. The payment of premiums and the insured's death are the necessary events giving rise to the full and complete possession and enjoyment of the face amount of the policies by the beneficiary. And the acquisition of life-insurance policy on one's own life is a substitute for a testamentory disposition of property.

I will not go on, but I just wanted the Senator to know that there was authority for my point of view and the point of view of the Treasury Department, and I am sure there may be other decisions in this—I had a little amount of time to look for the precedents—but I did find this one, and I would also like to inform my able friend, though I wouldn't expect him to recognize it from my limited experience in the field of taxation, among my many other handicaps I am a lawyer of limited experience and severely limited capacity.

Senator KERR. Now, you have made the Senator from Oklahoma feel adequately humble and of a disposition to apologize to his distinguished friend from Tennessee.

Senator GORE. You needn't to at all.

Senator KERR. But I read from the record:

Senator GORE. Mr. Smith, is it not testamentory in character when a father designates his son as his beneficiary of a policy of which he, the father, retains to the point of his death the right of changing the beneficiary?

Senator GORE. Is there any yield there?

Senator KERR. The Senator from Oklahoma readily understood that such was testamentory in character, but was of the opinion that we were discussing an insurance policy with reference to which the insured had no right to change the beneficiary.

Senator GORE. I was aware, Senator, that we were discussing a situation where the insured retained or had severed his right of direction. This was by way of a flank attack, if I may say it. And I was going from one step to another. But this decision does not draw the fine line of distinction which the able Senator from Oklahoma draws, as I have read. And I will undertake to supply the

Senator and the committee with the precedents and decisions if I can lay my hands on them.

The CHAIRMAN. The Chair would like to insert in the record letters from Senator Allen J. Ellender, Senator William F. Knowland, Senator Warren Magnuson, Senator Henry M. Jackson, and Senator Thomas H. Kuchel, the latter being endorsed by Senator Alan Bible. These Senators express their opposition to section 2, which they feel nullifies the basic concept of the community property laws. I likewise submit for the record statements on section 2 by Mr. William D. Buck, president of the International Association of Fire Fighters, AFL-CIO, Washington, D. C., Mr. Royce Givens, secretary-treasurer of the National Conference of Police Associations, Washington, D. C., and Mr. Leon H. Floyd, president of the Oakland Municipal Civil Service Employees Association, Oakland, Calif.

(The letters referred to follow:)

FEBRUARY 24, 1958.

Hon. HARRY F. BYRD,
United States Senate,
Washington, D. C.

DEAR HARRY: As I am sure you know, the House Ways and Means Committee has favorably reported H. R. 8381, the so-called Technical Amendments Act of 1957, which purports to be a measure designed to close certain tax loopholes in the 1954 Internal Revenue Code.

Section 2 of the committee bill deals with the retirement income credit, available to specified classes of our retired population. As reported, section 2 would actually work great hardship upon retired persons in community-property States, under the guise of equalizing retirement income tax credit benefits available to retired persons in community-property and common-law States. As I am sure you realize, the House committee amendment strikes a heavy blow at the very group of citizens which today need income help, not further injury.

In addition, the committee amendment would completely nullify community-property-law concepts insofar as vested conjugal rights are concerned. This would occur purely and simply because the committee amendment seeks to impose strictly common-law legal concepts upon the community-property system. It would arbitrarily declare that despite the existence of a community of acquests and gains between spouses as a result of a valid marriage, and despite the long-established civil-law rule that both spouses have an equal property interest in the fruits of the community, the interest of the wife is to be ignored in computing the retirement income credit.

I indeed hope that you will use your influence and good offices in prevailing upon the Senate Finance Committee to at least maintain the status quo insofar as the retirement income credit is concerned. As far as I know, there is no legal obstacle in the way of common-law States adopting the community-property system, and thereby bringing their citizens within the area of benefits which spouses domiciled in community-property States now enjoy.

In addition, I feel sure that you will agree that in this day and time, with the Federal Government constantly whittling away at the sovereign rights of States, any step designed to vary or modify long-established property rights, fixed by State law, would be most unfortunate.

In short, Harry, the House amendment displays not only an obvious ignorance of basic community-property-law concepts, but would obviously impose a heavy burden upon retired persons in community-property States to achieve a meager revenue increase estimated at some $3 million.

It occurs to me that if the majority of the committee should feel that the present status of the revenue code involves an inequity insofar as retired residents of common-law States are concerned, some consideration might be given to treating the situation in a manner similar to that adopted when the joint-return provision was approved in 1948—that is, extending to persons in common-law States the right to enjoy split-income provisions of joint returns. I have asked the Joint Committee on Internal Revenue Taxation to obtain an estimate of the revenue loss involved under such an approach, and as soon as it is provided me, I will be pleased to make it available to you, if you feel it would be helpful.

In addition, I am attaching hereto sample income-tax returns for retired persons having retirement income in both community-property and common-law States. These sample returns were prepared by one of my constituents. They demonstrate graphically the hardship which would result should the House committee's view on the retirement income credit be permitted to prevail.

With the kindest personal regards and best wishes, I am.

Sincerely,

ALLEN J. ELLENDER,
United States Senator.

"A" John & Mary Doe. He is retired from the Armed Forces and both under 65 however they reside in Louisiana a community property State.

Form 1040 U.S. Treasury Department Internal Revenue Service

U. S. INDIVIDUAL INCOME TAX RETURN—1957

or Other Taxable Year Beginning .... 1957, Ending .... 195..
(PLEASE TYPE OR PRINT)

Name John & Mary Doe
(If this is a joint return of husband and wife, use first names of both)

Home address ....
(Number and street or rural route)

.... Louisiana
(City, town, or post office) (Postal zone number) (State)

Your Social Security Number | Occupation Retired | Wife's Social Security Number | Occupation

If Income Was All From Salaries and Wages, Use Pages 1 and 2 Only. See Page 3 of the Instructions.

Exemptions

1. Check blocks which apply. Check for wife if she had no income or her income is included in this return.
(a) Regular $600 exemption .... ☒ Yourself ☒ Wife
(b) Additional $600 exemption if 65 or over at end of taxable year ☐ Yourself ☐ Wife
(c) Additional $600 exemption if blind at end of taxable year ☐ Yourself ☐ Wife
Enter number of exemptions checked → 2
2. List first names of your children who qualify as dependents; give address if different from yours. .... Enter number of children listed →
3. Enter number of exemptions claimed for other persons listed at top of page 2 ....
4. Enter the total number of exemptions claimed on lines 1, 2, and 3 2

Income

5. Enter all wages, salaries, bonuses, commissions, tips, and other compensation received in 1957, before payroll deductions.

Employer's Name	Where Employed (City and State)	(a) Wages, etc.	(b) Income Tax Withheld
Armed Forces	Washington 25, D.C. Separate Income	$ 2,400 00	$ 194 00
Night Patrol Inc.	Anytown, La. Earned Income	2,100 00	140 00
Enter totals here →		$ 4,500 00	$ 334 00

6. Less: (a) Travel, reimbursed expenses, etc. (See instructions, page 6. Attach required statements.) $ ....
(b) Excludable "Sick Pay" in line 5 .... — —
7. Balance (line 5 less line 6) .... $ 4,500 00
8. Profit (or loss) from business from separate Schedule C .... — —
9. Profit (or loss) from farming from separate Schedule F .... — —
10. Other income (or loss) from page 3 (dividends, interest, rents, pensions, etc.) .... — —
11. ADJUSTED GROSS INCOME (sum of lines 7, 8, 9, and 10) .... $ 4,500 00

If social security tax (FICA) withheld from your wages exceeded $94.50, see instructions, page 5.

● ATTACH COPY B OF FORMS W-2 HERE ●

Unmarried or legally separated persons qualifying as "Head of Household," see instructions, page 7, and check here ☐ | Widows and widowers who are entitled to the special tax computation, see instructions, page 7, and check here ☐

Tax due or refund

12. Tax on income on line 11. (If line 11 is under $5,000, and you do not itemize deductions, use Tax Table on page 16 of instructions to find your tax and check here ☒. If line 11 is $5,000 or more, or if you itemize deductions, compute your tax on page 2 and enter here the amount from line 9, page 2) $ 575 00

If income was all from wages, omit lines 13 through 16

13. (a) Dividends received credit from line 5 of Schedule J .... $ ....
(b) Retirement income credit from line 12 of Schedule K .... 420 00 | 420 00
14. Balance (line 12 less line 13) .... $ 155 00
15. Enter your self-employment tax from separate Schedule C or F .... — —
16. Sum of lines 14 and 15 .... $ 155 00
17. (a) Tax withheld (line 5 above). Attach Forms W-2 (Copy B) .... $ 334 00
(b) Payments and credits on 1957 Declaration of Estimated Tax (See page 8, instructions) .... $ 334 00
District Director's office where paid ....
18. If your tax (line 12 or 16) is larger than your payments (line 17), enter the balance due here → $ — —
Pay in full with this return to "Internal Revenue Service." If less than $1.00, file return without payment.
19. If your payments (line 17) are larger than your tax (line 12 or 16), enter the overpayment here → $ 179 00
If less than $1.00, the overpayment will be refunded only upon application. See instructions, page 8.
20. Amount of line 19 to be: (a) Credited on 1958 estimated tax $ ....; (b) Refunded $ 179.00

County in which you live. | Is your wife (husband) making a separate return for 1957? ☐ Yes ☒ No If "Yes," enter her (his) name. | Do you own any federal tax for years before 1957? ☐ Yes ☒ No

TAXPAYER—I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

Sign here .... (Your signature) (Date) (If this is a joint return, wife's signature) (Date)

→ To assure split-income benefits, husband and wife must include all their income and sign even though only one has income, BOTH MUST SIGN.

PREPARER (other than taxpayer)—I declare under the penalties of perjury that I prepared this return for the person(s) named herein and that this return (including any accompanying schedules and statements) is, to the best of my knowledge and belief, a true, correct, and complete return based on all the information relating to the matters required to be reported in this return of which I have any knowledge.

Sign here .... (Individual or Firm Signature) (Address) (Date)

BEST AVAILABLE COPY

"A" Computation for retired couple residing in a community property State.

Form 1040—1957 Page 4

IF INCOME WAS ALL FROM SALARIES AND WAGES, TEAR OFF THIS PAGE AND FILE ONLY PAGES 1 AND 2

Schedule J.—DIVIDENDS RECEIVED CREDIT (See instructions, page 15)

1. Amount of dividends on line 4, Schedule A	$
2. Tentative credit (4 percent of line 1)	
LIMITATION ON CREDIT	
3. Tax shown on line 12, page 1, plus amount, if any, shown on line 8(b), page 2	
4. 4 percent of taxable income	
Taxable Income Means: (a) If tax is computed on page 2, the amount shown on line 5, page 2. (b) If capital gains alternative tax applies, the amount shown on line 14, separate Schedule D. (c) If Tax Table is used, the amount shown on line 11, page 1, less 10 percent thereof, and less the deduction for exemptions ($600 multiplied by the number of exemptions claimed on line 4, page 1).	
5. Dividends received credit. Enter here and on line 13(a), page 1, the smallest of the amounts on line 2, 3, or 4, above	$

Schedule K.—RETIREMENT INCOME CREDIT (See instructions, page 15)

This credit does not apply:
1. If you received pensions or annuities of $1,200 or more from Social Security or Railroad Retirement,
2. If you are under 65 years of age and had "earned income" of $2,100 or more, OR
3. If you are 65 or over and under 72, and had "earned income" of $2,400 or more.

If separate return, use column B only. If joint return, use column A for wife and column B for husband →	A	B
Did you receive earned income in excess of $600 in each of any 10 calendar years before the taxable year 1957? Widows or widowers see instructions, page 15	☒ Yes ☐ No	☒ Yes ☐ No
If answer above is "Yes" in either column, furnish all information below in that column.		
1. Retirement income for taxable year which is included in line 11, page 1, of this return:		
(a) **For taxpayers under 65 years of age:** Enter only income received from pensions and annuities under public retirement systems, including retirement pay from Armed Forces	$ 1,200 00	$ 1,200 00
(b) **For taxpayers 65 years of age or older:** Enter total of pensions and annuities, including retirement pay from Armed Forces, interest, gross rents, and dividends		
LIMITATION ON RETIREMENT INCOME		
2. Maximum amount of retirement income for credit computation	$ 1,200 00	$ 1,200 00
3. Deduct:		
(a) Amounts received in taxable year as pensions or annuities under the Social Security Act, the Railroad Retirement Acts, and certain other exclusions from gross income	—	—
(b) Earned income received in taxable year: (This line does not apply to persons 72 years of age or over)		
(1) Taxpayers under 65 years of age, enter amount in excess of $900	150 00	150 00
(2) Taxpayers 65 or over and under 72, enter amount in excess of $1,200	—	—
4. Total of lines 3(a) and 3(b)	150 00	150 00
5. Balance (line 2 minus line 4)	1,050 00	1,050 00
6. Line 5 or line 1, whichever is smaller	1,050 00	1,050 00
7. Tentative credit (20 percent of line 6)	210 00	210 00

8. Total tentative credit on this return (total of amounts on line 7, columns A and B)	420 00
LIMITATION ON RETIREMENT INCOME CREDIT	
9. Amount of tax shown on line 12, page 1	575 00
10. Less: Dividends received credit from line 5, Schedule J, above	—
11. Balance (line 9 less line 10)	575 00
12. Retirement income credit. Enter here and on line 13(b), page 1, the amount on line 8 or line 11, whichever is smaller	$ 420 00

U. S. GOVERNMENT PRINTING OFFICE [illegible]

"B" Jack & Jane Doe. He is retired from the Armed Forces and both under 65 however they reside in a state that does not have community property laws in effect.

Form 1040 U.S. Treasury Department Internal Revenue Service

U. S. INDIVIDUAL INCOME TAX RETURN—1957

or Other Taxable Year Beginning .... 1957, Ending .... 195..
(PLEASE TYPE OR PRINT)

Name ...Jack & Jane Doe...
(If this is a joint return of husband and wife, use first names of both)

Home address ...
(Number and street or rural route)

... Does not have community property law
(City, town, or post office) (Postal zone number) (State)

Your Social Security Number | Occupation Retired | Wife's Social Security Number | Occupation

If Income Was All From Salaries and Wages, Use Pages 1 and 2 Only. See Page 3 of the Instructions.

Exemptions

1. Check blocks which apply. Check for wife if she had no income or her income is included in this return.
   (a) Regular $600 exemption .... ☒ Yourself ☒ Wife
   (b) Additional $600 exemption if 65 or over at end of taxable year. ☐ Yourself ☐ Wife
   (c) Additional $600 exemption if blind at end of taxable year ..... ☐ Yourself ☐ Wife
   Enter number of exemptions checked → 2
2. List first names of your children who qualify as dependents; give address if different from yours. .... Enter number of children listed →
3. Enter number of exemptions claimed for other persons listed at top of page 2 ....
4. Enter the total number of exemptions claimed on lines 1, 2, and 3 2

Income

5. Enter all wages, salaries, bonuses, commissions, tips, and other compensation received in 1957, before payroll deductions.

Employer's Name	Where Employed (City and State)	(a) Wages, etc.	(b) Income Tax Withheld
Armed Forces	Washington D.C. Retirement Income	$ 2,400 00	$ 194 00
Night Patrol Inc.	Any Town Earned Income	2,100 00	140 00
Enter totals here →		$ 4,500 00	$ 334 00

6. Less: (a) Travel, reimbursed expenses, etc. (See instructions, page 6. Attach required statements.) $......
   (b) Excludable "Sick Pay" in line 5 .... — —
7. Balance (line 5 less line 6) .... $ 4,500 00
8. Profit (or loss) from business from separate Schedule C .... — —
9. Profit (or loss) from farming from separate Schedule F .... — —
10. Other income (or loss) from page 3 (dividends, interest, rents, pensions, etc.) .... — —
11. ADJUSTED GROSS INCOME (sum of lines 7, 8, 9, and 10) .... $ 4,500 00

If social security tax (FICA) withheld from your wages exceeded $94.50, see instructions, page 5.

● ATTACH COPY B OF FORMS W-2 HERE ●

Unmarried or legally separated persons qualifying as "Head of Household," see instructions, page 7, and check here ☐ | Widows and widowers who are entitled to the special tax computation, see instructions, page 7, and check here ☐

Tax due or refund

12. Tax on income on line 11. (If line 11 is under $5,000, and you do not itemize deductions, use Tax Table on page 16 of instructions to find your tax and check here ☒. If line 11 is $5,000 or more, or if you itemize deductions, compute your tax on page 2 and enter here the amount from line 9, page 2). $ 575 00

If income was all from wages, omit lines 13 through 16

13. (a) Dividends received credit from line 5 of Schedule J .... $......
    (b) Retirement income credit from line 12 of Schedule K .... 000 00 | 000 00
14. Balance (line 12 less line 13) .... $ 575 00
15. Enter your self-employment tax from separate Schedule C or F .... — —
16. Sum of lines 14 and 15 .... $ 575 00
17. (a) Tax withheld (line 5 above). Attach Forms W-2 (Copy B) .... $ 334 00
    (b) Payments and credits on 1957 Declaration of Estimated Tax (See page 4, instructions) .... $ 334 00
    District Director's office where paid ....
18. If your tax (line 12 or 16) is larger than your payments (line 17), enter the balance due here → $ 241 00
    Pay in full with this return to "Internal Revenue Service." If less than $1.00, file return without payment.
19. If your payments (line 17) are larger than your tax (line 12 or 16), enter the overpayment here → $
    If less than $1.00, the overpayment will be refunded only upon application. See instructions, page 8.
20. Amount of line 19 to be: (a) Credited on 1958 estimated tax $......, (b) Refunded $......

County in which you live. | Is your wife (husband) making a separate return for 1957? ☐ Yes ☐ No If "Yes," enter her (his) name | Do you owe any Federal tax for years before 1957? ☐ Yes ☐ No

TAXPAYER—I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return.

Sign here .... (Your signature) .... (Date) .... (If this is a joint return, wife's signature) .... (Date)

→ To assure split-income benefits, husband and wife must include all their income and, even though only one has income, BOTH MUST SIGN.

PREPARER (other than taxpayer)—I declare under the penalties of perjury that I prepared this return for the person(s) named herein; and that this return (including any accompanying schedules and statements) is, to the best of my knowledge and belief, a true, correct, and complete return based on all the information relating to the matters required to be reported in this return of which I have any knowledge.

Sign here .... (Individual or Firm Signature) .... (Address) .... (Date)

BEST AVAILABLE COPY

"B" Computation for retired couple residing in a non-community property State.

Form 1040—1957 Page 4

IF INCOME WAS ALL FROM SALARIES AND WAGES, TEAR OFF THIS PAGE AND FILE ONLY PAGES 1 AND 2

Schedule J.—DIVIDENDS RECEIVED CREDIT (See Instructions, page 15)

1. Amount of dividends on line 4, Schedule A	$
2. Tentative credit (4 percent of line 1)	
LIMITATION ON CREDIT	
3. Tax shown on line 12, page 1, plus amount, if any, shown on line 8(b), page 2	
4. 4 percent of taxable income	
Taxable Income Means (a) If tax is computed on page 2, the amount shown on line 5, page 2. (b) If capital gains alternative tax applies, the amount shown on line 14, separate Schedule D. (c) If Tax Table is used, the amount shown on line 11, page 1, less 10 percent thereof, and less the deduction for exemptions ($600 multiplied by the number of exemptions claimed on line 4, page 1).	
5. Dividends received credit. Enter here and on line 13(a), page 1, the smallest of the amounts on line 2, 3, or 4, above	$

Schedule K.—RETIREMENT INCOME CREDIT (See Instructions, page 15)

This credit does not apply:
1. If you received pensions or annuities of $1,200 or more from Social Security or Railroad Retirement,
2. If you are under 65 years of age and had "earned income" of $2,100 or more, OR
3. If you are 65 or over and under 72, and had "earned income" of $2,400 or more.

If separate return, use column B only. If joint return, use column A for wife and column B for husband ⟶	A	B
Did you receive earned income in excess of $600 in each of any 10 calendar years before the taxable year 1957? Widow or widowers see instructions, page 15	☐ Yes ☐ No	☒ Yes ☐ No
If answer above is "Yes" in either column, furnish all information below in that column.		
1. Retirement income for taxable year which is included in line 11, page 1, of this return:		
(a) For taxpayers under 65 years of age: Enter only income received from pensions and annuities under public retirement systems, including retirement pay from Armed Forces	$	$ 2,400 00
(b) For taxpayers 65 years of age or older: Enter total of pensions and annuities, including retirement pay from Armed Forces, interest, gross rents, and dividends		
LIMITATION ON RETIREMENT INCOME		
2. Maximum amount of retirement income for credit computation	$ 1,200 00	$ 1,200 00
3. Deduct:		
(a) Amounts received in taxable year as pensions or annuities under the Social Security Act, the Railroad Retirement Acts, and certain other exclusions from gross income		—— ——
(b) Earned income received in taxable year: (This line does not apply to persons 72 years of age or over)		
(1) Taxpayers under 65 years of age, enter amount in excess of $900		1,200 00
(2) Taxpayers 65 or over and under 72, enter amount in excess of $1,200		—— ——
4. Total of lines 3(a) and 3(b)		1,200 00
5. Balance (line 2 minus line 4)		0,000 00
6. Line 5 or line 1, whichever is smaller		0,000 00
7. Tentative credit (20 percent of line 6)		0,000 00

8. Total tentative credit on this return (total of amounts on line 7, columns A and B)	0,000 00
LIMITATION ON RETIREMENT INCOME CREDIT	
9. Amount of tax shown on line 12, page 1	575 00
10. Less: Dividends received credit from line 5, Schedule J, above	—— ——
11. Balance (line 9 less line 10)	575 00
12. Retirement income credit. Enter here and on line 13(b), page 1, the amount on line 8 or line 11, whichever is smaller	$ 000 00

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UNITED STATES SENATE,
COMMITTEE ON APPROPRIATIONS,
February 25, 1958.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MR. CHAIRMAN: Inasmuch as the Senate Finance Committee is now considering H. R. 8381, the Technical Amendment Act of 1957, I want to place my views on section 2 of this bill before the members of the committee.

As you know, I have written to you before on this measure and pointed out briefly the apprehensions in the community-property States which the possible enactment of this section has created. Briefly, section 2 eliminates the benefits of community-property laws insofar as they relate to retirement income credits by restricting those credits to be used only by the spouse who rendered the service which resulted in the pension or annuity. The objective of this proposed amendment is to place the residents of noncommunity-property States on an equal basis with the residents of community-property States.

Irrespective of the objectives of this amendment, its adoption will result in a limitation of benefits and the overriding of community-property laws of the eight States involved and in an additional tax burden on thousands of elderly people in those areas. This, as the committee knows, is not the first attempt that has been made to deny tax advantages which result from the community-property system of ownership and you will recall that in 1948, the differences existing among the States as to what constituted community income resulted in the Government extending the income splitting privileges of community-property States to all of the States in the Union.

It is my hope that the committee will eliminate section 2 from H. R. 8381 and if, in the opinion of its members, further action should be taken to amend the definition of retirement income of section 37 of the Internal Revenue Code of 1954, it will permit spouses in noncommunity-property States to divide their annuity or retirement allowances between the spouses for the purpose of income-retirement credits. I seriously urge the most careful consideration by the members of the Senate Finance Committee on section 2 of this legislation.

With best personal regards, I remain,

Sincerely yours,

WILLIAM F. KNOWLAND.

UNITED STATES SENATE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
February 11, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR: We have been receiving communications from retired residents of our State calling our attention to the Technical Amendments Act of 1957, which passed the House on January 28 and is now pending before your committee.

As you know, the State of Washington is one of the community-property States. Section 2 of H. R. 8381, if enacted into law would completely disregard the method of computing annuities in community-property States and would inflict hardship on many elderly people in those States. These retired people now struggling to get along on fixed low annuities would, if H. R. 8381 passes in its present form, face further curtailment of their incomes.

We respectfully request your committee to carefully scrutinize this provision and we urge that section 2 be eliminated from the bill before it is reported to the Senate.

Thank you for your many courtesies and kind personal regards.

Sincerely,

WARREN G. MAGNUSON,
United States Senator.
HENRY M. JACKSON,
United States Senator.

UNITED STATES SENATE,
COMMITTEE ON INTERIOR AND INSULAR AFFAIRS,
February 26, 1958.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: Your committee now has before it for consideration H. R. 8381, designed to amend the Internal Revenue Code of 1954 in certain technical aspects. One provision of the bill, however, produces an inequitable result. This is section 2 of the House-adopted bill.

This proposed section provides:

"SEC. 2. RETIREMENT INCOME CREDIT.

"(a) Computation in case of individuals who are married.

"(1) DEFINITION OF RETIREMENT INCOME.—Section 37 (c) (defining the term 'retirement income') is amended by adding at the end thereof the following new sentences: 'In applying paragraphs (1) (A) and (2) in the case of individuals who are married, any pension or annuity attributable to services rendered by either spouse shall be treated as received by the spouse who rendered the services. For purposes of the preceding sentence, determination of marital status shall be made under section 143.'

"(2) LIMITATION ON AMOUNT.—Section 37 (d) (1) (relating to limitation on retirement income for purposes of retirement income credit) is amended by striking out 'any amount received by the individual as a pension or annuity' and inserting in lieu thereof 'any amount received by the individual (determined without regard to community property laws) as a pension or annuity'.

"(3) DEFINITION OF EARNED INCOME.—Section 37 (g) (relating to definition of earned income for purposes of retirement income credit) is amended by adding at the end thereof the following new sentence: 'For purposes of the preceding sentence, if income attributable to services rendered by a husband or wife is community income under community property laws applicable to such income, such income shall be treated as the income of the individual who rendered such services.'

"(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply only with respect to credits under section 37 of the Internal Revenue Code of 1954 for taxable years beginning after December 31, 1956."

The adoption of this proposed amendment would destroy the rights of a married woman in those States where community property law prevails. In my State of California, for example, a community property State, all property acquired after marriage except that acquired by gift, devise, bequest or descent is deemed to be community property and the interest of the wife is equal to that of the husband.

It is quite apparent that the proposed section 2 of the committee bill would effectively nullify this basic concept of community property law. It will work to the detriment of many classes of retired people in the community property States. I have had prepared for the use of the committee comparative examples of how the proposed amendment, if enacted into law, would work in a community property State such as my own. The Joint Committee on Internal Revenue Taxation has prepared an amendment deleting section 2 of H. R. 8381 in its entirety. I would appreciate the committee's favorable consideration of it.

Senator Alan Bible of Nevada joins me in the views expressed in this letter.

Very sincerely yours,

THOMAS H. KUCHEL.

SECTION 2 OF H. R. 8381—ILLUSTRATIONS

Background.—John Brown is 68 and his wife Mary is 65. They have lived all their married life (30 years) in California—John worked for his living until he was 65; Mary never worked for wages.

Case 1

John is receiving a pension of $5,000 per year (their only income) because of 40 years as an employee of the State of California. Under the laws of California half this pension is the property of Mary the instant John received it. Under present law it can be argued that the couple are entitled to two full retirement income credits, on the grounds that (1) $2,500 is a pension received by Mary, and (2) that she has received earned income (though she never worked for wages) for more than 10 years. If section 2 is enacted they will have only one retirement income credit, because, for that purpose only, the $5,000 will be viewed as John's pension, not half Mary's, and only John will be deemed to have received earned income for 10 previous years.

Tax consequences—present law (as above interpreted)

Gross income (joint return)	$5,000
Less: Standard deduction (10 percent)	500
Total	4,500
Less: 4 personal exemptions (both over 65)	2,400
Taxable income	2,100
Tax (20 percent)	420
Less: 2 retirement income credits (20 percent of $1,200 each)	480
Tax due	0

Tax consequences—enactment of sec. 2

Taxable income (as above)	$2,100
Tax	420
Less: 1 retirement income credit (John's)	240
Tax due	180

NOTE.—If their income was not more than $4,000 the enactment of section 2 would make no difference, because I retirement income credit would wipe out the tax.

Case 2

The facts are the same as before, except that John receives no pension (and no social security benefit, which would probably eliminate an earned income credit). However, he saved enough so that he receives interest dividends, and rents totaling $5,000 per year. Under present law, and under the law as amended by section 2, half of the $5,000 is Mary's income. So, if she can be said to have received earned income for 10 preceding years, she as well as John would be entitled to a full retirement income credit. If section 2 is enacted, however, although she has more than $1,200 of investment income, only John will be deemed to have received the necessary earned income for 10 preceding years so she will have no retirement income credit.

The tax consequences would be the same as in case 1.

Case 3

The facts are the same as in case 2, except that Mary worked for 10 years (earning more than $600 per year) before she married John (or after she was married). Under present law, and under the law as amended by section 2, both would be entitled to full retirement income credits, and there would be no tax due.

NOTE.—If John and Mary had lived in New York or Illinois they could likewise have 2 credits if John chose to make their situation the same as that in a community-property State by giving Mary half the investments (or enough to yield $1,200).

Case 4

The facts are the same as in case 3 ($5,000 of investment income, both worked more than 10 years) except that in addition John earned $4,800 as a consultant. Under present law neither would be entitled to retirement income credit, because John's present income from services would be half attributed to Mary, and the $1,200 of retirement income each would otherwise have had would be eliminated because of current earned income in each case $1,200 in excess of the permitted $1,200.

If the law is amended by section 2, however, Mary would be entitled to an earned income credit, because John's current earned income would not be attributed to her. The tax would therefore be $240 less, if section 2 is enacted, than if it were not.

[H. R. 8381, 85th Cong., 2d sess.]

AMENDMENT Intended to be proposed by Mr. KUCHEL to the bill (H. R. 8381) To amend the Internal Revenue Code of 1954 to correct unintended benefits and hardships and to make technical amendments, and for other purposes

On page 2, beginning with line 13 strike out all through line 24 on page 3. Renumber succeeding sections.

STATEMENT OF WILLIAM D. BUCK, PRESIDENT, INTERNATIONAL ASSOCIATION OF FIRE FIGHTERS, AFL-CIO

For the International Association of Fire Fighters, affiliated with the AFL-CIO, I, William D. Buck, as their president, wish to record our organization in disagreement with the provisions of section 2 of House bill 8381, which is before your committee.

H. R. 8381, as you know, is intended to amend the Internal Revenue Code of 1954. There are many provisions in the draft of this proposed legislation which are excellent in our opinion; however, one section of the bill, specifically section 2 titled "Retirement Income Credit," we the fire fighters respectfully solicit the members of your committee to delete this provision within the proposed petition.

We feel the fire fighter, who, in the twilight of his life, after serving the community for many years, receiving retirement income, and in a particular State where the community-property law is affected and with the realization that under the provisions of this law, he has the opportunity to plan on a retirement income, should the provision of section 2 prevail, our membership during this period of retirement will suffer a loss of income which was never anticipated and not expected by him at the time of his application for retirement which may have been forced on him as a result of long years of service.

No doubt over the last 10 years you have noticed an increase in the hue and cry on the part of the community at large that our States and municipalities have desired and exercised the right for home rule for the right of self-government. In this instance, it would appear to be proper that, where the provisions of a State community-property law is in effect which is intended to grant a specific group of people certain benefits and privileges, we feel that the legislative prerogative of the States involved should not be encroached upon by the Congress of these United States with respect to the community-property law.

In closing, may I express my personal appreciation for the indulgence of your committee for the privilege of presenting to you the views of the International Association of Fire Fighters.

NATIONAL CONFERENCE OF POLICE ASSOCIATIONS,
March 3, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: The National Conference of Police Associations wishes to be recorded as opposing section 2 of H. R. 8381, referred to in the House report as "Retirement income credit."

The undersigned has received communications from members in community property States advising that they are happy with the law as it is today and are opposed to the amendment as proposed in section 2 of H. R. 8381.

It is their contention that noncommunity property States should become community property States by State law so that they can enjoy the benefits under the Internal Revenue Act.

Mr. Gourney Turner of Los Angeles Fire and Police Protective League writes, "Section 2 of this bill would change the operations of section 37 of the Internal Revenue Code of 1954 to require residents of community property States to claim the tax credit on the income of the spouse who is actually receiving the retirement income. At present, husbands and wives in community property States may split the retirement income of one spouse between them in order to claim tax credit under section 37. * * * I understand that Florida is objecting to the community property law in these States and, instead of trying to get it for Florida, seems more interested in taking away from the States that now enjoy this income tax deduction."

We respectfully urge the committee to delete section 2 when H. R. 8381 is reported.

Respectfully yours,

ROYCE L. GIVENS, *Secretary-Treasurer.*

OAKLAND MUNICIPAL CIVIL SERVICE EMPLOYEES ASSOCIATION,
Oakland, Calif., February 25, 1958.

Hon. H. F. BYRD,
Senate Finance Committee, Washington, D. C.

DEAR SENATOR BYRD: The executive board of the Oakland Municipal Civil Service Employees Association desires to inform you of the action we have taken on H. R. 8381, an internal revenue measure (sec. 2).

At present our organization represents over 1,400 civil service employees of the city of Oakland, and having been a chartered association for over 35 years, it follows that a considerable number of our past members are presently living on retirement income. A large number are also planning retirement in the near future.

Consequently, when the proposed legislation was discussed at our regular monthly executive board meeting, our decision was that H. R. 8381 contained one very undesirable provision, specifically, the one eliminating the split benefit provision on retirement pay in community property States (sec. 2).

I am quite certain you are aware of the predicament that persons living on a fixed income find themselves in today. The constant rise in the cost of living and the inflationary spiral does nothing but reduce their standard of living. It appears to us that H. R. 8381 would further the damage already created by inflation.

As an organization, we strongly urge the deletion of this provision from the bill before final passage. The other provisions contained in the measure appear to be quite desirable.

Your careful consideration of this request will be appreciated.

Very truly yours,

LEON H. FLOYD, *President.*

The CHAIRMAN. The next witness, then is Mr. Andrew J. Cothran of the American Cotton Manufacturers Institute, Inc.

STATEMENT OF ANDREW J. COTHRAN, THE AMERICAN COTTON MANUFACTURERS INSTITUTE, INC.

Mr. Chairman and gentlemen of the committee, I am Andrew J. Cothran of Graniteville, S. C. I am secretary of the Graniteville Co., and also serve as chairman of the tax committee of the American Cotton Manufacturers Institute of Charlotte, N. C., and Washington, D. C., in whose behalf I present my testimony today.

The American Cotton Manufacturers Institute is a central trade association for the entire textile mill products manufacturing industry and serves as its spokesman in matters of national affairs. The industry is one of the country's largest, providing employment to approximately 1 million workers and having a production output valued in the primary markets of more than $12 billion per year. It is, therefore, a major factor in the economic well-being of our country and is a dominant factor in the prosperity of the area extending from Maine to Texas.

The textile mill products manufacturing industry is also a vital factor in the Nation's program for preparedness. As an industry, its essentiality is probably exceeded only by iron and steel. In serving the demands of the civilian population, and from the standpoint of its impact on the typical family budgets, its importance is exceeded only by food and shelter.

Despite its aggregate magnitude, it is basically an industry of small intensely competitive plants. The industry operates over 8,000 plants, no 1 company representing more than 4 percent of the total. Thus, the textile mill products manufacturing industry has always been distinctive as the most competitive and individualistic of the Nation's major manufacturing industries, and represents, to the maximum degree, the spirit of free business enterprise. The mills and plants which are members of the American Cotton Manufacturers Institute, Inc., are distributed throughout the industry's entire area, and operate about 85 percent of the industry's total spindles.

I wish to present our objections to three sections of H. R. 8381. These objections are as follows:

I. REMAINDERS TO RELATED PERSONS IN THE CASE OF CERTAIN CHARITABLE TRUSTS, SECTION 9

Section 9 of H. R. 8381 would amend section 170 of the Internal Revenue Code of 1954 so as to disallow the deduction of the value of property transferred in trust for a charity if the spouse of the grantor, his ancestors or his lineal descendants, or if a corporation, trust, etc., which are controlled by the grantor, have a remainder interest in the trust and at the time of the transfer the value of such remainder exceeds 5 percent of the value of the property transferred. The theory of this proposed legislation is that it prevents a taxpayer from receiving a double charitable deduction in the case where property is transferred in trust for a charity for a term of years with the remainder to a related person.

Under present law, section 673 of the Internal Revenue Code of 1954 provides that the income of the trust would not be taxable to the grantor because he has made a complete gift of the property and under section 170 the value of the gift to charity would be a charitable deduction. Nevertheless, this does not in any way constitute a double charitable deduction. The grantor would not be taxable on the income of any trust which provided income to a beneficiary for a term of years with remainder to a related taxpayer. The nontaxability of the trust income to the grantor is in no way dependent upon the beneficiary being a charity. Therefore, this proposed legislation would deprive a taxpayer of any deduction for a contribution to charity of this nature.

Furthermore, since colleges and universities have been the particular beneficiaries of donations of this nature, the disallowance of a deduction for such donations would tend to deprive these institutions of a source of income at a time when higher education is peculiarly vital to the national welfare.

This proposed legislation is peculiarly hard on the people in our industry. Many of our mills are owned by families whose entire fortunes are invested in such mills. Under either the Revenue Act of 1939 or the Revenue Act of 1954, a stockholder of a family-owned mill could place shares of stock in trust with the income being payable to charity for 10 years after which the stock went to children or grandchildren. The charity had the income for 10 years and the former owner was allowed a charitable deduction computed on the Treasury's actuarial tables at about 30 percent of the value of the stock. If section 9 of H. R. 8381 becomes law, the stockholder would have no charitable deduction.

There is no incentive to make a charitable gift; the whole incentive is to give both the income interest and the remainder interest to his descendants. Whether he directs the income to charity or to his children, it is no longer his income or taxable to him. It seems to us that if he directs the income to charity instead of directing it to his children, he has made a real charitable gift and is as much entitled to a charitable deduction as any other person. To us it seems a discrimination against the owner of a closely held family corporation as against other persons. Our people do not have diversified investment portfolios and yet the demand on them to make charitable gifts to our small colleges, hospitals, local YMCA's etc., is just as great as is the demand on the philanthropist whose holdings are diversified. This latter person can take 100 shares of General Motors and give 30 shares to charity and 70 shares to his children. Under the law and under the Treasury's actuarial tables he has made no larger a charitable contribution than would one of our family mill owners who gives 100 shares of the stock of his family corporation (assuming equal market value per share) in trust with the income of the full 100 shares to go to charity for 10 years with the remainder after those 10 years to go to his children.

Yet, although the dollar value of the contribution to charity is the same in each instance and although the donor in each instance eliminates the future income of the donated stock from his own tax return, the diversified philanthropist is allowed a charitable deduction while the mill owner, under section 9 of H. R. 8381, is not allowed any deduction.

These long-term charitable trusts are about the only way many of our family mill owners can make substantial charitable contributions. They cannot give their family holdings outright to charity because the charity might well feel compelled to sell such closely held stock to outside interests and these outside interests could be inimicable to the family ownership.

We do have one constructive suggestion to make to this committee. It seems reasonable that a charitable deduction should be allowed only where the charitable contribution is one of substance. It can be said that 1- or 2-year term charitable trusts give very little to charity. However, whenever a grantor gives the trust income to charity for 10 years or more he is giving a substantial term to the charity and therefore should be allowed a charitable deduction. The substitute amendment to accomplish this proposal is as follows:

Strike section 9 and insert in lieu thereof the following:

"SEC. 9. CHARITABLE TRUSTS. Section 170 (b) (1) (relating to charitable deductions) is amended by adding at the end thereof the following new paragraph:

"'(E) DENIAL OF DEDUCTION IN CASE OF CERTAIN TRANSFERS IN TRUST AFTER JUNE 30, 1958.—No deduction shall be allowed under this section for the value of any interest in property transferred after June 30, 1958, to a trust if such interest consists of the right to the income of the trust, or any portion thereof, for a period, which is, or as of the date of the transfer, may reasonably be expected to be less than 10 years.'"

II. DEPRECIATION OR AMORTIZATION OF IMPROVEMENTS MADE BY LESSEE ON LESSORS' PROPERTY—SECTION 14

This section would amend the Revenue Code to provide that if a landlord and lessee are "unrelated," leasehold improvements be depreciated over the term of the lease plus any period for which the lease may be renewed pursuant to an option exercisable by the lessee unless the lessee establishes that (as of the close of each taxable year)—

> it is more probable that the lease will not be renewed, extended or continued for such period than that the lease wil be renewed, extended or continued.

The section would be applicable to improvements begun after December 31, 1956, unless previously contracted for.

Under present regulations renewal periods are generally disregarded. New section 178 throws the burden of proof on the taxpayer during each and every year of the lease to satisfy the Internal Revenue Service that—

> it is more probable that the lease will not be renewed * * * than that the lease will be so renewed * * *

This is an impossible and unsettling burden. A taxpayer who has, for example, executed a 10-year lease with an option to renew (usually at rent to be negotiated) and who has made extensive leasehold improvements would be under the sword of Damocles from year to year to prove by a preponderance of the evidence that it was not probable that he would renew. How could be possibly know the answer, let alone prove it, during the early years of the lease or even during the later, final years? The proposed amendment is extremely vague, speculative, and provocative of dispute with the Service.

The provision could have the effect of destroying the value of accelerated depreciation if in the early years of the lease taxpayer fails to "establish that it is more probable that the lease will not be renewed."

Leases with renewal options at rents subject to escalator clauses are common and are good business for landlords and tenants' alike. New section 178 would tend to discourage this beneficial practice.

Whereas, in the early years of a lease taxpayer may have failed to meet the burden of proof which section 178 would impose upon him, he could be seriously embarrassed when at the termination of the lease changes in his affairs would indicate renewal to be unwise or even economically impossible. Treating unrecovered cost of leasehold improvements as an abandonment loss might well be worthless to the tenant, and moreover, the inability of the tenant to charge off such improvements during the life of his original term could distort his accounting and operations and deprive him of cost recovery which might be vital to the welfare of his business.

We recommend that new section 178 be deleted from the bill and that taxpayers be permitted to treat leasehold improvements under present law and regulations.

III. ADJUSTMENTS REQUIRED BY CHANGES IN METHOD OF ACCOUNTING—SECTION 24

Prior to the enactment of the Internal Revenue Code of 1954, when a taxpayer changed methods of accounting, such as from the cash to the accrual method, the Commissioner attempted to require the taxpayer to make certain transitional adjustments in order to prevent the duplication or omission of certain items of income and expense. These adjustments frequently worked hardships and inequities on the taxpayer by "bunching" large amounts of income in the year of the accounting change which income was in essence attributable to years otherwise barred by the statute of limitations. The courts had not always supported the Commissioner's authority to make such adjustments but had generally taken the position that adjustments could be made only where the change of accounting methods was voluntary. However, considerable confusion existed in the case law.

In section 481 of H. R. 8300 the House proposed to mitigate the "bunching" effect of adjustments by adopting a 3-year averaging device. In the Senate, section 481 was amended so as to exclude adjustments with respect to any taxable year prior to 1954. Its report stated:

> The House bill would have required taking into account the entire transitional adjustment determined by the Secretary or his delegate to be necessary to prevent duplicating items of income and deductions under the new method of accounting. Your committee felt that permitting the entire adjustment would result, in effect, in adjusting errors which occurred during years when there was no statutory authority for making such adjustments (S. Rept. No. 1622, 83d Cong., 2d sess., 65 (1954)).

Now, in section 24 of H. R. 8381, it is provided that adjustments will be required for years prior to 1954 when the taxpayer voluntarily changes accounting methods. This legislation is proposed on the basis that it will correct an unintended benefit. Certainly the limiting of adjustments to those in respect to taxable years subsequent to 1953 were not unintended. The Senate made a specific amendment of section 481 of H. R. 8300 to accomplish this purpose and clearly stated its reasons for doing so. Section 481, as amended by the Senate, was accepted by the House and enacted into law. To enact section 24 of H. 8381 would result in an undermining of the statute of limitations and a return to the confusion of the pre-1954 Code case law, as well as a direct reversal of the clear congressional purpose expressed in section 481, and should therefore be rejected.

Let me also emphasize that the proposed bill only attempts to pick up the pre-1954 adjustments where the taxpayer asks permission to make a change in accounting method. On the other hand, the 1954 Code provisions continue to apply in those cases where the Commissioner demands that the adjustment in accounting method be made. The net effect of section 24 is that errors in accounting methods or procedures will be permanently frozen into our tax system. For example, a taxpayer properly starts his business on a cash basis of accounting, but gradually accumulates over a period of years an inventory. As of January 1, 1954, this inventory value has gradually built up over, say 10 years, to $50,000. Logically the taxpayer should change his method of accounting to the accrual basis. He knows that if he asks permission to change then under section 24 of the bill, he will be taxed on the $50,000 of opening inventory. The Commissioner knows that if he demands that the taxpayer change to the accrual method, the taxpayer will not be taxed on the opening inventory of $50,000. Therefore, neither party will make the opening move and the incorrect accounting system continues ad infinitum.

The amendment made by this committee to section 481 in the 1954 Code was logical and sensible. It would not, as is pointed out above, cost the Government any material revenue, yet nevertheless presented the opportunity to both taxpayers and the Government alike to equitably adjust accounting errors that occurred many years ago, and which errors are now barred by the statute of limitations. Section 24 of the proposed bill has the effect of retroactively removing the bar of the statute of limitations.

One further thought should be mentioned. Section 481, as amended by this committee, became law over 3½ years ago. Taxpayers have acted upon the law as it has existed for that period of time. If section 24 is to be enacted, and we strenuously urge that it should not be enacted into law, then at least it should be made prospective in operation rather than retroactive to January 1, 1954.

I appreciate very much the opportunity of being allowed to appear before you.

And, Mr. Chairman, before I close, may I express to you, sir, the very keen interest and deep gratification with which we people below your State in the Deep South received your announcement to run for reelection.

The CHAIRMAN. Thank you.

I deeply appreciate that.

Senator MARTIN. With the permission of the Chair, I submit a letter which I received from the Honorable Gaylord P. Harnwell, president of the University of Pennsylvania, expressing his concern over section 9 of H. R. 8381, and urging modification of this legislation.

(The letter referred to follows:)

UNIVERSITY OF PENNSYLVANIA,
Philadelphia, December 31, 1957.

Hon. EDWARD MARTIN,
United States Senator from Pennsylvania,
Washington, D. C.

DEAR SENATOR MARTIN: I am advised that there is a bill presently pending before Congress numbered H. R. 8381 which is intended to provide various amendments to the Internal Revenue Code of 1954.

Section 9 of the bill would amend section 170 (b) (1) of the code and also section 267 in such a manner as might materially reduce certain charitable deductions which are now permitted.

For many years it has been legally possible for a generous individual to establish a trust providing that the income should be paid to an eleemosynary institution for a period of 10 years or longer, with the reversionary interest being paid over to children or grandchildren at the termination of the charitable trust. Such a trust entitles the donor to a charitable deduction upon his income-tax return and upon his gift-tax return of the commuted value of the income given to charity. This provides the donor with an incentive for making the charitable provision rather than making a direct gift, outright or in trust, only to his descendants.

The 1954 Code makes possible such a trust for as short a period as 2 years but generally similar in other respects to the so-called 10-year trust provided the fund does not revert to the grantor.

The proposed amendment would deny the donor any charitable deduction for such a charitable income trust if, after the charitable trust period, the reversionary interest goes to the grantor's spouse, ancestors or lineal descendants. The amendments would apply not only to the short-term trusts made possible by the 1954 Code, but also to trusts where income is payable to eleemosynary institutions for 10 years or longer, thus imposing a very material limitation upon what has been generally accepted as proper tax accounting for many years.

Many institutions of higher learning have been beneficiaries of these long-term trusts, and it would be a serious matter if their creation in the future were discouraged by this proposed legislation.

I am, of course, aware that there may be many reasons unknown to me that would favor the legislation in question, and I would not presume to comment specifically upon what legislation would be desirable. However, in view of the fact that higher education in this country is desirably dependent upon gifts from individual citizens, I would hope that the present legislation could be so modified as to encourage rather than discourage the gifts such as have been made under these charitable trusts to educational institutions.

Very sincerely,

GAYLORD P. HARNWELL.

The CHAIRMAN. Our next witness is Mr. Carlyle Barton. Mr. Barton will you have a seat?

STATEMENT OF CARLYLE BARTON, MEMBER OF BOARD OF TRUSTEES, JOHNS HOPKINS UNIVERSITY, BALTIMORE, MD.

The CHAIRMAN. Mr. Barton, you may proceed.

Mr. BARTON. Senator Byrd, and gentlemen, my name is Carlyle Barton, I am a lawyer in Baltimore.

I would like to say, Senator Byrd, that we in Maryland rejoice with the other States that you are going to run again and I want to say that my grandfather and uncle and first cousin practiced law in Virginia for more than 100 years in Winchester.

The CHAIRMAN. That is my hometown.

Mr. BARTON. Yes, sir.

I do not appear here today as a lawyer, I appear as a member of the boards of trustees of the Johns Hopkins University in Baltimore, and the Johns Hopkins Hospital, on which boards I have served for many years.

Until last month I have been president of the board of trustees of the university for some 17 or 18 years.

We are very much concerned about the proposed change in section 9. The situation has been fully explained beginning on page 2 in this excellent statement prepared by Mr. Cothran who spoke just ahead of me. And I wish I could have done as well. We adopt it in its entirety.

But speaking from the viewpoint of the beneficiary of these charitable trusts, it is a matter of vital importance to those of us trying to operate these private institutions that we keep up hese inducements to generous benefactors to make their gifts. At Johns Hopkins University, other than the research work provided for on a no-gain, no-loss basis by the United States Government and others, about one-third of our maintenance comes from tuition, another third from endowment income, and another third from charitable gifts.

Senator KERR. What percent of that one-third, now, would come within the category referred to in Mr. Cothran's statement?

Mr. BARTON. A comparatively small percent, but nevertheless a very vital percent.

Senator KERR. And one which you have hopes of being enlarged.

Mr. BARTON. And one which we have very emphatic hopes of being enlarged. But we watch those things, we cannot operate these nonprofit institutions and these private educational institutions except at the response of the public to our requests for gifts. And we are about to embark upon a campaign to raise for the university and the hospital some $76 million to bring our plant up to date and provide salaries for our professors.

Senator KERR. How much would that be for endowment?

Mr. BARTON. Of that fund?

Senator KERR. Of that $76 million.

Mr. BARTON. We would like to have the better part of half of that for endowment over the period, we do not expect to get it all next year. But we have been the recipients of generous gifts in recent years, and as I say, we are tremendously dependent upon gifts of this character, and anything that disturbs the prospects of receiving these gifts is of very serious concern to us.

And in watching this thing I am disturbed by the proposed change in the law. The amendment to the bill as passed by the House as recommended in Mr. Cothran's statement would clear up the matter, we think.

Prior to 1954 these gifts could be made on a 10-year basis, and we would get the income. Funds are given to us from time to time to be used over fixed periods, and we hope that the gifts will be renewed when the periods run out.

Sometimes they are put up to us by donors who say, "Now you go out and get matching funds," and it is a stimulant to us to do so and it is a stimulant to others to make similar gifts.

But the importance of this sort of thing to institutions such as the Johns Hopkins University and the hospital is incalculable. I would not know—maybe you gentlemen know—what this sort of thing means to the Treasury.

But just now, when there is so much emphasis on the need of education in this country, those of us who devote our time and effort to these matters, and others with more money than I have who help with their money, we need all the assistance we can possibly get. I would daresay that the amount of money that the Government would save taxwise by enacting this legislation would not be comparable to the amount that would be taken away from the many small institutions throughout the country as well as perhaps the few better known ones like the Johns Hopkins University.

Thank you very much.

The CHAIRMAN. Thank you for an excellent presentation.

Senator KERR. Your position is that if we pass the bill you hope that section 9 is deleted?

Mr. BARTON. Well, or amended as recommended in Mr. Cothran's statement; yes. That is the way we would like to see it amended, because it would really permit us to go back to the situation as it was prior to the 1954 code when we could get these 10-year trust gifts.

Senator KERR. You would rather see it deleted?

Mr. BARTON. We would rather see it deleted entirely.

Senator FREAR. Not the code?

Senator KERR. No; section 9 of the bill.

Mr. BARTON. Heavens, no. But the amendment proposed by Mr. Cothran in this legislation here is entirely acceptable from the viewpoint of the beneficiaries of these funds, entirely so.

I would like to submit this statement.

(The statement is as follows:)

STATEMENT BY CARLYLE BARTON, MEMBER OF THE BOARD OF TRUSTEES OF THE JOHNS HOPKINS UNIVERSITY, SUPPLEMENTING HIS ORAL STATEMENT

The inducement to generous donors to set up these charitable trusts for the benefit of institutions such as the Johns Hopkins lies in the fact that they can satisfy their desire to make a gift by making the income from the fund available to the university over a period of years and then have the corpus paid over by the trustee to their children.

Of course, the donor would no longer receive the income and he would part absolutely with the corpus or any control over it. The income would not be taxed to the donor after he had set up the trust and he would be subject to a gift tax on the gift of the corpus to be delivered to his children at the expiration of the period when the income is payable to the institution. However, this gift would be at a reduced value from a present gift to his children of the funds, with a corresponding reduction of the gift tax due to the fact that the gift would not be received in possession until after the period of years while the trustee is paying the income to the institution. There are tables customarily used in the courts, and I understand by the tax authorities, showing the reduced value of a gift to take effect in possession at a later date.

The donor benefits by this reduction in the gift tax and this argument is used with generous-minded people in the effort to have them set up trusts of this character.

Of course, there is no question of an estate tax involved as the donor has parted with ownership of the funds; nor is there any question of income tax because the donor no longer receives the income.

The CHAIRMAN. Thank you very much, sir.

The Chair submits for the record letters he received from Mr. Norman Sugarman, of Baker, Hostetler & Patterson, of Cleveland, Ohio; Mr. Barnaby C. Keeney, president of Brown University; Mr. James S. Coles, president of Bowdoin College; and Mr. Milton McGreevy, of Harris, Upham & Co., of Kansas City, Mo., all of whom express concern over section 9 of H. R. 8381.

(The letters referred to follow:)

BAKER, HOSTETLER & PATTERSON
Cleveland, Ohio, February 4, 1958.

Re H. R. 8381.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR BYRD: In studying H. R. 8381, I have come across a provision which has far-reaching results that I am quite certain were not intended by the Ways and Means Committee and House of Representatives. I am calling this to your attention because I am sure that you will want to know about any imperfections which can so easily occur in as complicated a bill as this one.

The section to which I am referring is section 9 of H. R. 8381. This section, if enacted, would for example have the following peculiar effects:

1. Mr. X can obtain a charitable contribution deduction for the value of property he gives directly to the X foundation (an exempt charitable foundation), but no charitable deduction would be allowed if he transfers the same property in trust to pay all the income for 1 year of the X foundation and then free of trust to the X foundation.

2. Mr. X can obtain a full charitable contribution deduction for the value of property transferred in trust to pay income to the X foundation (an exempt charitable foundation) and then free of trust to the American Red Cross. But if the order of the charities is reversed (i. e. to the American Red Cross first and X foundation second) no deduction at all is allowed.

I doubt seriously that these results were intended or contemplated. Other examples could be given of equally strange results where there is a charitable remainder.

Under section 170 of the present law, a donor is entitled to a charitable contribution deduction for the value of the interest conveyed in trust for the use of a charity unless the donor has a reversionary interest in the trust in excess of 5 percent of the value of the property. Section 9 of the bill seeks to apply the same rule where the reversion, instead of being to the grantor, is a remainder interest to a person closely related to the grantor. However, in defining such closely related person, the bill picks up the definitions in section 267 (b) of the code, including paragraph (9) which treats as a related person an exempt organization controlled directly or indirectly by such person or by members of his family. Neither the present law nor regulations attempt to define a controlled exempt organization.

While the definition of a related person as including a controlled foundation may be justified under section 267 which disallows losses on sales of property to a related person, this treatment of foundations is inconsistent with section 170. The purpose of the present law and the amendment is to disallow the contribution deduction where the contributed property will come back to the grantor; but the use of the definition will disallow the charitable contribution deduction for the very reason that the property will go to a charity.

The unsoundness of denying a contribution deduction under such circumstances is most evident in those cases where a transfer in trust is a substitute for an outright transfer to charity. In many instances a trust may provide the only practical way to make the charitable contribution. For example, property desired to be given to a charity may be subject to certain charges or obligations which the charitable organization is unwilling to, or cannot, assume. In such case the property may be irrevocably transferred in trust until the other obligations are satisfied (during which time part of the net income may be paid to or set aside for the charity) and then the property will pass free of trust to the charitable organization. Certainly neither the contributor nor the charity should be penalized under the tax law because a trust is used in such a case. (The amount of the deduction will, in any event, be only the actuarial value to the charitable organization of the interest in property so transferred).

If, as a matter of policy, the Congress desires to restrict contributions or otherwise limit controlled foundations, then the proper place to do so would be in the provisions on exemption of such foundations and not through the peculiar route of disallowing deductions where there are charitable remainders to such foundations.

It seems to me that the House could not have intended such a fundamental change in policy as the disallowance of deductions for charitable contributions because the remainder interest in property goes to an exempt charitable foundation. At least, such an important change in policy would warrant public hearings, particularly where, as in the case of this bill, such change is retroactive to January 1, 1957.

The bill may be corrected to avoid the problems to which this letter is addressed by including in section 170 (b) (1) (E) (i), as proposed to be amended by the bill, a provision to the effect that in applying section 267 (b) for this purpose, paragraph (9) thereof shall be omitted.

Very truly yours,

NORMAN A. SUGARMAN.

BROWN UNIVERSITY,
Providence, R. I., January 28, 1958.

Hon. JOHN O. PASTORE,
Senate Office Building,
Washington, D. C.

DEAR SENATOR PASTORE: I would like to call to your attention certain proposed amendments to the Internal Revenue Code of 1954 which, if enacted, will be harmful not only to Brown University, but also to other universities and colleges as well as to hospital and church groups who receive much of their support from generous individuals.

H. R. 8381, which is now before Congress, is intended to provide various amendments to the Internal Revenue Code. Some of these amendments are undoubtedly desirable, but section 9 of the bill would amend section 170 (b) (1) of the code and also section 267 is such a manner as materially to reduce charitable deductions which are now permitted.

For many years it has been legally possible for an individual to establish a trust providing that the income should be paid to an eleemosynary institution for a period of 10 years or longer, with the reversionary interest being paid over to children or grandchildren at the termination of the charitable trust. Such a trust entitles the donor to a charitable deduction upon his income tax return and upon his gift tax return of the commuted value of the income given to charity. This provides the donor with an incentive for making the charitable provision rather than making a direct gift, outright or in trust, only to his descendants.

The 1954 Code makes possible such a trust for as short a period as 2 years, but generally similar in other respects to the so-called 10-year trust, provided the fund does not revert to the grantor.

The proposed amendment would deny the donor any charitable deduction for such a trust if, after the trust period, the reversionary interest goes to the grantor's spouse, ancestors, or lineal descendants. The amendment would apply not only to the short-term trusts made possible by the 1954 Code, but also to trusts where income is payable to eleemosynary institutions for 10 years or longer, thus imposing a very material limitation upon what has been generally accepted as proper tax accounting for many years.

Many institutions are the beneficiaries of these long-term trusts and it would be a very serious matter if their creation in the future were discouraged by this proposed change in the tax situation. This type of trust has been especially beneficial in those situations where the founder of a family business wishes to make a substantial charitable gift but is unwilling or unable to sell stock of the family corporation.

We have been informed that when H. R. 8381 comes before the House of Representatives for action, amendments will not be permitted, but when the bill is passed by the House and reaches the Senate it should be possible to bring about an amendment in such a manner as to limit the application of section 9 to the short-term trust and so as to permit charitable trusts to be established for a period of 10 years or longer with the same tax results as have been recognized since long before the 1954 Code.

I will appreciate any consideration you can give to this matter when the bill reaches the Senate. I am writing also to the other members of the Rhode Island congressional delegation.

Best wishes,

Sincerely yours,

BARNABY C. KEENEY, *President.*

BOWDOIN COLLEGE,
Brunswick, Maine, February 19, 1958.

Hon. FREDERICK G. PAYNE,
United States Senate,
Washington, D. C.

DEAR SENATOR PAYNE: No doubt you are familiar with H. R. 8381, which is now pending in Congress. However, may I invite your particular attention to section 9. This section, if it is not amended in the final revision of this legislation, will eliminate the advantage of short-term trusts which charitable institutions now enjoy.

All institutions of learning, hospitals, and other charities are suffering from increasing costs of operation, and need all the support they can receive, in order that they may continue their work for the benefit of society. I trust, therefore, that in the final revision of this proposed legislation care may be taken that gifts to such institutions, in whatever form the gifts may be made, shall continue to be exempt from taxation.

If the benefit of trusts which are irrevocable for at least 2 years cannot be continued, it seems desirable to preserve the advantage to charitable institutions of such trusts having a term of 10 years or longer.

Sincerely yours,

JAMES S. COLES, *President.*

HARRIS, UPHAM & CO.,
Kansas City, Mo., January 20, 1958.

Hon. STUART SYMINGTON,
Senate Office Building,
Washington, D. C.

DEAR SENATOR SYMINGTON: I wish to call to your attention certain proposed legislation which, if enacted, will be harmful to many universities and colleges, and also hospital and church groups who receive much of their support from generous individuals.

There is a bill before Congress, H. R. 8381, which is intended to provide various amendments to the Internal Revenue Code of 1954. Some of these amendments are undoubtedly desirable but section 9 of the bill would amend section 170 (b) (1) of the code and also section 207 in such a manner as materially to reduce charitable deductions which are now permitted.

For many years, it has been legally possible for a generous individual to establish a trust providing that the income should be paid to an eleemosynary institution for a period of 10 years or longer, with the reversionary interest being paid over to children or grandchildren at the termination of the charitable trust. Such a trust entitles the donor to a charitable deduction upon his income-tax return and upon his gift tax return of the commuted value of the income given to charity. This provides the donor with an incentive for making the charitable provision rather than making a direct gift, outright or in trust, only to his descendants.

The 1954 Code makes possible such a trust for as short a period as 2 years but generally similar in other respects to the so-called 10-year trust provided the fund does not revert to the grantor.

The proposed amendment would deny the donor any charitable deduction for such a charitable income trust if, after the charitable-trust period, the reversionary interest goes to the grantor's spouse, ancestors, or lineal descendants. The amendment would apply not only to the short-term trusts made possible by the 1954 Code but also to trust where income is payable to eleemosynary institutions for 10 years or longer, thus imposing a very material limitation upon what has been generally accepted as proper tax accounting for many years.

Many institutions are the beneficiaries of these long-term trusts and it would be a very serious matter if their creation in the future were discouraged by this proposed change in the tax situation. This type of trust has been especially beneficial in those situations where the founder of a family business wishes to make a substantial charitable gift but is unwilling or unable to sell stock of the family corporation.

We have been informed that when H. R. 8381 comes before the House of Representatives for action, amendments will not be permitted, but when the bill is passed by the House and reaches the Senate, it should be possible to bring about an amendment in such a manner as to limit the application of section 9 to the short-term trust and so as to permit charitable trusts to be established for a period of 10 years or longer with the same tax results as have been recognized since long before the 1954 Code.

I am bringing the matter to your attention and hope you will have it in mind when the bill reaches the Senate.

Yours very truly,

MILTON MCGREEVY.

The CHAIRMAN. Mr. Warner, will you proceed?

STATEMENT OF STURGIS WARNER, WASHINGTON, D. C., APPEARING ON BEHALF OF YALE UNIVERSITY

Mr. WARNER. My name is Sturgis Warner. I am a lawyer here in Washington, and I am appearing because Yale University, of New Haven, Conn., has asked me to point out the effect on schools and colleges of proposed section 9 of the Technical Amendments Act in its present form.

Mr. Cothran and Mr. Barton have, it seems to me, covered the basis pretty thoroughly, and I would like to add simply some observations that will supplement the record, and will I think help the committee in its consideration.

In the first place, on section 9 there were no hearings on the bill. Section 9 was written in after the House committee, so it is appropriate to make a fairly complete record at this time.

Now, yesterday Mr. Smith on behalf of the administration, commented, and some members of this committee were commenting, on the general nature of the Technical Amendments Act as an act to cure and take care of gimmicks which have developed over the years.

We should make perfectly clear that section 9 in its present form would eliminate a deduction which has been available for over 30 years, and as such it is obviously not a gimmick that we are talking about, or a matter of accidental oversight in the draft of the 1954 Revenue Act.

Now, Mr. Cothran has suggested an amendment. We believe that an amendment along those lines will meet substantially the problems which are faced both by the colleges and schools and by the Government.

We believe that if section 9 is amended as Mr. Cothran has suggested—I have not checked the exact wording—but substantially as he suggested, so that the section will apply only to the short-term trusts, or of less than 10 years duration, the loophole which we believe is bothering the Treasury and the Ways and Means Committee will be closed, and at the same time if Congress adopts this amendment, the deduction which is now available in connection with long-term trusts of more than 10 years will continue to be available as a stimulus to charitable giving to the schools and universities of the country.

Now, these long term trusts, these 10-year or more term trusts, are of substantial help to educational institutions. Their advantage is that the school gets an irrevocable commitment of funds over the period of the trust, and it can really count on having the money come in over a period, so that the school can undertake construction of a building or some other project which takes time to complete. This method is obviously preferable to financing construction on a hand-to-mouth basis by annual money drives.

When a taxpayer sets up an irrevocable term trust of from 10 to 20 years duration with all the income going to a college or a church for that period, he is transferring to charity a substantial chunk of income for a substantial period of time. He ought to get a charitable deduction. He has been entitled to such a deduction under the law for over 30 years.

Section 9 as it is written now would deny him that deduction if, after the term of the trust were over, the principal went to the donor's son or daughter or wife, although he would get the deduction if the principal went to his nephew or to his brother.

The long-term trust arrangement is helpful, particularly where—and Mr. Cothran has presented this very well—the taxpayer's assets are tied up in a family business so that he is not in a position to give the school and the church an outright gift of stock in a publicly held corporation.

Let's look at these long-term trusts as they benefit or may benefit Yale University specifically. I am anticipating Senator Kerr's question. At the present time Yale is the beneficiary of two of these long-term trusts, they yield small amounts of income—no; as a matter of fact, they are substantial, they yield $10,000 a year or sums of that order—but in addition there are pending proposals for other trusts like it.

For instance, until section 9 of this bill was introduced, a generous would-be donor was in the process of arranging some similar trusts which would run for Yale's benefit for a period of 10 or 15 years, the income of which was going to be used to build Yale a much-needed scientific laboratory.

Now, this is a specific case of where the introduction of section 9 has stopped that transaction at the moment.

Now, Yale ought to be able to build that laboratory, and it ought to be possible to set up the trusts to take care of it, but if section 9 were to stay in its present form, that source of money to build that much-needed laboratory would disappear.

Now, Yale is only one college which would be adversely affected by section 9 if it is enacted in its present form. We have no way of estimating accurately the effect of the present section 9 on each of the educational institutions in the country. But one thing is clear. Section 9 in its present form will reduce substantially the opportunities for making contributions to private schools and colleges.

Now, at the present time about 45 per cent, nearly half, about 45 percent of all college students in this country are enrolled in privately controlled colleges. And it is only because of the existence of charitable deductions that these private colleges and universities can grow or even exist in this country today.

At any time that Congress eliminates or cuts down a form of charitable deduction which was previously in use in connection with gifts or schools, it means that somewhere some much needed school building or a laboratory may not get built, or that some teacher may not get a much needed raise.

Now, the job which lies ahead for these schools, both private and public, is a big one. There are more than 3 million people enrolled in colleges throughout the United States at the present time, and these colleges are jammed. All the people that will be in college in the next 16 years or so have now been born. One look at the census figures which are available today will give us an idea of the terrific pressures that the schools and colleges will be facing.

These are not simply pressures to expand in size. These schools must also expand and improve in quality in order to help the Nation meet the critical problems of the future.

It will take a lot of money. We have heard Mr. Barton about the program of Johns Hopkins. Yale alone in the next 10 years must raise over $100 million of capital funds. Now, the sources have got to be private, as we are talking about private colleges. Other schools and colleges are in the same boat.

Now, one method of raising funds that Yale and other schools and colleges would like to continue to have available for this staggering job is the long-term trust arrangement. If section 9 of the bill is modified in the way that Mr. Cothran has proposed, so that it would apply only to the short-term trust of 2 to 10 years duration, we feel that this would not hurt seriously the fund-raising operations of schools and colleges.

At the same time we believe that section 9 when modified in this manner will accomplish substantially the purposes which the Treasury and the House of Representatives have in mind.

Now, this amendment that Mr. Cothran has introduced or suggested refers to a 10-year limitation. And in connection with that amendment, there is nothing magic obviously about the 10-year period which we have proposed. It could be a longer period, but the 10-year period appears proper, because it is the same as the period that is used in section 673 (a), and which in turn reflects a period recognized for some years by the courts.

The CHAIRMAN. You approve of the Cothran amendment?

Mr. WARNER. Yes, I think it will do the trick and close a loophole. I should say, however, that section 9 in its present form goes beyond the basic purpose of the bill—that is, picking up the loopholes and making technical changes—because it wipes out this trust arrangement which has been in use for over a third of a century.

If, however, section 9 is modified, as Mr. Cothran has suggested, it will take care of a technical problem which has in fact arisen only because of the 1954 act, that is, the problem of deduction in connection with the 2-year charitable trusts under section 673 (b). But in its present form, gentlemen, section 9 is bad for schools and colleges, it is bad for Yale, it is bad for private education in general, and we urge respectfully that you amend it in the manner that has been requested, and we also ask for leave to file with this committee a supplementary statement.

The CHAIRMAN. Thank you very much, Mr. Warner. Are there any questions?

Senator DOUGLAS. I am trying to understand the present provisions, apparently section 673 (b) is controlling, is that true?

Mr. WARNER. 673 (b), sir, relates to 2-year trusts

Senator DOUGLAS. That is what prevails now?

Mr. WARNER. We are talking also about the long-term trust.

Senator DOUGLAS. I understand. But do you want to legitimatize the present provisions of the 2-year trust?

Mr. WARNER. Perhaps, Senator Douglas, the way to handle this is to give out a worksheet which will show to all the members of the committee what we are talking about.

Senator DOUGLAS. What I am trying to get at is this——

Mr. WARNER. We are talking only about a——

Senator DOUGLAS. As I understand it now, a deduction is permitted if the charitable institution receives the income for 2 years, and then the heirs receive it after 2 years.

Mr. WARNER. As it stands now, the income in a 2-year trust is excluded from the grantor's income.

Senator DOUGLAS. That is, it is not taxable.

Mr. WARNER. Not taxable. There is a deduction——

Senator DOUGLAS. And then after the 2 years the income is received, is that taxable to the recipient's income?

Mr. WARNER. Yes, when the trust is over, the corpus goes into the recipient's property, and it is taxed, the recipient or the children are taxed on the income, yes; that is correct.

Senator DOUGLAS. But there is no estate tax?

Mr. WARNER. There is a gift.

Senator DOUGLAS. Which is exempt from the inheritance tax?

Mr. WARNER. No, there would be a gift tax applicable.

Senator DOUGLAS. But not an inheritance tax.

Mr. WARNER. I think I had better study that one and submit a supplementary statement.

Senator DOUGLAS. The point I want to make is that the period 2 years is not a very long period.

Mr. WARNER. That is right.

Senator DOUGLAS. And there is always the danger that you will sprinkle a little holy water over these transfers and will legitimatize tax avoidance.

Mr. WARNER. We are not suggesting that this be exempt——

Senator DOUGLAS. That is what I am trying to find out. Are you standing on the 2-year provision?

Mr. WARNER. No; we are talking entirely in terms of 10 years and longer.

If the Senator will refer to this table here, we are talking about charitable deductions to the donor of the trust. We have set up this table in 2 horizontal columns, 1 relating to trusts for 10 years or more, and 1 relating to trusts for 2 to 10 years.

Senator DOUGLAS. Mr. Chairman, I ask that this exhibit be made a part of the record.

The CHAIRMAN. Without objection this table is made a part of the record.

(The table referred to is as follows:)

CHARITABLE INCOME TRUSTS

A comparison of income tax effects under the Revenue Codes of 1939, 1954, H. R. 8381 as it passed the House and H. R. 8381 with the proposed 10-year amendment. In each case below, the taxpayer sets up a trust under which income is payable for a term of years as stated, with the reversionary or remainder interest as stated, and the grantor having no power, directly or indirectly to alter, amend, terminate, or control the trust. Both the 1939 and 1954 codes provide a deduction against income for gifts "to or for the benefit of" a charity, etc.

	Income taxable to grantor?				Charitable deduction? [1]			
	1939 code	1954 code	H. R. 8381 as passed House	H. R. 8381 with proposed 10-year amendment	1939 code	1954 code	H. R. 8381 as passed House	H. R. 8381 with proposed 10-year amendment
Trust for 10 years or more:								
A. Reversion to grantor:								
(1) Income to noncharity	No	No	No	No				
(2) Income to charity	No	No	No	No	Yes	No	No	No.
B. Remainder to grantor's family:								
(1) Income to noncharity	No	No	No	No				
(2) Income to charity	No	No	No	No	Yes	Yes	No	Yes.
C. Remainder to persons other than grantor or immediate family:								
(1) Income to noncharity	No	No	No	No				
(2) Income to charity	No	No	No	No	Yes	Yes	Yes	Yes.
Trust for 2 to 10 years:								
D. Reversion to grantor:								
(1) Income to noncharity	Yes	Yes	Yes	Yes				
(2) Income to charity	Yes	No	No	No	No [2]	No	No	No.
E. Remainder to grantor's family:								
(1) Income to noncharity	No	No	No	No				
(2) Income to charity	No	No	No	No	No [2]	Yes	No	No.
F. Remainder to persons other than grantor or immediate family:								
(1) Income to noncharity	No	No	No	No				
(2) Income to charity	No	No	No	No	No [2]	Yes	Yes	Yes.

[1] The charitable deduction is the present value of the future income.

[2] A deduction was allowed under 1939 code in each year to the extent that the income was taxed to the grantor; exactly as if the grantor had never set up a trust.

Mr. WARNER. You notice that I have circled two groups of answers in the right hand column here.

Section 9 in its present form has this effect—and referring to the upper group here—section 9 would have the effect of denying to the donor a charitable deduction with respect to the computed income when the donor sets up a trust for 10 years with the income going to a college, and when at the end of that period the corpus of the trust goes to his wife or to his children.

Now, that is the upper group here.

Now, section 9 in its present form changes the provisions which have been in existence for years. This has been an allowable deduction for years. We think that is a mistake, to deny that deduction with respect to trusts of the group which are mentioned here in the upper part of the table, the long-term trusts.

With section 9 as it now exists, it would deny the deduction, not only for the long-term trusts but also for the short-term trusts, from 2 to 10 years.

We have no objection to that part of that provision with respect to 2 to 10 years. We feel that with respect to the long-term trusts the donor should get a deduction. This is all we are talking about.

In other words, we go along with H. R. 8381, section 9, with respect to the short-term trusts. We feel on the long-term trusts the donors should get a deduction, and that is all we are talking about.

Does that help you, sir?

Senator DOUGLAS. Yes, very much.

I want to ask this further question. What about the inheritance tax?

Mr. WARNER. Well, let's see now——

Senator DOUGLAS. This apparently is gaged in terms of the income.

Mr. WARNER. We are talking purely in terms of an income deduction.

Senator DOUGLAS. What is the present law? Would amounts conveyed under a reversionary trust be deductible from property passed on by death?

Mr. WARNER. I will have to do some homework on that, Senator. I will include that in the statement.

The CHAIRMAN. If you have a memorandum it will be inserted.

Mr. WARNER. Yes.

(The following letter was later received for the record:)

JONES, DAY, COCKLEY & REAVIS,
Washington, D. C., February 28, 1958.

Re section 9 of H. R. 8381, the Technical Amendment Act of 1957.

Senator HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: Thank you for your courtesy in permitting me to testify before your committee on February 26 on behalf of Yale University, in connection with the proposed section 9 of the Technical Amendments Act, H. R. 8381.

During the course of the testimony, Senator Douglas asked a number of questions with regard to the estate-tax implications of the term trust arrangements which were under discussion in connection with the above-mentioned section 9. I wanted to be sure that Senator Douglas received adequate answers to his questions, and that the answers include reference to specific sections of the Internal Revenue Code. I was somewhat handicapped in answering his questions during the hearing, because the questions which he raised do not actually relate to section 9 at all, and I did not have the statutory references in my mind at the moment. Section 9 does not relate to estate or inheritance tax problems, and in no way affects the estate-tax situation. I trust that the following information, which I am filing in order to supplement my testimony in accordance with the permission which you granted me at the hearing, will provide Senator Douglas with the material which he needs in order to set his mind at rest with regard to the estate-tax implications of these term trusts.

As our basic example, let us assume that the taxpayer establishes an irrevocable trust of stocks or other property having a value of $100,000. He provides in the trust that the income from the property shall go to an educational institution for a 15-year period, and that after the 15-year period has run, the property will go to the grantor's children.

As I understand it, Senator Douglas wants to be sure that the remainder which goes to the children after the 15-year period will be subject to the Federal estate tax. As I see it, the Senator may rest assured that this remainder is in fact taxed, either by the gift tax or by the estate tax or sometimes by both; in order to spell out the matter more thoroughly, however, here is an outline of the way in which the taxes would fall, as I see it.

As a result of setting up this irrevocable trust, the taxpayer has made a gift of a remainder interest to his children. This is a taxable gift, and as a result, the taxpayer becomes liable for a Federal gift tax, on the value of the remainder at the time of the gift. Because the remainder is probably a future interest, as defined in the IRC, section 2503 (b), the taxpayer would not be entitled even to the annual $3,000 per capita exclusion otherwise available under the gift tax law.

If the taxpayer then dies within 3 years after he has made this taxable gift, IRC, section 2035 (b) then creates a statutory presumption that the gift was made in contemplation of death, and the burden of proving the gift was not made in contemplation of death will fall upon the estate. Senator Douglas was interested in the problem of proof in connection with what constitutes "contemplation of death." This is a somewhat complicated matter, as suggested yesterday by a later witness, but the matter is covered generally by Treasury Regulation 105, section 81.16 (a) and the cases decided thereunder.

If the gift is established as having been made in contemplation of death, the value of the remainder at the time of the taxpayer's death will have to be included in his gross estate for purposes of computing the Federal estate tax. The estate does get a credit for the gift tax which has been already paid on the gift, but since the estate tax rates are higher than the gift tax rates, this means that the gift of the remainder to the children may again be subject to tax as a result of the donor's death. If the donor dies more than 3 years after making this gift in trust, the gift is ruled by IRC, section 2035 as not having been made in contemplation of death. The gift in such a case is subject to the gift tax only and not to the estate tax also.

I believe that the above general statement covers the precise points which Senator Douglas raised during the course of the hearing. In order to be sure that he has a comprehensive picture, however, I think it well to point out also the effects of the estate tax and the gift tax in a second and third type of situation.

The second situation is the one that arises if a taxpayer, instead of establishing a long-term trust during his life, establishes one by the terms of his will, and then dies. The value of the remainder going to his children would be subject to the Federal estate tax. (Actually, what happens is that the whole amount of the property which is put into the trust by the will is included in the gross estate, but the commuted value of the income to charity is deducted from the gross estate pursuant to IRC, section 2055, leaving the balance, which is the remainder to the children, subject to the estate tax itself.)

The third situation which is worthy of mention arises when the taxpayer during his lifetime establishes a term trust with income to charity and a reversion to himself after the term period. (This kind of trust is, of course, in no way involved in the sec. 9 problem, because the taxpayer in such a case is already denied a deduction against income by reason of IRC, 170 (b) (1) (D).) In the case of such a trust, with a reversion, there is no gift tax involved, because the donor is not making a gift of the reversion to himself, and the gift to charity is not subject to tax. If, however, the taxpayer dies at any time before the term of the charitable trust has expired and before the principal has reverted to him, and regardless of whether or not the gift was in contemplation of death, the value of the reversion as of the time of his death will be included in his gross estate for purposes of computing the Federal estate tax pursuant to IRC, section 2033.

Senator Douglas was particularly interested in getting information about the estate-tax aspects of the short-term trusts which can be set up for 2 to 10 years' duration under IRC, 673 (b). As I see it, the estate- and gift-tax problems in such cases are just the same as for the long-term trusts, except that the contemplation of death problem will always be present if the trust is for less than 3 years and the donor dies before the trust expires.

I trust that the above statements of general principles will set Senator Douglas' mind at rest with regard to the estate- and gift-tax aspects of these term trusts. These aspects are not, of course, actually involved in connection with section 9, because that section relates to deductions for income-tax purposes.

Thank you again for your courtesies at the hearing. We urge again that the Senate modify the proposed section 9 in the manner which I and other witnesses suggested during the testimony. Without further stressing the points raised during the hearing, it is a matter of fundamental importance to private education today that this recommended change in section 9 be incorporated into the Technical Amendments Act.

I am sending a copy of this letter to Senator Paul Douglas for his information and files.

Sincerely yours,

STURGIS WARNER.

The CHAIRMAN. Are there any further questions?

Thank you very much, Mr. Warner.

The next witness is Mr. Clinton Davidson of Bernardsville, N. J.

STATEMENT OF CLINTON DAVIDSON, BERNARDSVILLE, N. J.

Mr. DAVIDSON. My name is Clinton Davidson. My residence and office address is box 35, Bernardsville, N. J.

In appearing before you I represent four small religious colleges, namely, George Pepperdine College of Los Angeles, Calif.; Harding College of Searcy, Ark.; Abilene Christian College of Abilene, Tex.; and Northeastern Institute for Christian Education of Philadelphia, Pa.

I wish to discuss part of section 9 of H. R. 8381. To avoid possible confusion, I should mention that, as you gentlemen know, I write a column entitled, "This Week in Washington With Clinton Davidson," which is carried by 803 newspapers, largely but not exclusively weekly newspapers. I am here today, however, solely for the purpose of representing the four colleges just mentioned.

It will not be possible to present a complete technical discussion of this subject in the 10 minutes allotted me so I am delivering two technical memoranda prepared by Henry L. Wheeler, Esq., of Madison, N. J.

It is generally conceded that, if section 9 is enacted, it will reduce contributions primarily to churches, colleges, and hospitals. Also that its enactment would have very little, if any, effect upon the Government's revenue.

Some of the effects that may result from this remarkable section are, to express it mildly, startling. For example, if an individual created a trust giving income to the Methodist Church and principal to his wife, the grantor receives no religious tax deduction, but, if while giving the income to the Methodist Church he provides that the principal will go to his mistress instead of to his wife, there is a religious tax deduction.

We oppose this section because it reduces the incentive to make gifts to churches, religious colleges, and hospitals. It seems rather strange that under this section there would be an incentive, that is, a tax saving, if the principal went to the mistress of the grantor of the trust and no incentive if it went to his wife. The religious colleges that I represent do not wish to encourage such an idea.

To illustrate this principle further, we shall suppose that a widower who has 2 children marries a widow who has 2 children. He creates a trust giving the income to the Methodist Church and giving the principal to his own children. Under this provision he could not deduct the gift to the Methodist Church from his taxable income, but if the principal went to his wife's children instead of his children, then he could deduct from his taxable income the income that was given to the Methodist Church.

We believe that the Revenue Code already contains enough inconsistencies and we do not favor bringing about the two situations quoted above unless it is necessary to do so to save revenue. In just a moment I shall show that it is not necessary.

This section is retroactive to December 31, 1956. That is its worst feature. A taxpayer who created a trust 13 months ago, giving income to the church, would take a dedeuction in his tax return for last year's income. Probably more than 90 percent of the large contributions would not have been made if the incentive of tax saving had not been there.

Under section 9, however, the man who made the gift of income to the church 13 months ago will have the tax saving he counted upon canceled if the principal of the trust went to his wife, but it would not be canceled if the principal of the trust went to his mistress. Tying a retroactive penalty on good deeds created more than a year ago into the circumstances just described is, I hope, too much for this committee to swallow.

Now, may I have a few minutes to explain the section in general?

UNDER THE PRESENT LAW

Generally, if an individual creates an irrevocable trust, the income is not taxed to him. Also, if income from the trust goes to charity, the donor has a charitable tax deduction. This situation has existed for many, many years, probably since 1913.

UNDER SECTION 9

If the principal of the above trust goes to members of the family, the income still is not taxed to the donor, but if income goes to charity, there is no charitable tax deduction. The charities are penalized merely because the plincipal passes to the donor's family.

If any of you gentlemen wish to make gifts to members of your family and to charity, I see nothing sinful about it. I think that such ideas should be commended. Section 9, however, says that if you want to make gifts to your family, that is okay, but if you bring in charity at the same time by giving the income to charity, both you and the charity will be penalized. The tax-deduction incentive will be withdrawn.

I understand that section 9 originated because someone created a trust giving income to charity for 2 years with principal reverting to the grantor at the end of 2 years and that, although the property he donated produced no income, the grantor took a taxable deduction against his taxable income.

We believe that the Treasury already has authority to deny such a misuse. I refer to the case of *Minnie E. Deal* v. *Commissioner* (January 29, 1958, 29 T. C.). Also, if the Treasury wishes specific legislation against such misuse, it can be provided without destroying the entire charitable incentive.

As they say out in the country where I live, "It is not necessary to burn down the barn to kill a few rats." Or, "It is not good medicine to cut off a man's head because he has corns." If the Congress wishes to put in a requirement that income must be paid to charity for at least 10 years to be deductible, we have no objections, nor would we object if the deduction applied only to gifts to churches, colleges, and hospitals.

I should like to make clear, however, that I am not discussing trusts which revert to the donor. That subject was discussed before the Ways and Means Subcommittee and will probably be discussed here by others. I am discussing a subject which has always been fundamental in our tax law, namely, that if a man makes a gift and completely divests himself of both principal and income, the income is not taxable to him and the part that goes to churches is deductible, within certain percentage limitations.

Section 9 changes this fundamental principle, with no hearings having been given to the subject and the public was not informed until May 1957 (after the hearings were closed) and yet this drastic fundamental change is made retroactive to January 1, 1957, about 5 months before the taxpayer could have secured any knowledge of it. During that period millions of dollars were given away irrevocably. Do you not think that this retroaction is completely without justification?

President Eisenhower, recognizing the financial needs of educational institutions, has just recommended making available more than $1 billion of taxpayers' money, but none of it goes to the type of colleges I represent. Our institutions do not have hundreds of millions of dollars of endowments. They are engaged in a hand-to-mouth fight for existence. Is it not inconsistent to dish out over a billion dollars of taxpayers' money to a limited group of colleges and at the same time destroy an incentive to provide gifts to the smaller colleges, just because in 2 instances 2 individuals misused 1 of the provisions?

Let us suppose that under the present law an individual completely divests himself of certain property, giving half of the income to charity for 5 years and all other income to his son, with the remainder interest in the property to his grandchildren. Obviously, none of the income would be taxed to the grantor. And just as obviously, the gift to charity would be deductible by the grantor against his taxable income. The present law recognizes that there should be an incentive to encourage gifts to churches, colleges, and to hospitals.

Section 9, however, would deny the deduction by the grantor of the charitable gift. Remember that the grantor has completely divested himself of both principal and income and that, even under section 9, none of the income would be taxable to him. Section 9 does not tax the grantor on his income or his property that he has given away. It does not deny that the income is no longer the grantor's. It penalizes the churches, colleges, and hospitals by taking away from them one of the incentives that has kept their doors open.

For many, many years Congress has deliberately and rightly provided an incentive to encourage gifts to such institutions. Several years ago they provided a special incentive (10 percent additional) for gifts to churches, colleges, and hospitals. If section 9 is enacted, the churches, colleges, and hospitals will find that Congress, under some circumstances, has tied a string to this benefit and is now taking it away from them, even where the donor has completely divested himself of both principal and income, and, worst of all, section 9 says we will make this effective retroactively for more than 13 months.

Since the arrival of the sputniks and ICBM's, every newspaper in the country has been saying that we have not spent enough for missiles and education. No one could think of passing a law to take effect for more than 13 months retroactively, recalling funds that have already been spent on missiles and reducing such appropriations for the future. Why, therefore, should we do such a thing to education? We should be increasing incentives for gifts for education. How can we possibly afford to go back and penalize people because they made gifts to education more than 13 months ago?

I am sure that all of you have heard of the Italian who put a sign in his fruit store: "If you musta pincha da fruit, pincha da coconuts."

Gentlemen, if you musta pincha somebody, please do not pinch churches, colleges, and hospitals, that is, please do not enact section 9 because it will result primarily in pinching the finances of churches, colleges, and hospitals.

(Additional material submitted by Mr. Davidson is as follows:)

CONSIDERATION OF THE "DOUBLE BENEFIT LOOPHOLE" INTENDED TO BE BLOCKED BY SECTION 9 OF H. R. 8381

The sole purpose of this memorandum is to explain why it is, that, from a practical point of view, the "double benefit" envisioned in the comment contained in the report of the Committee on Ways and Means to accompany H. R. 8381, is nonexistent.

It is, of course, true, as is stated in the report, that the donor, who gives income of a trust to charity for a term and who gives all other income and ultimately all principal to members of his family, has the benefit of excluding the trust income from his income under section 673 and at the same time is entitled to a deduction for his charitable contribution under section 170 (b) (1) (D).

To treat the fact, that the donor may effect the exclusion of the income from his own income and take the deduction for a charitable contribution at the same time, as an undue advantage, taken at the expense of the Treasury, is to permit words, the "double benefit," which are without substance, and entirely disassociated from reality, to control the methods of taxation.

As is demonstrated in the writer's memorandum, of December 30, titled "Memorandum Concerning Section 9 of the Proposed Technical Amendments Act of 1957," the charitable deduction is necessary to the donor, who is giving income to charity, in order to give him equality with the donor who wishes to give principal outright.

It follows that, the draftsmen of section 9 of H. R. 8381, have ignored substance and have substituted for reality the concept of a "double benefit," to the grave disadvantage of charity and, quite possibly, to the disadvantage of the Government's revenues.

Let us consider the strongest argument that can be made for the impropriety of the double benefit. It is this:

What the donor gives to charity is income. If he is in an 87 percent tax bracket, he is giving to charity dollars of income, which the the income-tax law converts into 13-cent dollars if the donor keeps them. However, if he gives these same 13-cent dollars to charity they are treated as dollars for full value in computing the deduction for the donor's charitable contribution.

This statement is true. It cannot be permitted, however, to imply, as it quite naturally does, that there is a double bite into the Government's revenues. That implication is untrue. The fact is that the donor, who gives income to charity, realizes 2 benefits from 1 transaction, because the nature of the single transaction, the creation of the trust, is such that it combines 2 benefits, which any donor, who creates a trust and gives outright to charity separately, takes as 2 separate benefits. By creating the trust the donor removes the income on the assets, given to the trust, from his own income. By making an outright gift to charity he deducts the gift from his own income. Incidentally the donor, who makes the outright gift, removes from his own income on an amount equal to the net cost of his gift to charity.

The removal of the income of the trust's assets from the donor's income is not the result of a gift to charity. It results from the creation of the trust without regard to the nature of the beneficiaries, whether charities or individuals, or both. The fact that members of his family are the beneficiaries and that the remaindermen are members of his family does not make the income taxable to him.

But, by giving the income on the assets, placed in the trust, to charity the donor is not only removing that income from his own income by converting it into trust income, he is also diverting it from himself and his family to charity. Obviously, this diversion will not be made by any informed donor, unless that diversion is given recognition as a charitable contribution.

The double benefit results in normal course from 2 phases of 1 transaction: first, the creation of the trust, and, second, the gift to charity. Both of these benefits are necessary in order that the gift of capital and the gift of income may be kept on an even basis.[1]

If section 9 is enacted to discriminate against the gift of income, the double benefit is still available to the donor. He may make an outright gift to charity and simultaneously create a trust for his family.

As long as it is the Government's policy to permit a deduction for charitable contributions and to treat the income of a trust, created for the family of the donor, as removed from the donor's income, if the donor retains no reversionary interest whatsoever, it may be said that there is a double benefit available to the donor. To call this a double benefit is a misnomer. There are two separate benefits, each of which will exist, as long as charitable contributions are deductible and the owner of property may divest himself of income by creating a proper trust to effect the exclusion of the trust income from his own.

Until Congress is prepared either (1) to deny the deduction for charitable contributions in all cases or (2) to declare that an owner of property may not exclude the income on property from his own by giving the property in trust for the benefit of members of his family, there will be two separate benefits available to every donor who is prepared to create such a trust.

To deny either of these benefits in one particular type of case (the case in which the donor gives income of a trust to charity) is to inject an inconsistency into the law, which will not close a loophole but which will deprive charity of a most efficient means of raising funds.

Double benefit is no more than a phrase, which is as unsound as it is stimulating. It connotates a raid on the revenues, a larceny now inadvertently given protection by law. It implies that the donor in an 87 percent income-tax bracket will realize a saving of 87 percent from the exclusion of the income of the trust

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[1] A sharp differentiation must be made between the gift of income with the reversion retained by the donor and the gift of income with the remainder passing to the donor's family. The difference lies in these two facts:

First, the donor who gives to a trust for his family may exclude the trust income from his own and may cause the income to be accumulated for his family and to be taxed, as trust income, at low rates, to the extent that the 5-year throwback does not apply.

Second, the donor, who establishes a trust to accumulate income for himself, cannot avoid paying the tax upon that income.

This difference is the reason that, as appears from the memorandum of December 30, the donor, who creates a trust for his family, finds that it makes little difference under present law, whether he makes an outright gift, or a gift of income, to charity, while the donor who provides only for himself would find, that, if he were allowed to take the charitable deduction for his gift of income, the cost of his gift basically would be the amount of his gift less twice his income tax on an amount equal to the gift, so that, if he is in a tax bracket of more than 50 percent, he would realize a profit from the gift.

This is why it is sound for section 170 (b) (1) (D) to deny the charitable deduction to the donor who retains a reversionary interest. Although the treatment of a reversion worth 5 percent as the equivalent of a complete reversion, may be open to some criticism, it has justification on the theory that it should be only where the donor completely divests himself of principal that he should have the benefit to the charitable deduction. Otherwise there is a chance that by giving the charity he may realize for himself more than he could, if he retained the capital and made no gift to charity. In that case the Treasury would be foregoing two income taxes upon the donor's income in respect of each gift to charity.

It is absurd, however, to deny to the donor, who creates a trust for charity and his family, the charitable deduction for his gift of income, merely because that deduction is denied by present section 170 (b) (1) (D) to the donor, who seeks only a profit for himself.

from his own income and a second saving of 87 percent from his deduction for the charitable contribution. This is a total saving equal to 174 percent of what is given to charity. The net profit from the transaction appears to be 74 percent after deduction of the amount of the charitable gift.

So viewed, section 9 of H. R. 8381 has the appearance of being one of the first sections of that bill which should be enacted to protect the revenues.

The fact is, however, as appears in the writer's memorandum of December 30, 1957, and as appears above, that section 9 does not close a loophole and does not provide any substantial proection to the revenues. On the contrary, in most cases it may decrease the revenue by encouraging the coupling of outright gifts to charity with the creation of trusts of securities with high yields.

HENRY L. WHEELER, Jr.

DECEMBER 30, 1957.

MEMORANDUM CONCERNING SECTION 9 OF THE PROPOSED TECHNICAL AMENDMENTS ACT OF 1957—PROPOSED AMENDMENT IS UNSOUND

This section is based upon the assumption, appearing in the report of the Committee on Ways and Means to accompany H. R. 8381, that a donor by giving income rather than principal to charity realizes a double benefit, accruing to his family under the present law.

This view is summarized in the report on page 9, as follows:

"It is understood that a practice has developed of transferring property in trust for a term of years with the income going to charity and a remainder at the end of the term going to a close relative of the grantor (such as his child). In this situation under existing law, the grantor receives the benefit of excluding the trust income from his income under section 673, but because the children receive the remainder instead of the taxpayer, section 170 (b) (1) (D) does not prevent the grantor from taking a charitable deduction for the value of the income interest. This double benefit accrues in these cases despite the fact that the income-producing property is retained in the family group."

The idea of the double benefit is a misconception, based upon two erroneous lines of reasoning. To explain those errors in this memorandum seems quite unnecessary. It seems betted to show merely that there is no double benefit, and that, under present law, in many, if not most normal cases, the family of the donor who gives income will suffer a loss as a result of the gift of income, rather than of principal, to charity.

The proposed amendment would impose a tax penalty on the family which incurs a loss of capital even in the absence of the penalty.

The weight of the tax penalty is so heavy, that it can be said with certainty that with the enactment of proposed section 9, all gifts of income to charity will cease.

That the gift of income is a substantial source of funds for charity is recognized in the report of the Committee on Ways and Means.

The most direct way of comparing the effect of the usual outright gift to charity and the gift of income of a trust to charity, is to compare the case of two men, each of whom has the same amount of capital, which he wishes to use (*a*) to make a gift to charity that will permit him to take a definite amount as a deduction for a charitable contribution, and (*b*) to establish a trust for the benefit of his family.

Suppose that each donor in the 87-percent income-tax bracket, is willing to divest himself of the same amount, for example $68,629 plus the gift tax.

Under the present law, the first donor, I,[1] will set up a trust of $100,000 with all of the income payable to charity for 13 years.

Let us suppose that the second donor, O,[1] prefers to make an outright gift to charity this year and to place what is left of the principal of which he is willing to divest himself in trust for his wife and children.

The trust, which O will establish, will be $63,941 as compared to I's trust of $100,000, as appears in the table on page 3.

I's trust ($100,000) will be 1.56394175 times as much as O's trust ($63,941). This figure 1.56394175 will remain unchanged, no matter what the income-tax brackets and the gift-tax brackets of I and O may be as long as both are in the same brackets.

[1] The donors are named "I" and "O": I to denote the donor who gives income, and O to denote the donor who makes an outright gift.

To illustrate this point, let us assume in one case that I and O will find that the taxes, that, in the absence of a gift, would be payable on the $36,059, which each would claim as a charitable contribution, would be at the rate of 87 percent. In the second case, let us assume that I and O will find the applicable income-tax rate to be 60 percent rather than 87 percent.

	With I and O in 87-percent tax bracket		With I and O in 60-percent tax bracket	
	Column 1, I's case	Column 2, O's case	Column 3, I's case	Column 4, O's case
Amount of which donor is willing to divest himself[1]	$68,629	$68,629	$78,365	$78,365
Add income-tax saving on gift of $36,059[2]	31,371	31,371	21,635	21,635
Available to family and charity	100,000	100,000	100,000	100,000
Given to charity outright	0	36,059	0	36,059
Available for trust	100,000	63,941	100,000	63,941

[1] The divestment does not include the gift tax. The gift tax will be the same in each of the 4 columns—the gift tax on a gift of $63,941. To include the gift tax would be to include a figure without significance in our comparisons.
[2] $3,500 (income on $100,000 at 3½ percent) times 10.3027 (factor from table II of the Regulations).

The foregoing table makes unnecessary any further explanation of the facts that I's trust will remain 156.394 percent of O's trust and that O's trust will always be 63.941 percent of I's, regardless of their income-tax rates, as long as both have the same tax rates.

The only significant figure is that, for purposes of valuation, the income of a trust for 13 years, in the absence of special circumstances, has a present worth of 36.059 percent of the principal of the trust.

Since O's trust will be approximately 63.941 percent of I's trust, and since O's trust will be accumulating income for O's family for 13 years,[2] while all of the income of I's trust is being paid to charity, O's trust will provide more for his family, if the net yield upon the assets in each trust before income taxes equals 4.164 percent.[3] This appears from the following:

Net income before taxes on $63,941 in O's trust at 4.164 percent	$2,662.50
Less income tax on dividend income in that amount	412.25
Net for accumulation	2,250.25
This will be compounded for 13 years at 3.41448 percent (82 percent[1] of 4.164 percent). At 3.41448 percent, $1 a year for 13 years will amount to $16.027027	×16.027027
Total accumulations at end of 13 years	36,065
Add original principal in trust	63,941
Total capital in O's trust at end of 13 years	100,006

[1] 82 percent, because the income-tax rate on dividend income of the trust is 18 percent while the trust's net income before taxes is more than $2,150 and less than $4,150. In the 1st year the trust's net income will be $2,662.50. In the 13th year it will be $4,024.

This means that, if the net yield, after trust expenses, is 4.164 percent or more, there will be more for the family of O than there will be for the family of I, at the time when each family becomes entitled to all of the income of each trust.

If the yield is less than 4.164 percent, O's family will have less than I's at the end of 13 years.

Conversely, if the yield is more, I's family will have less, possibly a great deal less, than O's.

[2] The period of 13 years, upon which the figures in this memorandum are based, has been taken purely for illustration. It is the mean between 20 years and 6 years, the longest and shortest terms of the charitable income trust, which have come to the writer's attention. The length of the period for which income is payable to chartiy has no substantial effect upon the yield of 4.164 percent, after trust expenses but before taxes, on the basis of which the families of I andO will find it a matter of indifference under present law, whether the donor gives income or principal to charity. The figures demonstrating this fact are available for anyone who may wish to examine them.
[3] I's trust and O's trust must, of course, be assumed to have the same yield, if the comparison is to be a true one.

To illustrate the possibility of losses and gains to I's family resulting from the gift of income:

1. Assume that the net yield before taxes on the trust assets is 5 percent. In that case the loss to I's family, as compared to O's, at the end of 13 years will be $13,441. The present value of that loss, discounted at 4 percent,[4] is $8,072.

2. Assume that the net yield before taxes on the trust assets is 3½ percent. In that case, the gain for I's family, as compared to O's, at the end of 13 years will be $6,581. The present value of that gain, discounted at 2.87 percent,[5] is $4,389.

Of course, if the probable return on the property given to the trust is substantially less than 3½ percent, and if those assets were retained by the trustee, the gain to I's family and the loss of the Government's revenues may appear substantial. In the extreme case, in which the assets produce no income, the Government's loss and the gain for I's family would amount to the reduction in income taxes resulting from the charitable contribution allowed as a deduction from income.

It is hardly necessary to point out that any such sharp practice may be forestalled by the Treasury. The Government is not bound to value gifts of income on the basis of a 3½-percent yield. It may well determine the probable return to ble less and, in proper case, to be zero. It is submitted that the Treasury will have no difficulty in protecting its revenues.

It is further submitted that, if the gift of income is denied as a deductible charitable contribution, a ready source of funds will be lost to charity. To the writer's knowledge, several universities have received gifts by way of gifts of income which would not have been made in such large amounts, or which might not have been made at all if the gift of income were not deductible.

The value of what I gives to charity by way of income is the name for income-tax purposes as what O gives outright, $36,059.

As a matter of fact, on the 4.164-percent basis, I will give to charity more in total dollars than O. I will have given $4,164 a year for 13 years. This is a total of $54,132 (with a present value of $42,900, of which I is allowed a charitable deduction of only $36,059), as against the $36,059 which O gives in the first year.

Since a yield of 4.164 percent on trust assets, invested in equities, is slightly below rather than above normal, since what each gives to charity (on the 3½-percent interest basis on which valuations are normally computed under regulations) is the same, and since with the yield at as little as 4.164 percent, I's family will receive less than O's, it seems clearly unsound to deny to I the benefit of a deduction for his charitable contribution because he has seen fit to make a larger gift by extending it over a period of 13 years and by having it paid from income.

It would be impossible to prove to I that he would receive an unconscionable double benefit or, indeed, any benefit at all, if he is allowed to take the 36,059 as a charitable deduction.

There is no double deduction for I under the present law.

Under the law, as it is proposed to be amended by section 9 of the Proposed Technical Amendments Act of 1957, I would be unfairly denied the deduction which he must have to equalize his family's position with that of O's family.

Under the proposed amendment, at the end of 13 years, I's family would be worse off than O's family by the following amounts:

	Applicable income tax rate 87 percent	Applicable income tax rate 60 percent
With yield before tax 3.5 percent	$38,738	$24,673
With yield before tax 4.164 percent	48,546	32,481
With yield before tax 5 percent	65,676	49,465

[4] This rate is the average rate of net yield after income tax on the trust's stock over the period of 13 years, if the net yield before income taxes is 5 percent.

[5] This rate is the rate of net yield after income tax in each year of the 13-year period, if the net yield on the trust's stock before income tax is 3.5 percent.

The present values of these amounts, by which the assets of I's family will be less than the assets of O's family, are as follows:

	Income tax rate 87 percent	Income tax rate 60 percent
With yield before tax 3.5 percent	$20,815	$17,079
With yield before tax 4.164 percent	31,375	21,639
With yield before tax 5 percent	39,443	29,707

CONCLUSION

The belief, that the "double benefit" exists, is without foundation. It follows that section 9 of the Technical Amendments Act of 1957 is without justification. It should be deleted from the bill.

HENRY L. WHEELER, Jr.

The CHAIRMAN. You have made a very impressive statement, Mr. Davidson.

We thank you very much.

Mr. DAVIDSON. May I say hello and best wishes to a great servant whom I have not seen in 10 years.

Hello and best wishes, Mr. Stam.

The CHAIRMAN. Are there any questions?

Senator DOUGLAS. Yes.

By nonreversionary you mean nothing its to come back to the donor?

Mr. DAVIDSON. In the part I am discussing there is nothing to come back to the donor.

Senator DOUGLAS. What about the children? This is a question that I am not clear on, and I directed a question on this to Mr. Warner. What is the present practice as far as the inheritance tax is concerned?

Suppose there is a trust which provides that after 10 years the property and the income reverts to the heirs, is this exempt from inheritance tax now?

Mr. DAVIDSON. Yes, sir.

Senator DOUGLAS. It is not?

Mr. DAVIDSON. If the property reverts at any time to the donor, he has no inheritance tax saving.

Senator DOUGLAS. I do not mean revert to the donor, revert to the heirs, is it exempt then from the inheritance tax?

Mr. DAVIDSON. I think the word "revert" is wrong and gives the wrong impression.

Senator DOUGLAS. If it is passed to the heirs, is it exempt from the tax?

Mr. DAVIDSON. If a man makes a gift, completely divesting himself of principal, and the principal goes to his family or to anyone, it is then exempt from the estate tax unless the gift was made in contemplation of death.

Senator DOUGLAS. You see, I am not an expert, but you are an expert.

Mr. DAVIDSON. Senator, I am not an attorney.

Senator DOUGLAS. Suppose a man sets up a trust of a million dollars and gives to, let's say, Drew University, Drew University gets the income for 10 years, with the proviso that at the end of the 10 years the income is to go to his children, and during this 10-year period the man dies. Is that million dollars or any part of it then subject to an inheritance tax?

Mr. DAVIDSON. Senator, you have not said where the principal is to go, you have only discussed where the income is to go, and the inheritance tax will depend entirely on the principal.

Senator DOUGLAS. Let us say that the principal is temporarily conveyed to Drew University, but only for 10 years, with the understanding that at the end of 10 years the principal as well as the income goes to the children. The question that I am trying to get at is whether by this device you can, by giving to a charitable institution a bequest for a limited period of years, which, however, subsequently goes to one's heirs, can get exemption from the inheritance tax.

Now, the discussion this far has been in terms of the income tax. I am trying to find out what relationship this has to the inheritance tax.

Mr. DAVIDSON. I do not believe there is anything in this bill that improves the inheritance tax situation at all, I think the inheritance tax isn't touched upon.

Senator DOUGLAS. What is the present situation?

Mr. DAVIDSON. The present situation is that if a man completely divests himself, regardless of whether it goes to charity or to his children or to a labor union or what, if he divests himself completely and irrevocably of the principal, it is not in his estate when he dies, and if it is not in his estate, it is not subject to the estate tax.

Senator DOUGLAS. Of course, we know that the estate tax has been shot full of holes by various devices, and has been eroded very much by these provisions. But is this one of the erosions which occurs, that is the point.

Mr. DAVIDSON. I think, Senator, when you are speaking of the erosions you are thinking of where the word "reverted" comes in, of where the principal reverts to the man.

And the question there is, if it reverts to him, if it reverts automatically, or if he has an option or anything of the kind with which he can bring it back, then it is in his estate and taxable at his death.

Senator DOUGLAS. Suppose an elderly man is in bad health, catches cold, has pleurisy coming on him, and he decides this a good time to set up a trust for the benefit of Drew University, and he does so, a million dollars is to be conveyed to Drew University for 10 years, but thereafter it and the income will go to his children, and that unfortunately this pleurisy becomes fatal either in a shorter or longer period of time, and the man dies shortly thereafter, the question is, what happens then?

Mr. DAVIDSON. Senator, under nearly all of these cases, the Government would succeed, regardless of this thing you are talking about, would succeed in collecting the estate tax, because it was done in contemplation of death—he thought he was going to die and he did it in contemplation of death.

Senator DOUGLAS. How can you prove contemplation of death?

Mr. DAVIDSON. I am not a lawyer, and that is a subject——

Senator DOUGLAS. I know, but how can you prove contemplation of death?

Mr. DAVIDSON. I know there is at least one condition that is controlling in the law, and I have forgotten the wording of it. Also the courts have set up quite a number. So on the first part you asked about, if the man does this in contemplation of death, in the majority of cases it is going to be taxed.

Senator DOUGLAS. I can understand that a donation one minute before a man dies may be said to be in contemplation of death, but sometimes foreboding of what might happen are stimulated by an attack of pneumonia in the winter months.

Mr. DAVIDSON. Mr. Stam can tell us instantly the number of years that have to pass on that contemplation of death and estate tax situation.

Mr. STAM. That type of law has a 3-year period. If the gift is made within 3 years, then they have got to show that it was not in contemplation of death, if it is made after 3 years, they don't.

Mr. DAVIDSON. I am just talking about the contemplation of death.

If I may try to answer the other part of your question—I do not know that I can—section 9 does not change anything in the present law regarding the estate tax; it has no effect upon it.

Now, when you speak, if I may say this, when you speak of giving the principal to Drew University for 10 years, I would say that in 99 percent of the cases it is not done that way.

A man transfers his securities to a trustee, so the trustee then becomes the owner and has the title. And the trust provides that only the income will go to Drew University. So he does not give the principal to the university at all. The trust provides only for the income to be given.

Now, regardless of whether the property goes to his children or strangers, regardless as to when the trustee is to distribute the principal, regardless of any of that, if he has completely divested himself and, if it is not in contemplation of death, it is not in his estate and it is not subject to estate tax.

I think I am right, Mr. Stam?

Mr. STAM. I mean, it is just like a gift, if you make a gift, it is not intended to take effect at your death, or it is not in contemplation of death, why that is not in your——

Senator DOUGLAS. You see, I am not expert in these matters, but I know that financial agents for institutions and charitable organizations frequently make an appeal not only to the charity of donors but also to the fact that certain gifts are made in such a form that the donor could benefit from it also.

We have this tendency in conection with the businesses conducted by charitable, educational institutions. What I am trying to get at is, when you make an appeal to a man to settle a reversionary trust on an inheritance what is it that he receives as a tax favor in addition to the good deeds which he performs? For good deeds are frequently sweetened by a saving of money too, just what is your appeal to these people?

It is simply an appeal to charitable motives, or do you also tell them how they or their heirs will be able to reduce their total tax?

Mr. DAVIDSON. It is very simple, and it is of long standing. Just take a specific case. A man has $100,000 of your Government bonds, and he is getting $3,000 a year income. He gives these bonds to a charitable institution, to Drew University. He no longer has to pay tax on that income, of course, he does not have it, no more than if he had sold it. So of course he does not have to pay tax on it. The House committee report on section 9 refers to this as a deduction, it is not a deduction, he just does not have it, he gave it away, it is not his, so of course he does not pay tax on it. So that is not the incentive, if he burned the bonds up the same thing would be true, so that is not the incentive. But we have had in the tax law a provision for the purpose of helping the private colleges, hospitals, and charities.

Senator DOUGLAS. What is the added incentive?

Mr. DAVIDSON. That $100,000, the value of these bonds, is deductible from his taxable income if it does not exceed 30 percent of his taxable income.

Senator DOUGLAS. So that he can deduct both interest and capital.

Mr. DAVIDSON. He makes one deduction, Senator, which is $100,000, the whole thing. The interest is no longer his, but his deduction is just one deduction, $100,000, that is, the capital. The deduction is always the value of the gift. That is what he deducts, the value of the gift.

Senator DOUGLAS. He deducts that even though his heirs get it back again?

Mr. DAVIDSON. Well, the illustration that I gave was that he gives $100,000 of bonds.

Now, of course, his heirs do not get it. If we take another instance——

Senator DOUGLAS. In the reversionary trust, either he or his heirs get it back, and I understand that is the meaning of the term "reversionary."

Mr. DAVIDSON. Reversionary is when it reverts to him, as I understand it.

Let's take it that way. He creates a trust and gives $100,000 of bonds to the trust, and he instructs the trust to pay the income to Drew University, say, for 10 years, and then the income to go to his family or to anyone, and upon his death, or rather upon the death of the beneficiary, usually, the principal goes to the beneficiary's heirs. That is the usual form of trust.

Now, under that trust what has happened is, the value of the gift that is made to the university is deductible.

Now, if the gift was 3 percent on United States Government bonds ($3,000 a year) for 10 years, it is 10 times $3,000 or $30,000 discounted by an interest factor to get the present value. And the deduction then is the present value of the income that is given. And that is always true, whenever you make a gift to a charitable institution your deduction is the value of the gift that you make.

And whenever you divest yourself completely of principal, if it is not done in contemplation of death and a few things of that kind, then of course it is not in your estate at death, and there is no estate tax.

Senator DOUGLAS. What I am trying to get at is this. What is the special appeal which you make in these cases that would not apply to an outright gift?

Mr. DAVIDSON. Well, I think you are probably talking about this 2-year matter, which I certainly do not want to defend, and which the man before me did not defend, and the special appeal there, which is not the appeal that I am talking about that I have had in connection with here, but the appeal there was that it reverts to you yourself in 2 years.

Under the 2-year provision, the income goes over to charity, and 2 years later the principal comes back to you.

Senator DOUGLAS. Well, granted that 10 years is not as bad as 2 years, if you have got a 10-year elastic string on it you get it back at the end of 10 years.

Suppose you are a vigorous fellow, in the full prime of life.

Mr. DAVIDSON. Senator, as I said to start, that is a subject I am not discussing, I am not in any way either for or against it, but that subject came up before this committee some years ago, and there was a lot of discussion on it, which is in the record, and I have not read it.

Senator DOUGLAS. I was not a member of the committee. I hope you will bear with me and help us to understand the point at issue.

Mr. DAVIDSON. We are both in the same boat, Senator. I have not read these hearings, but they are available, and that whole subject as to why the 10-year provision should be available was discussed thoroughly in the Senate Finance Committee report.

Senator DOUGLAS. Well, could you give me the citation on those so that I may reduce my ignorance?

Mr. DAVIDSON. May I ask Mr. Stam a question?

Mr. Stam, could you tell me what year those hearings were? Or may I write you, Senator?

Senator DOUGLAS. You may.

The CHAIRMAN. If you care to it could be put in the record too, Senator Douglas——

Senator DOUGLAS. Yes.

The CHAIRMAN. If you write to Senator Douglas it may be placed in the record.

(The following was later received for the record:)

FEBRUARY 28, 1958.

The Honorable PAUL H. DOUGLAS,
Senate Office Building, Washington, D. C.

DEAR SENATOR DOUGLAS: While testifying before the Senate Finance Committee on Wednesday, February 26, you asked for a citation of the report of the Senate Finance Committee covering short-term revertible trust provisions.

I should like to refer you to the report of the Committee on Finance, United States Senate, Internal Revenue Code of 1954, printed June 18, 1954, section 673, found on pages 366 and 367.

For a further discussion of the 10-year provision, I refer you to the hearings before a subcommittee of the Committee on Ways and Means, dated November 19 through 28, 1956, on pages 374 and 375.

Sincerely yours,

CLINTON DAVIDSON.

Mr. DAVIDSON. Senator, I heard yesterday of a parakeet—you know, those little birds—that died because of a limited vocabulary. And I want to apologize for my limited vocabulary. The parakeet had only been taught to say, "Come here, kitty." I, like the parakeet, have a very limited vocabulary.

The CHAIRMAN. Thank you very much.

There are four more witnesses to be heard, and it has been suggested that we recess until 2:30 in the District of Columbia room over in the Capitol.

So we will recess now until 2:30, when the other four witnesses will be heard.

(Whereupon at 1:15 p. m., the committee recessed to reconvene at 2:30 p. m., the same day.)

AFTERNOON SESSION

Senator KERR. The hearing will come to order and we will hear from Mr. Marvin Kratter who will speak on section 14.

You may proceed, Mr. Kratter.

STATEMENT OF MARVIN KRATTER, OFFICE BUILDINGS SYNDICATES

Mr. KRATTER. I am president of Office Buildings Syndicates, Inc., 521 Fifth Avenue, and our business is that of setting up limited partnerships to own for investment fee and leasehold ownerships in real property.

I appreciate the committee's kind invitation and I apologize for not having a prepared statement, but would appreciate your permission to submit a prepared statement upon my return to my home in the next few days.

(Mr. Kratter later decided not to submit a supplement statement.)

Senator KERR. You may do that.

Mr. KRATTER. I would like to say first that we are in substantial agreement with the position of Mr. Cochran, who spoke earlier representing the American Cotton Manufacturers Institute, Inc., on the matter of section 14.

I think it is important for the record that the committee recognize that the enactment of section 14 as proposed would work a very grave and serious hardship on many small- and middle-income Americans who have made investments in the ownership of leasehold estates in real estate.

Senator KERR. Do you address yourself primarily to the retroactive feature of proposed section 14 or to all of it?

Mr. KRATTER. I address myself to section 14 in its entirety, Senator.

Senator KERR. All right.

Mr. KRATTER. And the circumstances of the enactment of such a section could indeed be very grave, because in effect the investments that these people have made in hope of having a certain amount of income usable, a certain recovery of their capital would now fail to achieve their objective in our particular case by the enactment of this section.

I must say that for want of a better word, and to use the most polite word I can think of, that the language of this statute is certainly the most unusual that our counsel or ourselves have ever seen in a Treasury act.

Senator KERR. I think we ought to have clear that while the Treasury is in the process of recommending section 17, it is not before us as a Treasury act.

Mr. KRATTER. I beg your pardon. I stand corrected, Senator.

Senator KERR. Before us is an act of the House of Representatives.

Mr. KRATTER. The language that I am specifically referring to in this proposed section 14 is that language which specifically says as follows:

> Unless the lessee establishes that as of the close of the taxable year—

this is in here at proposed new section 178, Senator, subhead (a) (2), page 16, of the document that you are using, sir.

Senator KERR. (a) (2) or (b) (2)?

Mr. KRATTER. (a) (2), I believe.

Senator KERR. All right; now read it.

Mr. KRATTER. It starts on page 15 and goes on to page 16, and it says in effect:

> In respect of any cost of acquiring the lease or in respect of any building erected, the term of the lease shall be treated as including any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee, unless the lessee establishes that (as of the close of the taxable year) it is more probable that the lease will not be renewed, extended, or continued for such period than that the lease will be so renewed, extended, or continued.

Now this is a venture into the pure field of conjecture. Most of the long-established leaseholds now in existence, representing investments of many millions of dollars individually and perhaps billions of dollars collectively, Senator, have initial terms of let us say 15 to 20 and as high as 30 years with 3 or 4 renewal options of 15 to 21 years.

I submit that, in the exercise of the best possible discretion, no individual or agent of the Revenue Service can possibly sit down, let us say, in the first, second, or fifth year of the initial term of such an operating leasehold, and determine that 20 years from now or 15 years from now economic conditions will warrant his entering into a new 21-year renewal.

Now, Senator, our contention is that the Treasury Department is doing very well with the existing law, both in the field and in the courts.

It is true that certain individuals have attempted to get in leaseholds on a 5-year basis, but the Service has been resisting them very vigorously and the courts have been sustaining the Service.

They have made the taxpayer show, or the Treasury Department, I should say, has been permitted to show, that there is a reasonable certainty of renewal, and where the initial term is ridiculously small ——

Senator KERR. Say for 5 years?

Mr. KRATTER. Say for 5 years in terms of the total amount invested with a 95-year tail, the courts are upholding the service.

Now our contention is that if the initial term is a reasonable term in relationship to the option periods, in other words, if you create a 99-year leasehold consisting of say a 25-year original term and three 24-year renewals, then certainly in the operation——

Senator KERR. That would not be a 99-year lease; but, go ahead.

Mr. KRATTER. In the trade, sir, we call it a 99-year lease.

Senator KERR. That would be 97.

Mr. KRATTER. Ninety-seven, I beg your pardon. I perhaps did not get the numbers exactly right. But generally there would be no way of determining on anybody's part, the Service or ours, that 25 years from now we were going to renew, particularly in view of the fact that most of these renewal options are conditioned upon either changes in the rent or the existence of some special commitment or requiring a payment or a requirement for construction or demolition, and so on. And I just say that in this fast-moving country we live in, nobody could predict 25 years from now what they are going to do with a piece of property.

Now I think that the Treasury is now applying a good commonsense businessman's rule. If the cost of this leasehold amortized over its initial term represents a reasonable investment, the type of thing a reasonable and prudent man would do, then certainly the writeoff should be permitted over that initial term. I refer to the owner of this leasehold—and I am speaking now of buying a leasehold with a building already on it subject to an existing and previously created lease.

When a man buys this, if his yield is such that in a period of 20 or 25 years he will amortize his capital, get his capital back plus a 4- to 5- to 6-percent return on his money, then certainly this is a reasonable calculated business risk, and a writeoff of his cost of acquisition should be permitted in the initial term.

Senator KERR. Let me get this picture in my mind here.

Mr. KRATTER. Yes, sir.

Senator KERR. I take it this statement you are making applies to a situation in which this may be an illustration.

Somebody has built a building down here on a piece of ground under the terms of the lease for that real estate, not an ownership, not a purchase, and we will say that it is for an initial period of 25 years, but with the option on the part either of the builder or the present owner of the building or any subsequent purchaser or owner of the building to renew the lease from time to time at stated periods for a total of 99 or 95 years.

Then the person who buys that building, let us say after it has been built 10 years, when there is yet 15 years remaining in the primary lease, under existing law is entitled to charge off the cost of that building in that remaining 15 years of the primary term of the lease; is that correct?

Mr. KRATTER. I cannot qualify as an expert on the law, sir, but I would say it is the customary practice now that if that yield represents an intelligent yield to an investor for that 15-year period, then he would attempt to amortize his leasehold cost, and if I may be permitted to say, Senator, in the interests of clarification, because I observed closely this morning your interest in showing the practical facts rather than the technical aspects, that as a practical matter, although you buy such a leasehold, you used the words "buy the building."

In effect, sir, you do not buy the building. When you own this piece of property down there at K and 14th and it has a building on it, and I come to you and I say, "I want to buy a leasehold estate in that building," in effect what you are doing is selling me a piece of paper, and for this piece of paper I may pay you a million dollars, and under this piece of paper I agree to pay you X dollars a year, and operate the property as if I own it, and on the other hand, I have the right to collect from the subtenants on that building an income and the difference between what I collect from them and what I pay you is the net effective yield on that property. But you cannot acquire ownership in most States of a building which is located on a piece of land owned by someone else.

The building affixes and becomes part of the realty, so that actually what we bought there, sir, is this piece of paper.

Senator KERR. I understand.

Mr. KRATTER. And your statement with those modifications is absolutely correct.

Senator KERR. I understand that the fellow who built it on a piece of leased ground cannot in effect sell the building.

Mr. KRATTER. That is right, sir.

Senator KERR. But I used the term as describing the transaction where he was in the posture of a temporary owner or at least in the posture of being able to rent it out to anybody that uses it, and anybody that uses it pays him for the use of it.

Mr. KRATTER. Right, sir.

Senator KERR. As long as he fulfills the obligations of the lease under which the building was built on the property.

Mr. KRATTER. Right, sir.

Senator KERR. All right. Now go ahead.

Mr. KRATTER. Our contention is that there are hundreds or perhaps thousands of such properties on all the major corners of the major communities of America that operate in this manner, and it is quite customary and common that the fee ownership, that is, the actual legal ownership of the property, title to the property, has generally moved into the hands of estates or institutions, and that it is practically impossible to buy that type of property today and acquire a fee ownership. Because once an institution or one of these long-range estates or trusts gets ahold of them, you just cannot pry them loose.

So that if you want to create investments for small investors in the ownership of such a property, you have got to buy leaseholds.

Senator KERR. Yes.

Mr. KRATTER. This, of course, works a serious hardship from the point of view of the small investor who does not have the money to acquire the fee, because the fee owner, who is generally not subject to the same tax schedules as the individual—by that I mean the insurance companies or the trusts or the charities that own them, and so on. For example the Chrysler Building ground in New York is owned by Cooper Union, the technical school. The return that they look for on just the land is a very small return in comparison to the earning requirements of an individual who would buy the leasehold position.

But of course as the operator and owner of the leasehold, he takes many greater risks. But if you penalize him from enjoying the same position that the fee owner does, then in effect he is being discriminated against because he does not have enough money to acquire the fee as well as the lease position, and this is the problem we are gradually facing in our field today.

Most of the fee ownerships today of the top-notch properties have gone into insurance companies, estates, trust companies, and eleemosynary institutions; and gradually, the minute they hit that they are off the market. This is the only basis on which we can as smaller investors participate in the real-estate market.

Going to the other extreme, and perhaps from the sublime to the ridiculous, this legislation as presently drawn would also very adversely affect, for example, the small-business man who seeks to build a merchandising establishment of some type such as a drugstore. He goes out and under normal conditions he is afraid to obligate himself for too long a period of time because he does not want his family or his estate tied up with litigations. So he signs a 10-year lease and he may take a 10- or a 15-year or a 20-year renewal period on, and he is hedging, to be sure, that 10 or 15 years from now this place is still worth operating as a drugstore, that a city dump hasn't moved in next door or that the neighborhood hasn't changed, and so on.

Now the way this legislation is enacted with its extreme requirement here, this man who has made this investment in fixtures and other types of leasehold improvements that have no value outside of the leasehold, will lose his opportunity to write it off during this initial term, and he would be forced to use a 25-year term, because he certainly could not prove that 10 years from now he would not renew.

Senator KERR. I can very well understand the basis of your concern. At the same time, I can understand the basis of the feeling of the Treasury in connection with a situation where we will say there has been what appears to be abuse of a provision in the law, and under which a person or a corporation buys a leasehold estate in a property which can be occupied by the owner of the leasehold estate for a period of, say, 90 years by complying with certain renewal provisions and stipulations, but who, since the primary term initially or yet remaining might be 5 to 10 years, and he charges off the entire cost in that time which might even exceed the operating income of the property, and by owning it and charging it off he could make it a charge against his other income, then he would find himself in a very peculiar position at the end of the primary term of having charged off either against the income of that property or other income, or both, the entire cost of the leasehold estate.

Then he would still be where he could exercise the option to renew for another 15 years or another 25 years, and then would be in a position to sell that leasehold estate and his tax liability would be on the basis of capital gain.

Mr. KRATTER. Yes, sir.

Senator KERR. So it would seem to me that there is some argument here on both sides of this question.

Mr. KRATTER. Senator, I absolutely concur. We are not interested in prolonging or extending any loopholes here. All I can tell you is that as a practical matter, this has not operated generally as a loophole.

Senator KERR. And do you think if there is a loophole that it could be corrected without the drastic remedy that is prescribed here?

Mr. KRATTER. Oh, certainly, sir. Look, I am agreeable to any remedy which will correct it as a loophole and just do this thing in a reasonable businessman's way. But this remedy is impossible, absolutely impossible of performance.

Now, there are many criteria which could be established, either by Service regulation or by the act. For example, you could say, and I will develop this more in the prepared memorandum we are going to submit because ours is not just to criticize without offering a constructive suggestion——

Senator KERR. Yes.

Mr. KRATTER. For example, you could provide that the initial term could not be used as the writeoff period unless it represented, let us say, at least 20 percent of the total term, or perhaps 25 percent of the total term, or unless it represented a minimum of, let us say, a 10-year period.

Now, even permitting a 10-year writeoff would certainly not be inconsistent with the accelerated depreciation idea and accelerated writeoff that has been sponsored since the 1954 Code, and particularly now if you want to stimulate new construction on a leasehold basis, you are going to have to do something to give these people who are going to take economic risks, the capital risks of putting a property on leased ground, the privilege of writing it off during that initial term.

Nobody can gamble, no honest businessman has the moral right to gamble much more than 10 or 15 years in advance. I don't care where the property is or how sound it is. That would be one criteria, for example.

A second criteria would be whether the renewal was just a flat renewal at the same rate or whether the rate would be a renegotiated rate.

Let me give you a specific point. For example, 15 years ago Park Avenue in New York City was primarily a residential community. Today between 42d Street and 60th Street it is a highly integrated office-building community. Now, if I built on leased ground, let us say, 10 years ago before this became an office-building area, the ground had a certain value, and normally if I rented this ground 10 years ago from the Astor estate they would have taken the then assessed or the appraised value and say, "All right, now, your rent is going to be a figure equivalent to 5 percent of the value of that ground." And let us assume that that ground was then worth a million dollars, Senator.

Senator KERR. That is residential?

Mr. KRATTER. For whatever purpose I built on it. I might have built a 10-story office building there or a 12-story office building, because at that time an office building on Park Avenue was a departure from the norm. So I might have gone up there and, let's say, put a 10- or a 12-story building on this land, and I am going to be paying what we call a ground rent or leasehold rent of 5 percent of this million-dollar value, and that 5 percent would be $50,000 a year.

Now suddenly the trend changes and we now have a string of monolithic skyscrapers up and down that street, and I, let us say, had an initial 15-year term or perhaps a 20-year term with four 21-year renewal options. But in the renewal option a proviso was written which said at the end of the first term if I want to renew it, this $50,000 rent will not continue.

Senator KERR. Renegotiate.

Mr. KRATTER. We are going to renegotiate and you are going to pay us 5 percent of the then land value. Well, now, the land value, when the option is exercised would be $10 million, Senator, because instead of building a 10- or 12-story building, now it is logical to build a 20- or 40- or a 60-story building. So I would be completely out and there would be absolutely no point whatsoever to my renewing, because the ground rent I had to pay, I couldn't possibly get out of rents from the tenants.

Certainly in that case it would be very unfair for me to have to worry during those 15 years, because you have got this thing set up here now on a year-to-year basis, which is even worse.

Senator KERR. You have made that point.

Mr. KRATTER. It is year to year. You have a sword of Damocles over your head from year to year. They come in and reappraise you every year on this thing. That is our basic problem.

There are plenty of criteria that can be used. Our trade groups, myself, my associates——

Senator KERR. Will assure against it being a loophole and not making it a snare?

Mr. KRATTER. Senator, I would not be so foolhardy as to say anything I could recommend would insure against a loophole, because so far nothing has ever been created which didn't have a loophole.

Senator KERR. I understood you to express that as a worthy objective.

Mr. KRATTER. Yes, sir. In principle we are just as interested in getting intelligent law here which will apply to all of us, because on a competitive basis it will improve all of us if everyone is subjected to the same type of law and regulation.

But this proposal as drawn is completely unworkable and unbusinesslike.

Senator KERR. I think you have made a very good point and in a very able way, and I would caution you if you become too generous in your language it might make other than an objective impression on any representative of the Treasury who might be here.

Mr. KRATTER. I am sorry.

Senator KERR. Understand it is your privilege to say what you want, but I was just thinking about the effectiveness of the approach.

Mr. KRATTER. Senator, the point is basically this. I perhaps am more vigorous and forceful and more dramatic than I should be, not because I am thinking primarily about myself. My operation is equivalent to a mutual fund in real estate. I have 3 or 4 thousand people, I would say over 4,000 at the present time, who have the bulk of their life's savings invested with me in limited partnerships which own these different leaseholds.

These people in these days, a lot of teachers, for example, who need this extra income and who would not have it if it was added on bracketwise under these conditions—I mean if it is a 99-year lease in terms of renewal options or 97-year, then it is only a 1 percent writeoff, and is so inconsistent with any other form of business operation it just doesn't make sense.

Senator KERR. I would say that you had made your point.

Mr. KRATTER. Under those circumstances, I should discreetly retire. Thank you for your time.

(Mr. Kratter subsequently submitted the following for the record:)

SUGGESTIONS MADE BY MR. MARVIN KRATTER

Statutory rules in lieu of those presently set forth in proposed section 178 (a), as set forth in section 14 (a) of the technical amendments bill of 1958 (H. R. 8381), which suggestions are referred to in Mr. Kratter's testimony before the Committee on Finance, United States Senate.

Except as provided in subsection (b) of section 178 where a lease may be renewed, extended or continued pursuant to an option exercisable by the lessee, the following rules shall be applicable in determining the term of a lease for the purpose of fixing the period over which the cost of acquiring the lease or the cost of any improvements on the leased property made by the lessee may be amortized or depreciated.

1. GENERAL RULE.—Unless the lease has been renewed, or the facts show with reasonable certainty that the lease will be renewed, only the initial term of the lease shall be taken into account and the renewal options shall be disregarded.

2. NOTWITHSTANDING THE FOREGOING.—

(a) If at the time the lease is made, the initial term is for 5 years or less, the renewal options shall be added to the initial term unless the period of the initial term is 50 percent or more of the term of the lease if all the renewal options would be exercised.

(b) The renewal options shall be disregarded and the initial term accepted as the term of the lease,

(i) At the time the lease is made the initial term is for a period of 21 years or more, and if the ownership of such lease is thereafter transferred, the period of the initial term remaining unexpired at the time of such transfer is more than 5 years or 40 percent or more of the remaining useful life of the improvements on the property, whichever is greater; or

(ii) The initial term of the lease or the amount thereof remaining unexpired at the date of transfer of such lease, is for more than 5 years, and the rental to be paid during the renewal period or periods is to be fixed pursuant to a formula set forth in the lease, the application of which is not within the control of the lessee, and the lease provides that the average of the annual rentals required to be paid during such renewal period or periods shall not be less than the average of the annual rentals required to be paid during such initial term.

(c) If the term of the lease, (determined in accordance with the rules herein set forth or otherwise), is longer than the useful life of the improvements on the leased property, the cost of making such improvements or the cost of acquiring the lease for the property on which such improvements were made (to the extent such costs are attributable to such improvements) shall be depreciated or amortized over the life of such improvements without regard to the term of the lease.

3. EFFECTIVE DATE.—Any statutory amendments made in accordance with the foregoing shall apply with respect to improvements begun after December 31, 1957 (other than improvements which on December 31, 1957, and at all times thereafter the lessee was under a binding legal obligation to make), and to the costs of acquisition of a lease, if such acquisition is made after December 31, 1957.

(The following letter from Richard Grossman, of Chicago, is made a part of the record:)

MAYER, FRIEDLICH, SPIESS, TIERNEY, BROWN & PLATT,
Chicago, Ill., February 21, 1958.

HOUSE OF REPRESENTATIVES COMMITTEE ON WAYS AND MEANS,
House Office Building, Washington, D. C.
SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D. C.

GENTLEMEN: I have had occasion to concern myself with section 22 of the technical amendments bill of 1958 (H. R. 8381, as passed by the House on January 28, 1958), and feel that there are sufficient problems concerning the manner in which this section is drafted to warrant calling them to your attention.

I have no quarrel with the purpose of section 22 to avoid what are described as the "unintended benefits" of the variable price provisions of the present section 421 of the code. My problems with the proposed draft of section 22 are as follows:

(1) As recognized in the report of the House committee accompanying the bill, section 22 necessarily requires that the average value during month of exercise test must be specifically included in the variable price formula itself or else the option will be disqualified as a restricted stock option. This injects into an already complicated statutory provision a requirement that many may fail to recognize, particularly since this requirement is not quickly disclosed by a fairly careful reading of the section itself. The result, therefore, can be that many options in no way seeking to obtain the "unintended benefits" of a lookback variable price provision would be disqualified. For example, if the formula option price is intended to be 95 percent of value at the time of exercise, but for convenience the valuation date used is the day preceding the date of exercise, disqualification will result under the present language of section 22

unless the formula itself spells out the average value requirement. Also, if the average value during the month of exercise is less than the value at the lookback date, this would require that even an 85 percent or more option provide for a reduction in the option price; this seems an absurd requirement.

(2) Since the average value test of section 22 covers the calendar month of exercise, this would either require options to be exercisable only on the last day of a calendar month or the inclusion of a provision for possible later adjustment in options exercisable at any other time. It is not clear to me why the evils sought to be avoided by the proposed section 22 could not be effectively met by a computation during the period of 30 days next preceding the date of exercise, even if everything else in the present draft of the section is left unaltered.

The problem mentioned in (1) above could be met by a provision in section 22 to the effect that the average value requirement is not applicable in case of a lookback provision where the option price is 85 percent or more of the value of the stock at the lookback date.

The problems mentioned in both (1) and (2) above could be met, and the result sought by section 22 accomplished, by substituting for the present average value requirements of section 22 a provision to the effect that an option with a lookback provision qualifies as a variable price option only if the option price (computed as if the option had been exercised when granted) equals at least 85 percent of the fair market value of the stock at the time of grant and also at least 85 percent of the average fair market value of the stock during the calendar month of grant. Such a provision eliminates any test as of the date of exercise. In addition to meeting the problems raised, such a provision would serve to avoid the absurd result that the required formula would force a reduction in the option price, which could be the result under proposed section 22. Probably, a further provision should be included to make it clear that if a grant results from a modification, then in computing the average value during the month of grant any higher earlier substituted value required by section 421 (e) (1) is disregarded; this last comment is also to be applicable to the proposed section 22. Inasmuch as the problems mentioned in (2) above in connection with a calendar month test do not appear of any moment insofar as the calendar month of grant is concerned, my suggestion uses the calendar month test.

Except for the manner in which section 22 is drafted, I see no necessity to apply the average fair market value test to the month of exercise. However, if this is deemed desirable, it could be accomplished by adding to the language suggested in the preceding paragraph, a provision requiring that in the case of a lookback provision the actual option price upon exercise equal at least 85 percent of the average fair market value during the 30 days next preceding the date of exercise. As I have remarked before, I believe it would be undesirable to apply the average to the calendar month of exercise.

Very truly yours,

RICHARD GROSSMAN.

Senator KERR. Our next witness is Mr. Richard H. Valentine who is appearing for Oliver R. Grace who was scheduled to testify on section 14 also.

STATEMENT OF RICHARD H. VALENTINE, APPEARING FOR OLIVER R. GRACE, BROKER, NEW YORK, N. Y.

Mr. VALENTINE. My name is Richard H. Valentine. I am appearing for Oliver R. Grace, who had originally intended to appear but could not.

I am an attorney. I have a very narrow point on this law.

Senator KERR. May I ask who Mr. Oliver R. Grace is?

Mr. VALENTINE. He is an individual who is principally in the brokerage business, but he has also invested substantially in real estate.

The point I would like to talk about is the effective date of section 14. As we just heard, section 14 adds a new section to the code, providing that the cost of improvements upon leased property and the cost of acquiring a lease should be amortized by including the renewal periods unless the lessee establishes that it is more probable that the lease will not be renewed than that it will be renewed.

Subsection (c) of section 14 says that this act does not apply to improvements made or begun before December 31, 1956, or committed for before that date. It says, briefly, that it does not apply to improvements made before December 31, 1956.

Senator KERR. Yes.

Mr. VALENTINE. There is no similar provision in here as to the cost of a leasehold. Therefore, I think that section 1 (c) (1) of this bill would be applicable, and this amendment as to the cost of acquiring the leasehold would be applicable to 1954 and for every year thereafter.

Senator KERR. In other words, you think that the retroactive feature provided for in subsection (c) should also be made applicable to the cost of the lease acquired at the same time?

Mr. VALENTINE. Yes.

Senator KERR. It should not be made retroactive with reference to the cost of the lease any more than with reference to the improvement of a lease?

Mr. VALENTINE. Yes, sir, and I think that that was an oversight. And my client wrote to Congressman Wainwright, Representative Wainwright, back in August, and I have a letter here which I would like to submit. He received back from Representative Kean a statement that he thinks this was a slip in drafting which was not intentional.

Senator KERR. Do you want to put that letter into the record?

Mr. VALENTINE. Yes, I would like to have those two letters put in the record.

(The letters referred to follow:)

NEW YORK, *August 6, 1957.*

Hon. STUYVESANT WAINWRIGHT,
House of Representatives, Washington, D. C.

DEAR STUYVIE: Section 14 of the Technical Amendment Act of 1957 amending the 1954 Internal Revenue Code, as reported by the House Ways and Means Committee, provides that the amortization of the cost of acquiring any leasehold interest in real property and depreciation of any buildings erected thereon shall be treated as including any period for which the lease may be renewed by the lessee, unless the lessee establishes as of the close of the taxable year that it is more probable that the lease will not be renewed than that the lease will be renewed.

Subsection (c) of this section provides that the amendments made by section 14 shall apply with respect to improvements begun after December 31, 1956. However, there is no similar limitation on the effective date with respect to the cost of acquiring a lease. It seems to me the omission of such an effective date is inequitable and unfair to those who acquired leases prior to December 31, 1956, in reliance on the 1954 code. I would like to urge that the provisions for the amortization of leaseholds be left as they were in the 1954 code and that if any change is made, it shall not apply with respect to the cost of acquiring leases acquired prior to December 31, 1956.

My partners and I, as Oliver Grace Associates, acquired a leasehold and assumed obligations for the amortization thereof in 1956 relying on the 1954 code. Section 14 as it now stands would be seriously inequitable and cause great financial embarrassment to us and to other taxpayers similarly situated.

Very sincerely,

(Signed) OLIVER R. GRACE.

HOUSE OF REPRESENTATIVES,
Washington, D. C., August 9, 1957.

Hon. STUYVESANT WAINWRIGHT,
House of Representatives, Washington, D. C.

DEAR MR. WAINWRIGHT: I think that Mr. Grace has a point.

There seems to have been a slip in drafting which was not intentional.

As you know, this bill has been reported by the committee but if there is opportunity to consider any committee amendments, I will try to remember to take this one up.

I have already asked the staff to remind me.

However, it is not probable that I will have this opportunity.

As you know, there is no chance of the bill being enacted into law this year as even if we send it over to the Senate, they will not consider it until sometime during the winter.

As the same staff from the joint committee to whom I spoke will help advise the Senate, they should remember this point, but when the bill is considered by the Senate Finance Committee, they should be reminded of it.

Sincerely,

ROBERT W. KEAN.

Mr. VALENTINE. It seems to me that it was clearly an oversight. It hits my client particularly hard because in 1956 he made a substantial investment in reliance upon the former law.

Senator KERR. You mean upon the existing law?

Mr. VALENTINE. Upon the existing law. And, as a matter of fact, he came to me and we discussed in great detail the problem of whether he could amortize his substantial investment that he was making in a leasehold over the original term.

To be a little more particular, he, through a partnership in which there were three other individuals, purchased a leasehold interest for $2,530,000, and he paid $430,000 and assumed the mortgage of approximately $2.1 million. When he made the investment he was figuring an average profit over the 22-year term of the lease of approximately $26,000 a year, which was about 6 percent upon the money he had to put up. He was committed to pay off the mortgage over a period of 18 years, and he was counting on an amortization of the cost of the leasehold of $115,000 per year.

We have the right to renew for 4 periods of 21 years each, and at a fixed rental which is the same as the present rental, but which will be, we believe, high based upon what the present value of that land is. The land has a building on it which is now 30 years old. When the lease expires that building will be over 50 years old, and unless it has an economic usefulness which it doesn't look like it will now, or unless the land goes up substantially in value, we won't renew.

Since we made this substantial investment relying on the law as it was in effect, and since we thought that was a fair rule that had been worked out by the courts, I think that the effective date should be such that this bill, if passed, should not apply to this cost of this leasehold which we acquired in 1956.

Senator KERR. All right, Mr. Valentine. We are glad to have heard from you, and feel that you have presented the case very well for consideration.

Mr. VALENTINE. Thank you very much, Senator.

Senator KERR. Mr. Rubin.

STATEMENT OF RAYMOND RUBIN, ATTORNEY, OF THE FIRM OF WIEN, LANE, KLEIN & PURCELL

Mr. RUBIN. Mr. Chairman and members of the committee, my name is Raymond Rubin. I am an attorney associated with the law firm of Wien, Lane, Klein & Purcell. We have several clients who are interested in section 14, in view of the fact that they either have substantial investments in leaseholds or have made improvements on leased property.

I had an extensive preparation, but Mr. Kratter covered a good deal of the ground which I intended to cover, and did so very ably. I have a few additional points, however.

I concur in general with what Mr. Kratter said, chiefly that the burden of proof under section 14, especially in the case of long-term leases, is such that it would often be impossible for taxpayers to sustain. The question whether an option to renew will be exercised depends on, among other things, the future condition of the economy as a whole, the physical condition of the particular property in question, and the obsolescence factor.

The proposed legislation in its present form would, I believe, create a great deal of administrative difficulty for the Treasury Department and for taxpayers as well, requiring as it does an annual reevaluation of highly speculative matters.

Some appreciation of the problems which might be raised by this legislation can be obtained by an awareness of the current volume of tax cases involving present valuations of property, which are themselves extremely difficult. Bearing the burden of proof under section 14 requires valuations of property 20 or 30 or more years in the future.

Senator KERR. Are you talking about the burden of proof if section 14 is enacted?

Mr. RUBIN. Yes, sir.

This difficulty in the burden of proof is in itself an inequity, and a factor giving rise to costs to both taxpayers and the Treasury Department. There are other kinds of inequities which would arise under the proposed provision.

For example, let us suppose the case of a leasehold which has 20 years to run with three renewal options of 20 years each, and let us suppose that the operation of that leasehold will give rise to a profit of $100,000 a year.

Senator KERR. For the 20-year initial period?

Mr. RUBIN. Yes, sir; assuming that rents remain level for that period.

Now let us suppose also that the renewal option requires that the rent for the renewal term be fixed by an appraisal of the property at the time of renewal, so that the owner of the leasehold will, if he renews, be required to pay what is then a fair rent for the property.

Senator KERR. And what is now an undetermined rate.

Mr. RUBIN. That is right.

Now, it is quite obvious that the purchaser of such a leasehold has made his entire investment in the initial term of the lease because he can count on a profit during that initial term. It is also fairly clear to him that there will be little if any profit during the renewal term. He will not be paying a low rent during the renewal term in view of the provisions of the renewal option.

Under the proposed section 14, the taxpayer is required, in order not to have to take into account the renewal term in writing off the cost of the lease, to prove that it is more probable than not that he will not renew. It seems to me that a court might very well hold in a situation such as I described that the taxpayer has not established that it is more probable that he will not renew since he will pay a fair rent during the renewal term. There may be no disadvantage to a renewal, but the profit will be small. There are variations of that situation where the inequity might be somewhat less.

Buildings become less valuable as time goes on. The obsolescence factor increases and operating costs increase because of the physical deterioration of the property, so that, apart from fluctuations in the value of real estate, there will tend to be less income from a piece of property as it grows older. I believe that this is one of the reasons underlying the allowance of declining balance depreciation to owners of property.

An owner of a leasehold is very often in a substantially similar position to that of a fee owner. Yet he is not allowed declining balance depreciation. He does not have the advantage which you are probably aware allows him to take larger deductions for depreciation in the earlier years of the property.

It is my opinion that the present rule which requires a reasonable certainty of renewal is much more easily susceptible of administration than is the proposed rule. The amount of avoidance possible under the present rule is limited by the courts and by the fact that the greatest profits from leasehold operation are usually in the earlier years. Any small advantage a lessee may have under the present law is usually offset by his inability to take declining balance depreciation on a leasehold.

If it is still felt, upon further consideration of this question, that the avoidance possibilities under the present law are too great, I would propose some softening of the language in section 14. I would suggest the elimination of the requirement that the lessee "establish"—I am using the word used in the present provision—establish facts which are at best, matters of speculation, and to substitute an evaluation based on what the available facts indicate. Also I suggest that the lessee be allowed to write off his acquisition cost over the first term of the lease unless it is substantially more probable that the renewal option will be exercised than that it will not be exercised. This rule is somewhere between the one laid down in section 14 and the rule of the regulations, which requires reasonable certainty of renewal. As a matter of fact, I believe that that is approximately the rule which the courts now apply.

That is the end of my statement.

Senator KERR. Are there any questions?

Senator FREAR. No questions, Senator. It is an interesting statement.

(The following statement of Benjamin M. Parker, chairman of the taxation committee of the National Retail Merchants Association, and a letter from Thomas Jefferson Miley executive vice president, Commerce and Industry Association of New York, were subsequently received for the record:)

STATEMENT BY BENJAMIN M. PARKER, ATLANTA, GA., ON BEHALF OF THE NATIONAL RETAIL MERCHANTS ASSOCIATION

My name is Benjamin M. Parker. I am a member of the law firm of Parker & Parker, Atlanta, Ga., and chairman of the taxation committee of the National Retail Merchants Association with offices at 100 West 31st Street, New York, N. Y. I am also a member of the taxation committee of the American Bar Association.

The National Retail Merchants Association has a membership of over 8,000 department and specialty stores located in every State in the Union and abroad. Its members provide employment for several hundred thousand people and do an annual volume of business amounting to $19 billion.

This committee has received voluminous testimony in respect to the various provisions of H. R. 8381. I shall not attempt to address myself to all the pertinent provisions of H. R. 8381 but rather confine my testimony to section 14 of the bill which has an important bearing on the retail industry.

Under present tax law capital expenditures made by a lessee for the erection of buildings or the construction of other permanent improvements on leased property are recoverable through allowances for depreciation or amortization. Whether the taxpayer-lessee recovers his cost for improvements through depreciation deductions (sec. 167) or amortization (sec. 162) depends on the useful life of the improvements. If the useful life of such improvements in the hands of the taxpayer-lessee is equal to or shorter than the remaining period of the lease, the allowances take the form of depreciation under section 167.

If, on the other hand, the estimated useful life of such property in the hands of the taxpayer, determined without regard to the terms of the lease, would be longer than the remaining period of such lease, in lieu of depreciation, the allowances take the form of annual deductions from gross income in an amount equal to the unrecovered cost of such capital expenditures divided by the number of years remaining in the term of the lease.

It is proposed under section 14 of H. R. 8381 (85th Cong., 1st sess.) presently being considered by your committee that a lessee, in determining the period over which the cost of improvements are to be recovered, must take into account any renewal option periods in the lease, unless he can prove to the satisfaction of the Treasury that he will not exercise the options. Accordingly, unless a tenant can prove that he will not exercise his option, the Government will not permit amortization over the life of the lease but only depreciation over the useful life of the asset. It is readily apparent that no taxpayer can with any certainty make any assurances that he will not renew his lease at some future time. The basic function of an option in a lease is to give the tenant some degree of freedom to act without compelling action. For sound business reasons, a taxpayer may not wish to renew his lease and, thus, under H. R. 8381 would arrive at the end of the lease without having completely recovered the cost of his investment. It is not clear under current tax law whether the Treasury would, under such circumstances, permit the taxpayer to write off the unrecovered portion of his cost in the year in which the tenant moves out or liquidates. Moreover, even if the taxpayer were allowed to write off the unamortized portion of his investment in the last year of the lease, it may well be that such year of operation resulted in a loss with no consequent tax benefit to the lessee.

The NRMA is of the opinion that the present method provided by law for deducting leasehold improvements does substantial justice and should be maintained.

I appreciate the time afforded to me on behalf of the National Retail Merchants Association to present these views.

COMMERCE AND INDUSTRY ASSOCIATION OF NEW YORK, INC.,
New York, N. Y., February 27, 1958.

Re: H. R. 8381, section 14 disapproved.

Hon. HARRY FLOOD BYRD,
Senate Office Building,
Washington, D. C.

DEAR SENATOR BYRD: The above bill on which your Finance Committee concluded hearings January 28 contains at section 14 a new section 178 of the Internal Revenue Code which will have a stultifying effect on building construction throughout the United States with the corollary of unemployment in the building material and construction trades fields.

The proposed amendment would require that:

"in determining the amount allowable to a lessee as a deduction for any taxable year for exhaustion, wear and tear, obsolescence, or amortization—

"(1) in respect of any building erected (or other improvement made) on the leased property, or

(2) in respect of any cost of acquiring the lease, the term of the lease shall be treated as including any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee, unless the lessee establishes that (as of the close of the taxable year) it is more probable that the lease will not be renewed, extended, or continued for such period than that the lease will be so renewed, extended, or continued."

Enactment of this provision would virtually eliminate any future building construction on leased land. Under the situation that would be created a taxpayer would be faced with the impossible burden of proving that the lease would not be renewed many years hence. The alternative tax consequence would be that if the lease should not be renewed, inadequate amortization would have been taken over the initial period, and the unrecovered balance may become a deduction in a year in which it would produce no tax benefit.

It is a common practice in all parts of the United States for a lessee to erect large buildings on leased land or to expend large amounts on improvements to existing buildings. Under existing law these capital expenditures may be depreciated over the period of the lease, without regard to any renewal options. With the reduced depreciation allowable under the proposed amendment, entrepreneurs would be discouraged from engaging in construction or building improvements on leased property.

The Congress is presently weighing the advisability of revising the tax law with the objective of stimulating the national economy. Enactment of the proposed section 14 of H. R. 8381 would be diametrically opposed to such an objective. As stated above, enactment of the subject provision would cause unemployment in a very vital segment of the nation's industry. We respectfully urge it be stricken from H. R. 8381.

Respectfully,

THOMAS JEFFERSON MILEY,
Executive Vice President.

Senator KERR. At the direction of the chairman I submit for the record a letter he has received from M. F. H. Duff, Floyd West & Co., Dallas, Tex., favoring section 24 of H. R. 8381.

(The letter is as follows:)

FLOYD WEST & CO.,
Dallas, Tex., February 3, 1958.

Hon. HARRY F. BYRD,
Chairman of the Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: We request that the following statement on behalf of the undersigned partnership be considered by your committee in connection with its review and recommendations pertaining to H. R. 8381 recently passed by the House of Representatives.

Floyd West & Co. is a general partnership engaged in carrying on a general insurance agency in the State of Texas with principal office in Dallas. The principal income of the partnership is derived from commissions on fire, casualty, automobile, farm, and hail insurance policies, which are sold pursuant to certain contracts between the partnership and several national insurance companies appointing it general agent for the State of Texas. The partnership in turn appoints local agents throughout the State who write most of the policies and who are entitled to part of the commission on all policies which they or the partnership write. The problem which the partnership wishes to call to the attention of this committee, and the solution for this problem which appears to be available only through the enactment of H. R. 8381 or similar legislation, concerns the method of reporting the net income of the aforesaid business for Federal income tax purposes. A brief description of the partnership operations related to the earning of its commission income will point up this problem.

The local agents referred to above report to the partnership shortly after the close of each month all policies they have written for such previous month. The partnership is required in turn to report to the insurance companies by the 25th day of each month all policies written by it or its local agents during the previous month. On the one hand, contracts between the partnership and its local agents permit these agents to remit to the partnership the amount of the premiums due less the commission of the local agent at any time within 60 to 90 days after the close of the month in which the policies are written and also allow credit to the local agent with respect to certain policies canceled after being written. In fact, collections by the partnership from its local agents are made on the average of 75 days after the end of the month in which policies are written, some collections always being later and the collections made constantly being subject to credits for cancellations. On the other hand, contracts between the partnership and the insurance companies require the partnership to settle its account in full for premiums due to the companies on policies not canceled less commissions of the partnership and the local agent by the 15th day of the third month following the month in which policies are written. This latter settlement date is mandatory regardless of collection by the partnership from its local agents, and in fact the local agents often have not paid the partnership for amounts which the partnership must remit to the insurance companies.

The partnership now accounts for its income and expenses and reports for Federal income tax purposes on the accrual basis. Under such method of accounting it takes into commission income for the month in which insurance policies are written the amount of commissions which it expects to realize out of the premiums on those policies after collections from its local agents and settlements with the insurance companies, although such commission income is not beneficially realized until the local agents have remitted and may never be realized in the event of cancellations of policies. Except for a few items which are relatively nominal in amount by comparison with the commission income thus accrued all partnership expenses are paid in cash currently within the month in which incurred. In summary, collections of income always run behind payment of expenses under such accrual method of accounting.

The partnership believes that under the cash method of accounting for both income and expenses, net income would be taxed to the partners in the period actually realized. Under the particular circumstances of our business, such cash method would seem clearly to reflect partnership income more accurately than the present accrual method. Furthermore, the cash method of accounting is traditionally employed by organizations which render services and which do not maintain inventories, including businesses similar to that conducted by this partnership.

Accordingly, pursuant to the requirement of section 446 of the Internal Revenue Code of 1954, Floyd West & Co. filed its first application with the Commissioner of Internal Revenue under date of March 14, 1955, requesting permission to change its method of accounting and reporting for Federal income-tax purposes from the accrual method to the cash receipts and disbursements method, effective for the calendar year beginning January 1, 1955. The partnership has since filed two additional protective applications substantially identical with the original application, one dated March 23, 1956, and the other dated March 26, 1957, requesting a change to the cash method of accounting effective alternatively for the calendar years beginning January 1, 1956, and January 1, 1957, respectively.

Section 481 of the Internal Revenue Code of 1954 for the first time provided statutory rules for making adjustments in connection with changes in methods of accounting. In general that statute was designed to prevent the duplication or omission of amounts of income and expense in accomplishing such changes. In the case of a change from the accrual to the cash method, the matter of preventing duplication of income and expense is the matter of principal concern. However, serious problems of interpretation have been raised concerning the treatment of adjustments made in respect of any taxable year not subject to this 1954 Code provisions (so-called pre-1954 period adjustments). Although none of the applications for change made by Floyd West & Co. has involved any question of duplication or omission of items of income or expense attributable to the so-called pre-1954 adjustment period, the Department of the Treasury and the Internal Revenue Service have been unable to act on any application for change of accounting method involving any adjustment under section 481 since enactment of the 1954 Code because of the confusion in certain aspects of that statute. By press release issued on January 3, 1956, the Service announced that it would not act on such applications until issuance of regulations under sections 446 and 481 (Internal Revenue Bulletin 1956-3, p. 32). By technical information release issued on February 15, 1957, the Service stated that proposed regulations under sections 446 and 481 would not be issued at that time "in view of the announced consideration of technical problems in connection with section 481 by the Subcommittee on Internal Revenue Taxation of the Committee on Ways and Means and the consequent possibility of legislation which would amend this section" (Internal Revenue Bulletin 1957-9, p. 38). This is the situation existing today.

By reason of the inability of the Service to act on the applications for change to the cash method of accounting filed by Floyd West & Co., the partnership is required to continue its accounting and preparation of income-tax returns indefinitely on the accrual method. Under the present estimated tax requirements applicable to the individual members of the partnership, income tax is currently payable on sizable net income before the partnership has realized such income in cash. The result is an actual prepayment of tax by the partners on income not yet realized. Only a change to the cash method of accounting by the partnership can eliminate this acutely burdensome result.

On June 26, 1957, Representative Wilbur D. Mills introduced in the House of Representatives a bill designated H. R. 8381 of the 85th Congress, 1st session, which contains certain technical amendments to the Internal Revenue Code of 1954. We understand that this bill was passed by the House of Representatives on January 28, 1958. Section 24 of this bill proposes certain amendments to section 481 relating to adjustments required by changes in method of accounting. As presently drafted we understand that the amendments contained therein clarify the problems of intepretation existing in the present form of section 481. As a result, we further understand that under the language of this bill the Internal Revenue Service wil be able to promulgate regulations under sections 446 and 481 and to act upon aplications for change of accounting method such as those heretofore filed by Floyd West & Co.

In conclusion we respectfully urge your committee to recommend and support the passage by the United States Senate of H. R. 8381 or other legislation embodying the substantive provisions of section 24 thereof at the present session of the Congress.

Sincerely yours,

FLOYD WEST & Co.,
By F. H. DUFF, *Partner*.

Senator KERR. Our last witness today is Mr. Meyer M. Goldstein, who is interested in section 25 of this bill. Will you have a seat, Mr. Goldstein.

STATEMENT OF MEYER R. GOLDSTEIN, EXECUTIVE DIRECTOR, PENSION PLANNING CO., NEW YORK, N. Y.

Mr. GOLDSTEIN. Mr. Chairman, I am Meyer M. Goldstein, of the Pension Planning Co., of New York.

I am here with reference to section 25, which appears on page 34 of H. R. 8381.

Section 25 has the title "Denial of Exemption to Organizations Engaged in Prohibited Transactions." It deals with pension, profit-sharing, stock bonus, and employee trusts generally.

The 1954 Code for the first time drew employees' trusts together with the regular exempt organizations, and hence brought to the front this question about lending money without adequate security and a fair rate of return.

As a result, the House of Representatives came out with this proposal to give relief. My point is that the relief is all right so far as publicly owned companies are concerned, but of no use to closely held corporations and small business. Out of the 40,000 tax-qualified employee plans and trusts throughout the United States, it is my guess that no more than 10 percent could meet these proposed investment standards because they are publicly owned; but 90 percent, or 36,000 of the 40,000 plans, cannot meet them.

So section 25, as now drafted, is no relief at all to small business.

I come here today, as a result of a letter I wrote to Senator Sparkman, chairman of the United States Senate Select Committee on Small Business. I gave Senator Sparkman some of the background of my thinking on this subject, and he was kind enough to arrange that I appear here today, because my suggestions fit right in with what the Senate Select Committee on Small Business is trying to do.

The reasons why the proposed relief of section 25 has no practical utility for small business is because the standards that are set up are built upon the principles of marketability and outside ownership. That is, the only employees' trusts that could meet the requirements of section 25 would be those of publicly owned companies whose obligations are listed on a stock exchange or over the counter, and where the outside public would own at least twice as much of the employer obligations as would the employees' trust.

Therefore, closely held corporations which do not have a market for any of their obligations could not meet the test of section 25. This is obvious by definition, because, being closely held, they can't be publicly owned.

Senator KERR. That is, there is no publicly known measuring rod of the standard of value?

Mr. GOLDSTEIN. That is exactly right. An integral part of this proposed ownership standard of section 25 is that there be a 2-to-1 ownership by outside parties. So if an employer wanted to sell $100,000 worth of debentures to the pension trust, it would have to have $200,000 owned by outside purchasers, and this is impractical in closely held corporations.

Those proposed standards of section 25 developed as a result of the hearings before the subcommittee of the House Ways and Means Committee, where the United States Steel and American Telephone & Telegraph gave practical examples of how impractical it was without some relief. So section 25 has given relief which is adequate for that type of publicly owned company.

But, as I said before, it offers no relief at all to small business. Therefore, one way or another, unless Congress wants to discriminate against small business, which I know Congress does not want to do, it would be doing exactly that if they passed this section 25 as is. Thus, section 25 needs to be liberalized in such a way as will satisfy the basic objectives of investment standards of Congress without at the same time discriminating against small business.

I have suggested an alternate test of "value" instead of marketability or outside ownership for your consideration as part of my formal statement, of which a copy is attached, as paragraph IV, entitled "Establish Alternate 'Value' Investment Test That Small Business Can Meet." I have given a suggestion that the net worth would be twice the outstanding debt; that the net working capital equal the debt; that the term of the obligation should not exceed, say, 25 to 30 years with sinking fund requirements that half of the obligation be paid off over the life of the debentures; that the rate of interest be, say, 1 percent more than the prevailing rate for bonds, and that the past earnings record show they could earn, at least 3 times over, the interest and the sinking fund requirements.

I do not hold any brief for this "value test" as being something that you could say is the alpha and omega of all investment standards. The point is, that I am trying to give some practical standards of value so that small business might be able to qualify under section 25.

Thus, I am suggesting alternate standards. A company could qualify under either standard it chooses. The marketability and ownership standards of section 25 as now drafted would be practical for publicly-owned companies, and my alternate "value" test could be practical for small business. Then you would have the same equality where small business could invest up to 25 percent of their employees' trusts in unsecured debentures, the same as publicly-owned companies.

From the moral standpoint, I might make this observation: that most of the employees' trusts in the United States are voluntary. They were set up by an employer who wanted to do something for his employees, and therefore he did it with the right motive, the right spirit.

Secondly, if he were to sell an unsecured debenture to his employees' trust, it would have priority over his commonstock ownership in the event of liquidation, etc. It would be ahead of his lifetime savings. Therefore, before any of the employee participants could get hurt, the employer's lifetime savings would have to evaporate to zero. So the employer is sitting in a junior position and he is giving his employees a preferred position when he is giving them the prior protection of debentures. So far as good faith, it seems the "small test" as the Revenue Service calls it. It is something which makes sense from the standpoint of the morals of the situation.

As an alternate to any specific investment standards in section 25, if Congress wants no investment tests at all, it could restrict section 25 to the single control of 25 percent maximum limitation, i. e., say that none of the employees' trusts can invest more than 25 percent in unsecured debentures, whether they are publicly owned, closely held or anything else. That, of course, would be the simplest rule.

That would merely use subsection (3) on page 36 of H. R. 8381, namely, that not more than 25 percent of the assets of the trust is invested in obligations of persons described in subsection (c).

Small business and publicly owned business could live with that simple definition of a 25 percent limitation, because there are existing now and there have been other fundamental controls in the Revenue Code. That is, basically, all employer investments including preferred stock, common stock, debentures, etc., must be for the exclusive benefit of the employee participants. The exclusive benefit test has been in the code as long as I can remember, I think all the way back to 1913. Since we have had anything about pensions that has been the purpose in the language and the intent of Congress. So we now have that fundamental control. The Revenue Service has developed some very effective rules, such as employer securities cannot be sold to an employees' trust for anything more than a fair value and a reasonable rate of return, and there also has to be sufficient liquidity left in the fund so that any employee who comes up to retirement can obtain the benefits to which he is entitled.

There is another observation I would like to make about this whole field, and that is this aspect of the catastrophe element. Nothing can happen to cause every employee to become age 65 overnight in a pension plan. It has to take a generation. A man is 40 years of age. It has got to take him 25 years to reach age 65. So as a going plan you cannot have a sudden demand on every penny of a pension fund that requires it to be 100 percent liquid at all times.

Like a savings bank, they can lend you on a 20-year mortgage because everybody isn't going to come and get their money at any one time. So, therefore, if you did have 25 percent of employees' trust funds invested in unsecured debentures of closely held corporations, and assuming that they did not have any market, that wouldn't necessarily be fatal to the long-term operation of the plan.

Senator KERR. The fact that it might be long-term would not of itself make it ineligible if the long-term value was there.

Mr. GOLDSTEIN. Exactly right. Now it is interesting in passing that as far as any statistics that we have, we do not find the abuses in this field that there have been in the welfare field, particularly in the joint labor-management that we have all been reading so much about and that Senator Douglas' committee has been so active on, and so forth.

The abuses have been almost entirely welfare plans, such as group life insurance, hospitalization, surgical with insurance commissions payable and all that sort of thing. But there haven't been these abuses in pension funds and certainly not in single employer voluntarily established pension funds where the employer doesn't want to waste his own money because it would cost him more money to run these plans.

The only investment statistics we really have as to employer securities is the study made by the New York State Banking Department in 1955. This study covered 60 percent of the assets of all of the pension trust funds in America at that time. They found less than one-fourth of 1 percent were not of prime investment grade. So there hasn't been the crying need for Congress to say, "Well, we have got to do something here to protect these poor people that are going to be deprived of their pension benefits after a lifetime of work."

You have all the other motivations which are inherent in the employer-employee relationship.

And then finally you have these new disclosure laws. There are a half dozen States that have established disclosure laws that employers have to file reports every year. So all the employee participants will be told if they have funds invested in employer debentures. The Congress, as you well know, is also considering a disclosure law. So we have a new development even since the Revenue Code of 1954 that may make specific investment tests unnecessary.

So maybe what Congress ought to do is let the present tax laws as they are, with perhaps this 25 percent maximum limitation on investment in employer unsecured debentures. Then give the disclosure laws a chance to operate, and see if they do enough self-policing to protect all the employees sufficiently. If they do, maybe that is a better control than a tax control anyhow.

I would like to give you two other aspects and I will be finished. That is, that small business today needs these plans the same as publicly owned business to attract employees, to hold employees, and to gracefully retire employees.

It so happens that I have pioneered in this subject since 1931, and we call ourselves the oldest independent consultants in the United States. I think we are. We have a good cross section of all size businesses of all types as our clients. Originally publicly owned companies started these plans, but now small and medium size businesses need them just as much and have them just as much as publicly owned companies, for the same reason. If you are running a medium-sized business and you want to hire a chemist or an engineer, you have to offer these fringe benefits to get them to come to work for you instead of going to work for one of the publicly owned corporations. So any way you look at it, Congress always has encouraged the development of these plans, and my whole plea here today is that that same purpose be continued by making the doors just as open for small business as for publicly owned companies.

Investment in employer debentures is not the sort of thing that is one sided, that is for the exclusive benefit of the employer. If the employers do invest the employees' trusts in company debentures, the employees can benefit. For example, 1 percent higher interest return on a pension fund over a long period of time could enable the company to improve the benefits to their employees by about a fourth, by almost 25 percent. That is, if you assume the fund is going to earn 2½ percent compound interest and instead it earns 3½ percent interest, that extra 1 percent, long-term compounded, would enable the company to improve the pension benefits to the employees by almost one-fourth without it costing the company another dime.

Surely, the Congress doesn't want to stand in the way of small business or publicly owned companies doing something that is for the good of their employees.

Employees can also benefit in another way by making it possible to invest in employer debentures, through a tie in with section 303 IRC. You will remember that when the Congress introduced section 303, the purpose of it was to prevent small business from disapeparing when the owner died.

Investment of employees' trusts in employer debentures is another way that helps that same problem. Let us say that the founder of the small business dies, and his Federal estate-tax bill is $100,000. His executor doesn't have the cash. Section 303 says, "You can sell some of your stock to the corporation without any ordinary or capital gains tax." But the corporation says, "What are we going to use for money? Our keyman is dead and our business credit is impaired."

Here is a way to find the cash. If a pension trust has $400,000 of liquid securities at that time, the closely held company can sell $100,000 of unsecured debentures to the pension trust and get the $100,000 cash. Then the corporation can buy $100,000 of company stock from the estate and the executor can pay the Federal estate-tax bill. The Government gets its money, the business continues, it doesn't have to liquidate, it doesn't have to merge. The employees of the small business continue to hold their jobs. I have seen this in actual operation, so this is more than a theory. I could give you more reasons why this is particularly adaptable to small business, but I think I have indicated enough to show that it is merely a matter of working out a solution. To that end, I have suggested language in paragraph VII, "Congress establish same rules for employer obligations as investments in section 401 trusts," of my prepared statement, to carry out the suggestions that I have made.

Senator KERR. Are there any questions?

Thank you very much, Mr. Goldstein.

(The prepared statement referred to is as follows:)

STATEMENT RE SECTION 25 OF H. R. 8381, THE TECHNICAL AMENDMENTS ACT, BY MEYER M. GOLDSTEIN, EXECUTIVE DIRECTOR PENSION PLANNING CO., NEW YORK, N. Y.

Having had the privilege of appearance before this committee on various occasions dealing with employees' trusts since 1942, it is a constant source of inspiration to see this democratic process of lawmaking in action. Since we tend to take these privileges for granted, I am taking the liberty of mentioning it here.

May I, today, respectfully suggest amendment of section 25 of H. R. 8381.

I. BACKGROUND

By way of background, an employees' trust which is qualified under section 401 (a) of the Internal Revenue Code is exempt under section 501 (a), unless it is a feeder organization (sec. 502, but not relevant here) or engages in any of the acts denominated as prohibited transactions (IRC, sec. 503).

Such prohibited transactions include (IRC, 503 (c)) a loan without the receipt of adequate security and a reasonable rate of interest.

The Commissioner of Internal Revenue's announced position is that the term "adequate security" means something in addition to and supporting a promise to pay, which is so pledged to the organization that it may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan (Income Tax Regulations (Proposed), 26 C. F. R. § 1.503 (a)-1 (b)).

The proposed regulations take the position that unsecured debentures of a borrower do not constitute adequate security under section 503 (c) of the Internal Revenue Code. That position has been challenged by various corporations and the proposed section 25 of H. R. 8381 is intended to give some relief.

II. PROPOSED RELIEF SECTION 25 OF H. R. 8381

The proposed relief section 25 would allow a purchase of unsecured employer debentures under these conditions:

A. The purchase price must be—

1. The prevailing price on a national securities exchange, or not more than the over-the-counter offering price quoted by persons independent of the employer; or

2. Not greater than an underwriter's public offering price, and equal to the price at which a substantial portion of the issue is acquired by independent purchasers; or

3. Not more than the current price paid to the employer by independent purchasers for a substantial portion of the issue.

B. In addition to any of the foregoing requirements, any one issue of debentures must be held as follows, immediately after acquisition—

1. By the trust—not more than 25 percent;

2. By independent purchasers—at least 50 percent.

C. Furthermore, not more than 25 percent of the trust assets at the time of the investment may represent the employer's obligations.

D. Also, as to purchases after November 8, 1956, the covering indenture must contain a negative pledge that if the employer later places a lien on substantially all of its property, the debentures will be given security as good as the lien's.

III. PROPOSED RELIEF USELESS FOR SMALL BUSINESS

We respectfuly submit that the proposed amendment would give relief to publicly owned companies but obviously does not go far enough to be of any help to closely held corporations and to small business generally.

Any relief provision for small business cannot be based on marketability or ownership—such as that independent purchasers own at least twice as much of the outstanding debentures—because most closely held and small business would not have any ready market for their debentures. In fact, the debentures would generally be created for, and owned exclusively by, the employees' trust.

Thus, it would be impractical to expect small business to meet these proposed stringent requirements of marketability and outside ownership. Therefore, for all practical purposes, small business would be unable to sell unsecured debentures to their employee pension and profit-sharing trusts if the proposed section 25 of the bill became the law.

IV. ESTABLISH ALTERNATE VALUE INVESTMENT TEST THAT SMALL BUSINESS CAN MEET

Hence, we respectfully suggest that section 25 be liberalized to enable "small business" to benefit from this proposed relief section. This relief might be made possible by establishing "value" as an alternate test. For instance, an alternate "value" test that "small business" might be able to meet, might be:

A. The net worth of the business should be at least twice the outstanding debt (including the employer debentures);

B. The net working capital should at least equal the debt;

C. The term of the unsecured debentures should be no more than, say, 25 or 30 years, with a sinking fund requirement so as to amortize at least half of the debentures prior to maturity;

D. The rate of interest be at least 1 percent more than the prevailing rate for prime bonds; and

E. The past earnings record of the company should indicate its ability to meet interest and sinking fund requirements at least, say, three times.

We recognize that the foregoing alternate "value" test is no complete substitute for investment judgment, but this merely reflects the difficulty of trying to establish any kind of investment rules or standards.

V. EACH CORPORATION CAN CHOOSE EITHER TEST

Our suggestion, therefore, is that each corporation be given the choice of either meeting the marketability and ownership tests of the proposed section 25 of H. R. 8381 or our above-stated alternate "value" test.

VI. ARE ANY SPECIFIC CONTROLS NECESSARY?

The problem of setting up investment tests brings up the basic question as to whether any specific investment controls are necessary, beyond, perhaps, a 25 percent ceiling on the amount of debentures that may be owned by an employees' trust.

As you know, employees' trusts became included as "exempt organizations" along with charitable, religious, and educational organizations under section 501 of the 1954 Internal Revenue Code. As a consequence of this joinder, there developed this problem of the prohibition against lending money to the employer without adequate security and a reasonable rate of interest.

Perhaps the existing investment rules of the Internal Revenue Service dealing with investment in employer securities, generally, if applied to unsecured employer debentures, would suffice to solve the problem and avoid the necessity for any investment tests of any kind.

A. Internal Revenue Code exclusive benefit requirement

The Internal Revenue Code now maintains that an exempt employees' trust must be maintained and operated for the exclusive benefit of employees or their beneficiaries. While an incidental benefit may inure to the employer through transactions with the trust, the primary purpose of such transactions must be to benefit employees.

B. Internal Revenue investment criteria

Further, Internal Revenue requires that:

1. The cost of employer securities must not exceed the fair market value at the time of purchase.

2. The employer securities must provide a fair return commensurate with the prevailing rate.
3. Sufficient liquidity of trust assets must be maintained so as to permit distributions to employee participants in accordance with the terms of the plan.

VII. CONGRESS ESTABLISH SAME RULES FOR EMPLOYER OBLIGATIONS AS INVESTMENTS INVESTMENTS IN SECTION 401 TRUSTS

Therefore, the Congress might care to restate its intent so as to permit investment of up to 25 percent of the trust assets in unsecured employer debentures, by qualified pension, profit-sharing and stock-bonus plans, if the debentures meet the other general rules which the Commissioner now applies to investments in employer securities generally (revenue procedure 56-12).

This simplified procedure could be accomplished by excerpting from the proposed section 25, and using subsection (h) and (h) (3) only as follows:

"(b) SPECIAL RULES RELATING TO LENDING BY SECTION 401 (A) TRUSTS TO CERTAIN PERSONS.—For purposes of subsection (c) (1), a bond, debenture, note, or certificate or other evidence of indebtedness (hereinafter in this subsection referred to as 'obligation') acquired by a trust described in section 401 (a) shall not be treated as a loan made without the receipt of adequate security if * * * immediately following acquisition of the obligation, not more than 25 percent of the assets of the trust is invested in obligations of persons described in subsection (c)."

VIII. INVESTMENT EXPERIENCE IN EMPLOYER INVESTMENTS SATISFACTORY

This suggested liberalization by the Congress can be justified by investment experience to date. No substantial serious abuses have occurred in investment in employer securities which have demonstrated the need for the Congress to restrict the quality, by specific investment tests. (It should be noted that the abuses that have occurred have been almost exclusively in joint labor-management welfare funds and not in pension funds.)

For instance, a survey of funds prepared by George A. Mooney, superintendent of banks, State of New York, in 1955, and which represented almost 60 percent of all trusteed pension funds in the United States, disclosed that the nonrated and substandard employer securities constituted less than one-fourth of 1 percent of the total assets of the 1024 funds.

IX. DISCLOSURE LAWS ARE A NEW SAFEGUARD

Furthermore, new protection for employee participants has developed through the recent disclosure laws. Several States have passed such laws, including Washington, New York, Connecticut, California, Wisconsin, and Massachusetts. Others are considering them, including pending bills before Congress.

These disclosure laws will require that the employee participants be kept informed as to investments in employer securities. This power of publicity and the employer-employee relationship should be given an opportunity to show whether it can be its own policeman. Stringent investment tests for tax approval can always be passed, later, if found really necessary in the public interest.

X. SMALL BUSINESS NEEDS THESE PLANS

Congress has always encouraged employees' trusts. Most of the large companies of the country now have employees' trusts. Therefore "small business" needs these plans in order to compete in attracting and holding desirable employees, as well as gracefully retiring long-service superannuated or disabled employees.

Practical rules for the investment of a portion of the funds in employer debentures is important to enable "small business," "growth companies," and closely held corporations to establish these funds and also find a source for long-term working capital without necessarily being detrimental to the employee participants.

XI. EMPLOYEES BENEFIT

Finally, the investment in employer obligations can be beneficial to the employee participants.

A. Higher interest yield

The rate of interest earned is a very vital factor in determining the amount of benefits which employers can grant to employees.

Therefore, one of the objectives of investing in employer obligations is to endeavor to increase the yield on investments underlying the conventional pension funds in order to use these higher yields to increase the benefits for the employee participants.

For example, if a pension fund assumed that it would earn 2½-percent interest and, instead, earns a continuously higher interest, the results could look something like this:

If interest earned, instead of 2½ percent, is—	*Then, the benefits to employees could be increased approximately—*
3 percent	10 percent.
3½ percent	22 percent.
4 percent	35 percent.
4½ percent	49 percent.
5 percent	65 percent.
6 percent	101 percent.

Of course, these estimated figures would only apply if the interest earnings were maintained permanently at the higher levels indicated.

Consequently, investment in unsecured debentures can be a benefit to employee participants—and hence the liberalization of section 25 to encompass small business is desirable.

B. Tie-in with section 303

The right of an employer to sell its obligations to an employee trust could serve as another channel to permit payment of Federal estate taxes—which is one of the important objectives of the United States Senate Select Small Business Committee. For example, if the executor needed $100,000 to pay the Federal estate-tax bill of the deceased small business employer, and if the employees' trust fund of that company had $400,000 of liquid investments, the corporation could then sell to the employees' trust $100,000 of its unsecured debentures (representing 25 percent of the employees' trust assets) and thereby obtain the cash with which to purchase sufficient employer company stock from the executor to enable the executor to pay the Federal estate-tax bill.

Thus, the suggested relief of section 25 for small business would make section 303 of the Internal Revenue Code more possible of fulfillment and thereby prevent small business from being absorbed by mergers due to the death of the small business founder and assure greater continuity of employment to employees in the small business, etc.

Senator KERR. That concludes the hearing of the witnesses who had been scheduled to testify today. We will recess until 10 o'clock in the morning.

(The following letter from John M. Barker of General Mills, Inc., proposing an amendment to Section 13 (c); a letter from Nathaniel H. Goldstick, corporation counsel of the city of Detroit, Mich.; and a letter from Edward Walker, president, and Paul W. Freestone, secretary, of the Los Angeles Police Relief Association, are made a part of the record:)

GENERAL MILLS, INC.,
Minneapolis, Minn., February 26, 1958.

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR BYRD: There is attached hereto a proposal for a stopgap remedy of an unintended hardship in foreign business operations. Included with it is a detailed statement of the tax inequities in foreign operations and quite detailed suggestions for remedying them.

I understand that the Senate Finance Committee is considering H. R. 8381, the Mills bill, and that it is the desire of the committee to limit any amendments to matters which are already covered therein. If the defect in the 1954 code, which denies an operating loss carryover to a United States parent for losses incurred by foreign subsidiaries, is corrected, the biggest part of this problem will be solved. This proposal is an attempt on my part to suggest the remedy and stay within your committee's wishes.

I hope that you can actively promote and support the proposed amendment. Others on your committee are being asked to support this proposal.

I was delighted to read in the paper a few days ago that you have decided to again seek election to the Senate. I know that many outside of your home State are glad that you have made this decision.

Sincerely yours,

JOHN M. BARKER.

PROPOSAL FOR A STOPGAP REMEDY OF AN UNINTENDED HARDSHIP IN FOREIGN BUSINESS OPERATIONS

The attached document entitled "United States Business and Foreign Country Operations Tax Inequities of Certain Losses" was presented to the Ways and Means Committee of the House of Representatives. It contains suggestions to remove inequities and involves several sections of the Internal Revenue Code.

Section 332 in the 1954 code denying taxpayers the right to choose whether losses on liquidation of a subsidiary company would be applicable, has resulted in an unintended hardship with regard to liquidation of foreign subsidiary corporations. The reason for this is because the net operating loss carryover permitted to the acquiring corporation upon liquidation of a domestic subsidiary corporation is not permitted upon liquidation of a foreign subsidiary corporation. In order to allay further hardships, the following stopgap remedy is suggested for addition to H. R. 8381 now before the Senate Finance Committee:

"SEC. 13 (c). NET OPERATING LOSS OF FOREIGN SUBSIDIARIES.

"Section 172 (c) of the Internal Revenue Code of 1954 is hereby amended by striking the period at the end of the first sentence and inserting the following: " 'and in the case of a foreign corporation shall be computed as though the corporation were a domestic corporation."

If this amendment is adopted, United States companies with foreign subsidiaries will be able to liquidate subsidiary corporations and use losses incurred since 1953 as loss carryovers under section 381. Section 172 (b) permits losses to be carried over for 5 years following the taxable year in which the loss is incurred. If this stopgap remedy is adopted now, losses which have been incurred since 1953 can all be included as loss carryover deductions to the acquiring corporation. If there is delay in remedying this defect, it is likely that losses of past years will be denied to certain taxpayers.

It is understood that it is the desire of the committee to limit H. R. 8381 to its present subjects. It has been the aim in this proposal to add through section 13 a further amendment to section 172 and to stay within the committee policy.

It is requested that this proposal be added to H. R. 8381 because of the uncertainty that the Ways and Means Committee will report another general tax revision bill soon.

JOHN M. BARKER,
Manager of Taxation, General Mills, Inc.

UNITED STATES BUSINESS AND FOREIGN COUNTRY OPERATIONS TAX INEQUITIES OF CERTAIN LOSSES

My name is John Barker. I am manager of taxation for General Mills, Inc. I wish to point out certain inequitable treatment of losses incurred from business operations in foreign countries. Several companies listed later herein join with me and endorse this proposal.

GENERAL STATEMENT

It is the policy of the United States Government to encourage investment abroad by United States citizens and corporations. We as a Nation believe it is best for us politically and economically to attempt to raise the income and living standards of other countries. To this end moneys are and have been appropriated for direct economic aid and business investment has been encouraged and helped by such matters as: maintenance by ICA in foreign countries of experts in business to advise American business on possible investments; appropriation of moneys to insure business investments in foreign countries as protection against expropriation and exchange convertibility. To some extent our tax laws, through the Internal Revenue Code, have helped to attract foreign investment.

All will agree that there is a risk of loss in any business undertaking. A foreign business carries an even greater risk of loss because of geographic distances, language barriers, foreign exchange problems, differences in skills of labor and differences in political atmosphere, to name a few. Business is willing to assume the risks of loss on foreign investments, however, if a loss is incurred on a foreign investment, it is only fair that the tax consequences in the United States should be at least as favorable as they would be if the loss was incurred from a United States investment. Unfortunately this is not the case, and in many instances a loss on a foreign investment cannot be deducted for tax purposes by the United States corporation which made the foreign investment.

This memorandum will deal with investments by United States corporations in foreign countries by the use of foreign corporations, and will attempt to point out the various tax problems and to suggest solutions. No attempt will be made to offer suggestions or make any analysis of the tax consequences of investments abroad by individuals.

THE PROBLEM OF NONRECOGNIZED OPERATING LOSSES, SUBCHAPTER O

Subchapter O of the Internal Revenue Code of 1954 is applicable to foreign corporations. Section 367 gives the Secretary or his delegate authority to determine if gain shall be recognized on certain exchanges if a foreign corporation is involved in the exchange but there is no provision anywhere in this subchapter which provides for the recognition of losses in exchanges which involve a foreign corporation.

Section 332 of subchapter C provides for the nonrecognition of gain or loss on complete liquidation of subsidiary corporations. When this section was written for inclusion in the 1954 code, it was changed from the previous similar provision in the 1939 code so as to deny taxpayers the right to choose whether the section would be applicable or not. The argument for this denial of choice was that the taxpayer could choose to come under the section in case there was a gain, but choose not to come under the section if there was a loss. It was not the purpose or policy, however, in making this change in the code, to deny an operating loss incurred by the subsidiary corporation as a deduction to the parent or acquiring corporation. Therefore, section 381 was concurrently enacted which permits the parent corporation to deduct as an operating loss carryover, the net operating loss of the subsidiary corporation.

In making these changes in subchapter C there was no provision made to take care of the case in which a foreign subsidiary corporation with an operating loss is liquidated. By the terms of section 332 no loss is recognized on liquidation and, furthermore, no loss carryover under section 381 is available to the United States parent corporation. The reason no loss carryover is available to the parent company is because the definition of the term "net operating loss" as contained in section 172 (c) is made applicable to section 381. The definition in section 172 (c) reads in part, "* * * the excess of the deductions allowed by this chapter over the gross income." Because the foreign corporation will not ordinarily have deductions under the code, it will not have a net operating loss.

To summarize the pattern as it now exists in subchapter C—United States parent corporations can be taxed on gains resulting from liquidation of a foreign subsidiary corporation if so determined by the Secretary or his delegate, whereas the United States parent of a domestic subsidiary corporation cannot be taxed upon gains resulting from liquidation of the subsidiary corporation—a United States parent corporation cannot inherit the operating loss carryover of a foreign subsidiary corporation whereas the United States parent of a domestic subsidiary corporation can inherit the loss carryover from the subsidiary.

To correct this inequity and to encourage business investment by United States corporations through foreign subsidiary corporations, the following amendments to the Internal Revenue Code of 1954 are suggested:

(1) Change section 172 (h) (1) to read as follows:

"(1) For treatment of net operating loss carryovers in certain corporate acquisitions and for definition of net operating loss of a foreign corporation; see section 381."

(2) Add a new paragraph (d) to section 332:

"(d) Special rule for liquidation of a foreign subsidiary corporation—if—

"(1) A foreign corporation is liquidated and Subsection (a) applies to such liquidation, and

"(2) The parent corporation incurs a loss and there is no net operating loss carryover under Section 381 on account of the liquidation, "then section 165 will apply and the nonrecognition of loss provided in subsection (a) of this section will not apply."

(3) Add a new subparagraph D to section 381 (c) (1):

"(D) For the purpose of this section, the term 'net operating loss' (for any taxable year ending after December 31, 1953) shall mean in the case of a foreign corporation, the excess of the deductions which would be allowed by Chapter I over the gross income whether or not the foreign corporation was subject in whole or in part to taxation under this subtitle A, and whether or not the foreign corporation is subject to tax in accordance with section 882. This section will be applicable to the acquiring corporation only if it succeeds to and operates the business of the foreign corporation."

RESULTS UNDER SUBCHAPTER C OF THE PROPOSED AMENDMENTS

If the proposed amendments are adopted, the following results will be obtained:

(1) The net operating loss of a foreign subsidiary corporation will be available to the United States parent corporation as a deduction the same as is the case for a net operating loss of a domestic subsidiary corporation.

(2) The power of the Secretary to determine if gains on liquidations of foreign subsidiary corporations are to be taxed is not changed.

(3) The United States parent corporation can only inherit the net operating loss of the foreign subsidiary if it succeeds to and operates the business of the foreign subsidiary.

(4) The policy of encouraging foreign investments by United States corporations is obviously helped.

(5) The discrimination against recognition of losses on investments in foreign subsidiary companies is eliminated.

LOSSES IF SUBSCRIBER C IS NOT APPLICABLE—LOSSES ON INVESTMENTS

It will not be possible in all instances for a United States corporation to continue the business of its foreign corporation in the foreign country. This may be because the foreign country does not permit a United States corporation to do business in the country; it may be because the United States corporation does not wish to subject its assets and operations to foreign attachment, scrutiny, risk, control, or other business reasons; or it may be that the foreign enterprise is unprofitable and should not be continued.

In such cases as these, if the foreign corporation is liquidated, one of several possible tax consequences can now come to pass:

(1) If the United States company owns 95 percent or more of the stock in the foreign company, it may have an ordinary loss on the stock investment, but to qualify the stock must be worthless. If there is only partial worthlessness, then no loss is recognized.

(2) If the United States corporation owns 80 percent or more of the stock in the foreign corporation, and in liquidation it receives any distribution on the stock (regardless of the amount and regardless of what part of the cost is recovered), then no part of the loss on the stock will be available to the United States corporation at the time of the liquidation nor at any time thereafter.

(3) If the United States corporation owns less than 80 percent of the stock in the foreign corporation, it may have a capital loss on the stock which can only be deducted against other capital gains. If the loss is ever deductible against capital gains, the tax benefit from the loss will only be at the lower capital-gain rates.

It is the policy of the United States to tax as ordinary income at regular corporation tax rates any dividends received by a United States corporation from a foreign corporation. By reason of the foreign tax-credit provisions of the code, the tax on this dividend income will never be less than the United States tax rate. Ordinarily the United States company pays United States taxes on the dividend at a rate which is equivalent to the difference between the United States rate and the rate applicable to corporations in the foreign country.

The policy which permits United States corporations to take credit for foreign income taxes paid by foreign corporations prohibits double taxation and is definitely an encouragement to foreign investment. It should be stressed, however, that this encouragement come only if the foreign enterprise is successful and can pay dividends from income.

It is suggested that if a foreign corporation fails there should be no doubt that any loss incurred by a United States company from such failure be fully deductible for tax purposes. This should be the result if a certain minimum percentage of ownership in the foreign corporation is in the United States company.

The following is suggested as an amendment to the Internal Revenue Code of 1954:

Add a new paragraph numbered (4) to section 165 (g):

"(4) Securities in foreign corporations.

"For the purpose of paragraph (1) any security in a foreign corporation affiliated with a taxpayer which is a domestic corporation and which becomes worthless in whole or in part shall not be treated as a capital asset and the excess of the basis (as provided in section 1011) of the security over the cash and fair market value of other property received in cancellation of such security shall be allowed as a deduction under this section. For the purpose of the preceding sentence, a foreign corporation shall be treated as affiliated with the taxpayer only if—

"(A) At least 10 percent of its voting stock is owned directly by the taxpayer, and,

"(B) More than 90 percent of the aggregate of its gross receipts, if any, for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

"In computing gross receipts for the purposes of the preceding sentence, dividends, interest, or rent received by the foreign corporation from another foreign corporation which meets the aggregate gross receipts requirement shall not be taken into account and gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom.

"This subparagraph (4) shall only be applicable if Section 381 (c) (1) (D) is not applicable to the domestic corporation."

RESULTS OF THE PROPOSED AMENDMENT TO INVESTMENT LOSSES

The suggested amendment will recognize a loss if the United States corporation owns 10 percent or more of the voting stock of the foreign corporation. This percentage is the same as is required to obtain the foreign tax credit on dividends. It is recommended not only to be uniform with the foreign tax credit provisions of the code, but also because it encourages United States industry to pool resources to form foreign corporations. It also recognizes that certain foreign countries limit the percentage of United States ownership in their domestic corporations.

The proposal recognizes as an ordinary loss complete or partial losses resulting from investment in securities in foreign corporations. This is suggested because the foreign business is, in effect, an extension of the identical business of the United States company. The foreign investment is not in the broad sense a capital investment because in most instances the foreign corporation exists because of the requirements of the foreign country or for business reasons separate and distinct from tax considerations. The proposal also takes account of the fact that if foreign operations are carried on through a branch of the United States company, losses are fully deductible currently as they are incurred. With the adoption of this proposal, the tax consequences of foreign losses are substantially identical whether the form of the organization is a foreign corporation or a branch of a United States company.

The gross receipts test is suggested to keep this proposed section from becoming a device for tax avoidance. The exception from gross receipts for dividends, interest, and rent received by a foreign corporation from another foreign corporation is included because it is often necessary and desirable to operate in a foreign field through more than one corporation. For example, a foreign corporation already in existence may be purchased, but to protect other assets to be acquired, it may be desirable to avoid a possible attachment of the new assets by placing them in a new corporation. Experience indicates that in some foreign countries the existence of recorded liens, the availability of audited financial statements, and the credit standing of possible sellers leaves much to be desired.

A loss on securities will only be applicable if the loss carryover is not applicable to the taxpayer. The amount of the loss cannot exceed the cost to the United States company of the investment in the stock of the foreign corporation.

If the suggestions herein are adopted, foreign investment by United States corporations will be encouraged and there will be equitable treatment of losses from foreign operations under the Internal Revenue Code.

The following companies join with General Mills, Inc., in recommending that the suggestions herein be adopted:

Allis-Chalmers Manufacturing Co., Milwaukee, Wis.
Campbell Soup Co., Camden, N. J.
Crouse-Hinds Co., Syracuse, N. Y.
Deere & Co., Moline, Ill.
Economics Laboratory, Inc., St. Paul, Minn.
Ex-Cell-O Corp., Detroit, Mich.
H. L. Green Co., Inc., New York, N. Y.
International Telephone & Telegraph Corp., New York, N. Y.
Jones & Laughlin Steel Corp., Pittsburgh, Pa.
Leslie Salt Co., San Francisco, Calif.
Mack Trucks, Inc., Plainfield, N. J.
Minnesota Mining & Manufacturing Co., St. Paul, Minn.
Norton Co., Worcester, Mass.
Santa Fe Drilling Co., Whittier, Calif.
Standard Pressed Steel Co., Jenkintown, Pa.
Stanley Home Products, Inc., Easthampton, Mass.
Stokely-Van Camp, Inc., Indianapolis, Ind.
The National Supply Co., Pittsburgh, Pa.
The Yale & Towne Manufacturing Co., New York, N. Y.
Walgreen Drug Stores, Chicago, Ill.
Winston Bros. Co., Minneapolis, Minn.

For summary purposes, all of the suggested amendments to the Internal Revenue Code of 1954 which are contained herein are attached in section number order.

Respectfully submitted.

JOHN M. BARKER,
Manager of Taxation, General Mills, Inc.

Dated: Friday, the 13th of December 1957.

SUMMARY OF PROPOSED AMENDMENTS TO THE INTERNAL REVENUE CODE OF 1954

Add a new paragraph numbered (4) to section 165 (g):

"(4) Securities in foreign corporations.

"For the purposes of paragraph (1) any security in a foreign corporation affiliated with a taxpayer which is a domestic corporation and which becomes worthless in whole or in part shall not be treated as a capital asset and the excess of the basis (as provided in sec. 1011) of the security over the cash and fair market value of other property received in cancellation of such security shall be allowed as a deduction under this section. For the purpose of the preceding sentence a foreign corporation shall be treated as affiliated with the taxpayer only if—

"(A) At least 10 percent of its voting stock is owned directly by the taxpayer; and

"(B) More than 90 percent of the aggregate of its gross receipts, if any, for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

"In computing gross receipts for the purposes of the preceding sentence, dividends, interest, or rent received by the foreign corporation from another foreign corporation which meets the aggregate gross receipts requirement shall not be taken into account and gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom."

"This subparagraph (4) shall only be applicable if section 381 (c) (1) (D) is not applicable to the domestic corporation."

Change section 172 (h) (1) to read as follows:

"(1) For treatment of net operating loss carryovers in certain corporate acquisitions and for definition of net operating loss of a foreign corporation, see section 381."

Add a new paragraph (d) to section 332:

"(d) Special rule for liquidation of a foreign subsidiary corporation—If—

"(1) A foreign corporation is liquidated and subsection (a) applies to such liquidation, and,

"(2) The parent corporation incurs a loss and there is no net operating loss carryover under section 381 on account of the liquidation.

"then section 165 will apply and the nonrecognition of loss provided in subsection (a) of this section will not apply."

Add a new subparagraph (D) to section 381 (c) (1):

"(D) For the purpose of this section the term net operating loss (for any taxable year ending after December 31, 1953) shall mean in the case of a foreign corporation the excess of the deductions which would be allowed by chapter I over the gross income whether or not the foreign corporation was subject in whole or in part to taxation under this subtitle A and whether or not the foreign corporation is subject to tax in accordance with section 882. This section will be applicable to the acquiring corporation only if it succeeds to and operates the business of the foreign corporation."

City of Detroit,
Office of the Corporation Counsel,
Detroit, Mich., February 27, 1958.

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

Gentlemen: The following statement is submitted to your honorable committee in behalf of the Detroit Police Benefit and Protective Association with respect to the Mills bill (No. 8381). The association is composed of police officers of the city of Detroit, who pay monthly assessments into the association and who are entitled to insurance in the sum of $4,000, payable upon death to their survivors.

The interest of the association in the bill is as follows:

The association is presently exempt from income tax under the terms of section 501 (c) of the 1954 Internal Revenue Code. The section in which the association is interested presently reads as follows:

"(9) Voluntary employees' beneficiary association providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents, if—

"(A) no part of their net earnings inures (other than through such payments) to the benefit of any private shareholder or individual; and

"(B) eighty-five percent or more of the income consists of amounts collected from members and amounts contributed to the association by the employer of the members for the sole purpose of making such payments and meeting expenses.

"(10) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or their designated beneficiaries, if—

"(A) admission to membership in such association is limited to individuals who are officers or employees of the United States Government; and

"(B) no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual. * * *"

Under the terms of this section, the association is entitled to exemption as long as 85 percent or more of its income consists of contributions collected from employers and members and not more than 15 percent of its income is derived from other sources. The association is now dangerously near the 15-percent profit limitation by reason of the fact that its investments, consisting of United States Government bonds, now amount to $4 million, bringing a rate of interest which may exceed the limitation now contained in the code.

Under paragraph 10 (A) of section 501 (C), no such provision for limiting the percentage of outside income is applicable to like associations, where the membership of such associations is limited to individuals who are officers or employees of the United States Government. It is my understanding that an exception was made for such Federal employees in 1939 when post-office employees found themselves in the same position now confronting members of the Detroit Police Benefit and Protective Association, at which time Congress amended the act so as to provide for an exception for Federal employees.

If your honorable committee is not inclined to grant a similar exemption to associations composed of municipal employees, it would be agreeable to raise the 15-percent limitation to 20 percent, and I am sure that such increase would solve the problem of the association.

If it is the desire of the committee to grant a hearing to the association, I would be pleased to appear at any future time at the convenience of the committee.

Sincerely yours,

NATHANIEL H. GOLDSTICK,
Corporation Counsel.

LOS ANGELES, CALIF. *March 3, 1958.*

UNITED STATES FINANCE COMMITTEE,
Senate Office Building, Washington, D. C.

GENTLEMEN: This statement is submitted to your honorable committee in behalf of the Los Angeles Police Relief Association and the Los Angeles Police Retirement Benefit and Insurance Association with respect to the Mills bill (8381).

These associations are composed of police officers of the city of Los Angeles who pay dues to the associations in the form of monthly assessments. Members of the Police Relief Association receive life insurance coverage in the amount of $2,000 as well as insurance against loss of salary income. Retirement benefits and insurance members are insured against loss of life in the amount of $3,000.

The associations are interested in section 501c of the Internal Revenue Code which provides exemption from payment of income tax by a:

(9) Voluntary employees benefit association providing for the payment of life, sick, accident, or other benefits to the members of such association as their dependents, if:

(*a*) no part of their net earnings inures (other than through such payments) to the benefit of any private shareholder or individual; and

(*b*) 85 percent or more of the income consists of amounts collected from members and contributed to the association by the employer of the members for the sole purpose of making such payments and meeting expenses.

Due to sound investments, much of which have been in United States Government bonds, the present income from the interest on these investments exceeds the 15 percent income limitation set forth in the code.

While it is clear that our associations do not qualify for exemption under paragraph (*b*), it is respectfully requested that consideration be given to the function being performed by the members. Policemen and firemen provide a service vital to the security of the community and the hazards are great. It is imperative that adequate provision be made for them and their families in the event of death, injury, or sickness.

The attention of your honorable committee is respectfully directed to official action taken in behalf of Government employees in 1939. Post office employees found themselves in much the same financial position as our associations and were granted exemption. Congress then amended the act to include other Federal employees. Under paragraph 10, section 501 (c), no provision for limiting the percentage of outside income is applied to like associations, where the membership of such associations is limited to individuals who are officers or employees of the United States Government. The paragraph reads as follows:

(10) Voluntary employees beneficiary associations providing for the payment of life, sickness, accident or other benefits to the members of such associations or their dependents or their designated beneficiaries if:

(*a*) admission to membership in such association is limited to individuals who are officers or employees of the United States Government;

(*b*) no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

The Los Angeles Police Relief Association and the Los Angeles Police Retirement Benefit and Insurance Association are administered under the strict provisions of the insurance laws of the State of California. All of the net income of both is returned to the members in the form of insurance protection and sickness benefits.

It is respectfully requested that favorable consideration be given to the amending of section 501 (c), paragraph 10, of the Internal Revenue Code to include police officers and firemen.

LOS ANGELES POLICE RELIEF ASSOCIATION, INC.,
EDWARD WALKER, *President.*
LOS ANGELES RETIREMENT BENEFIT AND INSURANCE ASSOCIATION, INC.,
PAUL W. FREESTONE, *Secretary.*

(By direction of the chairman, the following are made a part of the record:)

HOGAN & HARTSON,
Washington, D. C., March 4, 1958.

Re section 25 of H. R. 8381.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: I have been asked to bring to the attention of your committee, during its consideration of H. R. 8381, one provision of this bill which seemingly results in an unintended and inequitable discrimination between various debentures available as investments by an exempt pension or profit-sharing trust.

Of even more importance to some pension and profit-sharing trusts, such provision fails to protect from loss of exempt status those trusts which acquired certain employer debentures subsequent to November 8, 1956, without knowledge of the Internal Revenue Service position published on such date to the effect that such acquisitions would thereafter be considered prohibited transactions.

I refer to paragraph (4) of the proposed new subsection 503 (h). This paragraph sets out one of the conditions which must be met if an obligation of the employer is to qualify for the liberalized investment treatment provided in subsection 503 (h). The House Report No. 775 (report of the Committee on Ways and Means, House of Representatives, to accompany H. R. 8381) describes this condition as follows:

"In the case of an obligation acquired after November 8, 1956, such obligation must be issued pursuant to an indenture or other written agreement which provides that, if the issuer of the obligation mortgages (or otherwise subjects to lien) substantially all of its property after the issuance of the obligation, the obligation will be secured by a preference no less adequate than that afforded by the mortgage or lien."

It is my understanding that most corporate obligations of the type made available to the public through underwriters are issued with a restriction against mortgaging corporate property similar to the language in paragraph (4). So far as these obligations are concerned, the proposed statutory language presents no problem.

There is, however, at least one important industry which, because of its unique nature, has in the past been issuing debentures which would not meet the technical requirements of paragraph (4) despite the fact that a mortgage could not be given preference over the obligations.

This industry is the automobile-financing industry, made up of the automobile-finance companies which have been supplying much of the credit needed to sustain a high level of automobile sales. In order to operate successfully, such companies require large amounts of funds, most of which must be obtained by borrowing. Banks have supplied some of the necessary funds. Because such a large percentage of the assets of the automobile-finance companies consist of intangibles in the form of notes receivables, banks have been willing to lend money only if there is a uniformity of treatment of creditors insofar as security is concerned. That is, either all creditors must be secured or no creditors must be secured. Most of the automobile-finance companies obtain bank loans under an arrangement which provides that no creditor can be secured. In such cases, if a pledge of assets or other assignment for the benefit of creditors should occur, the banks would refuse to loan additional funds and would probably call their outstanding loans, which are traditionally on a short-term basis.

In addition to securing funds through banks loans, finance companies customarily borrow money by issuing debentures. Although large amounts have been sold to the public through underwriters, insurance companies are the principal purchasers of finance-company debentures. The insurance companies have developed standard debenture terms to fit such issues. There have been such debentures issued in the past which do not contain a provision, as required by paragraph (4), that if the issuer mortgages (or otherwise subjects to lien) substantially all of its property after the issuance of such debentures, such debentures will be secured by a preference no less adequate than that afforded by such mortgage (or lien). The reason such a provision is omitted is not to permit a preferential mortgage, rather it is because such a provision has been considered unnecessary to prevent such a mortgage in the automobile-finance industry, in view of the aforesaid requirements of the banks.

It seems obvious that the purpose of paragraph (4) of subsection 503 (h), as passed by the House, is to protect a debenture-holding pension or profit-sharing trust by preventing the issuer of such debentures from subsequently giving a preferred security to a mortgage holder.

As drafted, however, paragraph (4) contains the technical requirement that, as to bonds acquired after November 8, 1956, such a condition must be contained in the debenture or written agreement pursuant to which the obligation is issued. This technical requirement unfairly discriminates against those debentures which are, in fact, protected by bank agreement against a subsequent preferential mortgage but which were issued pursuant to an indenture not containing such a restriction.

This unfair discrimination can be avoided without eliminating the desired protection of debenture holders by redrafting paragraph (4) so as to permit debentures to qualify for the liberalized treatment in subsection 503 (h) even though not issued pursuant to an indenture or other written agreement containing the restriction specified in paragraph (4) provided such a restriction is agreed to by the issuer in a statement filed with the Commissioner of Internal Revenue. In order to be effective, some means of enforcing such an agreement not to mortgage property would have to be provided. Retroactive disallowance of deductions to the pension or profit-sharing trust in the event such an agreement is violated should provide adequate means of enforcing the desired restriction. By increasing the types of debentures which qualify under subsection 503 (h), such a proposal would also decrease the number of pension and profit-sharing trusts which now stand to lose their exempt status for the reason that they acquired employer debentures subsequent to November 8, 1956, even though such acquisitions were made without knowledge that the Revenue Service deemed them "prohibited transactions."

A more simple solution to correct the inequities and the discrimination would be to exempt all debentures issued prior to July 9, 1957 (the date of the House report explaining H. R. 8381) from the condition specified in paragraph (4), regardless of when such debentures are acquired. Debentures issued by automobile finance companies subsequent to that date will not doubt contain the restriction specified in paragraph (4). Hence, there should be no problem in respect of such issues. It would, of course, be necessary for all debentures issued prior to July 9, 1957, to satisfy the other conditions in subsection 503 (h) in order to qualify for the liberalized treatment.

A less satisfactory and only partial solution to the problem of unfair discrimination would be to exempt debentures acquired prior to July 9, 1957, from the condition specified in paragraph (4), making it clear that such debentures would qualify for the liberalized treatment if the other three conditions of subsection 503 (h) are satisfied.

Although the last solution described above would not eliminate completely the unfair discrimination against automobile finance company debentures which do not meet the technical requirements of paragraph (4), it would provide relief for and solve the dilemma of any pension or profit-sharing trust which acquired debentures subsequent to November 8, 1956, either without knowledge that such acquisition was deemed by the Internal Revenue Service to be a "prohibited transaction" or as the result of a purchase order placed with a broker prior to November 8, 1956. It would be highly inequitable for such an organization to lose its exempt status because of such circumstances.

It is respectfully requested that this letter be made a part of the record of the hearings on H. R. 8381 and that your committee consider the solutions suggested above to alleviate the discrimination and inequity in section 503 (h).

Sincerely,

SEYMOUR S. MINTZ.

MARCH 4, 1958.

SENATE FINANCE COMMITTEE,
Senate Office Building,
Washington, D. C.

GENTLEMEN: The following memorandum is addressed to section 14 of H. R. 8381, involving the depreciation of lessees' improvements and the amortization of the cost of acquiring a leasehold.

The effect of section 14 is to change present law to prevent opportunities for avoidance of taxation thought to exist under present law. It is submitted that existing opportunities for avoidance can be eliminated without the introduction of the inequities to taxpayers which would occur if section 14, in its present form, were enacted.

A. *Present law.*—The regulations provide that as a general rule, lessees may write off the cost of acquiring a lease over the initial term thereof, unless the facts show with "reasonable certainty" that the lease will be renewed. Improvements having a useful life less than the unexpired term of the lease are written off over their useful life. Where the useful life of the improvements exceeds the current term, they are written off over the remainder of the current term, unless there is a renewal option which is reasonably certain to be exercised. In such case, the improvements are written off over their useful life. See Proposed Regulations, section 1. 162–11.

B. *Discussion of section 14.*—The rule of section 14 requires lessees to take renewal options into account unless the lessee "establishes" that it is more probable that he will not renew than that he will renew. This rule imposes serious burdens on lessees. It is obviously extremely difficult, if not impossible, to "establish" probabilities regarding the exercise of renewal options in the distant future. The decision to renew depends, among other things, on the future state of the economy in general, the physical condition of the property involved, and on how obsolete the property will be at the time of renewal. The only one of these factors with respect to which any reasonable future evaluation can be made is the physical condition of the property. Evaluations with respect to the other factors can be characterized only as speculation. Therefore, the burden of proof in section 14, will, in practical effect, amount to the very rule contained in the original form of the proposed legislation which was rejected by the House of Representatives. The rule originally proposed required renewal terms to be taken into account under all circumstances. Furthermore, the requirement in section 14 that the likelihood of renewal be reevaluated each year multiples the burden. This requirement is contrary to the policy expressed in Regulations, section 1.167(a)-1(b) not to disturb the term of depreciation, once established, unless there is "clear and convincing evidence" to support a redetermination.

The inequity which may arise under the proposed legislation is further illustrated by the following example. Suppose a lease is purchased having an unexpired term of 20 years, with 3 renewal options of 20 years each. The entire value of the lease resides in its initial term because the rents payable are low and the lessee can earn substantial profits during that term. The lease provides that the rent for the renewal terms shall be a fair rent at the time of renewal, as determined by an appraisal. Since the lessee has the right to renew at a fair rent, he will presumably be unable to establish that the probability of renewal is less than the probability of nonrenewal. Under section 14, this situation appears to require a writeoff over an 80-year period. In the described case, the renewal terms have small value, if any. It is clear, then, that the lessee's investment is in the initial term of the lease and not in the valueless renewal terms. To require a writeoff over a period including the renewal terms is unreasonable.

Generally, taxpayers who purchase leaseholds do so primarily with a view to recovery of their investment and profits in the earlier rather than later years, or in renewal terms. Any value residing in such later years is usually smaller than in the initial term, or may be nonexistent. This is partially attributable to the decline of the income-producing potential of buildings with the passage of time, resulting from increasing costs of maintenance and the obsolescence factor. The declining income-producing level of buildings is one of the more important considerations underlying the allowance of declining balance depreciation to fee owners. It is inconsistent to afford this right to fee owners and to deny it to lessees in respect of leasehold costs.

There are, of course, instances where renewal options have great value, which indicate, fairly clearly, the probability of renewal. For example, if a lessee purchases a lease whose value is attributable to a building having a 40-year life at the time of purchase, where the unexpired portion of the current term is only 10 years, and there is a right to renew at a low rent, the lessee is probably investing a substantial portion of his money in the renewal terms. In a situation like this, however, it seems "reasonably certain" that the option to renew will be exercised. Thus, the present law adequately covers this type of situation. There appears to be only one case presenting facts superficially similar to those described where it was held that the renewal term was not required to be taken into account by the taxpayer, *Aiken Drive-In Theatre Corp.* (P. H. T. C. M., Par. 56.136). However, in that case, the result in favor of the taxpayer would probably have been reached even if the rule contained in section 14 had been in effect. The facts in that case clearly indicated that the lease would not be renewed.

C. *Conclusions.*—The area of law to which section 14 is addressed covers many varied situations. Possibly, rules could be formulated which would do exact justice to all taxpayers concerned. However, the administrative difficulties ensuing from the extensive provisions which would be required to do so make it preferable to provide a broad and flexible rule to cover all situations with substantial equity. The present rule appears to be well suited to this purpose, except in cases where the lessee and the lessor are related parties. The courts have, in general, prevented substantial avoidance under this rule. The proposed rule would create great difficulties for lessees, as described above. Therefore, the present rule should be allowed to stand, except insofar as it involves related taxpayers.

It is proposed, even if the "reasonable certainty" language of the regulations is deemed too favorable to lessees, that the approach in section 14 be modified to avoid creating hardships. Lessees should be allowed to take into account only the current term of the lease unless it is substantially more probable than not that the lease will be renewed. The evaluation should be based on what the facts indicate, and the lessee should not be required to "establish" probabilities. The rule is equitable because unless the facts available at the time of purchase indicate a substantial probability of renewal, the lessee usually does not regard the renewal term as a significant aspect of his investment. On the other hand, the rule proposed here requires renewal terms to be taken into account where the renewal option has material value and thus serious avoidance would be prevented. Furthermore, the proposed rule seems susceptible of flexible and reasonable administration.

D. *Proposed revision.*—Under the approach suggested here, section 178 (a) would read as follows:

"(a) GENERAL RULE.—Except as provided in subsection (b), in determining the amount allowable to a lessee as a deduction for any taxable year for exhaustion, wear and tear, obsolescence, or amortization—

"(1) in respect of any building erected (or other improvement made) on the leased property, or

"(2) in respect of any cost of acquiring the lease,

the term of the lease shall *not* be treated as including any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee, unless the [lessee establishes] *facts indicate* that [(as of the close of the taxable year)] it is *substantially* more probable that the lease will [not] be renewed, exended, or continued for such period than that the lease will *not* be so renewable, extended, or continued."

NOTE: Words eliminated from section 14 enclosed in black brackets; words added to section 14 indicated by italic.

Respectfully submitted.

WIEN, LANE, KLEIN & PURCELL,
By RAYMOND RUBIN.

TOUCHE, NIVEN, BAILEY & SMART

CERTIFIED PUBLIC ACCOUNTANTS

WASHINGTON, D. C., *March 5, 1958.*

Re section 9, H. R. 8381.

Hon. HARRY FLOOD BYRD,
Chairman, Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: I am writing in regard to section 9 of H. R. 8381, technical Amendments bill of 1958, which section is entitled "Remainders to Related Persons in the Case of Certain Charitable Trusts." Subsection (b) of section 9 in referring to effective date states as follows: "The amendment made by subsection (a) shall apply to taxable years ending after December 31, 1956, but only with respect to transfers to trusts after such date."

I wish to protest the setting of an effective date making this section applicable to taxable years ending after December 31, 1956, and to transfers to trusts after such date. It is my belief that this effective date provision is unfair and will result in undue hardship to taxpayers who in good faith made transfers under existing law which should result in contribution deductions pursuant to section 170 of the Internal Revenue Code of 1954. These persons had no way of knowing at the time transfers were made that a law would be proposed which would retroactively make such transfers nondeductible. I have in mind those taxpayers who made transfers in trust which meet the requirements of sections 170 (b) and 673 (a) of the Internal Revenue Code of 1954. A portion of the value of such transfers qualify as contribution deductions under existing law.

When the list of unintended benefits and hardships was released on November 7, 1956, there was no mention of the situation covered by section 9 and no indication that anything like section 9 was even contemplated. Nevertheless, the previously unannounced section 9 is in the bill and June 26, 1957, the date on which H. R. 8381 was introduced in the House of Representatives, was the first date on which taxpayers could reasonably have had any idea that such action was contemplated. No prior public notice had ever been given that such action was being considered. For these reasons I believe it most unfair to make section 9 applicable to transfers in trust which may have been consummated practically 6 months before taxpayers were first made aware that any changes were being considered in this area.

As a typical example, we know of an individual taxpayer who made a transfer in trust in early January 1957, acting in good faith and pursuant to section 170 (b). The trust instrument provides for an annuity of a certain sum per year to be paid each year to an exempt charitable foundation for a period of 30 years and further provides for income in excess of the charitable annuity and the remainder of the trust to be paid to the grandchild of the grantor. Using prescribed gift-tax tables, the value of the remainder interest in this particular case is approximately 9 percent. Thus, under section 9 of H. R. 8381 the present value of the gift to charity would not be deductible by the grantor in the year 1957 although at the time the transfer in trust was made all provisions of both existing and proposed law were complied with so that a portion of the transfer was deductible as a charitable contribution. When the taxpayer became aware of section 9 for the first time, it was impossible to modify provisions of the irrevocable trust so that it could now qualify under section 9. This example shows the injustice to one taxpayer which will result if section 9 of H. R. 8381 is made effective for transfers after December 31, 1956.

We believe that it would be only fair to make section 9 of H. R. 8381 effective at some date later than June 26, 1957, and respectfully recommend that section 9 be made effective for years ending after December 31, 1957, and then only to transfers to trust after that date.

This recommendation is in accord with the recommendation of the Treasury Department as expressed in the statement of Mr. Dan Throop Smith at a hearing before the Senate Finance Committee on February 25, 1958, wherein he stated as follows:

"* * * Special mention should also be made of the provision relating to remainders to related persons in the case of certain charitable trusts which presently would apply to transfers to trusts made after 1956.

"Since this provision was not offered in any formal list or bill before June of 1957, we think it appropriate to apply this amendment only to transfers to trusts made after 1957 * * *."

I hope your committee will give careful consideration to our recommendation.

Respectfully submitted,

W. KEITH ENGEL.

STATEMENT OF JOHN F. MECK, VICE PRESIDENT AND TREASURER, DARTMOUTH COLLEGE, HANOVER, N. H., REPRESENTING THE COMMITTEE ON TAXATION AND FISCAL REPORTING TO THE FEDERAL GOVERNMENT OF THE AMERICAN COUNCIL ON EDUCATION RE SECTIONS 9 AND 19 OF H. R. 8381.

FEBRUARY 28, 1958.

I am John F. Meck, vice president and treasurer of Dartmouth College. I represent, as chairman of the committee on taxation and fiscal reporting to the Federal Government, the American Council on Education.

The American Council on Education has a membership which includes 140 educational organizations and 1,005 institutions, among them nearly all the accredited colleges, universities, and junior colleges in the United States.

The committee on taxation and fiscal reporting to the Federal Government believes that the principle of tax exemption of colleges and universities is based upon the public service rendered by these nonprofit institutions. Any impairment of this principle would have the most serious consequences. One of the Nation's greatest needs in this day of increasing enrollments is to strengthen the resources of these public service institutions in order that they may meet the growing demands upon them. The committee believes just as firmly, however, that all questionable practices and abuses arising from this tax-exempt principle should be critically examined and avoided by the colleges and universities. It is with this in mind that I direct my comments to sections 9 and 19 of H. R. 8381.

SECTION 9

Section 9 of H. R. 8381 would amend section 170 of the Revenue Code of 1954 and, we are convinced, would have an adverse effect upon the income of many colleges and universities.

It has become an established practice to set up a trust fund with a trustee, providing that the income of the fund shall be paid to an eleemosynary institution for a period of 10 years or longer, after which the corpus of the fund shall be paid to designated persons, usually members of the grantor's family. Such a trust entitles the donor to a charitable deduction on his income-tax return and on his gift-tax return of the commuted value of the income given to charity. This plan provides the donor with an incentive for making the charitable provision rather than making a direct gift, outright or in trust, only to his descendants.

The 1954 code makes possible a trust such as this for as short a period as 2 years and generally similar in other respects to the so-called 10-year trust, except that the fund does not revert to the grantor.

In section 9 of H. R. 8381 it is proposed to amend section 170 (b) (1) of the 1954 code to provide that if the corpus of a charitable trust is to be returned at the end of the period of years to the grantor, or to his spouse, ancestors or lineal descendants, no charitable deduction shall be allowed. The amendment would apply not only to the short-term trusts but also to the trusts whose income is payable to eleemosynary institutions for 10 years or longer.

In this period of increasing enrollments and rising costs of education, colleges and universities need all the assistance they can get to encourage private contributions. The present law offers the opportunity of making such contributions, and an incentive to do so. While the net result of the proposed legislation may be to increase to a small extent the resources of the Government, this will be at the cost of depriving colleges and universities and other charitable organizations of the income from this type of trust which, in the past, has been substantial.

Because section 9, as now stands, would practically eliminate charitable trusts as a source of income for colleges and universities at a time when higher education is so vital to the national welfare, the council's committee on taxation and fiscal reporting to the Federal Government urges that section 9 be deleted from H. R. 8381 or, at least, amended. If amended, it should be in such a manner as to limit its application to the short-term trust, and so as to permit charitable trusts to be established for a period of 10 years or longer with the same tax results as have been recognized since long before the 1954 code.

SECTION 19

Turning now to section 19, I should like to point out that under present law, colleges can buy annuity contracts for their employees, and the employee pays no tax until he retires and starts receiving payments.

In hearings in November 1956 before the Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means, the spokesman for the Council's Committee on Taxation and Fiscal Reporting to the Federal Government opposed a proposal of the Treasury Department to limit annuity contributions of tax exempt organizations for their employees to 10 percent of salary. The Council's witness pointed out that the instances of diverting salary payments to the purchase of annuities are isolated ones, and can be taken care of by regulations under existing law. Such an approach, we felt, would have the basic advantage of taking into consideration all factors bearing on the annuity purchase, and not just the amount of the contribution.

In approving H. R. 8381, the House did not see fit to follow this recommendation. However, it did provide in section 19 of the bill an increase in the percentage limitation so that tax deferment would be permitted up to 20 percent of the employee's compensation for the current year, plus a past service allowance.

If a specific limit on the tax-free contribution of colleges and universities to their employees' retirement plan is determined to be necessary, the council's committee on taxation believes that the proposed 20 percent of compensation limit, together with adequate provision for past service, as provided in section 19, is fair, reasonable, and satisfactory.

A list of the members of the Council's Committee on Taxation and Fiscal Reporting to the Federal Government is attached for your information.

AMERICAN COUNCIL ON EDUCATION,
Washington, D. C.

MEMBERS OF COMMITTEE ON TAXATION AND FISCAL REPORTING TO THE FEDERAL GOVERNMENT

TERMS EXPIRING DECEMBER 31, 1958

Howard R. Bowen, president, Grinnell College, Grinnell, Iowa
C. O. Emmerich, business manager, Emory University, Emory University, Ga.
J. Parker Hall, treasurer, University of Chicago, 38 Dearborn Street, Chicago, Ill.
E. T. Jolliffe, business manager, State University of Iowa, Iowa City, Iowa
D. I. McFadden, controller, Stanford University, Stanford, Calif.

TERMS EXPIRING DECEMBER 31, 1959

A. Hollis Edens, president, Duke University, Durham, N. C.
L. H. Foster, president, Tuskegee Institute, Tuskegee Institute, Ala.
Richard A. Harvill, president, University of Arizona, Tucson, Ariz.
Asa S. Knowles, president, University of Toledo, Toledo, Ohio
Charles H. Sparenberg, comptroller, University of Texas, Austin, Tex.

TERMS EXPIRING DECEMBER 31, 1960

Kenneth W. Johnson, treasurer, University of Massachusetts, Amherst, Mass.
John F. Meck, vice president and treasurer, Dartmouth College, Hanover, N. H., chairman
Wilbur K. Pierpont, vice president, University of Michigan, Ann Arbor, Mich.
John N. Schlegel, treasurer, Lafayette College, Easton, Pa.
Charles H. Wheeler III, treasurer, University of Richmond, Richmond, Va.

UNITED STATES SENATE,
Washington, D. C., February 26, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR HARRY: I am writing with respect to section 9 of H. R. 8381, now under consideration in the Committee on Finance, which would amend section 170 (b) (1) of the Internal Revenue Code in such a manner as to materially reduce charitable deductions which are now permitted.

For many years it has been possible for a generous individual to establish a trust providing that the income be paid to a charitable institution for a period of 10 years or longer with the reversionary interest being paid over to the children or grandchildren at the termination of the charitable trust. Such a trust has entitled the donor to a charitable deduction, on his income-tax return and upon his gift tax return, of the commuted value of the income given to charity.

The proposed amendment (sec. 9) would deny the donor any charitable deduction for such a charitable income trust if after the charitable trust period the reversionary interest goes to the grantor's spouse, ancestors, or lineal descendants. There is no objection to the proposed amendment if it were applicable only to the short-term trusts made possible by the 1954 code, namely, up to 10 years' duration, but the proposed amendment also applies to trusts where income is payable to charitable institutions for 10 years or longer, thus imposing a very material limitation upon what has been generally accepted and approved by the tax courts as constituting long-term trusts.

The proposed amendment will leave no incentive to make long-term charitable commitments and, without question, will deprive charitable organizations of the income from this type of trust which in the past has been substantial. It will be harmful to colleges and universities, as well as hospital and church groups who necessarily must formulate their long-range plans on the basis of support from generous individuals.

In these critical times, when so much emphasis is placed on the need for expanding the facilities of institutions of higher learning, it seems most injurious to me to take such action as proposed in section 9 of H. R. 8381 which undoubtedly will deprive many colleges and universities of a most necessary source of funds.

It is my earnest hope your committee will perfect the proposed legislation so as to limit the application of section 9 to the short-term trust and so as to permit charitable trusts to be established for a period of 10 years or longer with the same tax results as have been recognized since long before the 1954 code.

Kind personal regards.

Sincerely yours,

CHARLES E. PORTER.

Re section 9 of the technical amendments bill of 1958 (H. R. 8381)

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Building, Washington, D. C.

DEAR SENATOR BYRD: Section 9 of the technical amendments bill of 1958 proposes to add a new subsection 170 (b) (1) (E), the effect of which is to deny to a taxpayer a charitable-contribution deduction in respect of a complete and irrevocable transfer of property in trust to pay income to a qualified charity if the remainder is payable to certain related taxpayers. It is respectfully submitted (1) that this is far more than a technical change or the correction of an unintended benefit; (2) that the announced reason for the change, that there is some kind of "double benefit" to the taxpayer, is fallacious; and (3) that the result is inconsistent with long-established principles of income, gift, and estate taxation.

THE PROPOSAL MAKES A MAJOR SUBSTANTIVE CHANGE

The stated purpose of the technical amendments bill of 1958 is to correct unintended benefits and hardships and to make technical amendments. The deputy to the Secretary of the Treasury stated before your committee that the bill does not have significant immediate revenue effect, but is directed at maintaining the fairness of the tax system. Rather than correcting an unintended benefit, however, section 9 proposes a substantive change overthrowing long-established principles of case and statutory law, and would, therefore, appear to be inappropriate in a bill of the stated nature of H. R. 8381.

Furthermore, the opportunities to present comments on the proposal have been limited. Although, at the time of the hearings before the Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means out of which the bill had its inception, the subcommittee did announce several proposed changes in the charitable-deduction field, no announcement was made that changes were proposed with respect to section 170 (b) (1) (D). Accordingly, section 9 was originally included in the bill without the advantage of critical discussion of the merits of the proposed change. While the public was on notice of the proposed change thereafter, consideration of the bill by your committee was only announced on Friday, February 21, and it is believed that some interested persons may not have had an opportunity to appear at the hearings on section 9 held only 2 business days later.

NO "DOUBLE BENEFIT" EXISTS

The existing provision, section 170 (b) (1) (D), is, in substance, a codification of well-established principles of case law that there is no completed transfer for income-tax purposes where a grantor retains a reversionary interest in the property transferred. It disallows a deduction for a gift of income from a trust if the grantor retains a 5 percent or greater reversionary interest. The report of the House Ways and Means Committee which accompanied H. R. 8381 states, however, that "It now appears * * * section 170 (b) (1) (D) does not completely block the opportunity for the double benefit which led to the enactment of this provision." The proposed provision, therefore, disallows the deduction for the gift to charity where the remainder is given to certain related taxpayers.[1]

The undersigned respectfully submits that there is, in fact, no "double benefit" involved, and that the announced purpose of the amendment is based on a fallacious assumption.

Some examples will illustrate.

Example No. 1.—Assume that a grantor executes a trust of stock having a value of $100,000 for the benefit of a qualified charity for 20 years, with remainder over to the grantor's son.

Treasury Regulations 105, section 81.10, table II, values the right to receive the income at $49,743.40 and the right to receive the remainder at $50,256.60. For simplicity, both figures are rounded off to $50,000. Under present law, the grantor will report a charitable deduction of $50,000 (subject to the 20 percent limitation) and the remainder to the son will be subject to the gift tax. The gift will also be a valid, completed gift for estate-tax purposes, so that the stock will not be included in the grantor's estate.

The proposed amendment would disallow the charitable deduction in the above situation on the ground that somehow there is a "double benefit" to the grantor. From the report accompanying the bill, it appears that the House Ways and Means Committee considers the grantor to enjoy one benefit because the earnings of the trust fund are not included in the grantor's income and another benefit because he is entitled to a charitable deduction for the present value of the gift of income.

This assumption appears to be fallacious. The fact is that the taxpayer has given his property away, one-half of the value to charity and the other half to his son. The Treasury does not question that the value of the 20-year interest in the income of the $100,000 fund is $50,000. Nor that the value of the remainder to the son is $50,000. The complete and irrevocable gift of the principal carries with it the future income. There is, therefore, no question of a benefit because of the exclusion of future income, and, thus, no justification for denial of the charitable deduction.

There is no question that the charitable deduction is allowable in other situations that do not differ in substance. For example:

Example No. 2.—The positions of the beneficiaries are reversed, that is, the son is the income beneficiary and the charity is the remainderman.

Example No. 3.—The income is payable to the charity for 20 years, but the remainder goes to a daughter-in-law or sister.

Example No. 4.—Gift of one-half of the stock to the charity and one-half to the son.

The charitable deduction of $50,000 is clearly allowable, both under present law and under the proposed amendment, in all 3 of these examples, and there is a gift of $50,000 on which the grantor will pay the gift tax. In all 4 examples, $50,000 in value is given to charity, and $50,000 to a family member. There would appear to be no justification for disallowing the charitable contribution deduction in example No. 1 and allowing it in the other 3 examples involving transfers of the same value.

It is entirely fallacious to base the distinction on the ground that the grantor has a second benefit in example No. 1 because the earnings from the stock are not reportable by him for income-tax purposes. He has made a complete transfer of his property, so that the income is no longer his in the first case just as surely as in the three others. It would hardly be contended that if the grantor gives cash to a charity there is both a deduction on account of the principal transferred and an exclusion of the future income to be earned thereon, and yet this seems to be what the Treasury is arguing as the reason for the proposed amendment.

THE PROPOSAL OVERTURNS LONG-ESTABLISHED PRINCIPLES OF TAXATION

A transfer of stock to a trust to pay the income to a qualified charity for 20 years, with remainder to the grantor's son, is clearly a complete and irrevocable gift on the basis of which a gift tax is imposed, and a complete and irrevocable gift on the basis of which the stock is excluded from the grantor's estate. But, if section 9 becomes law, it is not a complete gift for income-tax purposes.

Why? The grantor has irrevocably parted with every incidence of ownership. He can never, by his own action, regain possession of the stock. He has merely

[1] I. e., to the grantor's spouse, ancestors, lineal descendants, and certain corporations, trusts, etc., described in sec. 267.

chosen one of a number of ways of splitting his gift between the charity and his son. He has irrevocably given one-half of the value of the stock to charity and one-half of its value to his son. There is no reason to distinguish this case from the outright gift of one-half of the stock to each of the beneficiaries, or from the situation where the beneficiaries are reversed, or where the remainder is given to someone other than the grantor's spouse, ancestors, or lineal descendants. All these situations are substantially the same, in effect, and should be treated the same for income- as well as gift- and estate-tax purposes.

THE PROPOSAL DISCRIMINATES AGAINST STOCKHOLDERS OF FAMILY CORPORATIONS

Many stockholders of family corporations are benefactors of our charitable organizations. Frequently, they own no substantial amounts of other securities, so that they can make a sizable contribution of capital to charity only at the risk of admitting unfriendly outside interests. In such cases, the term trust provides a practical solution, permitting sharing of the fruits of the business with charity, but retaining control in the family group. To eliminate this method of charitable giving not only would discriminate against such contributors but would deny the charities an important group of supporters. The charitable-contribution deduction should be dependent simply upon the receipt of usable funds, not upon receipt by the charity of outright ownership of the stock.

NO INCOMES ESCAPES TAXATION

The only possible distinction between the four examples cited above is in the timing of the taxation of the income from the fund.

Example No.	Income, 1st 20 years	Income thereafter	Charitable deduction	
			Present law	H. R. 8381
1	100 percent to charity; not taxable...	100 percent to son; taxable...	Yes...	No.
2	....do....	100 percent to daughter-in-law; taxable.	Yes...	Yes.
3	100 percent to son; taxable...	100 percent to charity; not taxable...	Yes...	Yes.
4	50 percent to charity; not taxable... 50 percent to son; taxable....	50 percent to charity; not taxable.... 50 percent to son; taxable....	Yes...	Yes.

No income escapes tax under example No. 1 as compared with the others. It is true that, in example No. 1, as compared with example No. 4, only one-half as much income is taxed during the first 20 years, but twice as much income is taxed thereafter. If anything, it would seem that the Treasury will ultimately collect more in income taxes under example 1 than under example 4, where the charitable contribution is clearly allowable, and yet the effect of the proposed change will be to eliminate example 1 as a form of charitable giving.

A mere deferral of the taxation of part of the income cannot justify the complete disallowance of the charitable deduction, and this is not the basis of the Treasury's position that a double benefit is somehow involved.

CONCLUSION

Under the new provision, the Treasury will with one hand take away the charitable deduction because the settlor is presumed to retain the remainder interest, while with the other hand it will collect a gift tax because he has made an irrevocable gift of the remainder. This is truly a startling version of the admonition to "let not thy left hand know what thy right hand doeth."

It is respectfully submitted that no double benefit exists in the situation at which section 9 is directed. The taxpayer who executes an irrevocable trust for the benefit of a charity for a term of years, reserving no interest to himself, certainly deserves no less a tax benefit than the taxpayer who contributes only when and to the extent that a gift is advantageous to him from a tax standpoint.

Furthermore, gifts through the term trust are especially desirable from the viewpoint of the recipient charities, for they provide an assured source of funds for specified periods on which the charities can plan their budgets far more effectively than where they are required to rely upon the year-to-year decisions of their benefactors.

The Congress, in raising the limitation on the charitable deduction in 1954, recognized the desirability of increased encouragement of our churches, hospitals, and universities because of rising costs and the relatively low rate of return on endowment funds. This generous policy should not be reversed, and a long-established form of charitable giving eliminated, in the absence of a very clear need—certainly, not on the basis of what appears to be a fallacious assumption that the one form of term trust singled out for special treatment somehow involves an extra tax benefit of some kind not spelled out in the Treasury or committee reports.

Respectfully submitted.

WILLIAM A. PATTY,
Shearman & Sterling & Wright, New York, N. Y.

MARCH 5, 1958.

(Whereupon, at 3:55 p. m. the hearing was recessed, to reconvene at 10:15 a. m., the following day.)

TECHNICAL AMENDMENTS ACT OF 1958

THURSDAY, FEBRUARY 27, 1958

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met, pursuant to recess, at 10:15 a. m., in room 312 Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd, Kerr, Frear, Long, Smathers, Douglas, Gore, Martin, Williams, Malone, and Bennett.

The CHAIRMAN. The committee will come to order.

We have the honor to have with us this morning Hon. John Sparkman, of Alabama.

Will you proceed in your own fashion?

STATEMENT OF HON. JOHN J. SPARKMAN, UNITED STATES SENATOR FROM THE STATE OF ALABAMA

Senator SPARKMAN. Thank you, Mr. Chairman and gentlemen of the committee.

Mr. Bill Erickson, Mr. Chairman, of the staff of the Small Business Committee, is sitting with me.

I would like to speak very briefly against section 52 of H. R. 8381. This section would repeal section 1361 of the Internal Revenue Code of 1954 which provided an election for certain proprietorships and partnerships to be taxed as corporations, and will be of great importance to a large segment of our economy.

The purpose of this section was to grant certain unincorporated businesses the same advantages under the tax laws that were available to corporations. It was intended to benefit smaller concerns which could not afford the luxury of the corporate form of organization.

It should be pointed out that section 1361 was added to the Internal Revenue Code of 1954 by this committee as explained in Senate Report No. 1622 of the 83d Congress, 2d session. Because it was a new section, the Treasury was given specific authority to issue regulations "on the method of taxing a partnership or proprietorship as a corporation" in subsection (c). The complexity of the provision required regulations for an intelligent administration of section 1361.

It has been my understanding that the main reason for section 52 is that section 1361 has been ineffective due to administrative problems. Few concerns have chosen to make this election. However, the reason for the failure of section 1361 was described by many witnesses who appeared before the Senate Small Business Committee during its hearings on the tax problems of small business.

Most of these witnesses believed that this election would have been of great value if it had been implemented by regulations. Many professional tax advisers stated that they dared not advise any of their clients to use this section until final regulations had been issued by the Treasury Department.

I am sorry to report that now, 3½ years after section 1361 was enacted into law, final regulations still have not been issued by the Treasury on this section. It is perfectly clear that the ineffectiveness of this section is wholly due to the neglect of the Treasury in failing to comply with the stated purpose of Congress.

As I mentioned, it has been argued that this section must be repealed because of the administrative problems it presented. Upon inquiry, Under Secretary of the Treasury Fred S. Scribner stated that section 52 of H. R. 8381 "was not recommended by the Treasury and does not have its endorsement." I can hardly see that "administrative problems" should be a basis for repeal when the Treasury does not endorse such action. Even if it did endorse repeal, for the reasons stated above, I would question the sincerity of such an endorsement.

As you know, there is pending before your committee a bill which I introduced for myself and 35 other Members of the Senate, the proposed Small Business Tax Adjustment Act of 1958, S. 3194. Similar legislation is pending before the House Ways and Means Committee. I know that this committee is greatly interested in the tax problems of small business and I hope that it will be able to schedule hearings on legislation such as I have introduced. S. 3194 is the product of a 1-year study by the Small Business Committee on the tax problems of small business.

I bring this bill up at this time because I wish to point out that section 1361 of the present code is an integral part of the structure on which the proposed legislation is based.

A provision in that bill, which would permit certain corporations to be taxed as partnerships, is intended to complement section 1361. This additional election has long been advocated by persons interested in the welfare of small business.

The administration is on record supporting this provision as early as August 7, 1956, in the progress report of the Cabinet Committee on Small Business and recently in testimony of Secretary of the Treasury Robert B. Anderson before the Ways and Means Committee of the House. The President called for action on this specific proposal in his Economic Report to the Congress this year. I only wish to make it clear that such a proposal would make little sense without the existence of the election provided by section 1361.

I ask that you remove section 52 from H. R. 8381. It presents a question which should only be considered in connection with other matters which you will be studying in the near future. Certainly this provision should not be repealed before it has been operative, and especially when it is clear that its operation will be of great importance to a large segment of our economy.

The CHAIRMAN. Thank you, Senator Sparkman. What you have said will be of great influence with the chairman and members of the committee.

Senator SPARKMAN. Thank you, Mr. Chairman and gentlemen of the committee.

The CHAIRMAN. Thank you very much.

The next witness is Mr. David W. Herrmann, the chairman of the committee on fiscal policy and taxation of the American Retail Federation.

Will you come forward, please, sir.

STATEMENT OF DAVID W. HERRMANN, CHAIRMAN, COMMITTEE ON FISCAL POLICY AND TAXATION, AMERICAN RETAIL FEDERATION

The CHAIRMAN. Will you proceed?

Mr. HERRMANN. My name is David W. Herrmann. I am executive vice-president of Melville Shoe Corp, and I am appearing here as chairman of the tax committee of the American Retail Federation, with offices at 1145 19th Street NW., Washington, D. C.

The Melville Shoe Corp. operates 1,013 stores throughout the United States, under the names of Thom McAn, Miles, and John Ward.

The American Retail Federation, hereinafter referred to as the federation, is a federation of 38 statewide associations of retailers and 31 national retail associations, representing through their combined membership more than 800,000 retail establishments. A list of the association members of the federation is attached to this statement.

The retail organizations represented by the federation are strongly opposed to section 14 of H. R. 8381, which proposes the addition of a new section 178 (a) (1) (2) to the 1954 Internal Revenue Code, relating to depreciation or amortization of improvements made by the lessee on the lessor's property. This opposition does not relate to the provision covering a related lessee and lessor.

This new section provides that—

> except as provided in subsection (b) (which applies to related lessor and lessee) in determining the amount allowable to a lessee as a deduction for any taxable year for exhaustion, wear and tear, obsolescence, or amortization—
>
> (1) in respect to any building erected (or other improvement made) on the leased property, or
>
> (2) in respect to any cost of acquiring the lease, the term of the lease shall be treated as including any period for which the lease may be renewed, extended, or continued, pursuant to an option (whether or not specifically provided for in the lease) exercisable by the lessee, unless the lessee establishes that (as of the close of the taxable year) it is more probable that the lease will not be renewed, extended or continued for such period than that the lease will be so renewed, extended or continued.

We are confident that we can safely state that all segments of the retail industry concur in this opposition.

It will be almost impossible for a lessee taxpayer to establish that it is more probable a lease will not be renewed, extended, or continued, subject to existing options, as long as such options are not specifically waived by the lessee. The very inclusion and existence of such options in a lease, for the protection of the lessee, indicates there is a possibility they will be exercised, if it is to the advantage of the lessee to do so. In such a situation, the burden of proof is one the lessee might find most difficult to bear. It is completely unrealistic to expect that any taxpayer can forecast the future 10 years in advance, for the purpose of determining whether an option of renewal will be exercised or abandoned. The unfortunate result will, undoubtedly, force the lessee to pay considerably more taxes, during the original term, than under existing rules.

Section 14 will impose undue hardship upon retailers, small and large alike, and will probably result in considerable loss of revenue to the Federal Government.

Presently, the cost of improvements borne by a lessee is recoverable over the life of the improvement, or the remaining term of the lease, whichever is shorter. For this purpose, the life of the lease is confined to the original term, and is not inclusive of any extended period subject to options of renewal.

In line with customary practice, retailers have generally endeavored to obtain leases which grant options of renewal. The leasing of new locations for retail stores involves certain hazards and uncertainties, which make this practice not alone desirable but, in most instances, necessary to a successful operation. If a location proves profitable, a retailer must insure continued occupancy to capitalize on the goodwill and consumer acceptance built up over a period of years, and which may have required a considerable expenditure in the process of building.

The retail business is precarious at its best. It involves a considerable element of gamble. Large sums are invested in improving leased property, without any assurance of return. Capital expended on improvements and betterments must be recovered completely out of earnings during the original period of the lease, without consideration to the purely conjectural possibilities that existing options might be exercised.

If a store proves successful, and a lease is extended and renewed, there can be no further charges for depreciation, except those resulting from additional capital expenditures. If an option to renew is not exercised, certainly the necessity for recovery during the original term is of paramount importance.

Trends in store design are in constant state of flux, and require the accumulation of adequate reserves for modernization and rehabilitation, vital to maintain prestige and consumer acceptance.

According to statistics compiled by Chain Store Age, it is estimated that during the year 1958, $1,348 billion will be spent on modernization and construction by chainstores exclusively. This compares to an expenditure in 1957, $1.206 billion. Of these amounts, it is further estimated that seven-twelfths of the total were spent by lessees, five-twelfths by lessors. Therefore, total expenditures by chain store lessees of leased property were approximately $700 million in 1957, and are estimated to approximate $800 million in 1958. It is reasonable to assume, that if the provisions of section 14 were in effect during 1957, these expenditures would have been materially reduced.

Depreciation should always be on a conservative basis, in line with good business principles, so that funds are available, when necessary, to implement a progressive program of modernization, to the effect that the store will consistently be maintained on a competitive basis.

The rate of depreciation is one element of the tax program through which the Federal Government cannot lose ultimate revenue. Depreciation charges, under the present law, insuring the recovery of capital expenditures, if profits permit, reduce taxable profits during the original term of the lease, and inversely increase such taxable profits during any extended period subject to an option of renewal.

I would like to interpolate, Senators, at this point, I have read a statement given before the Ways and Means Committee that a large overpayment of taxes as a result of section 14 might be recovered during the last year of the lease. This will undoubtedly be true where profits of a large enterprise or from other sources are sufficient to offset a charge for unused depreciation. Although the provisions of this bill will handicap all taxpayers, large and small, the impact will be considerably greater in the instance of small business and of the small-business man who must discontinue business or pull up stakes and start all over again if he has the means of doing so. This represents an inequity in section 14 to give industry a stimulant and not a sedative.

The provisions of the Mills bill would compel lessees to abandon sound time-tested principles, by foregoing options of renewal to preserve working capital and maintain normal cash flow during the original term of the lease.

Additional capital expenditures and expansions are not financed solely through the employment of net earnings after taxes. A business, to remain healthy, requires sufficient cash flow, consisting of a combination of net earnings after taxes and liquid assets derived from depreciation it is able to earn. A higher tax liability, during the original term of the lease, drains cash through an unrealistic reduction of depreciation rates, siphons off funds needed for normal business requirements, decreases cash flow and, consequently, curtails growth and expansion, and expenditures for improvements and betterments necessary to maintain or increase sales volume.

Any tax measure, which inevitably curtails or prevents such capital expenditures, will adversely affect our economy, prevent full employment, and is immediately, and over the long-term, prejudicial to the best interests of business, and of the Federal Government through the reduction of tax revenues.

If section 14 of H. R. 8381 is enacted into the code, the Federal Government will be constituting itself a borrower at the expense of lessees, who can ill afford increased operating expense. By overpaying taxes, through reduced depreciation rates during the original term of lease, lessees can only hope for recovery during a period that may be extended by option, but which may never materialize. The Federal Government will be in a position, that cannot be morally justified, of having collected and retained funds from many persons, firms, and corporations, that it need not return, because of inequitable and poorly conceived tax legislation.

Section 14 of H. R. 8381 is one of the most injurious and inimical provisions to all business, including small business, that has been proposed in many years. It is inconceivable that such a provision could have been proposed at a time when relief for small business is the bipartisan objective of both Houses of Congress.

It is difficult to believe the Ways and Means Committee, when it introduced H. R. 8381, realized the implications and the impact of section 14, on small business, big business and, also, on Federal tax revenues which must inevitably suffer. Representative Mills has recently stated his position on relief, which might be necessary through the reduction of tax rates, to stimulate a falling economy and to free funds for increased consumer spending that might stop a further slide.

I am only citing the foregoing, to indicate that nothing could be more inconsistent with this policy than the imposition of onerous depreciation provisions, which would further impede business, curtail growth and expansion, and discourage new enterprise. If, over a reasonable period, no additional revenues will accrue to the Federal Government through the provisions of section 14, then this proposal must be regarded as either unsound, or punitive.

Business is presently struggling under the strain of constantly rising costs, declining ratio of profit, and excessive tax rates. Maybe the time is not propitious, because of military considerations and increased budgetary requirements, for a complete review and revamping of our federal tax structure, which must be undertaken and eventually accomplished. That is a subject which may be regarded as extracurricular, and beyond the scope of this presentation.

However, the imposition of additional burdens upon business, when relief is the keynote of popular demand, reflects a policy that cannot be justified by any existing or compelling circumstances.

All business should not be penalized because of a few transgressors, or isolated situations.

There is no evidence, or indication, that lessees of premises for retail establishments are temporarily enjoying abnormal rates of depreciation by entering into short-term leases, designed to obtain any undue tax advantage. This is completely inconsistent with the present trend of expansion and policies of financial institutions, which would render such practices improbable.

Expansion, today, is primarily in shopping centers and roadside stores in line with a radical change in consumer buying habits. The trend is from congested urban areas to the less congested suburbs, or periphery areas around large towns, where modern shopping centers provide ample parking facilities for a nation on wheels.

Financial institutions, which provide the mortgage money for these multimillion dollar projects, demand ample security, backed up by reasonable, long-term leases deposited as collateral. The majority of these leases provide for one or more options of renewal to safeguard any vested interest of the tenant, which is his most valuable asset. In practically every representative shopping center, small local merchants, with local following and identify, are in the majority. They are vital to the success of the center, and they will be irreparably injured, if impractical depreciation rules prevent them from signing leases with options. The risk they assume makes recovery of their capital expenditure, during the original term of the lease, imperative. Their reluctance, or inability to provide for options, if section 14 is enacted into law, may compel them to surrender valuable leaseholds, or submit to demands for exhorbitant rental increases, upon termination of the original term.

Section 14 of H. R. 8381 imposes upon the Federal Government a moral obligation over which it must pause and ponder. If a lessee, occupying the premises subject to a lease including one or more options, determines not to exercise said options, but has overpaid his taxes in accordance with the provisions of section 14, he may be unable to recover such overpayment during his last taxable year, even by availing himself of the carryback provisions of the code. It is extremely likely that this will happen in many instances where leases are not renewed. An option to renew will not be exercised primarily because a store has become unprofitable, and continued operation would only result in further depletion of capital.

For example, a lessee, occupying premises subject to a 10-year lease, with two 10-year options of renewal, decides to discontinue business.

He has spent $45,000 on improvements and betterments. Under existing law, he would be permitted $4,500 per year depreciation on the straight line method, and would have recovered his entire investment during 10 years of the original term.

However, under section 14, he would be permitted only $1,500 per year depreciation. During the original term, he will have recovered only $15,000 through depreciation, and will have overpaid his taxes—at a 30-percent rate—by $9,000, because of $30,000 unused depreciation. If the last 3 years of operation resulted in a profit of $3,000 per year, only $9,000 of unused depreciation could be charged against this profit (last year of the term, plus 2 years carryback). Consequently, only $2,700 of the $9,000 overpayment could be recovered. The Federal Government would retain $6,300, which the taxpayer could never recover.

Senators, I would like to interpolate at this point.

I have read a statement, made before the Ways and Means Committee, that a large overpayment of taxes, as a result of section 14, might be recovered during the last year of the lease.

This will, undoubtedly, be true, where profits of a large enterprise, or from other sources, are sufficient to offset a charge for unused depreciation. Although the provisions of this bill will handicap all taxpayers, large and small, the impact will be considerably greater in the instance of the small-business man who must discontinue business, or pull up stakes and start all over again if he has the means of doing so.

This represents an inequity inherent in section 14. We are not asking that the committee correct this inequity separately, in view of our hope that this section will be deleted from the bill.

Industry is presently creaking under the strain of a tax program, which appears to have reached the point of diminishing returns for both the taxpayer and the Federal Government. Depreciation provisions and regulations require liberalization—not tightening. This is the time for Congress to take aggressive, constructive, and sympathetic action, to give industry a stimulant, not a sedative.

And I wish to thank the members of this committee for the opportunity of making this statement, which is of grave concern to the entire retail industry.

The CHAIRMAN. We thank you, Mr. Herrmann, for a very interesting presentation.

Are there any questions?

Thank you for your appearance.

The next witness is Mr. William C. Greenough, president of the Teachers Insurance & Annuity Association of America.

Will you proceed in your own way?

STATEMENT OF WILLIAM C. GREENOUGH, PRESIDENT, TEACHERS INSURANCE & ANNUITY ASSOCIATION OF AMERICA

Mr. GREENOUGH. I am William C. Greenough, president of the Teachers Insurance & Annuity Association. I am appearing before your committee to speak in support of section 19 of H. R. 8381 as it applies to the retirement plans of educational organizations, and to request the consideration by this committee of related problems under section 55 and 57 of H. R. 8381.

Our interest in this matter is in behalf of participants and beneficiaries under the nearly 800 retirement plans of United States education organizations which are funded and administered through contracts issued by us.

TIAA was set up under Carnegie auspices as a common pooling for the whole country and for Canada of the retirement plans of nonprofit educational organizations—none except educational and nonprofit. These are formal plans adopted by the trustees to cover the faculty and staff members.

Now, rather than reading my statement if I might just highlight some of it, it will take a little less time.

The CHAIRMAN. Without objection your prepared statement will be printed in the record in full, and you may summarize your views orally as you so desire.

(The statement referred to is as follows:)

STATEMENT OF WILLIAM C. GREENOUGH, PRESIDENT TEACHERS INSURANCE & ANNUITY ASSOCIATION OF AMERICA

My name is William C. Greenough, and I am president of Teachers Insurance & Annuity Association of America, New York, N. Y. I am appearing before this committee to speak in support of section 19 of H. R. 8381 as it applies to the retirement plans of educational organizations, and to request the consideration by this committee of related problems under sections 55 and 57 of H. R. 8381, involving sections 101 (b) (2) (B), 403 (a) (2), and 2039 (c) of the Internal Revenue Code of 1954.

Our interest in this matter is in behalf of participants and beneficiaries under the 774 retirement plans of United States educational organizations (as of the end of 1957) which are funded and administered through contracts issued by us.

Section 19 of H. R. 8381 would amend section 403 (a) (1) of the 1954 code by adding a new section 403 (b). This new subsection would cover the purchase of employee annuities by nonprofit charitable, educational, and religious organizations now provided for in section 403 (a) (1). Its effect would be to limit the exclusion from current income of the employer's contributions in any taxable year for the employee's retirement to 20 percent of the employee's compensation in that year. Provision is made for past service benefits and plan adjustments by making this limit cumulative for prior years of employment.

The present provision in section 403 (a) (1) for the purchase of employee annuities derives from the same provision in section 22 (b) (2) (B) of the code as it existed prior to 1954. This in turn originated in the 1942 amendments to the code which imposed restrictions on retirement plans generally as a condition of certain tax advantages. At the same time the Congress concluded that these restrictions would create unnecessary problems under the retirement plans of section 101 (6) nonprofit organizations. Since these organizations gain no tax advantage from the deductibility of contributions to a retirement plan, there was no reason to subject them to the requirements of "qualification" of the plan. As a result, provision was made for exclusion of employer contributions from the employee's current income without regard to "qualification."

More recently, however, certain problems have appeared under this section. In the early 1950's a few arrangements came to our attention whereby nonprofit organizations, at an employee's request, reduced his compensation and applied a corresponding sum of money to the purchase of an annuity for him. We never believed that this was an effective tax-avoidance device, since it appeared to us that the employer was doing no more than using the employee's money for the annuity purchase. We were therefore happy that the Internal Revenue Service confirmed this position in 1954, by the issuance of Revenue ruling 54—267, and again in 1956 in the issuance of proposed regulations on retirement plans.

Nevertheless the Treasury apparently has felt the situation to be sufficiently doubtful that in November 1956 it proposed legislation on the subject to the Mills subcommittee on the House Committee on Ways and Means, as item No. 13 of the recommendations submitted at that time. We appeared before the subcommittee hearings to describe some of the difficulties that appeared to us in an arbitrary limit of 10 percent as proposed, and to urge that a further trial be given to control of the situation by regulations along the lines of Revenue ruling 54 267. The Committee on Ways and Means, however, concluded that legislation was needed. This was provided in section 19 of H. R. 8381, which was passed by the House of Representatives without amendment in this respect.

We believe that, if legislation is deemed necessary, the formula set forth in section 19 is an equitable solution to the problem. The increase of the proposed limitation to 20 percent allows reasonable latitude for the development of sound retirement plans, which the 10 percent limitation did not. Skillful drafting of the cumulative limitation appears to take care of most of the difficulties which had occurred to us and which we described before the Committee on Ways and Means. At the same time, there seems to be little scope left for any very attractive misuse of the provision made for the retirement plans of educational organizations.

We would make only two technical suggestions regarding section 19:

(1) As the section is drafted, if an institution has a "qualified" plan, it could make either no additional contributions or up to 20 percent additional contributions, depending on whether the same or a different annuity contract is used. We would suggest integration, that is, that any contributions to a "qualified" plan be deducted from the 20 percent. This may be particularly important to avoid uncertainty in cases where there is a retirement plan concerning which no "qualification" determination has been made.

(2) We would also suggest that consideration be given to a proviso that the exclusion allowance (that is, the limit of permissible contributions) should not in any event be less than 20 percent of compensation for the taxable year. Otherwise under certain circumstances, as a result of the cumulation of exclusion allowances, an employee whose salary was reduced might not be eligible for any employer contributions in a given year.

We now wish to turn to the request for further consideration mentioned above. Before the Internal Revenue Code of 1954 was enacted, participants and beneficiaries under the retirement plans of tax-exempt educational organizations were given the same tax treatment as participants and beneficiaries under the "qualified" retirement plans of taxable commercial organizations. This resulted from the provision in the old section 22 (b) (2) (B), discussed above, which dealt with the status of employer contributions to retirement plans as they affect individual income tax liability. This provision was continued in substance in section 403 (a) (1) of the 1954 Code, and to that extent consistent treatment under the retirement plans of tax-exempt educational organizations has been continued.

At the same time, however, the 1954 code included three additional tax relief provisions for participants and beneficiaries of retirement plans which were made available only in the case of retirement plans "qualified" with the Internal Revenue Service. Each of these relief provisions has a history of its own, and we do not wish to argue the necessity of any one of these provisions as they generally apply to retirement systems. We do, however, urge that if they are made available under "qualified" retirement plans of commercial organizations, they should equally be made available under the retirement plans of tax-exempt educational organizations, within any limitation which may now be deemed proper in this Committee's consideration of section 403 (a) (1). We submit that the reasons for the tax treatment granted under the old Section 22 (b) (2) (B) of the 1939 Code apply equally today, and that they extend to all applicable sections.

The provisions in question were referred to by us in our appearance before the Mills Subcommittee, and are as follows:

(1) Section 101 (b) (2) (B). Income tax exemption up to $5,000 for nonforfeitable death benefits. Under a retirement plan with vested death benefits prior to retirement, the payment of such death benefits results in taxable income to the beneficiary to the extent that the payment exceeds the employee's own contributions. If the plan is "qualified" the beneficiary has a further income tax exclusion of $5,000 if a single sum payment is involved.

(2) Section 403 (a) (2). Capital gains treatment for single sum distributions on termination of employment or death. On termination of service or death, any payment in excess of an employee's contributions made under a plan which has not been "qualified," is taxed in full at the ordinary income tax rate. Under a "qualified" plan the amount of such excess if paid in a single sum is taxable at the capital gains rate.

(3) Section 2039 (c). Estate tax exemption for value of death benefits resulting from employer contributions. This relief provision excludes from a tax-

able estate benefits to a named beneficiary resulting from an employer's contributions to a "qualified" plan. Section 55 of H. R. 8381 brings this section forward for a technical amendment.

Each of these sections could appropriately be dealt with in section 19, because of the close relation of the request made by us to the main subject of that section.

Similarly section 57 of H. R. 8381, which proposes a new section 2517, would provide a gift tax exemption for elections on retirement of a joint and survivor annuity. This would parallel the estate tax exemption in section 2039 (c). If favorable consideration is given under that section, we would hope that consistent treatment would follow under the proposed section 2517.

These code provisions are minor in the whole picture of tax benefits under retirement plans, and they involve little or perhaps no revenue loss. To the relatively small number of individual participants and beneficiaries affected, however, they may be of considerable importance. Because of these individual problems, the lesser tax aspects have become a source of annoyance and confusion under those retirement plans of educational institutions where deaths or other occurrences have forced individual situations to attention, and the number of these will undoubtedly continue to grow.

We respectfully suggest that the best means of solving this problem is to extend consistent tax treatment under the new provisions of the 1954 code. Once the basic question of the fair limits of employer contributions under these retirement plans has been settled, whether it be for or against a specific percentage limitation, it should be completely feasible to make such an extension. If a percentage limitation is imposed in the proposed new section 403 (b), this of course can be incorporated (probably by cross-reference) in the other sections as applied to these retirement plans.

We scarcely need to call attention to the problems which will be faced by the educational organizations in this country in the coming years, with the vastly increased importance of scientific knowledge, and with the growth of college populations. Our educational organizations need to attract and hold the best caliber of people for their staffs; and sound retirement plans play an important part in this. We therefore hope that this committee will see fit to continue the general tax situation as it existed prior to 1954, under which college retirement plans have grown strong, and to eliminate those present discriminations which give rise to dissatisfaction among a dedicated but relatively poorly paid group of scientists, teachers, and other academicians.

Mr. GREENOUGH. You know the literally fantastic problems the colleges will have in staffing during the next 20 years. Good retirement plans are a part of the job of attracting academic talent. Regarding college retirement plans, there are some unique items.

The first one is that these 800 plans give benefits to the individuals which are fully vested: that is, the contributions made by the employer are owned by the individual at all times, so that he can transfer from Columbia University to Michigan, Indiana to Stanford without loss of his retirement benefits. This is a socially desirable type of plan for the colleges.

Secondly, the colleges' contribution is a full dollar contribution. A college has no tax advantage to gain from its retirement plan—since it is nonprofit, it is a full dollar the college is spending.

Thirdly, one great area, a very great area for making employment attractive simply is not available to colleges; that is, profit-sharing plans, where not only are the profits shared, which is impossible in the colleges, but the sharing is under a tax shelter. And this is perfectly all right, but it is not available to the colleges. Therefore, the retirement plan is even more important for holding good staff members.

Now, on the specific points. As to the employer status, there is no need in dealing with nonprofits for justifying the expense of a retirement plan as a tax deduction for the employer. Therefore, no need for "qualification" of the plans.

Section 22 (b) 2 (b) of the 1939 code made the employer contributions of nonprofits excludable from the individual's income and in so doing gave the same tax treatment to participants and beneficiaries under such plans as was given under the plans of commercial organizations.

The 1954 code followed the same practice with respect to the employer contributions. But that code added three items, capital-gains treatment, $5,000 death benefit income-tax exemption, and an estate tax exemption, for beneficiaries and participants under qualified plans, but not for teachers and their beneficiaries under college plans.

Now, on the employer contributions, as you know, some instances of questionable use of the provisions of the law have come to attention, involving diversion of salary to purchase annuity contracts. The colleges can't do very much with this, since they don't pay very much in salaries, but some of it apparently has gone on for a few employees who can afford it. Our prepared statement goes into detail regarding section 19 and specifies that if legislation is necessary the section 19 limitation of 20 percent seems quite appropriate, and we support it. This means that any amount over 20 percent contributed by a college toward an annuity contract would be taxable income to the individual.

This occasional diversion of salary is the only questionable practice that has come to our attention, or, so far as the Treasury informs us, to their attention, and it can be controlled by the 20 percent limitation. With this limit of excludable employer contribution defined, it is difficult to see why the participants and beneficiaries under the retirement plans of the colleges are not treated consistently with their counterparts in industry.

The statement indicates the manner in which they are not now treated consistently. For instance, if a participant under a qualified retirement plan of a commercial organization dies, his beneficiary gets an additional $5,000 death benefit exclusion from income tax of retirement plan death benefits. However, if a college is following Congress' wishes, as expressed under section 403 (a) (1) of the 1954 code, covering purchase of employee annuities by nonprofits, and one of its professors dies, the widow does not get the $5,000 exemption that she would under a plan of a commercial organization. It seems appropriate to ask why this different treatment of college professors and their beneficiaries?

We hold no special brief for the 3 items, the capital gains treatment, $5,000 income-tax exemption on death benefits, and so forth, but if they are given to participants and beneficiaries of commercial concerns, then we submit they should be for nonprofit institutions also.

Just a very quick remark on qualification, which is not covered in the prepared statement. Nonprofit organizations could qualify their plans, technically they can. The main reason for going through the qualification procedure is so that a commercial organization can exclude its retirement plan contributions from its own taxable income, which the nonprofit does not need to do, and gets no benefit from.

Likewise procedures and requirements as to qualifications were set up with industrial, etc. plans in mind, and raise difficult as well as nuisance problems for nonprofit organizations, including not only the colleges but also religious and charitable organizations. The procedures arbitrary restrictions, tests and so on, are necessarily lengthy and complicated to cover the problems encountered in industrial retirement plans. Representatives of the Associations of American Colleges and the American Council on Education, have pointed out the real actuarial, legal, and so on, problems, for the 1,000 small colleges throughout the country if they are to qualify. And the churches would be in the same position.

So it is difficult to see any need for going through the essentially irrelevant task of qualifying the college retirement plan, and yet if a college does not qualify, it is not the college that is hurt, it is the faculty members and their beneficiaries.

So we suggest just two conclusions. The one area of uncertainty that has shown up in nonprofit organization retirement plans can be controlled by regulation, perhaps, but if legislation is necessary, by the proposed 20 percent limitation on excludable contributions of the employer in section 19 of H. R. 8381.

And having taken this step, we submit that the same treatment in the other matter should be given to participants and beneficiaries in college plans as in those of commercial companies. We are not asking better treatment for the college faculty member, staff member, or their beneficiaries, merely the same treatment.

Thank you, sir.

The CHAIRMAN. I understand it is your position that you favor section 19 except for two technical suggestions?

Mr. GREENOUGH. Yes, sir. There are two minor technical things that are spelled out in my prepared statement.

The CHAIRMAN. Thank you very much, sir.

Are there any questions?

There are no question.

Thank you.

(The following communication from Mr. Hurst R. Anderson, chairman of the commission on legislation of the Association of American Colleges, was subsequently submitted for inclusion in the record endorsing the testimony of the preceding witness:)

ASSOCIATION OF AMERICAN COLLEGES,
Washington, D. C., February 26, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: I am writing in my capacity as chairman of the commission on legislation of the Association of American Colleges to bring to your attention the interest of my association in testimony which I understand is to be given to the Senate Finance Committee on Thursday, February 27, by the Teachers Insurance and Annuity Association.

This testimony relates to the hearing in college and university retirement plans of certain provisions of the 1954 Internal Revenue Code and other provisions included in the amending bill H. R. 8381 now before your committee.

My association desires to support the recommendations to be made to the committee by TIAA for amendment of the Internal Revenue Code, because such amendment would relieve our members from the painful dilemma of seeing their faculties treated less favorably for retirement purposes than the employees of ordinary commercial undertakings or of having to go through complicated administrative procedures which would involve a lot of work and little or no benefit to anybody.

The case is explained in detail in the enclosed bulletin prepared by TIAA but the essentials of the argument are given in the few sentences I have underlined in red on pages 1 and 3 of the bulletin.

You will see that we are not asking that colleges be given any special privileges but only that their faculty members be treated on a footing of equality with the staffs of profitmaking organizations. I need hardly suggest to you that this is no time for unreasonable discrimination against college teachers. Nor, I think, will you need any persuasion that in these days of rising costs and staff shortages educational institutions cannot readily face an addition to their administrative burdens.

I hope, therefore, that you and your colleagues will give a sympathetic hearing to the testimony of TI.' ' in the knowledge that it is a matter of substantial concern to many, if not most, of the 704 liberal arts colleges represented by my association.

Sincerely,

HURST R. ANDERSON,
Chairman, Commission on Legislation.

[Bulletin, November 1957, Teachers Insurance & Annuity Association of America, College Retirement Equities Fund., New York, N. Y.]

FEDERAL TAX PROBLEMS UNDER COLLEGE RETIREMENT PLANS

Certain provisions of the 1954 Internal Revenue Code provide more favorable tax treatment for employees of retirement plans "qualified" with the Internal Revenue Service than for employees of tax-exempt educational organizations whose plans have not been qualified. The purpose of this bulletin is to outline the problem and to suggest an appropriate course of action.

"Qualification" of a business or industrial retirement plan permits the employer to class his contributions to the plan as a business expense, and hence not subject to taxation.[1] To qualify, a retirement plan must be submitted to the district director of internal revenue and must meet specific requirements and tests. A principal objective of the law is to make certain that tax advantages to the employer accrue only under plans that do not discriminate in favor of selected employees, and to further certain social objectives.

As a tax-exempt educational organization derives no tax advantage from classifying contributions to its retirement plan as a business expense, qualification for this purpose has never been required. However, the 1954 Internal Revenue Code introduced provisions that give more favorable tax treatment to employees and beneficiaries under qualified plans than to employees under educational organizations' plans that have not been qualified.

The tax relief items that are extended only to participants of qualified plans are itemized below:

(1) Capital gains treatment for single sum distributions on termination of employment or death (sec. 403(a)(2)). On termination of service or death, any payment made under an unqualified plan in excess of an employee's contributions is taxed in full at the ordinary income-tax rate. Under a qualified plan the amount of such excess is taxable at the capital gains rate. Thus it is taxable at 25 percent, or if less, at the ordinary income tax rate on one-half of the excess.

(2) Income tax exemption up to $5,000 for nonforfeitable death benefits (sec. 102(b)(2)(B). Under a retirement plan with vested death benefits prior to retirement, the payment of such death benefits results in taxable income to the beneficiary to the extent that the payment exceeds the empolyee's own contributions. If the plan is qualified the beneficiary has a further income tax exclusion of $5,000 if a single sum payment is involved.

(3) Estate tax exemption for value of death benefits resulting from employer contributions (sec. 2039(c)). This relief provision excludes from a taxable estate benefits to a named beneficiary resulting from an employer's contributions to a qualified plan.

In addition, legislation now pending would add a gift tax exemption on election of last survivor annuity (H. R. 8381, sec. 57).

Repercussions on the employing institution following from these provisions may be considerable, even though not all college employees are of the ages or ranks most likely to be adversely affected. It will be apparent that the financial impact will usually be on the widow or other survivor of a staff member.

In studying the problem, two means of achieving equitable treatment for educational employees and their beneficiaries may be considered: (1) legislative extension of the above tax relief items to the plans of educational organizations,

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[1] In addition, qualification is required of an industrial plan in order that the retirement contributions of the employer may be excluded from the employee's current taxable income. Contributions of nonprofit educational employers are generally excludable without qualifying. See p. 4 of this bulletin for discussion of this provision and a proposed limitation.

or, if this should fail, (2) taking the steps necessary to qualify the colleges' retirement plans.

QUALIFICATION

Since the procedures and requirements for qualification were established for industrial retirement plans, both serious and nuisance problems are raised for nonprofit institutions that try to fit their retirement plans into these patterns. The same problem affects nonprofit religious and charitable organizations as well as educational institutions.

We are certain that, with only sporadic exceptions, TIAA-CREF retirement plans come well within the spirit of the qualification requirements. The Internal Revenue Service, however, has had little occasion to review plans of educational institutions, so there are a number of questions to which answers are not now available. Furthermore, the qualification procedures, tests, and certain arbitrary restrictions tend to be lengthy and complicated. It is necessary to follow and comply with sections 401 to 404 of the Internal Revenue Code of 1954, Treasury Regulations, sections 1.401 to 1.404, and Revenue Ruling 57-163 (1957-16 I. R. B. pp. 10-38). Revenue Procedure 56-12 (1956-1 C. B., p. 1029) is also applicable. These tests and regulations were not established with nonprofit educational institutions in mind. To meet the requirements precisely, redrafting of retirement resolutions will be necessary in most cases, including class definitions, provisions for rights on termination of employment, and past service provisions. Trying to fit educational plans into an industrial qualification pattern would mean that educational institutions would be burdened with complicated technical and substantive problems.

Even where there is a minimum of problems with respect to the substantive provisions of the plan, the process of preparation and submissions of material to the Internal Revenue Service is a laborious matter. Extensive calculations and paperwork are necessary. The individual submission is made to the local district director of internal revenue and many district directors will have to consider the same questions, adding to the already heavy workload of the pension reviewers.

CHANGES IN THE LAW

The alternative to the cumbersome and essentially irrelevant task of qualifying an academic retirement plan is a change in the 1954 Revenue Code. The change would involve extending to employees of tax-exempt organizations the tax benefits already available to employees participating in qualified plans. Prior to the 1954 code, equal tax treatment was given to employees in college plans under the existing tax provisions, and this treatment, so far as it went, was continued in the 1954 code. Extension of these new provisions would simply continue and make entirely consistent the policy of Congress toward educational institutions expressed when the qualification provisions were first introduced into the law in 1942. It is important that this policy be fully restored in practice so that the existing tax benefits for annuitants and their beneficiaries contained in the 1954 code be extended to participants in retirement plans of educational organizations not having qualified plans. Concurrently, any new favorable tax treatment, such as the gift tax provision referred to, should be extended to educational organizations' retirement plans as well as to qualified plans.

The basic objectives of qualification are already being met by educational organizations and the procedures involved in actual qualification are not useful or appropriate in connection with them. Employees under the colleges' retirement plans should be entitled to the same tax benefits as employees under qualified plans, without the college employer having to undergo the process of qualification.

We hope that all proper representations to Congress will be made at this time in connection with hearings to be held by the House Ways and Means Committee commencing January 7, 1958, on amendments to the Internal Revenue Code, and by the Senate Finance Committee on H. R. 8381 when it is passed by the House.

PROPOSED LEGISLATION REGARDING EXCLUSION OF EMPLOYER CONTRIBUTIONS FROM EMPLOYEE'S TAXABLE INCOME

Another tax development that colleges and universities and their educational association representatives have been following is reported on below.

A proposed amendment to the Internal Revenue Code of 1954 regarding the exclusion of employer contributions from the employee's taxable income is contained in section 19 (a) of the technical amendments bill of 1957 (H. R. 8381), expected to come before the House of Representatives in early 1958. The amendment places a limit on the amount of the contribution by educational institutions toward the purchase of an annuity for an employee that may be excluded from the employee's current taxable income.

Under present law, when an employer exempt from income tax under section 501 (c) (3) of the Internal Revenue Code makes a contribution for the purchase of an annuity for an employee this contribution is not currently includible in the employee's taxable income. Accordingly, this amount is not taken into account in determining the basis to be recovered tax free when annuity payments begin. The net result is the deferment of tax upon such contributions until they are returned in the form of annuity or other payments. This is the same treatment provided under qualified plans.

Since the introduction of this provision (1942) it has appeared that in some cases tax-exempt organizations have at the request of an employee reduced his salary considerably and applied a corresponding sum to the purchase of an annuity for him, in the belief that this would result in an exclusion from the employee's taxable income.

The Treasury and the Mills subcommittee of the House Ways and Means Committee thought that some specific limitation on the amount excludable from the employee's taxable income is necessary. A limitation of the annuity contributions of tax-exempt organizations of 10 percent of the employee's salary was first considered. After the hearings before the Mills subcommittee on this and other subjects, in which educational organizations were represented, the full Ways and Means Committee included a provision for a 20-percent limit in the bill finally reported, H. R. 8381, now pending before the House.

If it is felt necessary to impose a specific limit on tax-free contributions, the proposed 20-percent limit, rather than the 10-percent limit, seems to be a reasonable and satisfactory resolution of the problem, especially as there is a provision extending the limit when past service benefits are to be financed. A 20-percent employer contribution limit encompasses the contribution rates prevailing at the vast majority of colleges. We call the attention of the colleges to this proposed legislation so that they may examine their retirement plans to determine the effect, if any, on their plans.

The CHAIRMAN. The next witness is Mr. Walter J. Rockler.

STATEMENT OF WALTER J. ROCKLER, OF LEDERER, LIVINGSTON, KAHN & ADSIT, CHICAGO, ILL.

The CHAIRMAN. Mr. Rockler, will you identify yourself and proceed?

Mr. ROCKLER. Mr. Chairman and members of the Finance Committee, my name is Walter J. Rockler and I am a member of the law firm of Lederer, Livingston, Kahn & Adsit of Chicago, Ill. I am appearing on behalf of Controls Company of America, Schiller Park, Ill., which is one of the principal manufacturers in the United States of home appliance and heating system controls and aircraft and missile components.

My purpose in appearing before you today is limited and specific, namely, to call your attention to the harsh and unfair effect of the proposed retroactive application of section 24 of House bill 8381. I should like to make it clear that we have little objection to the substantive provisions of this section. My comment is directed solely to the effective date of the provision, which in many instances will impose unjust and unfair taxes, simply because taxpayers acted in reliance on section 481 of the present code.

Proposed section 24, entitled "Adjustments Required by Changes in Method of Accounting," amends section 481 of the 1954 code. As you may recall, before the enactment of the 1954 code the consequences of a change of method in accounting where not governed by any specific statutory provision and were relatively unpredictable. In some instances a taxpayer might be required to duplicate income, in other instances a taxpayer might entirely avoid tax on increments of income accruing over many years. In general, the courts made a sharp distinction between "involuntary" changes in accounting methods, that is, changes forced by the Commissioner of Internal Revenue, and "voluntary" changes, resulting from the taxpayer's choice. Where the Commissioner compelled a change, judicial decisions tended to protect the affected taxpayers. As a result, in many situations where a particular method of accounting was questionable but had been in practice for a long period of time, taxpayers and the Government were at an impasse. Because a voluntary change in method would result in tax in a single year on income derived over many years, taxpayers could not ordinarily afford to make the change. On the other hand, the Commissioner was not inclined to compel the change where this might lead to some loss of taxes. Accordingly, the pre-1954 law encouraged continuance of incorrect or doubtful accounting methods.

Section 481 of H. R. 8300, the House version of the 1954 code, proposed to remedy the previous situation by abolishing the distinction between voluntary and involuntary changes in methods of accounting and taxing income resulting from any change. This would have been accomplished through adjustments which, in any change involving substantial amounts of income, would have taxed such income over a 3-year period.

When H. R. 8300 was reviewed by this committee, however, section 481 was amended to provide that—

> no part of the transitional adjustments will be based on items that were, or should have been, under the proper method of accounting, taken into account as an income-producing factor for taxable years to which subtitle A of the 1954 code does not apply. (See S. Rept. 1622, 83d Cong., 2d sess., p. 308, 1954).

The view of this committee was adopted in the final legislation in 1954. (See I. R. C. 1954, sec. 481 (a) (2), last clause thereof; conference report, H. Rept. 2543, 83d Cong., 2d sess., pp. 45–46, amendment No. 99, 1954.) As a result of the amendment made in the Senate Finance Committee, therefore, income attributable to years prior to 1954 could not be taxed under the new code by way of adjustments under section 481.

Because of the encouragement given by this provision, taxpayers were induced to change doubtful methods voluntarily in situations where, prior to 1954, they could not have afforded to make changes.

Proposed section 24 of H. R. 8381 would now retroactively reverse the amendment to the House bill of 1954 made by this committee so as to impose tax on income attributable to pre-1954 periods where the taxpayer voluntarily changes his accounting method. (See H. R. 8381, sec. 24 (a) (1), last clause thereof.) Although this provision flatly repudiates the decision made by the Finance Committee in its review of the 1954 code, this is perhaps not the most troublesome aspect of the proposed section.

In subsection (d) of section 24, the new rule is made applicable not only for future years but also with respect to any taxable year beginning after December 31, 1953.[1]

[1] There is, it is true, an exception provided in the event the taxpayer applied for a change in method according to Treasury regulations, and an agreement was reached on such change. Unfortunately, the Treasury has not provided regulations under this section and, in any event, has been extremely reluctant to reach agreement.

As a result of the combination of provisions in section 24, any taxpayer who was induced by section 481 of the 1954 code to change his accounting method, with the justified expectation that the income of pre-1954 years would not be taxed, is now to be taxed retroactively on that very income. The ultimate effect is to punish such taxpayers under something which very closely resembles a statutory entrapment in the tax area. I would like to illustrate this result in the actual situation of our client.

In 1954 Controls Company of America purchased from unrelated third parties all of the stock of another company, Milwaukee Valve Co., which thereupon became a wholly owned subsidiary. Upon a review of the methods of accounting and reporting of Milwaukee Valve Co., it was determined that the method of inventory valuation theretofore used by Milwaukee Valve for 25 or 30 years was open to objection. In fact, Internal Revenue agents had from time to time challenged the method of inventory valuation without, however, compelling a change of method. In reliance upon section 481 of the code, the method of inventory valuation was changed. The action was based on the express code assurance that any accession to surplus attributable to pre-1954 years would not be taxed in later years.

If section 24 as proposed should be enacted, this "voluntary" change of method will result in a wholly unanticipated tax on the company, and moreover a tax which will raise only because the company has been lured into a vulnerable position by the provisions of section 481 now on the books. Other taxpayers who have been content to continue doubtful accounting methods will under the proposed bill, retain a choice whether to hold fast or incur tax upon a change. We need not, I think, belabor the unfairness of this situation.

The "entrapment" aspect of section 24 in such cases can be avoided simply by providing that the new section shall be applicable only to changes in accounting methods made in taxable years beginning after December 31, 1956. This change in effective dates has obviously limited revenue implications, and will bring the application of the new statutory rule into line with the general principle against retroactive legislation, which this committee has always carefully observed.

Indeed, it may be noted that the House bill itself, for the most part, although it is in general a "loophole closing" bill, avoids retroactive applications of new substantive rules. Of its 82 sections, only 9 substantive sections are made retroactively applicable. Twenty-five sections involving substantive changes in the law are made applicable after either November 7, 1956, or December 31, 1956, or some other date subsequent to August 16, 1954. (These interim dates are dates as of which the Mills committee announced its intentions.) The remaining 48 sections are procedural, or clarifications of present law, or corrections of mechanical slips in the original code. As examples of nonretroactive substantive provisions aimed at rather patent loopholes in the existing code, I would like to refer to sections 3, 9, 11, 12, 16, and 34 of H. R. 8381. Retroactive taxation would be justified much more readily under any of these sections than in the case of section 24, and nevertheless the wise policy of making these provisions nonretroactive has been adopted by the House.

Long ago Mr. Justice Story wrote:

Retrospective laws are, indeed, generally unjust, and as has been forcibly said, neither accord with sound legislation nor with the fundamental principles of social contact.

The Congress has, I believe, very consistently been guided by similar principles. In the light of this well-established congressional policy, a change in the effective date of section 24 seems plainly to be called for. Otherwise the same unjust consequences will result for many taxpayers which the Supreme Court foresaw in a case some years ago where the Treasury attempted to impose a new principle of law retroactively:

> We are asked to make a retroactive holding that for some 7 years past a multitude of transactions have been taxable although there was no source of law from which the most cautious taxpayer could have learned of the liability. If he consulted the decisions of this Court, he learned that no such tax could be imposed; if he read the Delphic language of the act in connection with existing decisions, it, too, assured him there was no intent to tax; if he followed the congressional proceedings and debates, his understanding of nontaxability would be confirmed; if he asked the tax collector himself, he was bound by the regulations of the Treasury to advise that no such liability existed. It would be a pity if taxpayers could not rely on this concurrent assurance from all three branches of the Government. But we are asked to brush all this aside and simply to decree that these transactions are taxable anyway (*Helvering* v. *Griffiths*, 318 U. S. 381, 402 (1943)).

I wish to thank the members of the committee.

The CHAIRMAN. Thank you very much, Mr. Rockler.

Are there any questions? Thank you very much.

(The following letter relating to sec. 24, from Messrs. William A. Kelley, Jr., Folz, Bard, Kamsler, Goodis, and Greenfield, of Philadelphia, was subsequently submitted for the record:)

FOLZ, BARD, KAMSLER, GOODIS & GREENFIELD,
Philadelphia, February 28, 1958.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR SIR: We wish to express our opposition to section 24 of the Technical Amendments Act of 1958, H. R. 8381.

We submit that section 481 of the Internal Revenue Code affords a fair and reasonable solution to the Commissioner's problem as it existed under prior case law and that the amendment contained in section 24 of H. R. 8381 is unjust and should not be passed.

It has always been the rule, under the internal revenue acts, that a manufacturer or retailer, for whom inventories are an income-producing factor, must compute his taxable income upon the accrual method of accounting and by the use of opening and closing inventories. Such a taxpayer who reports income by the cash method deducts payments for inventory, whether related to current sales or not, and omits from income current receivables not collected during the period.

When such a wrong-method taxpayer changes to an accrual method, unless certain adjustments are made, either in the first accrual year or in prior years, the previous wrongful omissions and deductions might never be corrected.

Under the case law, the Commissioner was not allowed to add such items to the first accrual year.[1] The reason for this rule is that a taxpayer cannot be assessed in a given year for wrongful omissions or deductions from prior years.[2] The Commissioner was required to make the appropriate adjustments in the years during which the improper accounting was employed, subject only to the statutory limitation upon assessments for past years.

Some relief was afforded the Commissioner by section 481 of the Internal Revenue Code of 1954. This section prohibits adjustments in the year of change for items related to pre-1954 code years, whether the change be initiated by the

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[1] *Welp* v. *Comm'r*, 201 F. (2d) 128 (8th Cir. 1953); *Comm'r* v. *Dwyer*, 203 F. (2d) 522 (2d Cir. 1953); *David W. Hughes*, 22 T. C. 1 (1954); *Clement A. Bauman*, 22 T. C. 7 (1954); *Elsie SoRelle*, 22 T. C. 459 (1954).

[2] *Comm'r* v. *Dwyer*, 203 F. (2d) 552 (2d Cir. 1953); *Comm'r* v. *Frame*, 195 F. (2d) 166 (3d Cir. 1952); *Est. of Samuel Mnookin*, 12 T. C. 744 (1949); *Greene Motor Co.*, 5 T. C. 314 (1945).

taxpayer or by the Commissioner. The impact of 1954 code year adjustments is mitigated by providing that the additional tax due shall not exceed the aggregate of taxes which would have been due had the adjustments been prorated over the year of change and two or more preceding years.

The sole function of section 24 of H. R. 8381 is to amend section 481 of the Internal Revenue Code of 1954 to remove the prohibition of pre-1954 adjustments in cases where the change from a wrong accounting method to a proper accounting method is initiated by the taxpayer. The relief from such adjustments is preserved for wrong-method taxpayers who take no steps to terminate improper accounting practices, but who instead, wait for the Commissioner to demand the change.

It is a strange principle of justice which penalizes the voluntary correction of improper accounting, while preserving a benefit for the taxpayer who continues to employ an unlawful accounting method—a principle which should not be endorsed by the Senate.

Very truly yours,

WILLIAM A. KELLEY, Jr.

(The following statement of Merle H. Miller of the firm of Ross, McCord, Ice & Miller was subsequently submitted for the record:)

STATEMENT BY MERLE H. MILLER, ATTORNEY, ROSS, MCCORD, ICE & MILLER, INDIANAPOLIS, IND.

SECTION 24. ADJUSTMENTS REQUIRED BY CHANGES IN METHOD OF ACCOUNTING

Section 24 would amend section 481 (b) of the 1954 code by requiring taxpayers who voluntarily change methods of accounting to pick up all adjustments for prior years, while continuing to limit adjustments which may be made by the Commissioner of Internal Revenue to the years commencing after December 31, 1953. I wish to urge the continuation of this limitation on the Commissioner.

Section 481 of the Internal Revenue Code of 1954 as originally passed by the House in effect repealed any statute of limitations on deficiencies arising from any change in accounting methods whether at the instance of the taxpayer or the Commissioner. Although the courts had not allowed the Commissioner to take into income of the current-year items attributable to years barred by the statute of limitations, section 481 expressly allowed this in certain instances and cushioned the impact by allowing a spread of the tax liability over a period of 10 years.

The Senate Finance Committee wisely limited the application of section 481 to years commencing after December 31, 1953. The purpose of the statute of limitations is to allow business to go forward on the assumption that at the end of a certain time it knows its liabilities, and under section 481, as originally passed by the House, that could never be true. For example, a business that had used an erroneous method of valuing its inventory over a period of 20 years, and had had its method of valuing inventory approved on many audits by revenue agents during that time, could suddenly find itself confronted with a tax liability in the year of change of its method of valuing inventory by the revenue agent which might well be fatal to the business. That would be true of an expanding business where the net result of the change in the method of valuing inventory would be to take into account in the current year income that was really attributable to the past 10 or 20 years.

The amendment of section 481 by the Senate was, therefore, wise in that it placed a practical limit on the unforeseen liabilities that might confront a business as a result of changes in methods of accounting. However, this limitation applied to changes initiated by the taxpayer as well as those initiated by the Government, and there is less reason to be solicitous about the taxpayer who initiates the change than about the one who is forced to change pursuant to audit of the internal revenue agent. In the former instance, there is a possibility of changing voluntarily and thereby obtaining a temporary windfall. Section 24 of the technical amendments bill of 1958 would eliminate the possibility of a temporary windfall to one who initiates the change in accounting but would preserve for taxpayers, whose methods of accounting are changed pursuant to audit by the internal revenue agent, benefits intended by the Senate when it amended section 481 of the Internal Revenue Code of 1954 to preclude adjustments with respect to years prior to 1954.

Apparently, the Commissioner has been fearful of the consequences of the application of section 481 to those taxpayers who voluntarily change methods of accounting and so has refrained from issuing regulations under section 481, with the result that agents in the field do not feel free to follow the clear mandate of section 481 and restrict adjustments to years after December 31, 1953. The result is the holding up of the settlement of many many cases with the consequent uncertainties to the businesses involved.

We, therefore, urge the passage of section 24 or such similar provisions as would eliminate the possibility of a windfall at the election of a taxpayer, on the assumption that this amendment would leave the Commissioner free to issue regulations under section 481 to carry out the clear mandate of the Senate Finance Committee as indicated by its report on the Internal Revenue Code of 1954 at page 308. This would permit the settlement of deficiencies presently asserted under section 481 in accordance with the principles previously established by the Senate Finance Committee and eliminate much fruitless litigation.

The CHAIRMAN. The next witness is Mr. Clement J. Clarke, Jr. Will you identify yourself and proceed?

STATEMENT OF CLEMENT J. CLARKE, JR., PHILADELPHIA, PA., ON BEHALF OF PENNSYLVANIA BAR ASSOCIATION

Mr. CLARKE. My name is Clement J. Clarke, Jr. I am a member of the firm of Pepper, Bodine, Frick, Sheetz & Hamilton, of Philadelphia.

Senator SMATHERS. Is that George Wharton Pepper?

Mr. CLARKE. Yes, indeed.

Gentlemen, I am appearing on behalf of both the Pennsylvania Bar Association and the tax committee of the Philadelphia Bar Association. I will comment only on section 24 of H. R. 8481. The general assembly of the Pennsylvania Bar Association has adopted a resolution with regard thereto which has been filed with your committee. The tax committee of the Philadelphia Bar Association has commented on several sections of the bill, and a memorandum setting forth their comments will be left with you today.

I regret that my statement to some extent is a repetition in some parts of the statement that has just been made by the previous witness. However, it will not take more than 10 minutes, and if I may, I would like to proceed with the prepared statement.

The CHAIRMAN. You may proceed.

Mr. CLARKE. Section 24 deals with adjustments required by changes in method of accounting, and I believe it is desirable to set forth some of the background of this section. As an example of the type of problem involved, we will assume that a taxpayer who for many years has a simple accounting system has not included overhead in the valuation of his inventory.

As the business grew in volume, the amount of overhead which should have been included in inventory has been increasing irregularly at an average rate of $5,000 to $10,000 a year.

When the taxpayer installs a cost accounting system, he finds that his closing inventory includes $100,000 of overhead, although the increase in overhead in inventory during the year amounted to only $10,000.

The question is whether by reason of the change in method to include overhead the taxpayer should be required to include the whole $100,000 in income although this item was built up over a period of 15 years or whether only the increase of $10,000 attributable to the current year should be taxable in the current year.

Prior to the 1954 code, there were no statutory provisions setting forth what adjustments were to be made where there was a change in accounting methods. Where the taxpayer requested and obtained permission to change his method of accounting, the Commissioner generally required that all the adjustments be included in the year of change.

However, where the change was made by either the taxpayer or the Commissioner without an agreement, a body of case law developed as to the effect of such changes. Although the cases in this field cannot all be reconciled, there grew up two general lines of authority.

Where the taxpayer initiated the change, there is some authority that adjustments were required in order to prevent the taxpayer from escaping income tax with respect to certain items. Cases supporting this view are Z. W. Koby (14 T. C., 1103 (1950)), William Goodrich (25 T. C., 1235 (1956)). However, the Goodrich case was reversed by the court of appeals for the eighth circuit in *Goodrich* v. *Commissioner* (243 Fed. (2d) 686 (1957)). However, where the Commissioner initiated the change, the cases generally held that the Commissioner could not impose tax on more than the actual income for the current year and that any changes which were attributable to years which were closed by the statute of limitations should be ignored.

The leading cases on this point are *Commissioner* v. *Dwyer* (203 Fed. (2d) 522, second circuit, 1953); *J. H. Welk* v. *United States* (201 Fed. (2d) 128, eighth circuit, 1953); *Caldwell* v. *Commissioner* (202 Fed. (2d) 112, second circuit, 1953).

Earlier cases to the contrary such as *William Hardy* v. *Commissioner* were overruled.

Section 481 of the 1954 code abolished the distinction between changes initiated by the Commissioner and those initiated by the taxpayer. It provides quite clearly that adjustments attributable to years beginning prior to January 1, 1954, are not to be taken into account, and the example in the commitee report clearly demonstrates the application of this principle.

Section 24 of the pending bill would retroactively make a distinction between changes initiated by the taxpayer and those initiated by the Commissioner. It provides for the payment of tax, when the taxpayer initiates the change, with respect to all adjustments regardless of whether they are attributable to years prior to 1954.

Retroactive tax legislation imposing additional burdens by reason of changing the tax effect of particular transactions is usually unfair. It is particularly unfair where thel egislation is retroactive for a period of almost 4 years, and has the effect of trapping taxpayers who acted in reliance upon the express provisions of an act of Congress.

It is pertinent to consider the action of the Internal Revenue Service in this field since the enactment of the 1954 code. Regulations under section 481 have still not been promulgated, and it is expected that they will not be promulgated until sometime after action is taken on the pending legislation.

It is my understanding that the Internal Revenue Service has during this period refused to approve changes in method of accounting unless the taxpayer agreed to make adjustments for all items even though they were attributable to years prior to 1954.

The Internal Revenue Service therefore has been operating in this field in direct conflict with the clear and specific provisions of an act of Congress. The proposed legislation would sanction and enact into law the unauthorized actions of the Internal Revenue Service during this period. Such a precedent might well encourage the Internal Revenue Service in the future to disregard legislation with which they were not in agreement, in hope of having a subsequent Congress overrule the legislation.

The Internal Revenue Service may argue that under section 446 of the code a taxpayer is required to secure the consent of the Secretary of the Treasury or his delegate, and that no consideration should be given to a taxpayer who failed to follow this procedure.

Many changes in accounting methods have been made in the past without obtaining the consent of the commissioner, and the Internal Revenue Service on the audit of the return has the option of accepting the new method of accounting with whatever adjustments are considered appropriate.

Such a procedure has become a practical manner of changing an accounting method, and has been recognized in decided cases. It is particularly appropriate in a situation such as that with which we are here concerned, where the Internal Revenue Service has been exacting a price for approval which is in conflict with the code.

Senator KERR. May I interrupt and ask a question?

Mr. CLARKE. Certainly, sir.

Senator KERR. You talk about section 481 of the 1954 code?

Mr. CLARKE. That is correct, sir.

Senator KERR. Do you think that the enactment of that section created a loophole?

Mr. CLARKE. No, sir; I do not.

Senator KERR. Well, if a taxpayer goes off of the cash basis on to the accrual basis, and thereby escapes tax on income which he paid neither while he was on the cash basis nor when he goes on the accrual basis, doesn't that constitute a loophole?

Mr. CLARKE. It may constitute a loophole if his use of the cash method was correct. However, if the use of the cash method as applied to that taxpayer's business was incorrect, it should have represented income in the earlier years, and the Commissioner should have picked it up on the audit of the return for those years.

Senator KERR. If he is on a cash basis and therefore hasn't collected it in the preceding years, he wouldn't have paid tax on it, would he?

Mr. CLARKE. That is correct, sir, if I was authorized, if he should have been on a cash basis, but there are——

Senator KERR. My question assumed that he was on a cash basis.

Mr. CLARKE. And properly on a cash basis. I would agree with you, sir, under those circumstances there would be a loophole.

Senator KERR. Does it not seem to you that that ought to be closed?

Mr. CLARKE. Yes; I would agree that where there are changes from a correct method to a correct method that loophole should be closed.

Senator KERR. Let us say that there was a change from—maybe he had made a mistake.

Mr. CLARKE. Yes.

Senator KERR. The only purpose that I recall of 481 was to see to it that as the taxpayer had income he paid taxes on it. Now, you think that is a worthy objective; don't you?

Mr. CLARKE. It certainly is, sir. But I make a distinction between an honest mistake—and I see no difference between an honest mistake in an accounting method and an honest mistake of some other sort in which a taxpayer charges off something he is not entitled to charge off.

Senator KERR. If he is on a cash basis and hasn't collected something that was owing to him for something that he did last year, he doesn't pay any tax on it; does he?

Mr. CLARKE. That is correct, sir—assuming that he is properly on a cash basis; yes, sir.

Senator KERR. Then when he goes on the accrual basis, since that accrued prior to the time he goes on the accrual basis, since that accrued prior to the time he goes on the accrual basis, he doesn't pay any tax on it; does he?

Mr. CLARKE. You are correct, sir. I think the—if it is a loophole and it should be closed as to changes made from one correct accounting on another correct accounting method. If a taxpayer on the other hand makes an honest mistake in his method of accounting, I see no difference between that and any other honest mistake made in a return.

Senator KERR. What I think at the moment about your statement is that a person had better learn how to make honest mistakes.

Mr. CLARKE. No, sir. I believe the taxpayer should have good advice and should file a correct and accurate return.

Senator KERR. I think he should too, and once in a while he does. But they don't all have access to—Who did you say your firm was?

Mr. CLARKE. Pepper, Bodine, Frick, Sheetz & Hamilton.

Senator KERR. A lot of them may be better off to pay taxes.

All right, Mr. Clarke. It just looks to me like 481 was calculated to close a loophole.

Mr. CLARKE. Yes, sir.

Senator KERR. Now, say that there was a loophole. Now, how would you go about doing it?

Mr. CLARKE. There is a difference between my personal views and the organizations that I represent. Let me state that the organizations that I represent have authorized me here request, section 24, should either be prospective or these taxpayers who were trapped by changing in reliance upon 481 should have an option of getting out. We didn't get into the general area of whether 481 as originally enacted was sound, because there could be a lot of difference in views on that.

Senator KERR. I think the track you are talking about is one that was created by those who read a meaning into 481 that the Congress didn't intend it to have.

Go ahead.

Mr. CLARKE. Thank you, sir.

A taxpayer should not be required to perform a useless act, such as applying for permission to change an accounting method, when it is clear that permission will not be granted unless the taxpayer accepts adjustments which are contrary to law.

It is submitted that the Internal Revenue Service does not have an absolute right to refuse a request to change from an incorrect method to a correct method with such adjustments as are in accordance with the law.

Taxpayers who would be trapped by the proposed legislation are generally not attempting to gain a tax advantage. In a growing or stable corporate business, they will not obtain any tax benefit from the increased book value unless there is a substantial decline in their volume of business of a permanent nature.

Even if the assets of the business should be sold at a profit, a tax on such a gain could be avoided under section 337 of the code. There is more chance of an individual taxpayer's benefiting from a change under section 481 as it appears at present, but even then it will only occur when the business operations and assets substantially decline or are disposed of. On the contrary, changes which have been made under section 481 are normally made to reflect a more accurate accounting system, and will produce more taxable income under our expanding economy than if the taxpayer had continued to use his old accounting method.

We respectfully request that section 24 be made prospective only or, in the alternative, that those taxpayers who changed their method of accounting between the enactment of the 1954 code and the enactment of H. R. 8381 should be given the option of electing to return to their old method of accounting.

I think you, Mr. Chairman and gentlemen. Are there any further questions, sir?

Senator KERR. If you make it prospective only, then those who made that honest mistake that you are talking about escape from taxes; don't they?

Mr. CLARKE. To take, for example, this hypothetical case of mine, they would escape tax only when that inventory, when overhead including inventory went down below a hundred thousand, the business would be going on just the same——

Senator KERR. That happens at times?

Mr. CLARKE. It happens at times, but when the inventory goes up again it will have to pick up and pay the tax.

Senator KERR. How would you fix it so that if you made it prospective you wouldn't thereby leave that loophole there—or would you rather, in view of the fact that you are representing the other viewpoint, not answer that question?

Mr. CLARKE. I would say that it doesn't represent a real tax benefit, it represents possibly a postponement of taxes. The real income incurred in the year is the $10,000, the real income realized is the $10,000 of increase in overhead in inventory in the taxable year. And what you would do under section 24 is in effect impose tax on income that was earned many years before.

Senator KERR. But on which tax hadn't been paid?

Mr. CLARKE. Tax had not been paid. But under our recommendation tax would still not be paid on that inventory until some date in the future, and if the business continues to go along at the same size, or if it expands with labor rates increasing your overhead inventory is more likely to increase than to decrease, you are requiring payment of tax at this time which might never be incurred so long as the business continued to go on.

Senator KERR. And also he might never pay a tax on income; is that right? In fact, it looks to me like he definitely would not.

Mr. CLARKE. That is correct.

Senator KERR. So I think that in making a recommendation to change a provision which is calculated to close the loophole, which would result in an equity—I am afraid that as far as I am concerned that you would render the committee a service if you would tell it how you could both avoid the inequity and close the loophole.

The CHAIRMAN. You mean he would never pay an income tax, it would simply be postponed?

Mr. CLARKE. It would be postponed indefinitely.

Senator KERR. That is almost as beneficial as never.

Senator WILLIAMS. Has it not been ruled by the Court that the Treasury Department has the right to convert any taxpayer over to the inventory method when and if it is issued?

Mr. CLARKE. Yes, sir.

Senator WILLIAMS. And thereby this question of postponing it indefinitely so that it may never be paid is not exactly correct in that even under the old law prior to 1954 and the law now, the Treasury Department can always convert that fellow over to the inventory basis and catch it up all in 1 year?

Mr. CLARKE. No, sir. Under the old law when the Commissioner changed a taxpayer over to an inventory method he only could impose tax on the increase in the current year.

Senator WILLIAMS. I was thinking about the system, but when he was reauditing it would be on the basis that he had not paid?

Mr. CLARKE. Yes, when he reaudits he must use an opening inventory as well as a closing inventory. There have been cases to the contrary but a number of recent court decisions have clarified the law in that field.

Senator WILLIAMS. But they could pretty well go back to an extended date to establish the net worth to start with?

Mr. CLARK. They could go back to all years that were open under the statute of limitation. But certainly where taxpayers have acted in reliance upon an act of Congress they should not be trapped by reason of that reliance. And in most cases where a taxpayer has made an honest mistake, the Commissioner should have caught it up on audit in the earlier years in which the income is really earned.

Thank you very much.

The CHAIRMAN. The next witness is Mr. Arnold.

STATEMENT OF LINCOLN ARNOLD, CHAIRMAN, TAX COMMITTEE, AMERICAN MINING CONGRESS

Mr. ARNOLD. Mr. Chairman, my name is Lincoln Arnold. I am an attorney practicing law in the District of Columbia as a member of the law firm of Alvord & Alvord.

I appear before you as chairman of the tax committee of the American Mining Congress.

I am confining my testimony to section 32 of H. R. 8381, which section deals with the definition of the term "property" for the purpose of computing the percentage depletion allowance. The objective of section 32 of the House bill is to remove unintended hardships resulting from the provisions of section 614 of the Internal Revenue Code of 1954.

While we strongly endorse the objective, section 32 in its present form fails to resolve a number of problems, and will lead to litigation which is quite unnecessary.

In my limited time for oral testimony I can merely present an outline of the unintended hardships involved and of the solution needed by the mining industry. A more complete discussion is set forth in the attached appendix which includes a list of the court decisions under the 1939 code with reference to the right of a taxpayer to treat a mine as the depletion unit. And, Mr. Chairman, I wish that my appendix be included in the records.

The CHAIRMAN. Without objection, it will be included in the record.

(The appendix referred to appears at the end of his oral testimony.)

Mr. ARNOLD. The percentage depletion deduction has always been determined under the statute by a percentage of the gross income from "the property," subject to the limitation that the deduction cannot exceed 50 percent of the net profits from "the property." Prior to the enactment of the 1954 code the statute contained no definition of the term "property," but the regulations sought to define the term. Generally speaking, the courts interpreted the regulations as permitting the taxpayer to treat each mine as a property, whether the mine was only part of a single acquisition or was made up of multiple acquisitions.

The national office of the Internal Revenue Service, however, interpreted its regulations to mean that where a mine was made up of a number of acquisitions of claims or interests, each acquisition was a separate property, and the mine itself could not be treated as a single property. In the case of oil and gas, it was well established and accepted that each separate acquisition in each deposit constituted a property, and the Commissioner attempted to apply the same concept in the case of mines.

The courts, however, consistently rejected the "separate acquisition" concept where mines were involved and permitted taxpayers to treat each mine as a separate property, regardless of the number of leases, deeds, or other acquisitions which were included within the mine.

The national office of the Internal Revenue Service refused to acquiesce in the court decisions and, at the time the 1954 code was enacted, was still adhering to its position that a mine composed of several acquisitions could not be treated as a single property for percentage depletion purposes.

However, revenue agents in the field were not generally following the position of the national office. The agents were faced with the practical situation that a single mine may be made of hundreds or even thousands of acquisitions. Where conflicting mining claims overlap and duplicate each other, the mine owner often has to acquire all of the conflicting claims. The multiplicity of conflicting and overlapping claims was well illustrated by Allen F. Miller, of the Forest Service, United States Department of Agriculture, in a speech delivered at the annual meeting of the American Mining Congress in Salt Lake City, Utah, September 10, 1957. Mr. Miller stated, in part, as follows:

> We have found records of over 10,000 mining claims filed on one 30,000-acre area in Colorado. They are stacked almost knee deep in places. In one county in the State of Washington I counted 42 books containing mining locations and other mining instruments. There were about 400 pages per book. There are a tremendous number of abandoned, dormant and inactive claims.

Quite naturally, revenue agents were not prone to force a mineowner to make hundreds or even thousands of depletion computations for a single mine, which would involve, in the case of conflicting claims, a determination of which claims were valid. Thus, if the taxpayer owned 3 separate mines, and each of the mines was made up to 20 separate acquisitions, the agents did not insist that the taxpayer had 60 different properties on which to compute percentage depletion. Instead, the taxpayer was permitted to treat each of the 3 mines as separate properties, or he could combine all 3 mines into a single property, if they were contiguous, or nearly contiguous, or he could combine two of the mines into one property and treat the third mine as a separate property.

Of course, the field agents and the courts required consistent treatment on the part of the taxpayer—he could not shift his method of treatment from year to year.

Senator KERR. I would like to have you explain that to me, thousands of acquisitions. I know your statement is well founded——

Mr. ARNOLD. You mean to get up to thousands?

Senator KERR. Yes.

Mr. ARNOLD. There is a good example in the Butte district in Montana when, I forget the time—it goes way back to the early days of the Anaconda Co.—there was a tremendous amount of litigation as to who owned the claims underneath the hill, and there were literally thousands of conflicting claims. It finally ended up by getting all the claims together in one company.

Senator KERR. In the Anaconda?

Mr. ARNOLD. Yes. That ended a famous litigation.

Senator KERR. That is the giant mine there that goes literally——

Mr. ARNOLD. There are a number of mines on the hill, but each mine was made up of a vast number of claims.

Senator KERR. And they are all penetrating the same general body of ore?

Mr. ARNOLD. So I understand, yes. That of course was before my day, Senator.

Senator KERR. I understand. Well, I must say that is a sight worth seeing, and an exhibit worth being familiar with, just from the standpoint of academic interest in the portions of that tremendous reserve there which has been developed and mined over such a long period of time, and as time goes on, it has appeared that the developments would support the thesis that that was a single body of ore.

Senator GORE. May I ask a question?

The CHAIRMAN. Senator Gore.

Senator GORE. Were some of those acquisitions property, surface property, capital structures, not strictly of a mining or mineral nature?

Mr. ARNOLD. Well, the acquisition, I would assume, all went back to mining claims. You have your mining claims, they frequently overlap, Senator, or you could have a numbr of claims which were not overlapping but in order to make a mine, one person acquires claims by purchase from other persons.

Senator GORE. I understand. That wasn't the question I was asking. I was trying to get at the point of your contention here. You have said that the Internal Revenue regulations do not permit you to treat the whole as one?

Mr. ARNOLD. Yes, sir.

Senator GORE. But instead it requires you to treat it in its various parts.

Mr. ARNOLD. Let me give you an example of the type of case that would come up and be litigated. You have got a mine which is made up of, say, 20 acquisitions, that is, purchases from 20 different people. Let us say they are not even conflicting claims, you have got 20 different acquisitions, 20 tracts, but there is just one mine that mines the whole. The position of the national office in Washington was that you would have to complete depletion on 20 different properties, that is, on each acquisition, on each tract.

Senator GORE. And the percentage of the depletion would vary with the tracts, would it?

Mr. ARNOLD. Yes, the deduction for depletion can vary under a number of circumstances. You might have one acquisition which is probably richer than another in ore. You might get the full 15 percent of gross income if you could figure out what you made on this first acquisition, say a tract over here in the southwest corner of the mine. It may be producing 15 percent of gross without hitting the limitation of 50 percent of net.

Another part may be leaner, and the 50 percent of net would cut the depletion deduction down.

Senator GORE. Now, would another part be, another part the whole, if treated as a whole, be property, capital acquisitions, not entitled to depletion at all standing alone and apart by itself?

Mr. ARNOLD. No; they would all be entitled to percentage depletion.

Senator GORE. So your problem here is the variation of percentage of depletion and not variation from nothing to the maximum?

Mr. ARNOLD. That is right. Frequently it makes no difference whether you make 20 computations for the mine or if you may just make one computation for the whole mine.

Senator GORE. If it makes no difference, of what do you complain?

Mr. ARNOLD. I say frequently it makes no difference. Sometimes it does. Even if it didn't make any difference we would still complain. We don't see why a taxpayer should have to make 20 computations for the percentage depletion deduction if he has got a mine as one unit. He is keeping his records on the one mine, and he wants to treat it as a unit and make the depletion computation on the one unit.

Senator GORE. Is the onerousness of computation the only hurt?

Mr. ARNOLD. That can be very onerous, sir, very much so. In fact, sometimes they can't even compute depletion if you go to separate acquisitions, there are so many of them, Senator, in the operation of a mine, when they start pulling that ore out of a mine, what the complaint is—you can't be busy keeping books all day instead of mining.

Senator GORE. Is it the essence of your complaint it multiples it and onerousness of calculating depletion on many acquisitions, or is the inequity on the tax paid?

Mr. ARNOLD. It is primarily the former, so the taxpayer can use the mine as a unit and not have to break it down into component acquisitions. That is the chief thing.

Senator GORE. All right.

Senator FREAR. May I ask a question to clear my mind?

What is depletion?

Mr. ARNOLD. It is the return of the capital value of the mineral property. We have two types of depletion, cost depletion and percentage depletion. We used to have discovery value depletion.

Senator FREAR. Cost depletion?

Mr. ARNOLD. Yes. This can also involve cost depletion—a mine may be just on cost depletion, but they don't want to be making 20 calculations of the cost of the mine.

Senator FREAR. Did I understand your response to the Senator from Tennessee's question to be that if you have a mine of 20 acquisitions and they are only mining 5 of them, that they can take a percentage depletion on the other 15?

Mr. ARNOLD. No; there has to be income from it.

Senator FREAR. I didn't understand it that way, I thought it had to be on income, but I gathered your response did not contemplate that.

Mr. ARNOLD. I do not want to create any misunderstanding. It can make a difference taxwise if a mine is broken down into its component acquisitions, say 20 acquisitions, or treated just as one. There are cases where it can make a difference. For example, perhaps 1 acquisition that you have been mining during the year had a poor grade of ore, and if you kept track of that 1 separately your depletion allowance would be limited to 50 percent of your profit from that operation during the year, but if you combine it with the whole mine, the whole mine may not get hit with the 50-percent limitation, and the depletion would be 15 percent of the gross income.

Senator GORE. Now, following up, Senator Frear's question, would it be possible, if treated as a whole, that depletion would be permitted and allowed on acquisitions from which no income has been derived?

Mr. ARNOLD. It would not be.

Senator GORE. It would not be?

Mr. ARNOLD. No; if there is no income—let us take a mine that has several acquisitions, and you are actually working those, but there are other acquisitions that are part of the mine that are not being worked. If you treat the mine as a whole, the only thing the idle parts could do in that case is to hurt you. Let's say you have got two acquisitions, and they are a part of the mine but are not being operated, that is, you are not extracting ore from them. If you treat the mine as a whole, the taxes on those two idle properties, if they are ad valorem taxes, would go into computation of the depletion net income from the mine.

Senator GORE. We are not talking about ad valorem here.

Mr. ARNOLD. I am just giving an example of how it can hurt you. If you are not getting any income from those two properties which are part of the mine, you are not getting any ore, it can't help your gross income for percentage depletion, but it can hurt you if the 50-percent net limitation comes into play, because the cost of just carrying those two idle properties will reduce your percentage depletion deduction if determined under the 50-percent net limitation.

Senator GORE. Then would it follow that if you treat it as a whole, you do in fact obtain a depletion benefit if not a specific allowance on acquisitions from which no income is derived?

Mr. ARNOLD. No, sir.

Senator KERR. What he said was that you get a penalty.

Mr. ARNOLD. Yes; it is a penalty.

Senator KERR. The 50-percent net income principle limits the depletion factor; it does not add to it.

Mr. ARNOLD. And just having those two properties, if they don't produce any income, still may produce expense; for example, I mention the ad valorem taxes on them. So that could reduce your depletion net income from the mine.

Senator KERR. Which might reduce the amount of depletion that you could take?

Mr. ARNOLD. Right.

Senator FREAR. This is all percentage depletion?

Mr. ARNOLD. Yes, sir.

Senator FREAR. How would cost depletion conflict in this, or what advantage could be made of cost depletion in lieu of percentage depletion?

Mr. ARNOLD. Treating all the properties as one in a mine—you can get some variation. I don't know whether it would be important, because one acquisition may have cost a dollar a ton, another part cost you $2 a ton or a dollar and a half a ton, and when you put them all together, then you have got so much cost per ton for the whole mine. Then, cost depletion would not depend on what part of the mine you are digging out of at the time.

Senator WILLIAMS. This section you are speaking of deals primarily with percentage depletion?

Mr. ARNOLD. It deals with definition of a property for the purpose of percentage depletion and cost depletion.

Senator WILLIAMS. And I recognize how, if for instance, there are 15 different mining operations and 5 of them in production, the 5 would not be affected. But on the 10 that are in production, if 5 of those are not affected by the 50-percent limitation in that they are highly productive, and the other 5 are not, by consolidating and after arranging them you can in effect increase your tax advantages; is that not true?

Mr. ARNOLD. No, sir; you cannot increase your tax advantages by consolidating idle properties.

Senator WILLIAMS. I am not speaking of idle, I am speaking of operational properties. You have some of them which are affected, when you figure them individually, which are affected by the 50 percent limitation?

Mr. ARNOLD. Yes, sir.

Senator WILLIAMS. You have some of them which do not reach the 50 percent limitation?

Mr. ARNOLD. Yes.

Senator WILLIAMS. And then when you consolidate those which are producing, those which are effected by the 50 percent limitation and those which are below it, when you consolidate it you can take a greater tax deduction, is that it?

Mr. ARNOLD. It is possible that the 50 percent limitation may not come into play then, so you don't get less than the 15 percent of gross.

Senator WILLIAMS. I know that. I am not speaking of that. I am speaking about the net tax payable could be reduced as a result of aggregating the properties, after ranging it, and you could take a greater tax deduction.

Mr. ARNOLD. There is no question but what that is so. And that is how some of the litigated cases came up.

Senator WILLIAMS. I am not speaking of the merits or demerits of it, I am merely saying that it has a tax advantage.

Mr. ARNOLD. It can have. That has been answered.

Senator WILLIAMS. And the second point would be the——

Mr. ARNOLD. Multiplicity of computation.

Senator WILLIAMS. The bookwork of keeping the accounts?

Mr. ARNOLD. Yes, sir.

Senator KERR. Let me get a point clear in my own mind. The Senator talked about the limitation contained in the 50 percent of net income limitation?

Mr. ARNOLD. Yes, sir.

Senator KERR. Is that a rule that is applicable to an acquisition, a property, or to the taxpayer?

Mr. ARNOLD. It is to the property. The depletion allowance is 15 percent of the gross income from the property. But not more than 50 percent of the net income from the property. It is not per taxpayer; it is per property.

Senator KERR. It is per property, but not per acquisition?

Mr. ARNOLD. Well, that is the nub of the question. The Bureau's position, of the national office, was that each acquisition was a property, even though all of them are operated together as one mine.

Senator KERR. The 1954 code changed that to some degree?

Mr. ARNOLD. Yes.

Senator KERR. And it was the thought, in my judgment, if one who sponsored that provision, I believe, that the effect of it was to eliminate the basis to define an acquisition as a property regardless of its being connected with and made a part of a larger operation.

Mr. ARNOLD. Exactly what the 1954 code tried to do, yes. If a man had just 1 mine, and he had 10 acquisitions in it, there is no question that under the 1954 code he could elect to say, "I have got one property." That was fine. But the trouble with the 1954 code was this: A man might have 3 mines, let's say, in the same operating unit, 3 mines. Under the 1954 code—prior to the 1954 code he treated each mine as a property, because the courts let him do so, although the national office disagreed, even though each mine may have had 20 acquisitions in each. The 1954 code said, "You can make one aggregation only within this operating unit."

So you could throw all of your 3 mines together as 1 property, but you could not take each mine as a separate property, because that would be 3 aggregations. And the 1954 code says you can have only one aggregation within an operating unit. And that is where the rub came in the case of a mine. A fellow might have 3 mines within 1 operating unit, and he wants to treat them each as a separate property, as he had done before, and he couldn't do it under this new code.

One other thing it did. A man may have had 1 acquisition in 1 deposit, but he has got 2 mines on it, 1 at the south end and 1 at the north end. He was treating each mine as a property. The 1954 code comes along and spells out the rules so precisely on the definition of a property that he has now got only 1 property, because there is only 1 acquisition in 1 deposit. What we ask is that in that kind of a case the man can treat each mine as a property.

Senator LONG. May I ask a question there?

Senator KERR. I thought you said the 1954 required that he treat each mine as a property?

Mr. ARNOLD. No; in that case it is just one acquisition.

Senator BENNETT. He is not aggregating?

Mr. ARNOLD. He wants to deaggregate here.

Senator KERR. In other words, he had 1 acquisition, of which he developed 2 mines, and therefore 2 properties.

Mr. ARNOLD. Prior to the 1954 code he treated each mine as a property. Under the definition of the new code he cannot.

Senator WILLAMS. Are you suggesting that we repeal the 1954 code?

Senator LONG. I am so confused I could not even ask an intelligent question about it.

Mr. ARNOLD. It is a very complicated field.

Senator FREAR. How does the bill affect what you have told Senator Kerr?

Mr. ARNOLD. The proposed bill says, if you wish, instead of using the 1954 code rule, you can use the 1939 rules.

Senator FREAR. On this north and south mine?

Mr. ARNOLD. On anything. But the trouble is, What are those rules? We call it a license to litigate, because the national office has not acquiesced in the court decisions that were in favor of the taxpayers on treating the mine as a depletion unit. So we do not know exactly what the law is under the 1939 code.

It would take a lot more litigation to determine what those rules are.

Senator WILLIAMS. Are you endorsing the section of this bill?

Mr. ARNOLD. We are endorsing the objective of it; yes.

Senator WILLIAMS. Do you recommend that we repeal the 1954 act entirely and go back to the 1939?

Mr. ARNOLD. No, sir; I do not.

Senator WILLIAMS. You are asking for a choice whereby the taxpayer can use either the 1939 code or the 1956 code, whichever is the most advantageous.

Senator KERR. I believe that is what the bill does.

Senator WILLIAMS. That is what you are recommending and you are endorsing.

Mr. ARNOLD. Yes——

Senator DOUGLAS. What was the answer to that question?

Mr. ARNOLD. No; I think I spoke too fast, Senator. The 1954 code was supposed to liberalize the rules in this area. It was not intended to take away what the taxpayers could treat as a property prior to 1954.

We are asking that the taxpayer can continue to treat the mine as a unit for percentage depletion, and that he can have the rules of the present code. If he wants to use the 1954 code, he can do so.

Now, under the 1954 code, if you had 3 mines in an operating unit, you could elect to aggregate all the interest in 1 mine, and treat each acquisition in each of the other mines separate.

A taxpayer would still have, under our proposal, the right to do that if he wishes to do so. However, he would also have the right to treat each mine as a property, or to combine the mines.

Senator KERR. As it would be——

Mr. ARNOLD. Under the 1939 rules, that is what the courts have allowed.

Senator FREAR. How does your proposal differ, then, from the 1939 rules?

Senator KERR. See if this does not answer your question. What you are trying to get in the law specific authorization to handle it as the industry interpreted the law to be under the 1939 code?

Mr. ARNOLD. You have said it very well.

Senator KERR. But the Bureau of Internal Revenue did not interpret it that way, and now you are setting up as a statute the industry's interpretation rather than the Internal Revenue's interpretation; isn't that right?

Senator BENNETT. The court interpretation.

Mr. ARNOLD. The court says if a taxpayer has got 3 mines in 1 area he may treat each mine as a property. The national office says, that is wrong, you should go to separate acquisitions.

Senator WILLIAMS. To get back to my original question, as I understand it, you are endorsing a proposal in this bill which would permit a taxpayer to elect as to whether or not he computed his returns under the 1939 code or the 1954 code. And you could take the 1939 code or you could take the 1954, at our own discretion. This is my understanding of the gist of your endorsement.

Mr. ARNOLD. As to the operating unit.

Our proposal would be that he can—he starts with the 1954 code, but we would give him the the right to make more than one aggregation. We would change the 1954 code in that respect, in order to reach the result he could get under the 1939 rules.

Senator WILLIAMS. That still gets back to the point that he at his discretion could use the 1939 or the 1954 code, whichever was the most advantageous.

Mr. ARNOLD. Yes. If he makes more than one aggregation he gets the 1939 rules. If he makes only one aggregation, he uses the 1954 Code, which is all right.

Senator WILLIAMS. And that would be at the discretion of the taxpayer.

Mr. ARNOLD. That is right. And that is what the 1954 code did, it was at the discretion of the taxpayer whether he aggregated or not. There is an election in the 1954 code, you can treat your mine as a unit, if you have just got one mine, or you can leave it alone and treat each acquisition in the mine as a separate property.

Senator WILLIAMS. You are getting me confused. If he can do that under the 1954 code, what are you talking about the 1939 code for?

Mr. ARNOLD. Because under the 1954 code you could only do that once within an operating unit.

Senator WILLIAMS. And this gives him the chance to go back and forth?

Mr. ARNOLD. No, there is no switching back and forth. He makes up his mind which way he wants to go, and he is stuck with it, unless the Commissioner——

The CHAIRMAN. The Chair would suggest that on page 5 the witness has made very clear what he desires to be done.

If he would read those two clauses, I think the committee could then understand what he proposes.

Mr. ARNOLD. Shall I pick up where I left off?

The CHAIRMAN. Let's begin at "we urge an amendment."

Senator BENNETT. May I interrupt at this point to say that I have the technical amendment that I should like to offer for the consideration and study of the committee before we meet in executive session.

I also have a brief statement which complements and supplements what the witness has said, and at the conclusion of his testimony.

I should now like to offer the text of the amendment with a brief statement to be included at the end of the witness' testimony.

The CHAIRMAN. I think the witness has very clearly stated his objectives. It is in three or four classifications apparently.

I would suggest you read "we urge an amendment," and maybe we can understand it.

Mr. ARNOLD. Thank you, Senator Bennett.

Senator MALONE. Can I ask a question?

The CHAIRMAN. Senator Malone.

Senator MALONE. First, I want to compliment the witness, Mr. Lincoln Arnold, on the clarity of his explanation. It is not an easy subject to attack, it is not an easy subject to legislate upon.

Now, you speak of 15-percent depletion. What minerals do you have in mind?

Mr. ARNOLD. The one I had in mind, I was thinking of copper.

Now, if I had mentioned lead, I would have said 23 percent.

Senator MALONE. I did not know you had mentioned copper.

Mr. ARNOLD. No; I had not mentioned it. That was the thing I had in mind.

Senator MALONE. The 1954 code did raise to 23 percent the depletion allowance.

Mr. ARNOLD. For lead and zinc 23 percent, and some other minerals.

Senator MALONE. Yes. I think everything else is made clear in your testimony, and I think you are a very good witness.

The CHAIRMAN. Senator Bennett's amendment and explanation will be inserted in the record without objection.

(The amendment and statement referred to will be found at the end of Mr. Arnold's testimony.)

Mr. ARNOLD. Section 614 of the Internal Revenue Code of 1954 provided the first statutory definition of the term "property." Since this definition is based upon the separate acquisition concept, and only one aggregation of such separate acquisitions within an operating unit is permitted under section 614, the taxpayer can no longer—as was permitted under the 1939 code—treat each mine as a separate property if there is more than one mine within a single operating unit or on a separate acquisition.

Moreover, section 614 took away a right which the oil and gas industry had under the 1939 code—the right to combine mineral deposits under each lease or tract of land.

In addition, section 614 of the 1954 code requires that the taxpayer make a binding election with respect to aggregation of separate acquisitions as of the first year in which he makes any exploration expenditures with respect to such acquisitions, which may occur years in advance of development. Under this requirement, a taxpayer may be forced to guess, far in advance, how he will extract the mineral from a given area. It is absolutely impractical to require the taxpayer to make his election prior to the year in which he makes his first expenditure for development or operation of a given acquisition. I understand that a subsequent witness will develop this matter further.

Section 614 was not intended to take away from taxpayers the right to treat as a property a depletion unit which was permissible under the 1939 code. As stated by Congressman Mills, chairman of the Ways and Means Committee, in his explanation to the House of section 32 of H. R. 8381 (Congressional Record, Jan. 28, 1958, p. 1037):

This definition in the 1954 code was intended to liberalize the provisions of the 1939 code with respect to the definition of "property."

In an effort to correct the unintended hardships resulting from section 614, section 32 of the bill as passed by the House provides, in substance, that a taxpayer may elect to treat any property as if the 1939 code continued to apply. This provision is merely a "license to litigate," since it does not furnish affirmative rules under which the mining industry can operate with certainty and without constant litigation.

We urge an amendment which will set forth the necessary affirmative rules to meet the objectives of section 32. The amendment should specifically restore to the mining industry the right in all cases to use the mine as the entity or unit on which depletion is computed. It should restore the right, in the case of oil and gas, to aggregate deposits in each lease or tract of land. It should also provide that the election to aggregate or combine need not be made prior to the development stage of the mine or deposit.

The proposed amendment should also permit royalty owners to aggregate interests in the manner permitted under the administration of the 1939 code. This subject will be covered in detail by a subsequent witness.

The Ways and Means Committee stated in its report on the bill that section 32 "is expected to result in a negligible revenue loss." It is our opinion that the same will be true if section 32 is amended to spell out the foregoing rules. Spelling out the needed rules will save taxpayers and the Government a vast amount of time and money which would otherwise be spent for additional tax personnel, bookkeeping help, engineering surveys, and litigation expenses.

We respectfully urge the adoption of the amendment offered by Senator Bennett.

The CHAIRMAN. That covers your proposal in very clear language.

Mr. ARNOLD. That is right, and the amendment that Senator Bennett has carries out these objectives. In other words, in effect, you add to section 614 of the 1954 code the 1939 rules; that is what it amounts to.

Senator BENNETT. Mr. Chairman, as I view this amendment, it is an attempt to define in specific terms the meaning of the word "property" for purposes of depletion. So it is, in a sense, a slightly different approach to the problem, though its net effect should be as the witness had indicated.

Mr. ARNOLD. The technique is to work on the right of aggregation, to let the person have more than 1 aggregation within an operating unit, so that if he has got 3 mines in an operating unit he can have 3 aggregations; that is, treat each mine as a property, which he could do under the 1939 code.

Senator GORE. Will you explain why you said to Senator Williams that a taxpayer could not, after having made an election to file under the 1954 or the 1939 provisions, change in the next year or at some other time to another one?

Mr. ARNOLD. Our amendment, as does the present law, provides that if you make an election to aggregate properties, you cannot then switch the following year, because we are not trying to get a tax advantage. There can be advantages from one year to another when you are not consistent.

The taxpayer has got to choose his bed and sleep in it.

Senator GORE. That is contained in the amendment.

Mr. ARNOLD. Oh, yes; the amendment is binding, once made, with one exception, and that is in the present law.

Senator GORE. You mean the election, once made?

Mr. ARNOLD. The election is binding. Maybe your manner of operation has been changed, so that you ought to have a different kind of a unit on which to compute depreciation. Maybe, instead of having 2 mines you have now got 1 mine, and would like to treat them just as 1. You can go to the Secretary and ask permission to change your election, but, unless he gives you permission to change, you are still stuck with your original election.

And I suppose the Commissioner is not going to give you a right to change the election if you are just coming in there for tax purposes. You have got to have a good, solid justification other than taxes for changing your election, such as a change in operations of your units.

Senator BENNETT. May I suggest a possible example? During these recent difficult years in the lead-mining industry, in my State, a number of hitherto separately operated mines have been merged under one management. And I imagine in some cases they are actually being operated physically as one party.

Senator FREAR. Republican or Democrat?

Senator KERR. Or one commercial identity?

Senator BENNETT. One commercial property. You take my mind back to this particular situation, and I find both Republicans and Democrats.

Senator KERR. You used the word "party."

Senator BENNETT. The word should have been "property."

In that case I would assume that the manager of the new entity should go to the Secretary and ask permission to aggregate the two previously separate properties into one. But that is a matter of the option of the Secretary.

Mr. ARNOLD. Correct. That is a very good example.

Senator GORE. Do I correctly understand you to say that though tax benefits might accrue to some, or not accrue to others, that the reduction of tax liability as a result of the proposed amendment would not be substantial?

Mr. ARNOLD. Correct.

Senator GORE. And you assure this committee that your principal concern is to eliminate the onerousness, multiplicity of computations from multimum acquisitions?

Mr. ARNOLD. Yes. There is one more thing that we have done in our amendment, as I have mentioned. We are asking that the time for making the election as to when to aggregate be delayed to a later date than under the present law, because it is almost impossible——

Now, what the rules were under the 1939 code as to when you should decide to treat a mine as a unit were never litigated, we do not know what the rules were. It may be that what we are proposing here as to the time for deciding whether you are going to treat the mine as a unit or not may be later than what the rules were under the 1939 code, because they were never settled.

We have asked expressly that as to the time for electing, making a binding election, you do not have to make it until the first year in which you start development or operation of the mine, or of the property. And the present law says you have to do it the first year you do some exploration. We think that is too early. You do not know when you start exploring whether or not you are going to have 1 mine, 2 mines, or 3 mines. So we have made that different.

Senator GORE. Thank you.

The CHAIRMAN. Thank you very much, Mr. Arnold.

(The technical amendment and accompanying explanation submitted by Senator Bennett referred to above and the appendix submitted by Mr. Arnold follows:)

SENATOR BENNETT'S MEMORANDUM IN EXPLANATION OF PROPOSED AMENDMENT TO SECTION 32 OF H. R. 8381

Prior to the enactment of section 614 of the 1954 code, the law did not contain any definition of the "property" which forms the basis for the computation of percentage depletion. The national office of the Internal Revenue Service attempted to apply to the mining industry the individual lease, or separate acquisition, concept which grew out of the oil and gas industry.

However, in extensive litigation, the mining industry established the right to compute depletion on the basis of each mine, or combination of mines, without regard to the number of mining claims, leases, or other acquisitions. The Internal Revenue Service never acquiesced in these decisions, but its field agents generally accepted the mine concept as the only reasonable one for mining. In many instances, a mine may consist of hundreds of overlapping and duplicating mining claims, and it is completely unreasonable to deny to the taxpayer the right to use the mine as the depletion unit. Otherwise, he may be forced to compute the gross income and net income individually for each separate mining claim or lease.

On the other hand, in some industries (such as coal) it is not unusual to have two mines on a single tract of land, and in such cases the taxpayer was permitted (prior to 1954) to treat each mine as the "property."

The taxpayer was always required to follow consistent treatment—he could not switch back and forth. However, his consistent treatment was not required to begin until the lease or mining claim in question became part of a mine.

When Congress enacted section 614 of the 1954 code, it did not intend to restrict rights of the taxpayers with respect to the meaning of the "property." Instead, it intended, as stated by Ways and Means Chairman Wilbur Mills in explaining section 32 of H. R. 8381, "to be more liberal than the definition of property followed by the courts under the 1939 code."

Unfortunately, the actual result of section 614 of the 1954 code was that it did, unintentionally, take away important rights in this field. It deprived the mining industry of the following rights:

(*a*) The right to use the mine, in any circumstances, as the unit for depletion.

(*b*) The right to wait until an acquisition, or lease, became part of a mine (that is, until the development stage) before determining the mine of which it would be a part.

Section 32 of H. R. 8381 contains a partial correction of these unintended hardships. It provides that a taxpayer may "* * * treat any property (determined as if the Internal Revenue Code of 1939 continued to apply) as if subsections (a), (b), and (c) had not been enacted."

While this theoretically restores the previous rights, it is primarily a "license to litigate," because the national office of Internal Revenue Service has never acquiesced in the court decisions establishing those rights. Further, this provision does not prevent the national office from destroying such rights for the future by amending the regulations under the 1939 code.

The proposed amendment to section 32 grants the same relief as that intended in the present section 32, but it spells out the rights which were previously available under court decisions and commonly accepted actual practice.

The Ways and Means Committee stated, in its report on H. R. 8381, that section 32 "is expected to result in a negligible revenue loss." The same will be true of the proposed amendment to section 32.

In summary, the proposed amendment is designed to save taxpayers and the Government a vast amount of time and money which would otherwise be spent for additional tax personnel, bookkeeping help, engineering surveys and litigation expenses.

[H. R. 8381, 85th Cong., 2d sess.]

AMENDMENT Intended to be proposed by Mr. Bennett to the bill (H. R. 8381) to amend the Internal Revenue Code of 1954 to correct unintended benefits and hardships and to make technical amendments, and for other purposes

On page 44 of the bill, in section 32, strike out lines 5 to 13, inclusive, and insert the following:

Section 614 (relating to definition of property) is amended to read as follows:

"SEC. 614. DEFINITION OF PROPERTY.

"(a) GENERAL RULE.—For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

"(b) SPECIAL RULE AS TO OPERATING MINERAL INTERESTS.—

"(1) ELECTION TO AGGREGATE SEPARATE INTERESTS.—If a taxpayer owns two or more separate operating mineral interests which constitute part or all of an operating unit, he may elect (for all purposes of this subtitle)—

"(A) to form *one* [an] aggregation of, and to treat as one property, any two or more of such interests; and

"(B) to treat as a separate property each such interest which he does not elect to include within *the* [an] aggregation referred to in subparagraph (A).

For purposes of *the preceding section* [this subsection], separate operating mineral interests which constitute part or all of an operating unit may be aggregated whether or not they are included in a single tract or parcel of land and whether or not they are included in contiguous tracts or parcels. A taxpayer may *not* elect to form more than one aggregation of operating mineral interests within any one operating unit. *In the case of mines, if the taxpayer elects to form more than one aggregation within an operating unit, no aggregation within such operating unit may include any interest which is part of a mine without including all of the operating mineral interests in such mine at the time the election to aggregate is exercised, and any operating mineral interest which thereafter becomes a part of such mine shall be included in such aggregation as of the first time any expenditure for development or operation of such interest is made after such election is exercised. In the case of oil and gas wells and other natural deposits (not including mine), only one of the aggregations within each operating unit may consist of interests which are located in more than one tract or parcel of land, and not more than one aggreoation may be made with respect to each tract or parcel of land.*

"(2) *ELECTION TO TREAT A MINERAL INTEREST AS MORE THAN ONE PROPERTY IN THE CASE OF MINES.—Wheve the mineral deposit in a tract or parcel of land is being extracted, or under the then existing plans of the taxpayer will be extracted, through more than one mine, each such mine and the portion of the mineral deposit allocated thereto by the taxpayer, in the manner required by Regulations prescribed by the Secretary or his delegate, together with any other operating mineral interests which are a part of such mine, may be treated by the taxpayer as a separate property. and any operating mineral interest which thereafter becomes a part of such mine shall be included as a part of such separate property as of the first time any expenditure for development or operation of such interest is made after such mine is treated as a separate property.*

"(3) *MANNER OF ELECTION.*—The election provided by paragraphs (1) and (2) shall be made for each operating mineral interest, in accordance with regulations prescribed by the Secretary or his delegate, not later than the time prescribed by law for filing the return (including extensions thereof) for whichever of the following taxable years is the later: The first taxable year beginning after December 31, *1958* [1957], or the first taxable year in which any expenditure for *exploration*, development, or operation in respect of the separate operating mineral interest is made by the taxpayer after the acquisition of such interest, *except that in no event shall the time for exercising the election expire prior to the last day of the third month following the month in which Final Regulations under this section as amended by the Technical Amendments Act of 1958 are* *published in the Federal Register. An election made by the taxpayer pursuant to the provisions of this section prior to the enactment of the Technical Amendments Act of 1958 shall be deemed an exercise of the election provided in this subsection unless a new election is made prior to the expiration of the time prescribed in the preceding sentence.*

"(4) *BINDING EFFECT ON ELECTION.—The taxpayer's election under this subsection shall be binding upon the taxpayer for all subsequent taxable years, without regard to changes in operations or other circumstances, except that the Secretary or his delegate may consent to a different treatment of the interests with respect to which election has been made and with respect to those as to which no election has been made. In case an operating mineral interest or a part thereof included in an aggregation becomes a nonoperating mineral interest, it shall be excluded from the aggregation, but only during the period while it is not an operating mineral interest.*

"(5) *OPERATING MINERAL INTEREST DEFINED.—For purposes of this subsection, the term 'operating mineral interest' includes only an interest in respect of which the costs of production of the mineral are required to be taken into account by the taxpayer for purposes of computing the 50-percent limitation provided for in section 613, or would be so required if the mine, well, or other natural deposit were in the production stage.*

"(6) OPERATING UNIT DEFINED.—For purposes of this subsection, the term 'operating unit' means one or more properties which may conveniently and economically be operated as a single unit. An operating unit claimed by the taxpayer in an election under this subsection shall be deemed appropriate unless it clearly fails to represent a reasonable interpretation of these requirements.

"(c) SPECIAL RULE AS TO NONOPERATING MINERAL INTERESTS.—

"(1) AGGREGATION OF SEPARATE INTERESTS.—If a taxpayer owns one or more separate nonoperating mineral interests in a single tract or parcel of land, or in two or more tracts of land which are in the same general geographic area, he may elect to treat (for all purposes of this subtitle) such interest or interests (whether or not producing revenue) in each separate kind of mineral as one property or as two or more properties. If such election is made for any taxable year, the taxpayer shall treat such interests affected by such election in the same manner for all subsequent taxable years unless the Secretary or his delegate consents to a different treatment.

"(2) NONOPERATING MINERAL INTERESTS DEFINED.—For purposes of this subsection ,the term 'nonoperating mineral interests' includes only interests which are not operating mineral interests within the meaning of subsection (b) (5)."

(The appendix to the statement of Lincoln Arnold is as follows:)

I. DEVELOPMENT OF THE MEANING OF THE TERM, "PROPERTY," PRIOR TO THE 1954 CODE

(a) THE STATUTES

The term "property" in connection with depletion was first used in the Revenue Act of 1918. In granting discovery value depletion "in the case of mines, oil and gas wells," the Revenue Act of 1918 based the discovery value depletion on "the fair market value of the property at the date of the discovery, or within 30 days thereafter."

In the Revenue Act of 1921, discovery value depletion was limited to the net income "from the property upon which the discovery is made." In the Revenue Act of 1924, discovery value depletion was limited to "50 per centum of the net income (computed without allowance for depletion) from the property upon which the discovery was made * * *"

The "separate deposit" concept was first expressed in the law when the Revenue Act of 1926 provided, with respect to discovery depletion, that "Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit."

In the Revenue Act of 1926 percentage depletion was provided in the case of oil and gas wells, at the rate of "27½ per centum of the gross income from the property" and limited to "50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property. * * *"

In the Revenue Act of 1932, percentage depletion for coal and metal mines and sulphur was first provided, at specified percentages of the "gross income from the property during the taxable year," and limited to "50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property * * *"

No further significant changes with rspect to the "property" were made in subsequent revenue acts until the enactment of section 614 of the 1954 Code. Until that time, the successive revenue acts and the 1939 Code continued to provide depletion for "mines" without statutory definition of the "property" upon which percentage depletion was based.

(B) THE REGULATIONS

Regulations 62, issued under the Revenue Act of 1921, defined the "property" in article 201 in the following terms:

"(*c*) A 'mineral property' or 'property' is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface as is reasonably expected to be underlaid with the mineral. The value of a mineral property is the combined value of its component parts.

"(*d*) A 'mineral deposit' refers to 'minerals only,' such as the 'ores only' in the case of a mine, to the 'oil only' in the case of an oil well, and to the 'gas only' in the case of a gas well, and to the 'oil and gas' in the case of a well producing both oil and gas. The value of a mineral deposit is its cost, or it is the value of the mineral property, less the value of the plant, equipment, and surface of the land for purposes other than mineral production."

These definitions were continued without substantive change until the issuance of regulations 77 under the Revenue Act of 1932. However, in article 221 of regulations 69, issued under the Revenue Act of 1926, it was provided that "the property," in the case of oil and gas wells, "refers to the separate tracts or leases of the taxpayer." This provision also appeared in article 241 of regulations 74, issued under the Revenue Act of 1928.

In regulations 77, issued under the Revenue Act of 1932, it was provided in article 221, as follows:

"A 'mineral property' is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction. The value of a mineral property is the combined value of its component parts.

"* * * 'The property,' * * * means the interest owned by the taxpayer, freehold or leasehold, in any mineral property. The taxpayer's interest in each separate mineral property is a separate 'property'; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single 'property,' provided such treatment is consistently followed."

The definition of "property" contained in regulations 77 was continued without further change and last appeared, prior to the enactment of the 1954 Code, as subsection 39.23 (m)-1 (d) (2)—defining "mineral property"—and subsection 39.23(m)-1 (i)—defining "the property"—of regulations 118.

(C) JUDICIAL DECISIONS AND ADMINISTRATIVE INTERPRETATIONS PERTAINING TO OIL AND GAS

In *Vinton Petroleum Co. of Texas* v. *Commissioner* (71 Fed. 2d 420 (CCA, 5, 1934), cert. den. 293 U. S. 601), the court held that in the case of oil and gas the "property" meant each separate lease, even though several leases were contiguous. This decision accorded with other judicial determinations involving oil and gas and with the generally-accepted practices in oil and gas.

On the basis of *Vinton Petroleum*. General Council's Memorandum 22106 was promulgated (C. B. 1941-1, p. 245), holding the separate acquisition or "lease" concept applicable not only to oil and gas but also to mining. In subsequent published interpretations, this determination has been adhered to at all times.

(D) JUDICIAL DECISIONS PERTAINING TO MINING

Jewel Mining Co. v. *Helvering* (126 F. 2d 1011 (CCA 8, 1942), reversing 43 BTA 1123): In the *Jewel* case the court refused to permit the taxpayer to combine a royalty interest (known today as a "nonoperating interest") with the interest representing that portion of a tract which he operated himself (known today as an "operating interest"). In reaching its decision, the court construed the pertinent regulations dealing with the term "property" to apply to mining operations as follows:

"Each separate coal mine independently operated by its owner constitutes a separate 'property' for all practical purposes in computing depletion."

Black Mountain Mining Corporation (5 TC 1117 (1945)): Taxpayer operated two coal mines on numerous acquisitions which were contiguous. The two mines were physically separated by erosion. The Tax Court held the taxpayer could continue to treat each mine as a "property" for depletion purposes. The Commissioner first contended that both mines constituted a single property, but then reversed his position and contended that each separate acquisition was a separate "property," but the Tax Court stated:

"Thousands of acres of coal were mined from each of these mines. Many tracts of that coal were obtained in blocks of less than an acre. The difficulty of determining the net income and the gross income for any year if each acquisition is to be treated as a property is at once apparent * * *

"The petitioner contends that 'the property' as used in section 114 (b) (4) means the economic and practical unit which the taxpayer must use and develop in order to extract a particular block of coal. It includes whatever portion of the mineral deposit can be properly mined as a unit and it includes also the development, plant, and surface land necessary for the extraction of that particular block of coal. Under this theory a large block of coal acquired at 1 time might constitute more than 1 property, or smaller blocks of coal acquired at different times might combine to form a single property.

"The regulations and decided cases support the petitioner's contention * * * There are several cases dealing with oil properties which may present a somewhat different problem."

Rialto Mining Corporation (TC Memo. Op., Dkt. 6978 (1946)): In the *Rialto* case taxpayer extracted ore from a 200-acre tract of land, through 2 interconnected shafts. The Tax Court held the entire tract constituted a single "property" since the taxpayer consistently treated the 2 shafts as 1 "property."

Clover Splint Coal Company (TC Memo Op., Dkt. 4790 (1946)): In this case taxpayer had a lease on acreage containing 5 seams of coal, surrendered the lease and took in turn a lease limited to 2 of the seams. The court upheld the position of the Commissioner that no new property had been created by the second lease. Since the taxpayer had failed to treat the 5 seams as 1 "property," each seam constituted a separate property.

Cresson Consolidated Gold Mining & Milling Co. (11 TC 192 (1948), petition for review dismissed, 175 F. 2d 774 (CA 10, 1949)): In the *Cresson* case, taxpayer operated a gold mine which contained one shaft and hoist. Taxpayer executed "split-check" leases, granting to others the right to mine specific blocks of ore. Taxpayer computed depletion on the basis of a single "property." The court held the agreements were merely a different method of paying the operating expenses, and did not operate to create separate properties. Even if separate properties were created, the court said, the taxpayer had consistently treated them as one property and the Commissioner was bound thereby.

Amherst Coal Co. (11 TC 209 (1948)): Taxpayer operated 3 coal mines on an area of over 4,600 acres, consisting of 17 acquisitions, both fee and leasehold, acquired over a period of 38 years. The Commissioner contended taxpayer should compute depletion on the basis of 17 different "properties," but the Tax Court ruled that since the taxpayer had consistently treated the various acquisitions as 1 property, they constituted 1 property.

Gifford-Hill & Co. (180 F. 2d 655 (CA 5, 1950), affirming 11 TC 802 (1948)): This case arose under the excess-profits tax law, which contained a statutory definition of mineral property identical to that contained in the income tax regulations, i. e., "a mineral deposit, the development and plant necessary for the extraction of the deposit, and so much of the surface of the land as is necessary for purposes of such extraction."

The court permitted the taxpayer to treat as one property various noncontiguous acquisitions of sand and gravel deposits, stating:

"There is nothing in this statutory provision which confines a mineral property or deposit to the boundaries of any single tract or parcel of land."

Morrisdale Coal Mining Co. (13 TC 448 (1949)): The Tax Court permitted the taxpayer to treat 2 leases as 1 property where the coal therefrom was extracted from a single mine and the taxpayer consistently treated the 2 leases as a single property.

Tennessee Consolidated Coal Co. (15 TC 424 (1950)): The Tax Court permitted the taxpayer to compute depletion on the basis of 1 property where the taxpayer consistently followed such treatment with respect to 3 tracts of land.

Buffalo Chilton Coal Co. (20 TC 398 (1953)): Taxpayer mined coal from 3 mines under 7 leases. Prior to 1948 the taxpayer treated each mine as a separate property, but in 1948 he attempted to combine the mines into one property. The Tax Court refused to let him switch to one property, since consistent treatment was required. However, it should be noted that even here depletion was computed on 3 properties (the number of mines) rather than on 7 properties (the number of separate acquisitions).

Hanna Iron Ore Co. (TC Memo. Op., Dkt. 36017 (1953)): The Commissioner computed depletion as though there were 3 properties—1 consisting of 3 40-acre tracts in which taxpayer owned 2 leasehold interests and which were mined through shaft No. 2; the second consisting of a 40-acre tract which taxpayer owned in fee; and the third consisting of a tract in which taxpayer owned a partial fee interest and a partial leasehold interest, and which was mined through shaft No. 1. The Tax Court stated:

"The mine covered all of a single deposit of ore which the petitioner was mining in one single operation * * *. The petitioner has consistently claimed deductions for percentage depletion from the mine on the theory that it is but one property. The method of the petitioner, under such circumstances, was correct and the Commissioner had no authority to depart from it by computing the allowances for percentage depletion as if there were several properties."

(E) COMMONLY ACCEPTED PRACTICES IN THE MINING INDUSTRY UNDER THE 1939 CODE AS ADMINISTERED IN THE FIELD

The following are the basic concepts which were commonly followed and accepted under the 1939 code as actually administered, in the case of mining:

(1) The mine could be treated as the "property," even where there were two or more mines on a single tract or parcel of land;

(2) The mine could be treated as the "property," even where the mine was made up of a great number of tracts;

(3) Each mine could be treated as a separate "property," even where several mines were operated in a group that might have constituted what is now called an "operating unit";

(4) Two or more mines contained within a continuous boundary could be combined and treated as a single "property," even though each mine was made up of a large number of different tracts or acquisitions;

(5) In each and every case, the taxpayer was required to follow consistent treatment. He could not switch back and forth. The "consistent treatment" began when a tract became part of a mine—from that time on he had to follow consistent treatment with respect to that tract. There was no requirement that the beginning date for the "treatment"—equivalent to the 1954 code election—be the date of exploration activities.

II. Section 614 of the 1954 Code—Congressional Intent and Actual Result

In enacting section 614 of the 1954 code, Congress intended not only to preserve existing rights of the taxpayer, but also to grant him additional rights. Thus, the report of the Committee on Ways and Means on H. R. 8300 (H. Rept. 1337, 83d Cong.), contained the following statement (p. 59):

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

As stated by Congressman Wilbur Mills, chairman of the Ways and Means Committee, in his explanation to the House of H. R. 8381 (Congressional Record, Jan. 28, 1958, p. 1037):

"This definition in the 1954 code was intended to be more liberal than the definition of property followed by the courts under the 1939 code."

Unfortunately, however, the definition of "property" adopted in section 614 was not the definition established by regulations and by court decisions, but instead was the judicially discredited (insofar as mining was concerned) definition enunciated in the national office's published interpretations of the regulations. As a result, Congress by adopting section 614 unintentionally precluded the following practices which were commonly followed and commonly accepted in the administration of the 1939 code:

(1) Where there are two or more mines on a single tract (acquisition), the taxpayer can no longer treat each mine as a property.

(2) Where there are two or more mines within a single operating unit, each mine being made up of multiple tracts, the taxpayer can no longer treat each mine as a property.

(3) The taxpayer can no longer wait until he begins development to decide how he will extract the mineral from a given tract. He is now required to make an election in the return for the first year in which exploration expenditures are made, even though extraction of the mineral may not begin until many years in the future. It is not unusual for a career mining company to conduct exploratory activities on reserve acreage, to ascertain the extent of reserves, and to enable it to plan its operations in an orderly manner, with the intention of deferring actual development until the mineral is needed.

With respect to oil and gas, it should be noted that section 614 (contrary to pre-1954 regulations) does not permit the taxpayer to combine deposits within each lease, where there are several leases within an operating unit.

III. The Effect of Present Section 32 of H. R. 8381

As presently written, section 32 of H. R. 8381 would permit the taxpayer to treat any proeprty as if section 614 of the 1954 code had not been enacted, but if such treatment would constitute an aggregation then it shall be treated as an aggregation for the purpose of applying section 614. In effect, therefore, the taxpayer is permitted to choose between 1954 code treatment and 1939 code treatment in each operating unit—except that he would be permitted to treat a mine constituting only a portion of an acquisition as a property (under the 1939 code) and still utilize the 1954 code to make one aggregation within that same operating unit.

Theoretically, this operates to restore to the mining industry those rights which were unintentionally taken away in the enactment of section 614. Unfortunately, however, the national office of the Internal Revenue Service never acquiesced in the court decisions interpreting the regulations with respect to the meaning of the "property" as applied to mining, and not all of the points involved were squarely covered by judicial decisions. The vast gulf between enuciated theory of the national office and the ordinary practices which were commonly adopted and commonly accepted by the revenue agents in the field was not completely spanned by court decisions, with the result that the taxpayer would be hard put to prove judicially his legal right to all of the points set forth here.

In substance, therefore, the present section 32 of H. R. 8381 constitutes primarily a license to litigate. It is unreasonable to leave the situation in such an unsatisfactory position when the definition of "property" can be spelled out to the satisfaction of the taxpayers without substantial detriment to the Government.

IV. Rights Which Should Be Restored by Amending Section 32 of H. R. 8381

Section 32 should be amended to specifically restore the following rights which the taxpayer had under the 1939 code as actually administered:

(1) The taxpayer should be permitted to treat each mine as a separate property where the mineral in a single tract or parcel of land is or will be extracted through more than one mine.

(2) The taxpayer should be permitted to treat each mine (or group of mines) as a separate property where several mines, each made up of multiple acquisitions, are contained within a single operating unit.

(3) The taxpayer should be permitted to wait until he begins development of a deposit in a tract to make his election with respect to such deposit.

(4) In the case of oil and gas wells and other natural deposits (not including mines), the taxpayer should be permitted to make an aggregation of deposits in each tract or parcel of land, even where several tracts are included within one operating unit.

(5) Previously permissible concepts with respect to nonoperating mineral interests should be restored.

A definition of "operating unit" should be written into the law, couched in the language of the committee reports pertaining to the 1954 code, and a presumption of correctness should be granted to the taxpayer's determination of "operating unit." This is necessary because the operating-unit concept was never previously spelled out in the law or regulations, and the term is so vague as to be practically without meaning as applied to the varied situations which exist in the many industries affected thereby.

V. The Tax Consequences of Such an Amendment to Section 32 of H. R. 8381

Since the major objective of such an amendment would be to spell out in specific language the rights which are restored under section 32 as it is presently written, it can readily be seen that there would be no revenue loss from such an amendment if the taxpayer could establish those rights under the language of present section 32. However, as previously mentioned, there would be considerable difficulty of legal proof with respect to some of the practices which were commonly accepted in the past. Therefore a short discussion will be given here of the tax consequences of the changes which should be made in present law by amendment to section 32 of H. R. 8381:

(1) Under given conditions, there is a tax consequence flowing from restoration of ability to treat each mine as a property where two or more mines are contained within a single mineral interest. In such cases, if one mine is operating at a profit with depletion limited by net income, and the other mine is operating at a loss, the tax consequences are obvious. The amount of revenue involved, however, should be relatively small—any taxpayer who can foresee extended periods of heavy losses for a given mine, while another of his mines is operating at a profit, will inevitably be forced to close the mine which operates at a loss—particularly if the operation of the loss mine is going to reduce his depletion for the profitable mine. At any rate, the small loss of revenue here involved should not be a factor in considering this proposal, because restoring this treatment is clearly as a matter of correcting an unintended hardship. It has been common practice in the past for the mining industry to treat each mine, in such situation, as a separate property.

(2) There would be no tax advantage resulting from restoration of the right to treat each mine (or group of mines) as a separate property where several mines, each made up of multiple acquisitions, are contained within a single operating unit. Obviously the first aggregation within an operating unit may result in tax advantage to the taxpayer if he is fortunate enough to foretell the future with accuracy. But the first aggregation is already permissible under section 614 of the 1954 code. Under any circumstances where the operating results can be foretold with sufficient accuracy to derive a tax benefit from aggregation, the same tax benefit can be derived from the already-permitted single aggregation as could be achieved from multiple aggregations consisting of complete mines (or groups of mines).

(3) There will be little tax advantage flowing from restoration of the time of development as the time of election. At first glance it may appear that there is a tax consequence, because the taxpayer thereby keeps the exploration expenditures on the reserve acreage from affecting the net income limitation on the aggregated property. However, the present law does not require aggregation, so the taxpayer is already at liberty to accomplish the same result by refusing to aggregate. In effect, therefore, this provision would not affect the tax consequences, but would merely permit simplification of depletion computations by allowing aggregation instead of barring aggregation through tax penalties. As a practical matter, no taxpayer can be expected to determine years in advance how he will extract the mineral from a given tract.

(4) For the same reasons as those set forth under paragraph numbered (2) above, there would be no tax advantage resulting from the restoration of the right to combine deposits within each lease, in the case of oil and gas and other natural deposits (not including mines). Briefly, whatever tax advantage there is from any number of aggregations in an operating unit is already available under present law, since all of such advantage can be gained from the already-permissible aggregation.

(5) There would be no tax advantage resulting from restoration of the previously permitted flexibility in the case of royalty owners. The owner of a non-operating interest is always, or nearly always, on the gross limitation for depletion purposes, or is taking cost depletion (or, in the case of coal, using capital gains instead of depletion). The total depletion allowable will obviously be the same whether the taxpayer is permitted to treat his interests as 1 property, 10 properties, or 3,000 properties. (There are situations where landholding companies have as many as 3,000 acquisitions.)

In summary, an amendment along the lines herein discussed will have an insignificant effect upon the revenue. It would save taxpayers and the Government a vast amount of time and money which will otherwise be spent for additional tax personnel, bookkeeping help, litigation expenses, and engineering surveys.

The CHAIRMAN. The next witness is Mr. Richard L. Hirshberg, assistant counsel, National Coal Association.

Please identify yourself, Mr. Hirshberg.

STATEMENT OF RICHARD L. HIRSHBERG, ASSISTANT COUNSEL, NATIONAL COAL ASSOCIATION

Mr. HIRSHBERG. Mr. Chairman and gentlemen, I am Richard L. Hirshberg, assistant counsel of the National Coal Association.

I am appearing in place of Mr. Tom Pickett, our executive vice president.

Our organization is the trade organization of bituminous coal mineowners and operators throughout the United States. Our members mine more than two-thirds of the commercially produced bituminous coal in this country.

I appear before this committee today to urge you to consider an amendment to section 32 of the technical amendments bill, also known as the Mills bill (H. R. 8381).

Our proposal, like section 32 itself, would amend section 614 of the Internal Revenue Code of 1954.

For the purpose of identification, I would like to point out that our proposal is the same as the amendment offered by Senator Bennett during the testimony of the last witness, Mr. Arnold.

Senator KERR. In other words, your position is the same as that of Mr. Arnold?

Mr. HIRSHBERG. Yes, sir.

Senator KERR. And the amendment which he urged and which has been offered by Senator Bennett will achieve the objective that you now urge?

Mr. HIRSHBERG. Yes, sir, it will achieve that, Senator, among other objectives. As I state later on in my prepared statement, I speak only for the coal industry.

Section 614 is a technical and complicated provision of the Internal Revenue Code. It is entitled "Definition of the Property." A proper definition of the term "property," as explained later, is of great importance to coal mine operators in computing their income tax liabilities. It is also of importance to other extractive industries, but I deal only with the coal industry's problems.

Congress, as you know, completely revised the Internal Revenue Code in 1954. And because the subject of property is so technical, it is quite understandable that Congress at that time included some language in section 614 which created an unintended hardship on coal mine operators in computing their income tax liabilities.

Incidentally, the 1954 code was the first time that the term property had been defined by statute, although there were regulations, rulings, and court decisions on the subject.

Now, in order to correct this unintended hardship inherent in the 1954 code definition of "property," the House Committee on Ways and Means has approved, and the House has already passed, section 32. Before going into a detailed explanation of our proposal, the amendment offered by Senator Bennett, I want to emphasize three points.

(1) This proposal only has the effect of giving the taxpayer the same rights as he had before the 1954 code was enacted with the alternative of using the 1954 code if he so desires. Stated another way, the two things that our proposal does not do are to create rights which the taxpayer did not previously possess, or to give taxpayers the privilege of combining the new 1954 code treatment with what they could have done under the 1939 code.

(2) I want to emphasize that our proposal makes no substantive change in section 32 of the Mills bill. It simply spells out the provisions of that section with the purpose of forestalling a large number of lawsuits.

(3) This proposal would not result in any large loss of revenue. In this connection, I would like to point out that the report of the House Ways and Means Commiteee noted that the revenue loss from the enactment of section 32 would be negligible.

Why is this term "property" important? Mr. Arnold has gone into that, but at the risk of being somewhat repetitious I will go into it briefly myself.

The term "property" was defined, as I have stated, for the first time legislatively by the 1954 code. The definition is of vital importance to the coal mining industry, because property is an essential element in computing the depletion allowance. Briefly stated, the allowance for percentage depletion is the lower of two things, (1) in the case of coal, 10 percent of the gross income from the property, or (2) 50 percent of the taxable income from the property. So you can see that the property does enter into making that computation.

With the chairman's permission, I will omit the citations to the code and the cases, since they will appear in the record.

The CHAIRMAN. They will be inserted in the record without objection.

(The prepared statement of Tom Pickett, executive vice president, National Coal Association, is as follows:)

STATEMENT OF TOM PICKETT, EXECUTIVE VICE PRESIDENT, NATIONAL COAL ASSOCIATION

INTRODUCTION

My name is Tom Pickett. I am executive vice president of the National Coal Association, which is the trade organization of bituminous coal mineowners and operators throughout the United States. Our members mine more than two-thirds of the commercially produced bituminous coal in this country.

I appear before your committee today to urge you to consider an amendment to section 32 of the technical amendments bill of 1958 (H. R. 8381, also known as the Mills bill). Our proposal, like section 32, would amend section 614 of the Internal Revenue Code of 1954.

Section 614 is a technical and complicated provision of the Internal Revenue Code entitled "Definition of the Property." A proper definition of the term "property," as explained later, is of great importance to coal mine operators in computing their income tax liabilities. It is also of importance to the other extractive industries, but my testimony will be limited to the coal industry's problems.

Congress completely revised the Internal Revenue Code of 1954. Because the subject of property is so technical, Congress quite understandably included some language in section 614 which created an unintended hardship on coal mine operators in computing their tax liabilities. Incidentally, this was the first time that property had been defined legislatively, although there were regulations, rulings, and court decisions on the subject.

In order to correct the unintended hardship inherent in the definition of "property" in the 1954 code, the House Committee on Ways and Means approved, and the House passed, section 32 of the technical amendments bill. Before getting into a detailed discussion of our proposal, I wish to emphasize three points:

(1) This proposal only has the effect of giving the taxpayer the same rights he had prior to the 1954 code, with the alternative of using the 1954 code if he so desires. Stated another way, the two things which this proposal does not do are to create rights which taxpayers did not previously possess, and to give taxpayers the privilege of combining 1954 code treatment with the previously established treatment.

(2) This proposal makes no substantive change in section 32 of the technical amendments bill. It simply spells out the provisions of that section with the purpose of forestalling a large number of lawsuits.

(3) This proposal would not result in any large loss of revenue. In this connection, the report of the Ways and Means Committee noted that the revenue loss from the enactment of section 32 of the technical amendments bill would be negligible.

IMPORTANCE OF THE DEFINITION OF THE TERM "PROPERTY"

The term "property" was defined by act of Congress for the first time in 1954. This definition is of vital importance to the coal mining industry because property is an essential element in computing the depletion allowance. Briefly stated, the allowance for percentage depletion is the lower of: (1) 10 percent of the gross income from the property (in the case of coal), or (2) 50 percent of the taxable income from the property (sec. 613, 1954 code).

In the maze of statutory and regulatory technicalities which have accumulated on this subject, it is important to remember the basic purpose of defining "the property." That purpose is to aid in computations of gross income and taxable income which bear a reasonable relationship to sound and long-established business practices. Such computations, in turn, are made for the purpose of carrying out the basic and long-standing congressional mandate that there shall be allowed as a deduction in computing taxable income a reasonabble allowance for depletion * * * according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate (section 611 (a), 1954 code).

If the end result is not a reasonable allowance for depletion, in terms of economic realities rather than abstract legalistic concepts, then it is time to look for something wrong in the application of the important word "property."

NO DEFINITION OF "PROPERTY" IN 1939 CODE

As mentioned above, there was no definition of the term "property" in the Internal Revenue Code of 1939. Mine operators made their computations of gross income and net income from the property under regulations prescribed by the Treasury Department.

WORKABLE RULES IN REGULATIONS UNDER 1939 CODE

Regulations issued under the 1939 code contained workable definitions of the term "property." In most cases, the end result was a reasonable allowance for depletion as contemplated by Congress, so long as the regulations were sensibly interpreted.

"The property" was defined in the regulations as "the interest owned by the taxpayer in any mineral property" (regulations 118, section 39.23 (m)-1(i)). The term "mineral property" was defined as "the mineral deposit, the development and plant necessary for its extraction, and so much of the surface of the land only as is necessary for purposes of mineral extraction" (regulations 118, section 39.23(m)-1(d)(2)).

Then there was this further important sentence: The taxpayer's interest in each separate mineral property is a separate property; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single property, provided such treatment is consistently followed (regulations 118, section 39.23 (m)-1(i)).

This last provision of the regulations meant that, as a general rule, depletion had to be figured separately for each separate mineral property. As an exception to that general rule, the Treasury regulations gave the taxpayer the right to combine mineral properties in computing the depletion allowance under specified circumstances. This method of combining properties came to be known as aggregation.

However, the taxpayer had to be consistent: he could not figure depletion on each property separately in 1 year and then switch to the combined properties (or aggregation) method the following year. The obvious purpose of this requirement of consistency was to protect the Government from possible juggling of the depletion allowance to gain improper tax advantage.

CONFUSION CAUSED BY SHIFTING OFFICIAL INTERPRETATIONS OF REGULATIONS—GCM'S 22106 AND 24094

The regulations themselves were reasonably clear. The coal industry looked at the definition of "mineral property" and decided that, in most cases, it meant simply a coal mine. Accordingly, coal mine operators treated each mine as a separate property for depletion purposes or, alternatively, they lumped 2 or more mines together as 1 property where such mines were included in a single tract or parcel of land.

This treatment prior to the 1954 code seemed to accord with the Commissioner's regulations governing the computation of a reasonable allowance for depletion. The courts generally agreed with the industry's position that the property was equivalent to the mine.

Confusion was injected into the picture when the Commissioner attempted to give bizarre and unexpected interpretations to his own regulations. Two General Counsel's memorandums were invoked against taxpayers where the Government thought their application would increase tax liabilities (GCM 22106, 1941-1 C. B. 245, and GCM 24094, 1944 C. B. 250). The effect of these GCM's was to provide that each interest in mineral deposits separately acquired (that is, acquired by a separate conveyance) had to be considered as a separate property, even though the result was a single tract or parcel of land in the hands of the taxpayer.

The Tax Court rejected this interpretation of the depletion regulations in several cases. Typical of these cases was *Black Mountain Corp.* (5 T. C. 1117 (1945)), where there were 3 acquisitions, in separate years, contiguous to each other and containing 1 seam of coal. There were 2 mines on this tract, which the taxpayer consistently treated as 2 properties. Agreeing with the taxpayer and expressly rejecting GCM 22106, supra, the court held that the term "property" meant an "economic and practical unit * * * to extract a particular block of coal" and that "each separate coal mine indipendently operated" was a separate "property."

The Commissioner's interpretation of his own regulations was not merely unrealistic as applied to coal mining; it was also inconsistent.

In the Black Mountain case, the Commissioner first claimed that the 2 mines were 1 property, then invoked GCM 22106 and said that each separate acquisition was a separate property. The Government's shifting position is also illustrated by *Amherst Coal Co.* (11 T. C. 209 (1948)), in which 14 tracts within 1 continuous boundary, acquired in 7 seven separate transactions and containing 3 mines, had been consistently treated by the taxpayer as 1 property. The court agreed with the taxpayer, but not before the Commissioner had first argued that there were 2 properties and then that there were 17 properties, citing GCM 22106, supra.

The inconsistency of the Internal Revenue Service in its sporadic attempts to rely on GCM 22106 is pointedly illustrated by *Buffalo Chilton Coal Co.* (20 T. C. 398 (1953)), which the Government won. In this case, a total of 8 contiguous tracts had been acquired on 4 separate occasions. Each of the three mines operated in this area was held to be a separate property. This result was actually urged by the Commissioner who failed to mention the separate acquisition theory of GCM's 22106 and 24094, supra.

DEFINITION OF "PROPERTY," SECTION 614, 1954 CODE

With this background of administrative uncertainty and attempted judicial clarification, the Congress in 1954 enacted a definition of the term "property" and also expressly permitted the combination (or aggregation) of separate mineral interests under some circumstances (section 614, 1954 Code). Apparently, the intention was to give taxpayers the clear right to aggregate in some cases where they previously lacked it, but not to deprive taxpayers of any rights which they had under the 1939 code, regulations, judicial decisions, and practice.

Unfortunately, however, the definition of property which reached the 1954 code was the discredited definition of GCM's 22106 and 24094. Section 614 (a) provides:

"(a) GENERAL RULE.—For this purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."

The definition in the regulations which made "the property" virtually equivalent to "the mine" (in the case of coal) was inadvertently dropped when this section was drafted (regulations 118, sections 39.23 (m)-1(d) (2) and 39.23 (m)-1(i)).

CLARIFICATION PROPOSED IN TECHNICAL AMENDMENTS BILL OF 1957

In recognition of this unintended hardship in section 614 of the 1954 code, and with the intent to restore to taxpayers all rights with respect to the definition of "property" which they previously had, the House has passed section 32 of the technical amendments bill. This section provides:

"SEC. 32. RETENTION OF 1939 CODE RIGHTS WITH RESPECT TO TREATMENT OF MINERAL INTERESTS.

"Section 614 (definition of property) is amended by adding at the end thereof the following new subsection:

"'(d) 1939 CODE TREATMENT.—Any taxpayer may treat any property (determined as if the Internal Revenue Code of 1939 continued to apply) as if subsections (a), (b), and (c) had not been enacted. If any such treatment would constitute an aggregation under subsection (b) or (c), such treatment shall be taken into account in applying subsections (b) and (c) to other property of the taxpayer.'"

The committee report explains this section as follows (H. Rept. 775 (1957), p. 25):

"Section 614 of the 1954 code was intended to liberalize the provisions of the 1939 code with respect to the definition of property. Some taxpayers have contended that the 1954 code section has deprived them of rights they previously had under the 1939 law, regulations, court decisions, or practices. Since, under the 1954 code, there was no intention to remove any rights which the taxpayers had, the bill restores such rights as taxpayers had under the 1939 code.

"The bill accomplishes this by adding a new subsection to section 614 dealing with the definition of property. This subsection in effect provides that a taxpayer may elect to treat any property as if the present 1954 code definition of property had not been enacted and as if the 1939 code rules still apply. Thus, with respect to a property for 1954 and subsequent years, a taxpayer has two choices: he can apply the 1954 code rules, or he can adopt the 1939 code rules.

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

POSITION OF NATIONAL COAL ASSOCIATION ON SECTION 32 OF TECHNICAL AMENDMENTS BILL

The National Coal Association regards section 32 of the technical amendments bill as an important step in the right direction.

From an examination of the relevant Tax Court cases discussed above and other cases, it appears reasonably certain that a taxpayer going into court under the 1939 law, regulations, court decisions, or practices (see H. Rept. 775, supra) could win his point. He could probably convince the court to follow the economical and practical test approved in Black Mountain Corp., supra, where it was held that each separate coal mine independently operated was a separate property for depletion purposes.

Although a taxpayer would be likely to succeed in court under section 32, there still remains the fact that he would probably have to spend time and money to litigate the definition of "property." In other words, this section contains no guaranty that the Internal Revenue Service will not revive and reassert the principles of General Council's Memorandum 22106 and 24094, supra, even though they have been pretty thoroughly discredited by the Tax Court as interpretations of the 1939 code and regulations.

For this reason, we urge the adoption of our proposal. Briefly stated, this proposal would—

(1) Allow the taxpayer to continue treating the mine as the basic unit for "property" purposes (whether the mine consists of one interest, several interests, a part of one interest, or any combination of the above);

(2) Enact a workable definition of the term "operating unit," with a presumption of correctness given to operating units set up by the taxpayer (if consistent practice is followed, there is no chance of substantial revenue loss); and

(3) Provide realistically for the problem of reserve acreage, by removing the requirement that mine owners must decide whether or not to "aggregate" during the first year of exploration expenditures (since exploration often precedes actual use of the mining property by many years), and substituting a requirement of election to "aggregate" during the first year of development expense.

Our proposal would thus spell out the rights granted in section 32 of the technical amendments bill and would have the effect of sparing both the taxpayer and the Government from a costly burden of litigation. Let me emphasize again that this proposal removes the unintended hardship created by the provision in the 1954 code defining the term "property," and that it grants no rights to taxpayers which they did not possess before the enactment of the 1954 code.

Mr. HIRSHBERG. In the maze of statutory and regulatory technicalities which have accumulated on this subject, it is important to remember the basic purpose of defining the term "property". That purpose is to aid in computing gross income and taxable income so that these computations bear a reasonable relationship to sound and long established business practices.

These computations in turn are made for the purpose of carrying out the basic and long-standing congressional mandate——

Senator LONG. Might I make a suggestion, Mr. Chairman?

The CHAIRMAN. Senator Long.

Senator LONG. I believe that this witness is testifying for the same thing as the previous witness is testifying on, and we asked the previous witness a great number of questions in order to get an understanding of this matter. My feeling is that a case has been made for this provision.

I think it is sufficient that he make a statement. I would suggest that that be the procedure in regard to those who are supporting this section 32.

The CHAIRMAN. That is the proposed amendment to 32?

Senator LONG. Yes, sir.

In my judgment the case has been made for this amendment, and if he would like to add something to this to explain it I would like to hear it. As far as giving the same statement, I think it would expedite the matter if they would submit the statement and simply comment on it.

That was the general statement of the Reorganization Act, and I think it would be more expeditious in this case.

The CHAIRMAN. Do you have any additional comments, Mr. Hirshberg?

Mr. HIRSHBERG. Yes, sir, I do. I would like to emphasize a few points not covered specifically in Mr. Arnold's statements.

The first one, skipping to page 4—I realize, Senator, that I have been repetitious, since we did not know exactly what the American Mining Congress was going to say—but the first point is that under the 1939 Code the coal industry had no objection to the Treasury regulations. The objection was to the flip-flopping, indecisive, and inconsistent interpretation of those regulations that was urged by the Treasury Department from time to time.

So that, unlike most tax cases, you did not have the taxpayer trying to contest the validity of the regulation and saying it was contrary to the Code, you had the taxpayer urging that the regulation was valid but urging his own interpretation against that of the Commissioner of Internal Revenue.

Without going into the details of this, the term "property" under the 1939 regulations was defined in such a way that it was roughly equivalent in the coal business to the term "mine." Because the 1954 Code was so complicated and was so hurriedly drafted, in terms of the tremendous job Congress had to do, some of the definitions in the regulations under the 1939 Code were left out of the 1954 Code, and this essential part was left out. You may refer to the written statement for the actual technical provisions.

One thing that I would like to emphasize is that in the 1939 Code regulations, which we are seeking to restore at the option of the taxpayer if he does not want to use the 1954 Code treatment, there was this important sentence: "The taxpayer's interest in each separate mineral property is a separate 'property'; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single 'property,' provided such treatment is consistently followed."

So the taxpayer was required to be consistent. He could not switch treatments from one year to another.

This method of combining came to be known by the technical name of "aggregation", a term which appears in the 1954 Code.

The obvious purpose of the consistency requirement was so that the taxpayer could not juggle his properties back and forth and get an unfair tax advantage.

Now, some of the Commissioner's interpretations, skipping to page six, are illustrated by three of the many cases on this subject. These cases illustrate not only that the Commissioner was inconsistent from case to case, but that even within a particular case he changed positions, in some cases several times.

In the *Black Mountain* case, there were three acquisitions, in separate years, contiguous to each other and containing one seam of coal. There were two mines on this tract, which the taxpayer consistently treated as two "properties"; in other words, he "aggregated." Agreeing with the taxpayer and expressly rejecting the Internal Revenue Service General Counsel's Memorandum 22106, the Tax Court held that the term "property" meant "an economic and practical unit * * * to extract a particular block of coal," and that "each separate coal mine independently operated" was a separate "property."

In the *Black Mountain* case, the Commissioner first claimed that the two mines were one "property." Then he shifted his position and invoked this General Counsel's Memorandum, saying that each separate acquisition was a separate "property." Of course, the court disagreed.

In the *Amherst Coal* case, there were 14 tracts within one continuous boundary, acquired in 7 separate transactions. There were 3 mines, all of which had been consistently treated by the taxpayer as one "property" under the permissive aggregation provision of the regulations. The Tax Court agreed with the taxpayer, but not before the Commissioner had first argued that there were two "properties," and then that there were 17 "properties."

The last case that I will cite is the *Buffalo Chilton* case, which is on our side, but which oddly enough the Government won. There were 8 contiguous tracts acquired on 4 separate occasions, and each of the 3 mines operated in this area was held to be a separate "property." This was the result urged by the Commissioner, who in this case conveniently neglected to cite General Counsel's Memorandum 22106.

Now, the 1954 code definition, I believe, has been discussed thoroughly enough, unless there are any questions.

Our main objection is that it inadvertently dropped part of the definition of "property" in the 1939 code regulations.

The Mills bill, the technical amendments bill, contains proposed section 32 to clarify the definition of the term "property," and to remove the unintended hardship. I will not read the text of the bill, which the committee is familiar with. The House committee report explains the section, stating that section 614 of the 1954 code was intended to liberalize the provisions of the 1939 code with respect to this definition.

The report states that some taxpayers have contended that the 1954 code deprived them of rights they previously had under the 1939 law, regulations, court decisions, and practices. Then it goes on to say that there was no intention to deprive anyone of rights which he had previously, and further states that under section 32 the taxpayer will have a choice of going back to the 1939 code or using the 1954 code.

It finally makes this very important point, which I think bears repetition, that there will be no appreciable revenue loss involved. And I think the Treasury Department itself will bear us out on that.

We regard section 32 as a very important step in the right direction. We think from the cases I have cited, and from other cases, that we could win our point in court, that the property is equivalent to the mine. However, I think that section 32 does leave something to be desired in that the taxpayer will have to spend time and money to litigate the definition of the term "property."

For the reasons stated, I urge the adoption of our proposal. Just to go into the proposal briefly, and then I will conclude, this proposal in quite general terms would:

No. 1, allow the taxpayer to continue to treat the mine as the basic unit for property purposes, no matter whether the mine was made up of several mineral interests, or one or less than one or any combination of the above. We think this is realistic.

No. 2, enact a workable definition of the term "operating unit," which is not now defined in the code, with the presumption that the taxpayer's operating unit is correct. If consistent practice is followed (in other words, if the election once made is binding), there is no chance of any appreciable revenue loss.

No. 3, provide realistically for the problem of reserve acreage by not requiring a taxpayer to decide whether a particular acquisition is part of a mine until the development stage is reached. A later witness, I understand, will go into that in more detail.

In conclusion, our proposal would spell out rights granted by section 32 of the Mills bill, and would have the effect of sparing not only the industry but also the Government from a heavy burden of litigation.

Let me emphasize again that this proposal removes the unintended hardship written into the 1954 code by section 614, and that it grants to taxpayers no rights which they did not possess before the enactment of the 1954 code under the Treasury's own regulations.

The CHAIRMAN. Are there any questions?

Thank you very much.

Mr. HIRSHBERG. I appreciate the opportunity of appearing.

The CHAIRMAN. The next witness is Mr. J. M. B. Lewis, Jr.

STATEMENT OF J. M. B. LEWIS, JR., NATIONAL COUNCIL OF COAL LESSORS, INC.

The CHAIRMAN. Mr. Lewis, will you identify yourself and proceed.

Mr. LEWIS. Mr. Chairman and gentlemen of the committee: My name is J. M. B. Lewis, Jr. I reside at Bluefield, W. Va., and am full-time counsel for Pocahontas Land Corp., a coal lessor, and a director and secretary of National Council of Coal Lessors, Inc., a trade association of coal lessors with members in most of the coal-producing States. I appear before you today on behalf of this group of coal lessors.

My subject is simple and does not involve loss or gain of revenue. It involves the practical aspect of determining and reporting the rate of unit depletion of mineral, based upon cost or 1913 valuation, by the owners of nonoperating mineral interests.

I might digress from my written statement to say that you have just had a discussion of the problem of aggregating operating interests for coal or other mineral producers; and I am speaking on behalf of the owners of what is called nonoperating mineral interests.

Nonoperating mineral interests are those owned by companies which do not extract the minerals but dispose of them to their lessee-purchasers for a consideration based upon the number of units, such as tons, extracted throughout the life of the mineral property.

Senator KERR. Are you speaking for the royalty owners?

Mr. LEWIS. The so-called royalty owners, the lessors, the parties who do not mine coal themselves but who sell the coal by way of leases in installment payments based upon the tons of coal, which are paid for as they are removed.

Prior to adoption of the 1954 code, the Treasury permitted owners of nonoperating mineral interests to aggregate their respective mineral tracts which were contiguous or in a general geographic area and had been acquired at varying costs per acre into specified combined areas, generally called mineral properties, and to determine by calculations of aggregate costs or 1913 valuation and estimated mineral content the average cost per unit in the specified area. Of course, that is the method of arriving at the unit rate of depletion.

Senator KERR. That is your cost depletion on 1913 valuation.

Mr. LEWIS. In the event you owned the land when the income tax law was first adopted, the depletion is based on 1913 valuation.

Then, exceedingly large areas that were composed of many contiguous tracts have been divided into two or more separate mineral properties, with a uniform rate of depletion for each property. Aggregation of tracts was recognized for each separate mineral when there were two or more minerals in the same land; and there could be aggregations prior to sale by lease instead of waiting until sales were actually made.

Since this Treasury practice was based upon rulings and regulations and not statutory authority, it was decided to authorize aggregation in the 1954 code and section 614 (c) (1) was added for this purpose. You have heard a great discussion of section 614 (b) relating to aggregation of operating interests; now you drop down and (c) (1) relates to aggregation of nonoperating interests. But the wording of section 614 (c) (1) is narrow and restrictive to the extent that the types of aggregation that I have just mentioned are not included. And in addition, there is required a formal showing of undue hardship as a prerequisite to the right to aggregate, even though it is entirely plain and manifest that it would be a hardship (and highly impracticable to both the owner and the Treasury) if the owner were not allowed to aggregate as a matter of right.

I have attached at the end of my written statement an illustration that is very simple which explains this feature of undue hardship. If the members of the committee would turn to the last sheet of my statement, you will see there a very simple illustration. You have shown there a sort of a map of 23 different tracts of land that were acquired at 23 different times at a different price per acre. Now, if the owner of those lands were not allowed to aggregate all 23 of those 23 tracts, the coal in which would be sold to one lessee, if he were not allowed to aggregate the total cost and get a uniform rate of depletion, then he would have to have a separate rate of depletion for each of those 23 tracts. To me, on the face of it, it would be a hardship if he were not allowed to aggregate. Still the statute requires a formal showing of "undue hardship" which, taken literally, means that every time you have a group of lands that you have acquired over a 10- or 12-year period, and they are about ready to be sold or leased to a big coal producer, you have got to come up and make a formal showing, which sometimes might consume a year or two, with all of your records being brought up here. It is just unnecessary, that is all; and it is unnecessary for the Government, as well as it is for the taxpayer.

That illustration shows just as to a mere 23 tracts. There are instances of coal lessors that have over 1,500 separately acquired tracts that are finally developed into one property for the purpose of obtaining a uniform rate of depletion for their whole property.

Bear in mind that your depletion here is not percentage depletion. It is based entirely on total costs. So that when, with a uniform rate of depletion, you have gotten back your total costs, then there is no more depletion. And I might say that if your rate at some time or other, based upon the estimated mineral content in the land, should turn out to be a little bit large; if it is 2.1 cents per ton when it should be 1.9 cents, the Treasury, after so many years, realizes that and they make you reduce the rate in an effort to make the rate come out even at the end—when all of the mineral is removed. But in any event, you only get back what you have paid for the property or your 1913 valuation.

Senator KERR. Mr. Lewis, can you help me out a little bit here?

Mr. LEWIS. If I can, I will be delighted.

Senator KERR. There are two questions I want to ask you. On the basis of this map you show here, how many tracts are there?

Mr. LEWIS. That is just 23.

Senator KERR. Twenty-three. These have an engineering appraisal of how many tons of coal there are under each acre, and, therefore, under this whole acreage?

Mr. LEWIS. That is right.

Senator KERR. And then you add up the total cost?

Mr. LEWIS. Yes.

Senator KERR. And how many acres do you have here?

Mr. LEWIS. Well, I didn't add up the acres, sir. There are 23 tracts. But let's assume there are 1,200 acres.

Senator KERR. Let's assume there are 2,500 acres.

Mr. LEWIS. All right.

Senator KERR. Now, what depth is that coal?

Mr. LEWIS. Well, it is of varying depth. Sometimes you have——

Senator KERR. Sometimes you have an outcrop on the surface?

Mr. LEWIS. Sometimes an outcrop on the surface, and sometimes the seam is 1,500 feet below the surface.

Senator MARTIN. Would those be adjacent tracts?

Senator KERR. It could be the same vein of coal.

Senator MARTIN. I mean, outcrops 1,000 or 1,500 feet deep.

Senator KERR. 1,500 feet, 1 mile or 10 miles.

Mr. LEWIS. All coal outcrops at some particular point, and if it is a very extensive seam, it can go on, on, on, until it gets under a mountain where it could be 1,500 feet deep. But that would be unusual, for a seam of coal that outcrops at one point to be 1,500 feet deep at another point. In some lands which have been explored lately over in Buchanan County, Va., the seam is 1,200 to 1,500 feet below the surface.

Senator KERR. Not only could it be that deep by reason of going under a mountain. It could be that deep by reason of a 15° or 20° depth.

Mr. LEWIS. Yes.

Senator KERR. And it might get deep even though it is underlying an elevation which is no higher than that at which it outcrops.

Mr. LEWIS. You will find seams of varying depths. There are plenty of outcrop seams, some 20 feet below the surface, some 50 feet——

Senator MARTIN. There are some seams that don't outcrop at all.

Mr. LEWIS. Some of it does not; you are right.

Senator KERR. What thickness is a vein of coal?

Mr. LEWIS. Some of the finer seams back in the older days were 10 or 12 feet thick. But they have been exhausted, and coal that is 30 inches thick is being mined now.

Senator KERR. 30 inches?

Mr. LEWIS. Yes.

Senator KERR. What is that, that is about 4,500 tons to the acre, would you say?

Mr. LEWIS. Not being an engineer, I do not know; but you can just take a random figure, sir.

Senator KERR. You said that the cost might be 2 cents per ton?

Mr. LEWIS. Yes, sir; that is what it might work out to be, or 1.348.

Senator KERR. Let's assume that it is 2 cents.

Mr. LEWIS. Yes.

Senator KERR. And the royalty, we will say, is 10 cents.

Mr. LEWIS. That is right.

Senator KERR. Now, do you get a depletion on the 8-cent differential between the 2-cent cost factor and the 10-cent factor?

Mr. LEWIS. No, sir, we just get the plain cost depletion.

Senator KERR. I see. Now, then, the suggestion you are making, would it in any way conflict with the amendment offered by Senator Bennett?

Mr. LEWIS. No, sir. As a matter of fact the Coal Association and the Mining Congress are recommending the same revision which I recommend.

Senator KERR. I know, but you are representing the lessors, and I wanted to inquire as to whether or not your position is different than his.

Mr. LEWIS. There is no conflict.

Senator KERR. In other words, the amendment he offered would meet the objective you have in mind, also?

Mr. LEWIS. The National Coal people told me this morning that Senator Bennett had a proposed revision of 614 (b) and (c), both, and we are in (c). So it is my understanding that Senator Bennett has our proposed amendment of section 614 (c) (1). I am going to make sure that he does have it. And, of course, our proposed amendment is attached to my written statement.

And to conclude, unless there are some more questions, all that we are doing is asking that the previous practice of the Treasury be put into clear, simple language. And I can say to you that, so far as I can see, it does not involve a gain or loss of revenue at all in our instance.

The CHAIRMAN. Are there any questions?

Thank you very much, Mr. Lewis.

Mr. LEWIS. Thank you.

(The latter part of the prepared statement which Mr. Lewis did not read follows:)

When the Ways and Means Committee was apprised of the narrow and restrictive wording, it approved a provision (section 32 of H. R. 8381) that owners of nonoperating mineral interests might treat any property (determined as if the 1939 Code continued to apply) as if section 614 (c) (1) had not been enacted. This indicates an intention not to upset or invalidate past aggregations of separate tracts into properties and, perhaps by implication, to authorize similar aggregations in the future; but this method of expressing statutory rights is highly unsatisfactory because (1) the past Treasury practice is not expressed in definite, consolidated language and there is still some doubt and uncertainty as to consistency of practice and (2) it seems questionable whether the amendment can or will be construed as extending to owners the right of aggregation in the future to the same extent and in the same manner as heretofore approved. Briefly stated, in our opinion the present wording of the statute and its amendment contained in H. R. 8381 do not express properly the past practice developed by the Treasury or express with certainty the right of the owners to aggregate in the future as they have in the past. We think a clarification is important to the Treasury also, in its job of administering the statute.

PROPOSAL

We propose that section 614 (c) (1) be revised by definite and clear language which assures not only the security of aggregations already approved but the right in the future to aggregate tracts hereafter acquired in the same manner as other tracts have been aggregated heretofore—and without the useless requirement of a formal showing of undue hardship as a prerequisite to aggregation. As stated before, loss or gain of revenue is not involved.

The suggested revision is worded in clear language attached to my written statement, with additions and deletions indicated. We would like to discuss it further with your staff.

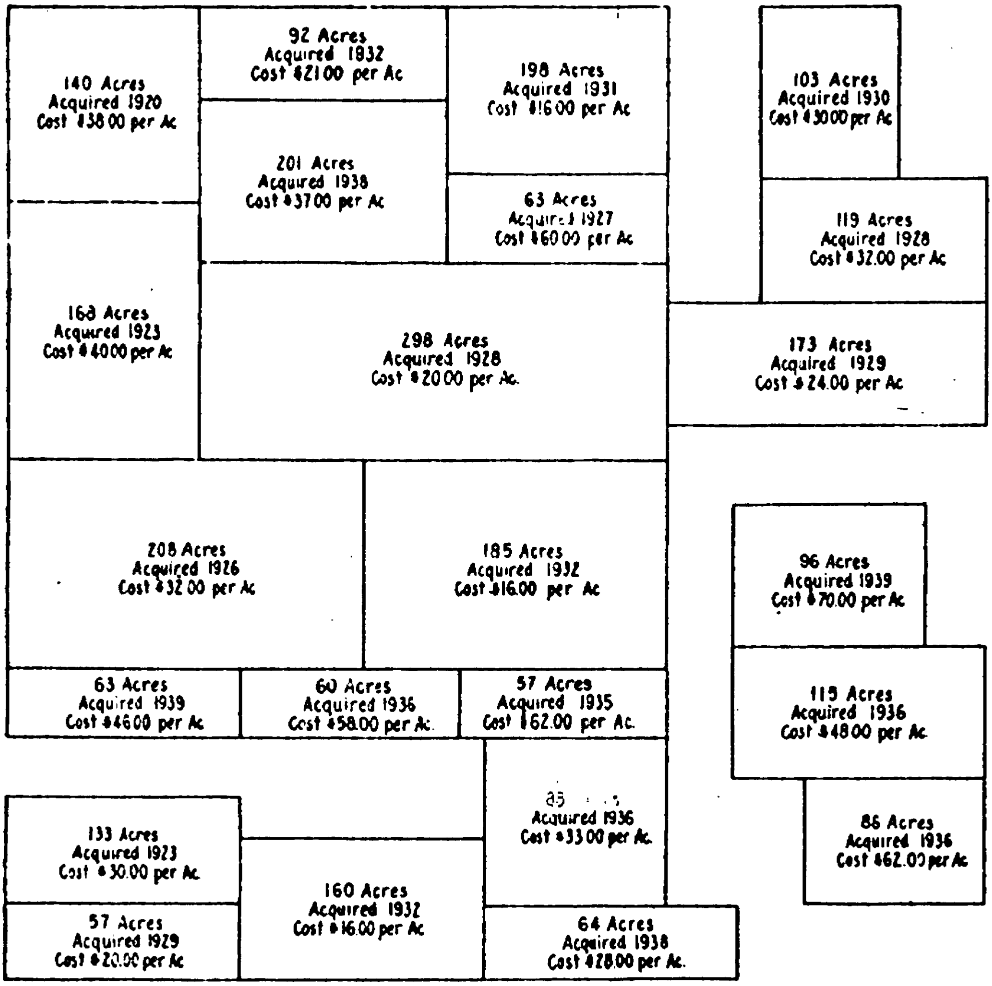
I thank you for the privilege of appearing here.

Proposed redraft of 1954 code, section 614 (c) (1): "If a taxpayer owns one or more separate nonoperating mineral interests in a single tract or parcel of land, or in two or more tracts of land which are in the same general geographic area, he may elect to treat (for all purposes of this subtitle) such interest or interests (whether or not producing revenue) in each separate kind of mineral as one property or as two or more properties. If such election is made for any taxable year, the taxpayer shall treat such interests affected by such election in the same manner for all subsequent taxable years unless the Secretary or his delegate consents to a different treatment. This paragraph shall be effective with respect to taxable years ending after December 31, 1953."

Proposed redraft of 1954 code, section 614 (c) (1), showing in detail all deletions and additions (additions italicized, deletions in brackets):

If a taxpayer owns [two] *one* or more separate nonoperating mineral interests in a single tract or parcel of land or in two or more [contiguous] tracts or parcels of land *which are in the same general geographic area,* [the Secretary or his delegate may, on showing of undue hardship, permit the taxpayer] *he may elect* to treat (for all purposes of this subtitle) [all] such [mineral] *interest or* interests *(whether or not producing revenue) in each separate kind of mineral* as one property *or as two or more properties.* If such [permission is granted] *election* is [granted] *made* for any taxable year, the taxpayer shall treat [all] such [mineral] interest *affected by such election* [as one property] *in the same manner* for all subsequent years, unless the Secretary or his delegate shall consent to a different treatment. *This paragraph shall be effective with respect to taxable years ending after December 31, 1953.*

Illustration of Aggregation of Nonoperating Mineral Interests To Determine the Unit Rate of Depletion of the Minerals



Explanation: The cost per unit of the estimated minerals in each of these 23 tracts varies as to each tract. Each mineral in the combined aggregated area will eventually be sold by lease to a lessee-purchaser which will recover all the mineral. Obviously, there should be a uniform rate of unit depletion, determined by the aggregate cost and aggregate estimated mineral content, instead of 23 different rates for the 23 separate tracts. Since it is apparent that it would be an undue hardship (and highly impractical) if the owner were not permitted to aggregate, the statute should not require a formal showing of undue hardship as a prerequisite to aggregation.

The CHAIRMAN. The next witness is Roland G. Smith.

STATEMENT OF ROLAND G. SMITH, AMERICAN IRON ORE ASSOCIATION

The CHAIRMAN. Will you identify yourself and proceed?

Mr. SMITH. My name is Roland G. Smith. I am a tax attorney for Pickands, Mather & Co., a partnership which has been operating and managing iron ore properties since 1883. My appearance today, however, is on behalf of the American Iron Ore Association of Cleveland, Ohio. This association represents the producers of about 90 percent of the iron ore mined in the United States.

With the Chairman's permission, I would suggest that a good deal of this should be put in the record, because the subject matter has been very ably covered by Mr. Arnold.

I just want to point out that our Association has carefully considered all of the recommendations of the Mining Congress and we believe that the adoption of those proposed amendments would not only assist the Internal Revenue Service in administering the depletion provisions of the Code, but they would provide the taxpayers with a more practical procedure for preparing their tax returns.

Mr. Arnold mentions that one of the amendments they suggest would remedy the present situation requiring a taxpayer, upon its first expenditure for exploration to make an election to aggregate properties when the taxpayer does not have sufficient facts to decide——

Senator KERR. Doesn't have sufficient facts upon which to make a valid or wise decision?

Mr. SMITH. That is correct. And now whether the particular operating mineral interest involved will be operated together with another interest for the purpose of producing minerals is dependent upon two factors, first, upon whether the type of minerals, the quality, location and extent is such that it would be amenable to operating in conjunction with another property of the taxpayer; and, secondly, upon whether those factors indicate that the two separate properties can be operated more efficiently as a single operating unit. It is not until sufficient exploration has been done to establish the existence of ores in commercially marketable quantities that the taxpayer has enough information to make a correct aggregation.

This is particularly true in the iron-mining industry, where a difference in the chemical analysis or physical characteristics between two ore bodies may require entirely different mining and beneficiating methods for each type of ore.

We, therefore, urge that section 32 of H. R. 8381 be amended in accordance with the recommendations of the American Mining Congress. And we wish to thank the members of this committee for allowing us to present our views on this important subject.

Senator KERR (now presiding). Very good, Mr. Smith. We are glad to have your statement.

(The prepared statement of Mr. Smith is as follows:)

STATEMENT OF ROLAND G. SMITH FOR THE AMERICAN IRON ORE ASSOCIATION

My name is Roland G. Smith. I am tax attorney for Pickands, Mather & Co.; a partnership which has been operating and managing iron ore properties since 1883. My appearance today, however, is on behalf of the American Iron Ore Association of Cleveland, Ohio. This Association represents the producers of about 90 percent of the iron ore mined in the United States.

Section 32 of H. R. 8381 does not, in our opinion, resolve certain fundamental and practical problems concerning the definition of property that have arisen in applying Code Section 614 to actual mining practice. The right to consider the mine as a proper unit for depletion purposes and the necessity of establishing a realistic time for making the aggregation election are not recognized by the provisions in section 32 of H. R. 8381 which merely would allow a taxpayer to treat his properties as if the Internal Revenue Code of 1939 continued to apply.

Our association has carefully considered, and is in complete agreement with the position of the American Mining Congress. We believe that the adoption of its proposed amendments to section 32 would not only assist the Internal Revenue Service in the administration of the depletion provisions of the Internal Revenue Code but would provide taxpayers with a more practical procedure for the preparation of their tax returns. Rather than to repeat the arguments propounded by the American Mining Congress, we would like to emphasize one phase of their proposal which is of particular significance to the iron ore mining industry, namely, the time for making the election to aggregate.

When the American Iron Ore Association appeared before the subcommittee (Mills committee) of the Ways and Means Committee on November 28, 1956, the following paragraph was included in its statement:

"The code requirement that an election must be made as to aggregation with respect to any single operating mineral interest owned by the taxpayer, either in the first taxable year ending after December 31, 1953, or in the first taxable year in which exploration, development, or production expenditures are incurred with respect to such interest compels a taxpayer to make an election before the necessary facts have been developed to ascertain whether the mineral interest involved would be considered to constitute a part of any particular 'operating unit' under the tests laid down in the proposed regulations. Until such factors as the existence, location, extent, or quality of the ores or minerals contained in the mineral property have been established through exploration to the point at which the existence of ores or minerals in commercial quantities have been disclosed, no logical basis for aggregation exists. Whether the particular operating mineral interest involved will be 'operated together' with another interest 'for the purpose of producing minerals' is dependent, first, upon whether the type of minerals, the quality, location, and extent is such that it would be amenable to operation in conjunction with another property of the taxpayer, and, secondly, upon whether those factors indicate that the two separate properties can be operated more efficiently as a single operating unit."

It is not until sufficient exploration has been done to establish the existence of ores in commercially marketable quantities that enough information is available to make the correct aggregation. This is particularly true in the iron mining industry where a difference in the chemical analysis or physical characteristics between two ore bodies may require entirely different mining and beneficiating methods for each type of ore.

It is the position of this association that the adoption of the proposal of the American Mining Congress would, by recognizing such practical mining problems as this, avoid many needless appeals to the Secretary for permission to make a new election—an expensive and time-consuming activity for both the Government and the taxpaper.

We, therefore, urge that section 32 of H. R. 8381 be amended in accordance with the recommendations of the American Mining Congress.

Senator KERR. At the direction of the Chair I submit for the record two letters he has received on section 37 of this bill. These letters are from Senator Clinton P. Anderson and Mr. William S. Swingle, president of the National Foreign Trade Council. (The letters referred to follow:)

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
February 10, 1958.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee.

DEAR MR. CHAIRMAN: I would like to register my opposition to section 2 of H. R. 8381, the proposed Technical Amendments Act of 1957, which is presently pending before the Finance Committee.

This section seeks to amend section 37 of the Internal Revenue Code of 1954. It would have the effect of eliminating the splitting of annuity and pension incomes and allotments of retirement credits to which a husband and wife in community property States, such as New Mexico, are now entitled. This would have far-reaching detrimental results on the States and would seriously curtail purchasing power of our elder citizens. If this section is enacted into law, it would only result in a saving of about $3 million per year. I believe the harm this would cause through loss of purchasing power and total effect on the economies in community property States would be far greater than any possible gain in revenue.

Sincerely yours,

CLINTON P. ANDERSON.

NATIONAL FOREIGN TRADE COUNCIL, INC.,
New York, N. Y., February 6, 1958.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SIR: Reference is made to the Technical Amendments Act of 1958 (H. R. 8381, 85th Congress, 2d sess.), which has has been passed by the House of Representatives and referred to your committee.

Enclosed is a memorandum of the Tax Committee of the National Foreign Trade Council, Inc., supporting the enactment into law of section 37 of H. R. 8381. The subject of section 37 is carryback and carryover of foreign tax credit.

It is requested that this memorandum be reviewed by your committee in connection with any consideration of section 37 and that it be made a part of the record of any hearings on H. R. 8381.

Sincerely yours,

WILLIAM S. SWINGLE, *President.*

CARRYBACK AND CARRYOVER OF FOREIGN TAX CREDIT, SECTION 37, TECHNICAL AMENDMENTS ACT OF 1957, H. R. 8381, 85TH CONGRESS

Section 37 of H. R. 8381, if enacted, would add a new subsection to section 904 of the Internal Revenue Code to permit foreign taxes which cannot be credited currently as a result of the country-by-country limitation to be carried back to the 2 prior years and then forward to the 5 succeeding years and used in these years to the extent the foreign taxes for such years are less than the amount allowable under the country-by-country limitation. Relatively few taxpayers would be affected by the new provision, and hence not much loss of revenue would be involved.

In 1918, Congress decided to give some relief from international double taxation. It recognized that the foreign country in which income was derived had at least a prior right to tax the income, and resorted to the expedient of allowing the foreign tax to be offset against the United States tax.

However, to protect the revenues derived from taxing income from sources in the United States, the Congress adopted an overall limitation which provided that the credit for all the foreign income taxes paid could not exceed the United States tax on income from sources without the United States. In 1932, the additional limitation was introduced which requires the computation of the credit country by country. The Internal Revenue Code of 1954 repealed the original overall limitation and retained the per-country limitation which has the defect that section 37 of the pending bill seeks to mitigate.

Nevertheless, it has been the policy of the United States since 1918 to encourage investments and trade abroad through granting the credit for foreign taxes. The Congress has amended the foreign tax credit provisions from time to time to carry out this policy.

The report of the Committee on Ways and Means (H. Rept. 775, 85th Cong. concerning the Technical Amendments Act of 1957, H. R. 8381) shows that the primary purpose of section 37 is to obviate in some degree the fact that the country-by-country limitation can result in double taxation where the methods of determining net income are different in the United States and the foreign country.

The per-country limitation results in the loss of foreign tax credit even in instances where the foreign income tax rate is lower than the United States rate. Excess foreign income tax credit may arise when the foreign country (1) includes in taxable income a particular item which is not reportable for income tax purposes in the same year in the United States, (2) grants a special deduction (i. e., accelerated depreciation) in 1 year rather than over a period of years in computing taxable income, or (3) disallows a particular expense which is a proper deduction under United States law. The report of the Committee on Ways and Means concerning section 37 cites a number of examples of differences between the United States tax law and the tax laws of foreign countries—pricing of inventories, foreign exchange, depreciation methods, and other factors. To illustrate the effects of these differences on the foreign tax credit there is attached a set of examples together with an explanatory memorandum of certain factual situations which have arisen in practice. These exhibits are numbered I through V and show the results arising from depreciation allowances, foreign exchange gains or losses, differences in taxable income concepts, and higher than normal local income taxes. All of these reflect cases where excess foreign tax credits could arise.

For example, on exhibit I, the effective foreign rate in the first year is considerably higher than the United States rate on the same income. In the second year, the effective foreign rate is substantially lower than the United States rate, because of the deduction permitted for taxes paid during the second year to the foreign government on the first year's income. Thus, under the circumstances set forth in exhibit I, under present law, the United States corporation would receive no credit against its United States tax in the second year for the excess $154,206 paid to the foreign government for the preceding year. It appears to be unreasonable not to permit the United States corporation to receive the benefit of the unused excess foreign tax payment.

Many foreign governments as a result of tax conventions with the United States allow, in computing the taxable net income of a branch in their territory, a deduction for a reasonable proportion of the general overhead and administrative expense incurred at the principal office in the United States. However, it is unlikely that the foreign governments could be induced to adopt our law in regard to all the items of income and deductions any more than the Congress could be induced to adopt the law of the foreign country.

The objection has been made that section 37 would permit a high foreign tax of 1 year to reduce a high United States tax of another year, and the credit carryover would be a method of averaging out foreign taxes to the level of the United States rates. While this may be true under certain circumstances, the averaging of foreign tax rates should be permitted to encourage foreign investment. As a matter of fact, foreign tax credit is presently being allowed for the Swiss national defense tax which is based annually on income resulting from averaging the income of 2 years. Moreover, if it is desirable to eliminate double taxation, the mere intervention of an annual accounting period should not prohibit full relief from double taxation of the same income. This is the result where the per-country limitation is effective under the circumstances set forth in the examples.

Except in unusual cases, section 37 would not be used to average income tax rates, but would be used chiefly to correct unusual and inequitable results due to different tax concepts in the United States and foreign countries with respect to the same item of income or deduction. Where the foreign rate is consistantly higher than the United States rate, the provision would not be effectively utilized at all, since the per-country limitation would still apply in the year to which the unused foreign tax credit was carried.

The objection has also been made that the carryover principle does not apply to other types of tax credits, such as the retirement income and the dividend credit, and there does not appear to be any important policy considerations to justify a carryover of the foreign tax credit in preference to the carryover of other types of credits.

The fact that the carryback for 2 years and carryforward for 5 years already prescribed for net operating losses is being extended into a new area is commendable, inasmuch as it would be utilized to carry out a long-established policy of encouraging foreign investments and trade through relief from double taxation.

The justification of its use in this connection is in no sense weakened because the carryover principle has not been applied to certain other types of credits, such as retirement income and the dividend credit, both of which involve relatively minor items of income that are not subject to the variations resulting from the applications of the foreign tax laws. Nevertheless, the Congress has recently provided for a carryforward of excess charitable contributions and excess contributions to pension trusts. It could be argued that the carryover should like-

The policy of the administration in promoting overseas investments and trade has been shown not only by the succession of amendments improving the foreign tax credit, but also by the conclusion of income tax conventions with 21 foreign countries which embody the foreign tax credit. Many countries now recognize as deductible, certain expenses of United States branches that were formerly disallowed, thus bringing the taxable income in the foreign countries closer to our own. However, tax treaties help only in very limited circumstances since the excess tax credits for 1 year usually encountered are due to many different tax concepts found in foreign tax laws which are not recognized in the United States Internal Revenue Code. Furthermore, tax treaties are far from universal and require a considerable amount of time to negotiate.

It is believed the enactment of section 37 of H. R. 8381 would encourage United States corporations to invest in foreign countries.

Accordingly, the tax committee supports the enactment of this provision.

Explanation of Exhibits I to V Attached

EXHIBIT I—DENMARK

In Denmark a United States corporation is taxed at rates applicable to individuals which range from 14 percent to 110 percent on incomes in excess of about $60,000 annually. Because the Danish income tax is allowed as a deduction, for income tax purposes, in the year in which the taxes are paid, a corporation starting business in Denmark will reflect variations in Danish income taxes paid even though income before taxes were the same from year to year. After about 10 years of operation if the same income were realized the taxes would tend to level off to a constant amount.

EXHIBIT II—BRAZIL

Foreign exchange losses or gains incurred in connection with the conversion of Brazilian cruzeiros income into United States dollar amounts for United States tax purposes are not deductible for Brazilian tax purposes and consequently require either a smaller or larger tax payment in Brazil which may be much smaller or greater than the equivalent United States tax on the corresponding amount of taxable income. Presently the Brazilian income tax rate including the Brazilian nonresidents' income tax is effectively at about 33.34 percent.

EXHIBIT III—NETHERLANDS

Netherlands allows for local tax purposes a greater deduction for depreciation due to accelerated methods being permitted than does the United States for tax purposes. Netherlands permits a doubling up of depreciation for the first 3⅓ years of new investment. Consequently a variation results in the annual foreign taxes paid in Netherlands as contrasted to the United States income tax paid during the life of the asset. Exhibit III shows the case where additional depreciation is allowed for local income tax purposes. After 3⅓ years, depreciation allowable for Netherlands tax purposes would be less than normal depreciation allowed for United States tax purposes and result in higher local taxes in those years than the United States tax.

EXHIBIT IV—GERMANY

A United States company operating in Germany which adopts LIFO inventory for United States tax purposes would not be allowed to use LIFO for German tax purposes. Assuming a constant foreign income on the LIFO inventory basis, the United States taxable income base would be lower in times of a rising market than the foreign taxable income base. However, in a declining market, the United States taxable income base would be higher than the foreign taxable income base. The result would be variations between United States and foreign tax bases even though the foreign income remains the same. Exhibit IV shows the result in a typical case.

EXHIBIT V—UNITED KINGDOM

The United Kingdom tax law provides that the first taxable year of a calendar year corporation shall be used as the base for the tax levied in the first 2¼ United Kingdom fiscal years. This results in an unusually large accrual of United Kingdom taxes in the first year of operation which cannot be recovered through the foreign tax credit allowance. Upon termination the company may be relieved of United Kingdom tax with respect to 1¼ United Kingdom fiscal years which in effect is a compensation for the additional 1¼ years tax paid in the initial year of operations. In these last years the company may be burdened with a full 52 percent United States tax on these untaxed earnings. Exhibit V shows the result of this situation.

EXHIBIT I

United States corporation operating in Denmark—Computation showing excess foreign tax credit [1]

	1st year	2d year	3d year	4th year	5th year	6th year	7th year	8th year
Net income	$500,000	$500,000	$500,000	$500,000	$500,000	$500,000	$500,000	$500,000
Danish income taxes	408,796	84,212	341,932	137,302	299,778	170,772	273,203	191,873
Net income after Danish income tax	91,204	415,788	158,068	362,698	200,222	329,228	226,797	308,127
United States income tax on $500,000	254,500	254,500	254,500	254,500	254,500	254,500	254,500	254,500
Less foreign tax credit	408,796	84,212	341,932	137,302	299,778	170,772	273,203	191,873
Net United States income tax	0	170,288	0	117,198	0	83,728	0	62,627
Net income after income taxes	91,204	245,500	158,068	245,500	200,222	245,500	226,797	245,500
Excess foreign tax credit	154,296	0	87,432	0	45,278	0	18,703	0

[1] Assumptions: Annual income before tax, $500,000; capital, $1,000,000.

NOTE.—Rate of exchange used Danish kroner 6.92 to $1.

EXHIBIT II

United States corporation operating in Brazil—Computation showing excess foreign tax credit [1]

	1st year	2d year	3d year	4th year	5th year
Net income before income tax	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Brazil income tax—33.34 percent	333,400	333,400	333,400	333,400	333,400
Net income after Brazilian tax	666,600	666,600	666,600	666,600	666,600
Net income before United States income tax	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Foreign exchange losses (gain)		200,000	(100,000)	(150,000)	50,000
Net United States taxable income	1,000,000	800,000	1,100,000	1,150,000	950,000
United States income tax on $1,000,000 at 38 percent	374,500	298,500	412,500	431,500	355,500
Less foreign tax credit	333,400	333,400	333,400	333,400	333,400
Net United States income tax	41,100		79,100	98,100	22,100
Net income after all income taxes	625,500	466,600	687,500	718,500	594,500
Excess foreign tax credit		34,900			

[1] Assumptions: Annual income before income tax, $1,000,000; foreign exchange losses deductible for United States tax purposes; United States rate 38 percent (Western Hemisphere Trade Corp.).

EXHIBIT III

United States corporation operating in Netherlands—Computation showing excess foreign tax credit[1]

	1st year	2d year	3d year	4th year	5th year	6th year
Net income before depreciation and income tax	$1,400,000	$1,400,000	$1,400,000	$1,400,000	$1,400,000	$1,400,000
Less accelerated normal depreciation	1,000,000	1,000,000	1,000,000	600,000	400,000	400,000
Net income subject to Netherlands tax	400,000	400,000	400,000	800,000	1,000,000	1,000,000
Netherlands tax, 47 percent	188,000	188,000	188,000	376,000	470,000	470,000
Net income after Netherlands tax	712,000	712,000	712,000	524,000	430,000	430,000
United States income on $900,000 tax at 52 percent	462,500	462,500	462,500	462,500	462,500	462,500
Less foreign tax credit	188,000	188,000	188,000	376,000	470,000	470,000
Net United States income tax	274,500	274,500	274,500	86,500		
Net income after all income taxes	437,500	437,500	437,500	437,500	430,000	430,000
Excess foreign tax credit					7,500	7,500
Net income before depreciation and income tax	1,400,000	1,400,000	1,400,000	1,400,000	1,400,000	1,400,000
Less normal depreciation per books (straight line)	500,000	500,000	500,000	500,000	500,000	500,000
Net income subject to United States income tax	900,000	900,000	900,000	900,000	900,000	900,000

[1] Assumptions: Income before depreciation and income tax, $1,400,000; fixed assets, with estimated life of 20 years, purchased in 1st year, $10,000,000.

EXHIBIT IV

United States corporation operating in Germany—Computation showing excess foreign tax credit[1]

	1st year	2d year	3d year	4th year
Net income before income tax	$1,000,000	$1,000,000	$1,000,000	$1,000,000
German income tax, 45 percent	450,000	450,000	450,000	450,000
Net income after German tax	550,000	550,000	550,000	550,000
Net income	1,000,000	1,000,000	1,000,000	1,000,000
Difference between LIFO and FIFO inventory	(300,000)	(200,000)		100,000
Net United States taxable income	700,000	800,000	1,000,000	1,100,000
United States income tax on $700,000 at 52 percent	358,500	410,500	514,500	566,500
Less foreign tax credit	450,000	450,000	450,000	450,000
Net United States income tax	0	0	64,500	116,500
Net income after all income taxes	250,000	350,000	485,500	533,500
Excess foreign tax credit	91,500	39,500		

[1] Assumptions: Annual income FIFO inventory method, $1,000,000.

EXHIBIT V

United States corporation operating in United Kingdom—Computation showing excess foreign tax credit [1]

	1st year	2d year	3d year
Net income before income tax	$1,000,000	$1,000,000	$1,000,000
United Kingdom income tax, 45.5 percent	[2] 1,023,750	455,000	455,000
Net income after United Kingdom tax	(237,750)	545,000	545,000
United States income tax $1,000,000 at 52 percent	514,500	514,500	514,500
Less—Foreign tax credit	[2] 1,023,750	455,000	455,000
Net United States income tax		59,500	59,500
Net income after all income taxes	(237,750)	485,500	485,500
Excess foreign tax credit	509,250		

[1] Assumptions: Company on a calendar year basis; annual income before income tax, $1,000,000; taxes in 1st year accrued for 2¼ years.

[2] Assumes that United States corporation operates in other foreign countries and elects to claim credits for foreign taxes generally.

Senator KERR. We are very happy to have this very distinguished citizen from the great State of South Carolina, I believe. He is chairman of the board of the Singer Manufacturing Co.

STATEMENT OF MILTON C. LIGHTNER, CHAIRMAN OF THE BOARD, THE SINGER MANUFACTURING CO.

Senator KERR. I remember the first time I ever saw a Singer sewing machine, Mr. Lightner. You look like you might have been old enough to have been around at that time, but I doubt if you had any part in making that particular one.

Mr. LIGHTNER. Thank you.

My name is Milton C. Lightner. I live in Ridgewood, N. J. I appear here as chairman of the board of directors of the Singer Manufacturing Co. and also of the Singer Sewing Machine Co., our subsidiary, in support of section 37 of H. R. 8381, providing for a carryback and carryover of foreign tax credit.

Section 37 of H. R. 8381 endeavors to correct certain defects in the provisions of the Internal Revenue Code for carrying out the policy of Congress to avoid double taxation of income from foreign sources, a policy first established in 1918. If double taxation occurs because of such defects, it may take most of, or even more than 100 percent of the income. My company has had a wide experience with this subject, as we do business in practically all countries in the world outside the Communist orbit.

Senator LONG. How many countries is that, Mr. Lightner?

Mr. LIGHTNER. New countries have been formed so rapidly since the war, Senator, that I couldn't give you an accurate statement. But it is in the neighborhood of 80 countries, perhaps.

Under existing law, income tax paid abroad by an American taxpayer on business done by it in an individual foreign country is offset against the American income tax computed under our tax law on the business of the taxpayer that year in that foreign country. The difficulty under existing law is that this balancing of tax paid to the foreign country against the American tax is required on an annual basis. The basic principle of our law is that there should not be double taxation on income earned aboard. If the foreign tax paid exceeds our computed tax, then there is no United States tax to be paid, but the excess of the foreign tax is not allowed to reduce the United States tax on income from another country or on income from within the United States. We make no protest against this result, and section 37 of H. R. 8381 would not effect any change in the rule against using an excess tax credit in a way to reduce United States taxes on business done in any other country.

If the foreign and American taxes were computed under the same tax law, this system would carry out the basic intent of Congress to avoid double taxation, as construed by the Supreme Court. (See *Burnet* v. *Chicago Portrait Co.*, 285 U. S. 1, 7 (1932).)

Senator LONG. I would like to get this straight, Mr. Lightner. What you are saying is that if the foreign governments collected their taxes the same way that this country collects its taxes, you wouldn't have any problem?

Mr. LIGHTNER. We wouldn't be here, sir.

Senator LONG. I understand.

Mr. LIGHTNER. Unfortunately there are many factors which can and do cause income to be included in the American tax computation in whole or in part in a different way than in the foreign tax computation, and, naturally, the reverse then occurs in another year. The obvious result is that, when this bulge is in the income reported in the American income-tax return, the American tax is up and the foreign tax is down. When the corresponding bulge is in the income in the foreign country—and may I interpolate that what we mean is income in the income-tax report in the foreign country, as finally audited by that country—the foreign tax is up and the American tax is down.

Senator LONG. It is all the same income, but that country requires you to report it on 1 form and report it in 1 way, and this country requires you to put it on a different form and report it in a different way?

Mr. LIGHTNER. My statement primarily, of course, has reference to the American company which has a branch abroad. And under American law, all of this income earned in a particular year goes into the American tax return of that year. And at the same time you are returning that same income under the foreign law in the foreign country, irrespective of whether you have got the cash or not. And the result may not be the same base for applying the applicable tax rates.

Senator BENNETT. And while you are doing that in 80 countries, you have a wide variety of interpretations of the same income?

Mr. LIGHTNER. That is almost an understatement, Senator.

Since the taxpayer pays the higher tax in each year, it pays full tax twice on the amount of this bulge. Often this double tax means a combined tax burden of 100 percent, or even more, on this item of income. This resulting double tax is confiscatory, and I believe is surely contrary to the intent of Congress.

There are many factors which can cause an amount of foreign income to be taxed by the United States in 1 year and by the foreign country in a preceding or following year. A vivid illustration is income from installment sales which is taxed under United States law as payments are collected, but is frequently taxed in full in the foreign country in the year in which the sale is made. Other significant factors resulting in a distortion of the intended effect of the foreign tax credit include variations in the methods of pricing inventories, differences in reporting foreign exchange profit or loss, differences in depreciation methods, and varying requirements as to method of accounting.

A theoretically possible solution would be to identify each item of income from each foreign country and to endeavor to match the United States tax in 1 year on that item against the foreign tax applicable to that item, irrespective of when the foreign tax is paid.

Senator LONG. May I ask this question? Do you think, Mr. Lightner, that this could be handled by restricting this provision in cases where the method of reporting of foreign income is different from the method of reporting it in the United States?

Mr. LIGHTNER. I do not think that is feasible or really susceptible even of being written in the form of legislation. We have endeavored to consider that, to consider it very seriously. And the intricacies of a business and the intricacies of the numerous foreign laws, where American companies operate, seem to us to make the effort to apply tax to individual items of income separated out in a particular tax return, and then try to find where that particular item of income may have entered into the other tax return a few years ago or a few years later, an accounting matter that I think would drive both the taxpayers and the revenue people pretty nearly mad. I don't want to exaggerate, but that is my honest opinion. Further, having identified each item of income, it would be extremely difficult to say just what part of foreign income tax was paid on each item of income, in view of the great variety and complexity of systems of determining foreign income tax.

Senator LONG. If I understand it, your position is that in 80 foreign countries they hand you a form, and you undertake to fill it out to show what your sales were, what your cost was, and they require you to handle your inventory one way, your sales on installment one way, and to handle your depreciation one way, and so forth and so on. After you fill out that form it works out to a certain amount of tax.

Then in this country you fill out a completely different form based on the same income in that foreign country. Now, 1 year it might say in that country that you made $90,000, and in this country, the form you fill out here, by the time you add it up the way this country tells you to add it up it says you made a hundred thousand.

Mr. LIGHTNER. That is right.

Senator LONG. The next year in the foreign country when you fill out the same form it says there that you made $100,000 and over here you made $90,000. As far as trying to figure out why it worked out that way, it is your feeling that it is an administrative impossibility. But you know this, that the law says that if you paid 52 percent of your taxes in that foreign country, that you are entitled to take that as a credit in this country.

Mr. LIGHTNER. That is right.

Senator LONG. And as far as you are concerned, it is all the same thing.

Mr. LIGHTNER. It is all the same business.

Senator LONG. But to try to go back and explain exactly how it worked out that way, it is practically an impossibility, because of the way those people require you to do business.

Mr. LIGHTNER. If I may interpolate a thought that just comes to me about a constant source of irritation, we have a great many people employed partly on commission. Where there is a commission payment, it may be paid entirely when a sale is made or it may be deferred until payments are coming in. Where it is deferred until payments come in, it is a sort of reserve against a future payment. In some countries, that entire commission enters into expense the day that the sale is made, even though it may not be paid to that salesman for a couple of years. In other countries, it does not enter into expense until the day that the salesman receives the payment. And over a reasonable period of time either method will balance out. But in the meantime, what might be considered insignificant items, such as those, may add up to a considerable amount.

Senator LONG. Do you have cases where you have high sales in 1 country in 1 year and low sales in another year?

Mr. LIGHTNER. Unfortunately, that is true a great many times. That is not nearly so much affected by the desire of people to buy, but it will be greatly affected by import quotas, and whether we are allowed to bring in machines that year, and whether our inventories are heavy or not. Things of that kind affect our sales up and down, and those of plenty of other companies, too. We are not isolated in that.

Senator LONG. I stated an extreme case the other day. If you are in Pakistan with a tax of 60 percent on your income, and you may have made $100,000 of income—and Pakistan makes you handle that on the accrual basis and you have elected under the law of this country to do business on a cash business. Then the $100,000 is taxed at a 60 percent rate in Pakistan for $60,000. In this country your tax falls in a subsequent year, so in this country you are taxed $52,000. You can't write that off again in any of the 80 other countries you may be doing business in. The tax credit is good only in Pakistan, and only for that year, so that tax is then taxed at 112 percent.

Mr. LIGHTNER. That is right. And in the neighboring country of India, we are today liquidating our business because we are not allowed to import or come in and manufacture either one. And in liquidating our inventory, I mean in liquidating our outstanding accounts, we are collecting income here, subject to American tax, and if my memory serves me correctly, we have already paid the tax on those sales in India. And, therefore, I think when we come to analyze our 1957–58 returns, that we are likely to find that we have quite an American tax on business done in prior years in India, and not much in the way of a foreign tax credit.

Senator LONG. In other words, it is quite likely that you may find that you agreed to do business in some foreign country, and when you got through you paid more than 100 percent in taxes?

Mr. LIGHTNER. It can, on the bulge that moves from 1 year to another.

Senator LONG. It is possible?

Mr. LIGHTNER. Yes, sir.

Senator BENNETT. May I just ask one question, a part of the material that Senator Long has been developing. You referred earlier to a tax form and a tax statement made in one country, and another tax statement made in the United States. Actually, in the United States you aggregate all of this material from all companies and make it in one statement?

Mr. LIGHTNER. Certainly.

Senator BENNETT. So that in an attempt to follow a single item from your statement in the United States to its balancing item in that statement in a foreign country, you really would be hunting for a needle in a haystack?

Mr. LIGHTNER. The income from the operations of the Singer Sewing Machine Co. in Turkey is reported to Ankara on a Turkish form in accordance with Turkish law. The income in Iraq the same way. When we come to our United States return, we pick up in the appropriate form of the United States return the income earned in both of those countries as income is measured by American laws. We bring all that in. But we must separate and show that the Turkish income was this amount and the Iraq income was that amount. That information has to be in your working papers in order to apply the limitation which says that you cannot take an excess foreign tax credit on income from one country against the United States tax on income from another country. That phase is not touched by this section.

Senator BENNETT. You still have, then, adequate working papers to make a comparison?

Mr. LIGHTNER. Yes, sir, we must have for the United States tax return.

Senator BENNETT. I see.

Mr. LIGHTNER. As well as for our own information as to what is happening.

The carryback and carryover provisions of section 37 of H. R. 8381 represents a practicable and reasonable solution. It would correct in large part the consequence of difference in reporting and computing the same business income under different tax systems. The 2-year carryback and 5-year carryover take into account 8 years, which is a period within which most such disparities should be eliminated. Under the provision, the amount by which foreign tax paid to a particular country in a particular year exceeds United States tax upon income from that country for such year could be carried back or carried forward to another taxable year in which the limitation is greater than the foreign tax for which credit is claimed. The foreign taxes would remain subject to the country-by-country limitation, so that over the 8-year period as a whole no credit in excess of the limitation would ever be allowed.

Section 37 is carefully worded to assure that its application will accomplish the purpose of correlating foreign and United States taxation to avoid double taxation, and yet not be subject to abuse or produce any result outside the long-established policy of Congress. A mixing of foreign tax credits and foreign tax deductions among different countries is not permissible in any year. Moreover, foreign tax credits will be lost if they are not actually used as a credit in the years to which they are attributed under section 37. Finally, total tax credits for all years are carefully restricted so that they can never exceed the United States tax on income from within a particular country.

The credit for foreign taxes upon income from long-term contracts, upon blocked income, and with respect to dividends from a foreign subsidiary is allowed under existing law, regardless of the year in which the foreign tax was paid.

Senator LONG. Would you explain to me how they are allowed under existing law?

Senator KERR. He just illustrates that in the next sentence.

Mr. LIGHTNER. The most important comparison is that of a foreign subsidiary. A foreign subsidiary of an American corporation may earn $100,000 over a period of 10 years from 1950 to 1959, inclusive. During that time it has paid income taxes to the foreign country at the rates effective from year to year. If we assume that such taxes amounted to a total of $40,000, and the subsidiary in 1960 pays a dividend out of such earnings to the American parent company, the latter is entitled under existing law to credit for the taxes paid by the subsidiary over the preceding 10-year period, which are allocable to the earnings and the profits out of which the dividend is paid. In this example, the American taxpayer is enabled to pick up the foreign taxes paid over the 10-year period at whatever rate may have existed, provided the total foreign tax does not exceed the United States tax on such income.

Senator LONG. It was all paid in 1 year?

Mr. LIGHTNER. In other words, when you compute the foreign tax credit in the case of a corporation which is owned by an American company, you do not look solely at the foreign tax paid in the year in which a dividend is reported as income in America. You look to see what the earnings and profits are out of which that dividend has come, and then you reach back over the years during which those earnings and profits have been made and have been accumulated and pick up the taxes paid in the foreign country during those years. Then you apply the statutory formula which is based upon the percentage of earnings that turn into the dividend, and you bring that in, and you bring your dividend into income, and you bring in the foreign taxes under a formula—the details of which I think perhaps are not appropriate here—but under that formula you claim as a credit your foreign income taxes, irrespective of the year, reaching back over the years during which the fund has been accumulated out of which the dividend is paid.

Senator KERR. Provided you have taken no previous credit for that foreign tax paid?

Mr. LIGHTNER. You can't take it until the dividend comes in, Senator.

Senator KERR. I understand, but——

Mr. LIGHTNER. If a dividend has taken a part of the earnings then of course a part of the tax credit has disappeared, that is right.

Senator DOUGLAS. Let's see if I understand this. What you are saying is that you should choose a longer period of time than 1 year to prevent double taxation, is that true?

Mr. LIGHTNER. Yes.

Senator KERR. What you are saying is that a company with a branch over there should have the same privilege in computing their tax here as they would have if that operation over there had been carried on by a subsidiary, that is the the principle.

Mr. LIGHTNER. That is the broad principle, Senator.

Senator DOUGLAS. That raises the question, why don't you create subsidiaries?

Mr. LIGHTNER. In the first place, if I may say so, Senator, I am not asking for something specifically for the Singer Co. As far as our own situation with respect to subsidiaries is concerned, we have foreign subsidiaries in Britain, France, Germany, the Low Countries, Scandinavia, Italy, and in South Africa. With respect to the rest of Europe, all of the rest of Africa, all of Asia, all of North and South America, it is the Singer Sewing Machine Co. of New Jersey which operates there. The Singer Sewing Machine Co. was organized in 1905. And in 1905 it was put into every foreign country where the Singer Manufacturing Co. was formerly operating directly or through an agency. And since then the number of countries that we are operating in has largely expanded by virtue of the breaking up of a geographical area into new countries. But the Singer Sewing Machine Co. has been pretty much all over the world for years.

Now, if I correctly understand the law, if we were to abandon the use of an American company in all of those countries, which I personally would regret, and were to try to form corporations and transfer the business to them, perhaps we would have very serious tax problems. I don't know, but certainly we would have to come down to Washington and ask for permission to make that kind of transfer. And if the facts that are developed in our request show that the reason that we wish to change our method of business is in order to lighten our American tax burden, it is my understanding that the United States Treasury just shakes its head and says "No". So I don't think we want to adopt a lot of new foreign subsidiaries, and I don't think we would be permitted to do so. And I may say that that may be the case with most of the companies operating through branches, except some of the ones that have just gone abroad in the last few years.

Senator DOUGLAS. I am puzzled by this. What you say seems so fair, and yet the Treasury is opposing it, as I understand it. Isn't that true?

Mr. LIGHTNER. That is true. The Treasury, represented by Mr. Dan Throop Smith, presented certain views to this committee two days ago. It would be presumptuous of me to review those views, or to review the questions which were raised here. But I do think that it is quite fair and proper for me to refer to the written statement. And the written statement says that section 37 relates to a minor area of treatment of foreign income. I never before heard that the fact that an unintended hardship affected only a minor area of the great flow of revenue into the United States Treasury was any reason for not correcting it. In fact, from the point of view of effect upon income, the more minor it is the more quickly justice should be given. That might be an amateur point of view but it is mine.

The next statement is that it provides special relief in that area by itnroducing a tax averaging principle with respect to foreign income taxes which does not apply to the income of corporations or individuals from domestic sources. My comment would be that when he says it is introducing a new tax averaging principle, perhaps he would not use the term "tax averaging principle" to describe the way in which foreign income tax is now set up as a credit in the case of a corporate subsidiary. To my mind, it is the same thing. And I don't think that it is introducing something new in that respect.

Senator DOUGLAS. One sentence of his puzzles me—and he is not here and I don't want to be uncharitable to him—it says "this provision does not deal with an unintended hardship." Do you think he means by that that it was an unintended hardship?

Mr. LIGHTNER. I suppose grammatically it is open either to the interpretation that it was not intended or that it was not a hardship. I read it as an admission that it is a hardship, and a statement that it was not unintended. Since I question that Congress really intended to draw the law so that when income bulges up in a foreign tax return in 1 year and bunches up in the American tax return in another year, and thereby to tax that income double, I would say it was unintended.

And may I digress for a moment, Senator, in answer to your question. You may say, why have taxpayers such as we not come and sought relief before? There is a practical question. I have thought a good deal about it, myself. Before the war, I never heard from our tax department any serious complaint about losing foreign tax credit. After the war I have heard nothing but complaints on that score, and the practical reason is that foreign countries in which we do business have been steadily raising their tax rates. If we had a high American tax rate, and a much lower foreign tax rate, we could take these ups and downs in reporting of income without losing tax credit. But it has been the terrible tendency since the war for foreign tax rates to come up so that in some cases they exceed our own and in others they are barely under the United States rate. And as those foreign tax rates have come up, any bulge may throw you over the American tax rate. And that is the situation which has become increasingly onerous during the last decade.

Senator DOUGLAS. Say that you pay double taxes on the same income when it goes up in 1 year. Let us say this happens in the Year 1, on the accounts of the foreign operations, the foreign tax, and in the next year it happens on the subsequent operation here or vice versa.

Mr. LIGHTNER. That is right.

Senator DOUGLAS. And the purpose of the international convention on double taxation was to eliminate just this, but they took the year as a basis for the same corporation.

Mr. LIGHTNER. The main objective of the international convention is to get a treaty under which both countries that are parties to the convention agree that they will not impose tax in any way that results in double taxation. Now, from the American point of view, if we are operating here, and we are doing business here, and we are also doing business in Italy, Italy might very well prime its tax laws so as in effect to tax the income from both sources and not allow any credit at all. And these conventions really are aimed to get into a dual arrangement the same principles that Congress has recognized in our domestic legislation since 1918.

Senator DOUGLAS. And this is done in the case of the subsidiaries, that is——

Mr. LIGHTNER. Yes, it applies just the same way.

Senator DOUGLAS. And you are simply asking, as the Senator from Oklahoma mentioned, that the principle which now applies to the subsidiaries averaging over the years apply to the operations of the parent companies?

Mr. LIGHTNER. Yes, but not that it be done that way, because it would be a rather long way beyond our proposal. It might very well bring in to a taxpayer utterly unintended benefits in some way. This section has been carefully drawn so as to take the present operation of a branch, and enable it to spread within a limited number of years.

Senator DOUGLAS. An 8-year period?

Mr. LIGHTNER. And to continue all of the other limitations that apply to the branch.

Now, reverting again to what Mr. Smith said, there are a number of very broad proposals which have been before the Treasury and before the Congress for some years back which are aimed at trying to increase the amount of American foreign trade by giving benefit in the taxation field. And if I understood Mr. Smith correctly the other day, he rather intimated that this minor correction in this, as he considers it, a very minor field—it is not to us—really ought to be pushed to one side and taken out of this bill in spite of the merits of it, and the endorsement which it has received in our sister house, to wait until the Treasury and Congress in their wisdom evolve some overall improvement of the taxation of American business abroad which may be so beneficial that those who are squeezed by it will sit back and say "well, thank goodness, we are now in so much better position that we will stop talking." Now, I can't follow that. But I believe that is the substance of what Mr. Smith refers to as broader ways of dealing with foreign taxes. I wish I didn't have to comment so much on Mr. Smith because he isn't here, and I am restraining myself.

Senator BENNETT. I would like to comment on the use of this word "unintended." Of course, I am just speculating on what was in Mr. Smith's mind. But many of the changes suggested in this H. R. 8381 are changes that are made to close loopholes that were created unintentionally in the 1954 act and in the 1939 act. It was not an intention to create loopholes but loopholes did appear, so we are now attempting to close them, because some taxpayers have unintended benefits. And when he uses the word "unintended" here, I think he is saying that this is not one of those because you are dealing with a problem that has been in existence for a long, long time, but which did not become acute until now, so it was not the action of the 1939 or the 1954 code that created the problem. That is just a speculation.

Mr. LIGHTNER. I certainly would not consider that I had any right to define what Mr. Smith said

Senator BENNETT. I haven't either.

Senator LONG. Let me just ask one further question to get this straight. As long as foreign countries were taxing you at a rate well below the rate at which this country was taxing you, you would have no particular problem, would you? If a country is taxing you at 30 percent, no matter how they make you fill the form out, the odds are that you would never take the full 52 percent tax credit.

Senator KERR. You would wait for a 30 percent tax on the same income to entitle you to the full 52 percent.

Senator LONG. That is right. So as long as the foreign country was taxing you at a rate well below the tax in this country, in very few instances would you find that you were unable to take your full tax credit.

Mr. LIGHTNER. That is right. And before the war that was the common thing. There are still quite a number of countries in the world where the tax rate is low enough so that in those countries this problem of double taxation doesn't arise.

Senator LONG. But when they advance their taxes to tax at a greater rate than this country, then you find that you are being squeezed and from time to time paying far in excess of the taxes that you feel Congress intended you to pay when it enacted the foreign tax credits?

Mr. LIGHTNER. That is right. And it has been a serious matter to us, or we wouldn't be here testifying in behalf of the bill.

Senator LONG. Let me ask you this question. With regard to a country like Pakistan, suppose that in 1958 they would tax you at 60 percent, and then reduce their tax to 30 percent in 1959, would not that allow you to take a 52 percent tax credit against the income for 1959?

Mr. LIGHTNER. I believe it would.

Senator LONG. Now, could you do the same thing if you are operating through a subsidiary?

Mr. LIGHTNER. Yes, of course. When you brought in your dividend you would pick up all the tax credit, whatever it is.

Senator LONG. Even though in 1 year the tax credit would have been below the 52 percent allowable and in another year it would have been more than 52 percent allowable?

Mr. LIGHTNER. Yes.

May I only inject the comment that, the world being what it is, tax rates seem to go up.

Quite a bit of what I have in my formal statement has been covered in this colloquy. To save time, may I skip?

Senator FREAR (now presiding). You may. And that part of your prepared statement which you do not cover in your testimony will be inserted in the record.

(The unread portion of the prepared statement of Mr. Lightner is as follows:)

Section 37 of H. R. 8381 would merely allow a spread of 8 years during which the credit for foreign taxes paid on income earned by an unincorporated foreign branch may be taken into account.

A simple example illustrates the confiscatory consequence of failure of the foreign tax credit to function as Congress had intended. Assume the tax rate in the foreign country on income of $100,000 earned and reported in 1957 was 55 percent. Assume also, that the same income is properly reported in the United States in 1958 and is taxable here at a rate of 52 percent. The combined United States and foreign tax on this $100,000 of income would be $107,000 in such a case, instead of the $55,000 tax burden which would apply if section 37 of H. R. 8381 is enacted to prevent such double taxation.

Such an onerous, discriminatory result is intolerable, even though in general application it may be lesser in extent than indicated in the example above. It is difficult for me to believe that Congress ever intended such a travesty upon the basic principle of the foreign tax credit, despite the assertion of the Deputy to the Secretary of the Treasury, before this committee on February 25, 1958, that "This provision does not deal with an unintended hardship." There is, in fact, no basis for any contention that Congress intended this present discriminatory hardship. In fact, it is the rise in tax rates abroad in the last decade that has brought this discrimination to a confiscatory stage.

With all deference to Mr. Smith's reputation and his opinion that section 37 relates to a minor area of treatment of foreign income and provides specific relief in that area, and does not deal with an unintended hardship, I suggest that these are not sound reasons for continuing to require an American taxpayer to submit to confiscatory double taxation merely because it carries the American flag abroad through its foreign branches instead of doing business through foreign subsidiaries.

It may be noted that not only has the committee on Ways and Means agreed unanimously that enactment of this legislation is required effectively to prevent double taxation within the historic policies of Congress, but also that approval by that committee was given in the 84th Congress, as well as the 85th, despite the adverse report from the Treasury.

Although I am speaking only on behalf of my own company, I feel I should call attention to the fact that carryback and carryover of foreign tax credit has received the endorsement of several diverse groups. The strong statement in behalf of the National Foreign Trade Council, Inc., before the Committee on Ways and Means, House of Representatives, on January 20, 1958, reads in relevant part as follows:

"The basic theory and intent behind the enactment of the foreign tax credit provision in 1918 was to provide a mechanism whereby foreign source income was to be relieved from double taxation. Generally, in practice this theory accomplishes the desired result. However, in many instances the intended relief is not achieved, principally because of differences in the foreign government's concept of taxable income and that of the United States.

"As a step in implementing the intent of Congress in originally enacting the foreign tax credit to provide relief from double taxation the Council recommends that taxpayers be permitted to carryback and carryforward unused foreign taxes paid to foreign governments."

The principle of carryback and carryover of foreign tax credit has also been endorsed recently by the Committee on Taxation of Foreign Income, section of taxation, American Bar Association; Committee on Federal Taxation, American Institute of Certified Public Accountants; Machinery and Allied Products Institute; Manufacturing Chemists' Association, Inc.; the Taxation Committee of the National Association of Manufacturers; and the Committee on Taxation, United States Council of the International Chamber of Commerce.

I urge this committee to retain section 37 of H. R. 8381 in the form in which the bill was passed by the House of Representatives.

Mr. Chairman, may permission please be granted to include a more extensive memorandum dealing with some of the questions which have arisen during the consideration of this legislation.

MEMORANDUM IN SUPPORT OF SECTION 37 OF H. R. 8381, RELATING TO CARRYBACK AND CARRYOVER OF FOREIGN TAX CREDIT

Under existing law, double taxation of income from a foreign country is usually prevented, in accord with the policy maintained consistently by Congress since 1918, by providing that taxes paid on such income to the foreign country shall be credited against the United States tax on such income. The foreign tax credit, however, cannot exceed either the foreign tax or the United States tax on the business done in the individual foreign country in the taxable year. When income from the same business activity is reported for taxation in a foreign country in one year, but in a different year in the United States, double taxation, bordering upon confiscation, and contrary to the policy of Conugress, occurs. The purpose of section 37 of H. R. 8381, now pending in the Committee on Finance, is to correct this result by provision for carryover and carryback of foreign tax credit, in effect correlating the credit for tax paid to a foreign country to the year when that income is reported for United States income tax purposes. Various questions have been raised about the pending bill, but none appears valid. The questions are briefly summarized and answered as follows:

1. Question. If carryback and carryover of foreign tax credit were provided, would this be a precedent for similar treatment of the retirement income credit and dividend credit for individuals?—Answer. The latter credits extend exemption from any individual income tax upon limited amounts of dividend or retirement income, while the foreign tax credit protects against the payment of two taxes on the same income to the same taxpayer—first, in the foreign country and then, again, in the United States. The loss of the foreign tax credit, which, as explained in exhibit A, can result in taxation of the same income at combined foreign and United States corporate tax rates of frequently from 80 to 90 percent, surely cannot be compared with the failure of an individual to have sufficient retirement income or dividend income to receive the full available relief under

the retirement income and dividend credits. The tax-writing committees of Congress are constantly making far more subtle and less basic distinctions in enactment of amendments to the Federal tax laws.

2. Question. Would provision for carryback and carryover of foreign tax credit be a new or novel principle?—Answer. Carryback and carryover of foreign tax credit is completely consistent with the principle that the credit for foreign taxes should be allowed in the year in which income from a foreign country is reported in the United States, which has already been recognized by Congress and the Treasury Department in section 902 (a) of the 1954 code, relating to foreign taxes deemed to have been paid by the taxpayer because paid by a foreign corporation in which it has at least a 10-percent stock ownership and from which it receives dividends; in T. D. 5281, relating to blocked income; and in Revenue Ruling 288, C. B. 1953-2, 27, relating to income from long-term contracts, all as stated more fully in exhibit B.

3. Question. Does the bilateral treaty program now being actively pursued by the United States Government make the enactment of section 37 of H. R. 8381 unnecessary?—Answer. There are only 19 treaties for the prevention of double taxation of income now in effect in which the United States is a party. Although others are now in preparation, it will obviously be far in the future before treaties can be consummated with the hundred or more nations with which the United States engages in trade. Moreover, as explained in exhibit C, the income tax treaties now in effect do not solve the problem at which section 38 of H. R. 8381 is directed.

4. Question. Would section 37 of H. R. 8381 permit carryback and carryover of foreign tax credit resulting from the variation from year to year in the applicable tax rates of the foreign country and the United States?—Answer. Section 37 of H. R. 8381 provides strict rules to prevent taxpayers to whom it applies from being treated more favorably than taxpayers whose income is reported in the same taxable year in the foreign country as in the United States. No special safeguards against theoretical and highly improbable benefit to taxpayers from fluctuating tax rates have been considered necessary in those situations in which a taxpayer is permitted under existing law to take foreign tax credit against United States tax for the year in which the foreign income is reported in the United States, even though such tax was actually paid to the foreign country in a different taxable year. A change in tax rates, whether to the benefit or detriment of the taxpayer, is just as possible in the case of a taxpayer receiving income under long-term contracts, or blocked income, or dividends from a foreign subsidiary. In these situations, the foreign tax credit is, nevertheless, applied to prevent double taxation.

5. Question. Would the enactment of section 37 of H. R. 8381 take into account only "a minor area" of the complex problem of taxation of foreign income which can be more satisfactorily resolved in comprehensive legislation which the Treasury Department at one time submitted to the Congress, but now apparently has abandoned?—Answer. Section 37 of H. R. 8381 would effectuate a longstanding (since 1918) policy of Congress that income from a foreign country should not be subjected to double taxation. H. R. 7725, 84th Congress, which embodied the comprehensive Treasury recommendations, proposed entirely new concepts in the taxation of foreign income, including an election of indefinite deferment of United States tax on income earned through foreign branches and a 14-percentage-point credit against the United States tax on all foreign income. If such far-reaching changes are revived, however meritorious they may be in principle, they will surely require extended consideration by the tax-writing committees of Congress. Meanwhile, it would be an unjustifiable hardship to continue to exact a discriminatory and frequently confiscatory double tax upon foreign income, contrary to policies already approved by Congress, merely because longer range legislation on the taxation of foreign income may possibly be revived.

SUPPLEMENT TO MEMORANDUM IN SUPPORT OF SECTION 37 OF H. R. 8381, RELATING TO CARRYBACK AND CARRYOVER OF FOREIGN TAX CREDIT

EXHIBIT A

Enactment of section 37 of H. R. 8381 would not be a precedent for similar treatment of the retirement income credit and dividend credit for individuals.

Federal tax laws since the Revenue Act of 1918 have provided a credit for taxes paid to a foreign country or a possession of the United States. In holding that credit is available for taxes paid to a political subdivision of a foreign country, the Supreme Court said in *Burnet* v. *Chicago Portrait Co.* (285 U. S. 1, 7 (1932)):

"We think that the purpose of the statute is clear. The fact that the provision is for a credit to the domestic corporation, against income taxes payable here, of income taxes paid during the same taxable year of any foreign country, itself demonstrates that the primary design of the provision was to *mitigate the evil of double taxation*." (Emphasis supplied.)

The general statement in the report of the Committe on Ways and Means on a separate bill, H. R. 6728, in the preceding Congress (H. Rept. 1346, 84th Cong. p. 1) explains the corresponding provisions of the 1954 code as follows:

"Under the Internal Revenue Code of 1954, as well as under prior Federal income-tax laws, citizens and alien residents of the United States and domestic corporations are subject to tax on income both from sources within and sources without the United States. Income from without the United States generally is subject to taxation under the income-tax laws of the foreign country or possession of the United States from which derived. In order to avoid double taxation of the same income in these cases, the taxes paid or accrued to the foreign country (or to a possession of the United States) are allowable as a credit against Federal income tax. Under section 904 of the 1954 code, however, the foreign taxes eligible for the credit against United States tax are restricted by the so-called per country limitation. This limitation restricts the foreign tax which can be claimed as a credit to an amount which is the same proportion of the taxpayer's total United States tax liability before credit as the taxable income from the foreign country bears to the total taxable income of the taxpayer for the same taxable year. Thus, under this limitation, credit is denied with respect to that part of the income tax of a foreign country which is proportionately greater than the United States tax."

In reporting that bill unanimously, the Committee on Ways and Means stressed that its purpose is to prevent the double taxation of income from sources without the United States, as follows:

"* * * Double taxation occurs under present law because of the manner in which the per-country limitation works where the methods of reporting income are different in the United States and the foreign country. Such differences in reporting frequently cause the same income to be reported in 1 year in the United States and in another year in the foreign country. When this occurs (other things being equal) the allowable credit will be less than the tax paid or accrued to the foreign country in the year the income is reported in the foreign county but not the United States, because the credit is limited by the amount of income from the foreign country which would be reported under United States income-tax rules in that year. In another year, when the income is reported in the United States but not the foreign country, the credit which would be allowable under the limitation will exceed the foreign taxes paid or accrued" (H. Rept. 1346, supra, p. 2).

Rulings of the Treasury Department have long recognized that the law should be administered to "give effect to the intention of Congress to avoid double taxation by permitting a credit for foreign taxes" (G. C. M. 16144, C. B. XV-1 (1936) 152, 155).

Thus, since Congress, the Supreme Court, and the Treasury Department have long recognized the principle against double taxation of foreign income, legislation to correct an unintended defect in the foreign tax credit involves important public policy considerations which justify carryback and carryover of the foreign tax credit.

The following example illustrates the confiscatory double taxation which can occur when a taxpayer doing business in several foreign countries, and electing to take the foreign tax credit, finds that there is $100,000 of income from business activity in one of those countries that is reported in 1 taxable year in the foreign country and in another taxable year in the United States:

	1955	1956
Foreign income-tax return	$100,000	
Tax (60 percent)	60,000	
United States income-tax return		$100,000
United States tax (52 percent)		52,000

NOTE.—1955, $60,000 foreign tax, no tax credit; 1956, $52,000 United States tax, no tax credit; $100,000 income, $112,000 tax.

It is seen from the above that the limitation came about due to differences in timing of income with absolutely no relationship to the foreign rate. The same result would have happened (but to a lesser degree) even if the foreign rate were lower than the United States rate. All that section 37 of H. R. 8381 would do is to prevent such taxpayers from paying this heavy penalty (112 percent rate) for operating abroad by putting them on the same footing as domestic taxpayers, i. e., as if their income was earned entirely from operations within the United States.

The loss of the foreign tax credit, which can result in taxation of the same income at combined foreign and United States tax rates of 112 percent, surely cannot be compared with the loss of the retirement income or dividend credits, the purpose of which is to grant to certain types of income a limited exemption from individual income taxation. Not only the basic purpose and effect, but also the mechanics and application of the dividend credit and retirement income credit differ from the foreign tax credit. Under present law, it is questionable whether there is actually such an item as an unused dividends received or retirement income credit. Rather, individuals of varying circumstances receive such credits in varying amounts, depending upon their respective circumstances.

For the foregoing reasons, therefore, carryback and carryover of foreign tax credit would not be a precedent for similar treatment of the retirement income credit and dividend credit for individuals.

EXHIBIT B

Provision for carryback and carryover of foreign tax credit would not involve a new or novel principle.

Congress and the Treasury Department have, over the years, manifested a concern consistent with the policy of section 37 of H. R. 8381 that the foreign tax credit should not be lost merely because income is taxed in 1 year in a foreign country and in a different year in the United States.

This conclusion is supported by the following:

(1) Section 902 (a) of the Internal Revenue Code of 1954, which has its origin in section 238 (e) of the Revenue Act of 1921, permits a domestic corporation which receives dividends in any taxable year from a foreign corporation to receive the benefit of the income taxes paid by such foreign corporation to a foreign country with respect to the accumulated profits from which such dividends are paid, and this rule applies even though the dividends may be paid several years after the taxes were paid to the foreign country by the foreign corporation.

A foreign subsidiary of an American corporation may earn $100,000 over a period of 10 years from 1950 to 1959, inclusive. During that time it has paid income taxes to the foreign country at the rates effective from year to year. If we may assume that such taxes amounted to a total of $40,000, and the subsidiary in 1960 pays a dividend out of such earnings to the American parent company, the latter is entitled under existing law to credit for the taxes paid by the subsidiary over the preceding 10-year period, which are allocable to the earnings and profits out of which the dividend is paid. In this example, the American taxpayer is enabled to pick up all foreign taxes paid over the 10-year period at whatever rate may have existed provided the total of foreign tax does not exceed the United States tax on such income. Section 37 of H. R. 8381 would merely allow a spread of 8 years during which the credit for foreign taxes paid on income earned by an unincorporated foreign branch may be taken into account.

(b) Blocked income and the treatment of credit for foreign taxes attributable thereto were reviewed by Congress at the time of enactment of the Revenue Act of 1942. The conference report on the Revenue Act of 1942, Report No. 2586, 77th Congress, 2d session, page 50, reads in relevant part as follows:

"The conferees gave consideration to the question of an amendment to section 131 of the code to provide that the credit for foreign taxes on foreign income not reported in the taxable year because of its being blocked should be deferred and allowed in the taxable year in which such income is released and realized for income tax purposes. It was agreed that such an amendment is unnecessary. Under a proper interpretation of existing law, the credit for foreign taxes, as well as the various allowable deductions, follows the income into the taxable year in which it is realized for purposes of the income tax law.

This might appropriately be covered specifically by departmental regulations in view of the importance of the question to a large number of taxpayers."

Thereafter the Treasury regulations were amended by Treasury Decisions 5281 (1943 C. B. 213), to permit the credit for income taxes imposed by a foreign country with respect to blocked income to be taken proportionately in the taxable year or years in which such blocked income is includible in gross income for Federal income tax purposes.

(c) Revenue Ruling 288 (C. B. 1953-2, 27), holds that a domestic corporation which reports income from a long-term contract on the percentage of completion basis for foreign income tax purposes may take credit for the taxes paid to the foreign country during the period of performance of the contract against United States income taxes paid in the taxable year of completion of the contract under the completed contract method of reporting used by the taxpayer in the United States.

The allowance of the foreign tax credit, therefore, in a taxable year other than that in which the tax is actually paid to the foreign country, is not novel and introduces no new precedent.

EXHIBIT C

The bilateral tax treaty program of the United States is not a satisfactory solution of the problem at which section 37 of H. R. 8381 is addressed.

The suggestion that this problem be taken up on the tax treaty level is somewhat perplexing in view of the fact that the tax treaties themselves seem to suggest a course of action similar to the one contemplated, i. e., by way of legislation in the state of company's creation. They provide in effect that where the actions of the revenue authorities of the treaty states have led or will lead to double taxation, a taxpayer may lodge a claim with the state of which he is a resident or citizen and that corporate taxpayers should file claims in the state of creation or organization. Article XVI of the Canadian-United States Income Tax Treaty, quoted below, is typical of such provision found in almost all other treaties, for example, with Australia, Belgium, Denmark, Finland, Greece, Japan, Netherlands, etc.

"Article XVI—Where a taxpayer shows proof that the actions of the revenue authorities of the contracting states have resulted in double taxation in his case in respect of any of the taxes to which the present convention relates, he shall be entitled to lodge a claim with the state of which he is a citizen or resident or, if the taxpayer is a corporation or other entity, with the state in which it was created or organized. If the claim should be deemed worthy of consideration, the competent authority of such state may consult with the competent authority of the other state to determine whether the double taxation in question may be avoided in accordance with the terms of this convention."

The double taxation complained of results from the actions of the United States revenue authorities in application of United States tax laws. Elimination of the injustice which results from differences in timing of income in connection with its own taxpayers who, for example, use the installment sales method of reporting income would hardly involve any proper complaint under such a provision of a treaty. The installment sales method of reporting income is recognized under our laws without any coordination with the foreign tax credits. Therefore, if any remedy should be had it would seem that it is within the province of the United States to grant it, for, as suggested by the tax treaties, complaint should first be lodged with our own taxing authorities. This is exactly what section 37 of H. R. 8381 is attempting to do.

Foreign and United States tax laws in many situations differ as to amount and timing of income and deductions. This failure of synchronization among the stated countries' tax laws often results in a United States tax that should otherwise not have been levied. It is believed difficult for tax treaties to correct a situation of this kind that produces unintended double taxation—particularly when the remedy is clearly within legislative (United States) amendment as is embraced in section 37 of H. R. 8381.

Mr. LIGHTNER. I would like to refer to something at the end, if I may just take a moment.

Senator FREAR. You may.

Mr. LIGHTNER. Mr. Chairman, there is attached to my statement a somewhat extensive memorandum dealing with some of the questions that have arisen during the consideration of this legislation, and that have been touched upon in these hearings.

Senator FREAR. Thank you for your appearance. And although I was not here for all of your testimony, I am sure the members of the committee were enlightened by your answers to the questions.

Mr. LIGHTNER. You are not referring to my name of "Lightner" when you say "enlightened," are you?

Senator FREAR. No, sir.

(The following letter was subsequently received for the record:)

MANUFACTURING CHEMISTS' ASSOCIATION, INC.,
Washington, D. C., March 4, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR MR. CHAIRMAN: The Manufacturing Chemists' Association, Inc., respectfully requests that the Committee on Finance recommend the enactment of section 37 of H. R. 8381 without amendment.

Foreign income is presently burdened by double taxation arising through differences between United States and foreign country accounting concepts and procedures for determining taxable income. The resulting differences in income and related taxes tend to be equalized in the aggregate over a period of years, but such equalization cannot be realized in tax computation under existing law. Section 37 of H. R. 8381 would eliminate double taxation existing under present law by permitting foreign taxes, which cannot currently be claimed as a tax credit because of the per country limitation in Code Section 904, to be carried back to the 2 prior years or forward to the 5 succeeding years, and to be used in those years to the extent of any excess of the limitation over foreign taxes paid in those years. The report of the House Ways and Means Committee presents an adequate explanation of section 37, which we will not repeat in this letter. (See House Report 775, 85th Cong. 1st sess. beginning at page 27 and at page 82.)

A substantial number of the 170 chemical manufacturing companies which are members of this association engage in business operations in foreign countries and experience the double taxation of foreign income which would be ameliorated by section 37 of the Technical Amendments Act. We respectfully urge that you approve the enactment of this provision.

Sincerely,

J. E. HULL.

Senator FREAR. Mr. Herbert A. Bergson.

Mr. Bergson, I am sorry that we have detained you for so long, but we hope that you have enjoyed listening to the testimony of the previous witnesses.

STATEMENT OF HERBERT A. BERGSON, WASHINGTON, D. C.

Mr. BERGSON. I have indeed, Senator. And I appreciate the opportunity to present my statement at this late hour. It is very kind of you to hear me.

Senator FREAR. Thank you.

Mr. BERGSON. My name is Herbert A. Bergson. I am an attorney in private practice in Washington, D. C. Prior to returning to practice, in October 1950, I had been Assistant Attorney General in charge of the Antitrust Division since June 1948. While serving in that capacity, I became convinced that antitrust enforcement would benefit from legislation alleviating the tax consequences of forced liquidation under divestiture decrees in civil antitrust cases. Although I did not formally recommend such legislation at that time, I did take up the matter informally with a staff member of the Joint Committee on Internal Revenue Taxation. My views have not changed, and I appear here today to urge this committee to amend H. R. 8381, the measure now under consideration, to permit nonrecognition of gain, for tax purposes, of involuntary conversions of property pursuant to antitrust divestiture decrees. While sections 39 and 41 of the pending bill deal with some of the problems of involuntary conversions, the related area of antitrust divestiture seems to have been overlooked.

In considering such legislation, it is important to recognize at the outset that the relief which it offers is available only when, in civil actions, the court has invoked the equitable remedy of divestiture. The Supreme Court has many times made it clear that equitable relief in antitrust cases is remedial, not penal. Such relief is invoked not to punish those whose businesses are found to infringe the antitrust laws, but to restrain anticompetitive practices and eliminate concentrations of market strength in order that competitive conditions may be reestablished. There has been no dissent from the observation of Chief Justice Vinson and Mr. Justice Reed, concurring in *Timken Roller Bearing Co.* v. *United States* (341 U. S. 593, 603 (1951)), that—

divestiture is a remedy to restore competition and not to punish those who restrain trade * * *

The proposal to give involuntary conversion treatment to antitrust defendants can, therefore, be supported solely in terms of the essential fairness of mitigating the consequences of divestiture, which are harsh enough even without considering the tax implications. As Assistant Attorney General in charge of the Antitrust Division, however, I favored legislation of this type for an additional, and to me most impelling, reason; namely, that such legislation would not only help to overcome judicial reluctance to order divestiture, but would also encourage defendants in civil antitrust actions to enter into consent decrees calling for divestiture.

There is now general recognition that an effective antitrust program is a necessary adjunct to a free competitive enterprise system. The effectiveness of antitrust enforcement hinges, however, on the attainment of complete relief in civil actions instituted by the Government. In this connection, the reluctance of the courts to order divestiture, whether it be of plant, facilities, stocks, or other forms of property, has frequently impeded the complete restoration of competitive conditions. This judicial attitude stems primarily and properly from the fact that divestiture is a harsh remedy, inappropriate except in the most compelling anticompetitive situations. But the reluctance to order divestiture, is, I believe, reinforced and strengthened by the fact that it would cause the defendant to suffer substantial tax consequences on the gain realized from the involuntary disposition of his property. The result is that our present tax law has unwittingly been impeding enforcement of the antitrust laws so that the Government, after winning antitrust cases on the merits, has frequently lost out in its quest for effective relief. Unless this growing trend can be reversed, the enforcement of the antitrust enforcement requires divestment of plant, stocks, or other property. Antitrust Division attorneys are well aware of the tax difficulties created by involuntary realizations, and strive to work out solutions which will void the immediate imposition of a heavy tax burden. On a number of occasions, defendants who would have accepted consent decrees calling for divestiture, have refused solely because of the tax consequences. The Division was then forced to abandon divestiture, which it could otherwise have obtained, or else to enter into a long, bitterly-contested and costly trial. If the tax problem were ameliorated, it is reasonable to expect that cases requiring divestiture relief would more frequently be handled by consent judgments, with the result that antitrust enforcement could be directed to additional areas of the economy.

Senator LONG. What you are saying, as I understand it, Mr. Bergson, is that cases will arise where it is really in the public interest to require divestiture of certain holdings by a corporation. And the corporation would be willing to do that except for the fact that by doing so they would incur a major tax liability.

Mr. BERGSON. That is one facet of it.

Senator LONG. And that being the case, the corporation would feel compelled to fight the matter out, many times successfully, against divestiture, and in many cases the Court would be inclined to order divestiture, but when the Court sees the large tax liabilities that would be imposed upon the corporation as a result of it, they are inclined to look for some other remedy.

Mr. BERGSON. Exactly, that is exactly my position.

Senator LONG. Your feeling is that if the divestiture is not ordered, there is no tax liability there. Therefore, the corporation would be inclined to continue an economic concentration which might not be in the public interest because to accede to the Government's view might require that there be a very great tax liability on the corporation.

Mr. BERGSON. I think you have stated it excellently, Senator.

Senator FREAR. Both ways?

Mr. BERGSON. Both ways.

Imposition of a heavy burden of taxation as a result of dispositions of property under antitrust decrees clearly is not contemplated by the antitrust laws themselves. Indeed, at the time the Sherman and Clayton Acts were passed, income taxation was for all practical purposes nonexistent. Some have suggested, however, that in this area the tax laws reinforce the antitrust laws, and that enactment of this legislation will encourage persons to enter into questionable mergers because the tax consequences of a divestiture order will have been substantially mitigated. I do not believe that this is a realistic objection. Divestiture relief is so drastic, and its impact upon the structure of the corporations involved is so serious that the possibility of mere tax postponement would hardly constitute an invitation to a buildup of economic power which would warrant divestiture. Divestiture represents forced liquidation and involves risks of tremendous sums of money. Forced liquidation itself carries with it the prospect of liquidation at depreciated values entirely apart from the other implications of the divestiture. In short, the very nature of divestiture relief is inconsistent with a suggestion that the mere postponement of the tax would constitute an invitation to would-be violators of the antitrust laws. This is equally true of stock divesting. No business could take the risk of acquiring stock that would likely be forcibly divested, where the only possible tax inducement was that the tax on any gain would be postponed. Accordingly, I believe the tax consequences of divestiture do not deter questionable mergers, but do deter courts from imposing, and defendants from accepting, antitrust decrees calling for divestiture.

When antitrust considerations are supplemented by a look at the Internal Revenue Code, it becomes evident that the proposed legislation comports fully with the principle that gain realized on involuntary conversions should not be recognized. It also becomes clear that Congress has invoked this principle in a variety of involuntary realization situations, at least two of which involve analogous sales of property ordered by agencies charged with regulating particular areas of the economy. One of these is section 1081 of the Internal Revenue Code of 1954, which provides for the postponement of taxation on gains realized when property is sold at the direction of the Securities and Exchange Commission acting under the Public Utility Holding Company Act of 1935. The other is section 1071, which relates to sales of radio broadcasting facilities by order of the Federal Communications Commission.

Like the Sherman and Clayton Acts, the Public Utility Holding Company Act of 1935 was designed to remedy certain economic evils and abuses. In describing the necessity for regulation of holding companies, Congress declared that the public interest was adversely affected when, among other things:

> The growth and extension of holding companies bears no relation to economy of management and operation or the integration and coordination of related operating properties * * * (15 U. S. C. 79a (6) (4)).

Thus, the act was directed against undue growth and extension of holding companies, an evil closely resembling monopolization, and undue concentration of economic power with which Congress was concerned in enacting the Sherman and Clayton Acts. The Holding Company Act likewise declares that it is the policy of the act to eliminate abuses of the sort described above by compelling—

> the simplification of public-utility holding-company systems and the elimination therefrom of properties detrimental to the proper functioning of such systems (15 U. S. C. 79a (c)).

This declaration is the source of the SEC's power to order the exchange, sale, and transfer of physical property or securities for other property, including cash. In exercising that power the SEC has caused a regrouping and shifting of physical property and securities for a purpose and with an effect which I believe to be indistinguishable in principle from the purpose and effect of divestiture orders in civil antitrust cases. Thus, both in terms of basic statutory policy and mode of effectuation, the Holding Company Act and the antitrust statutes are closely analogous.

The tax implications likewise are precisely analogous. When, under either the Holding Company Act or the antitrust laws, the sale, disposition, or exchange of any property is ordered, there is an involuntary realization of gain and an involuntary imposition of tax. It was to temper the inequity of such an involuntary realization that Congress, in 1938, enacted the provision now embodied in section 1081 of the 1954 code. I see no reason why antitrust defendants should be treated differently since divestiture orders under both the holding company and antitrust statutes are essentially remedial in nature, rather and punitive.

Moreover, in enacting the legislation now embodied in section 1081, Congress sought not merely to eliminate the inequity of involuntary realizations, but sought also to encourage the public utilities to comply more readily with SEC orders. Thus, in reporting favorably upon that legislation, this committee declared:

It is believed that the above provision will greatly facilitate the simplification and integration of public-utility holding-company systems. By such provisions the public-utility systems will be encouraged to cooperate with the Securities and Exchange Commission and will effect results which will carry out the purposes of simplification and integration without undue burden on the companies and their shareholders, resulting from forced reorganizations, liquidations, and transfers. The effect of these provisions will not be to exempt gains from tax but merely to postpone their taxation until subsequent voluntary realization (S. Rept. 1567, 75th Cong., 3d sess., at 10).

The committee's reasoning applies to the proposed legislation, since its enactment would encourage antitrust defendants to cooperate with the Division by accepting consent decrees calling for divestiture. Antitrust enforcement would benefit from the resulting elimination of prolonged and expensive litigation.

Another closely analogous provision is section 1071 of the Internal Revenue Code of 1954 providing for nonrecognition of gain or loss realized on the sale or exchange of radio stations to effectuate policies of the Federal Communications Commission. As the Senate Finance Committee noted, the sales covered by this provision are sales directed by the Commission—

in pursuance of the policy of eliminating common ownership of directly competing radio facilities * * * (S. Rept. 627, 78th Cong. 1st sess., at 53).

Thus in that situation, as here, the involuntary sale is ordered for the purpose of improving competition. The Commission's action in ordering such a sale is neither more nor less punitive than is the action of a court in ordering divestiture by a defendant in a civil antitrust action. In both situations, the objective is a realinement of ownership in the interest of promoting competition and in neither case, is it inconsistent with this objective to relieve the seller from the harsh tax consequences of an involuntary realization of gain.

In summary I urge enactment of legislation to postpone recognition of gain realized upon the involuntary conversion of property pursuant to divestiture decrees in antitrust cases because such postponement is inherently fair to the taxpayer, because such relief already has been provided in closely similar situations, and, most significantly, because such legislation will remove an important obstacle to effective antitrust enforcement in situations where divestment of plant, stocks or other property is needed to restore competitive conditions in an industry.

That completes my statement, Senator.

Senator FREAR. Questions, Senator Long?

Senator LONG. No questions.

Senator FREAR. Senator Bennett?

Senator BENNETT. No questions.

Senator FREAR. Thank you, Mr. Bergson.

(The following letter and statement supplementing the testimony of Mr. Bergson was submitted for the record by Mr. Charles L. Fletcher, vice president and treasurer, Hilton Hotels, Chicago, Ill.)

HILTON HOTELS CORP.,
February 27, 1958.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR BYRD: On Thursday, February 27, your committee heard testimony from Herbert A. Bergson, Esq., urging amendment to the tax laws to permit nonrecognition of gain from involuntary conversions of property pursuant to antitrust divestiture decrees. I believe that your committee would be interested in the facts relating to an actual case to show how the present law with its changing applications operates to the disadvantage of the taxpayer as well as the Government, even though it has acted in the best of good faith.

I therefore respectfully submit the attached statement.

Very truly yours,

CHARLES L. FLETCHER,
Vice President and Treasurer.

STATEMENT OF CHARLES L. FLETCHER

I am a vice president and treasurer of Hilton Hotels Corp. (hereafter referred to as "Hilton") and also of Statler Hotels Delaware Corp., and I am the principal financial officer of both companies.

GENERAL BACKGROUND

On October 31, 1954, in connection with the complete liquidation of the former Statler Co., the nine operating Statler hotels in Boston, Buffalo, New York, Hartford, Washington, St. Louis, Cleveland, Detroit, and Los Angeles, together with a tenth under construction in Dallas, were sold to a newly organized company entitled Statler Hotels Delaware Corp. (hereafter referred to as "Statler"). Statler is not a subsidiary of Hilton, but is an independent company. It is, however, under common control with Hilton, as 1,654,509 out of its 1,805,509 outstanding shares of common stock—its only class—were offered pro rata to Hilton stockholders and were taken up on this offering. Simultaneously with the purchase of the hotel properties by Statler, Hilton leased or subleased all 10 for an original term of 25 years. Hilton separately owns the furniture, furnishings, and equipment in the hotels. In order to finance the transactions, in addition to $11,584,947.78 raised by Statler through the sale of its common stock, the sum of $49,500,000 was loaned to Statler through mortgages on the properties by the Equitable Life Assurance Society of the United States (subject to then existing mortgages on certain of the properties of $17,942,242) and $20,000,000 was loaned to Hilton by the First National Bank of Boston.

ANTITRUST PROCEEDINGS

Shortly after the first announcement of the transacton, on August 2, 1954, the Department of Justice on August 27, 1954, wrote to request information about it. "While we do not mean to imply," said the Department in their letter, "that the acquisition necessarily violates antitrust laws, it does raise certain questions under those laws." Information relating to those questions was requested and, following several telephone conversations, was completed and furnished on September 20, 1954.

Meanwhile, our general counsel, Messrs. Friedman, Zoline & Rosenfield of Chicago, Ill., were asked to advise Hilton as to whether any antitrust problems would arise. Also, Messrs. Paul, Weiss, Rifkind, Wharton & Garrison of New York City, were retained and requested to investigate independently into all of the circumstances and to render an opinion as to whether any of the transactions or proposed transactions would violate the Federal antitrust laws. An opinion was rendered by that firm on September 15, 1954, concluding that the transactions were not subject to attack on the antitrust laws. Messrs. Friedman, Zoline & Rosenfield, of Chicago, rendered an opinion on October 28, 1954, to the same effect. Messrs. Ropes, Gray, Best, Coolidge & Rugg of Boston, counsel for the First National Bank of Boston, which, as indicated, loaned $20 million to Hilton in connection with the transactions, rendered an opinion to that bank based upon the opinion of Messrs. Paul, Weiss, Rifkind, Wharton & Garrison, and also based upon an independent investigation, to the effect that the possibility of a suit being successfully brought under the antitrust laws so as to affect that bank materially and adversely was remote. It is believed that the Equitable Life

Assurance Society of the United States was similarly advised by its special counsel, Messrs. Milbank, Tweed, Hope & Hadley of New York City, in connection with its $40,500,000 mortgage loan upon the properties. I also believe that Messrs. Chadburn, Hand, Jaeckel & Brown of New York City, counsel for Carl M. Loeb, Rhodes & Co., underwriters of the offering of approximately $11,500,000 in new stock of Statler, rendered a similar opinion.

As indicated, during a period of approximately 2 months after its original inquiry, nothing was heard on the subject from the Department of Justice. After the closing of the transaction, on October 31, 1954, however, on November 12, 1954, the Department of Justice again wrote to the effect that upon study of the material previously furnished in September, further information would be of interest. The major portion of the information requested went forward on December 1, 1954, and the balance in January 1955. Further correspondence took place and the Department, on February 25, 1955, requested copies of certain basic documents in connection with the October 31, 1954, transactions. Without further correspondence, discussion or notice, either written or by telephone, a civil suit under section 7 of the Clayton Act was filed in the United States District Court at Washington, D. C., against Hilton and Statler on April 27, 1955. A motion to transfer the case from Washington to Chicago was filed on July 11, 1955. After extended affidavits, briefs and arguments, an order was entered in the court at Washington, D. C., transferring the proceedings to the United States District Court sitting at Chicago.

THE OFFENSE CHARGED

Six of the ten Statler hotels at the time of any dealings between Hilton and Statler were located in cities or areas in which there were no Hilton operations of any kind—Boston, Hartford, Buffalo, Detroit, Cleveland and Dallas. Despite vague language in the complaint about the lessening of competition generally throughout the United States, even the Government appeared to recognize that no possible violations of the antitrust laws existed with respect to the operations of hotels in these cities. The complaint thus struck at and appeared to seek divestiture of the Statler units in the four cities of Los Angeles, Washington, New York and St. Louis. Even as to those cities, the proportion of hotel rooms owned or controlled by Hilton and Statler separately and the two combined is so small in relation to the total available rooms and facilities in each city that no problem really appeared to exist to the group of law firms which had investigated into the matter. The thrust of the Government's complaint appeared to be leveled at one particular phase of the hotel business in these four cities—the servicing of conventions. While the convention segment of the hotel business may be one of the largest single segments, it is still but a small part of the overall business transacted. Thus, we appear to be dealing in this case with what was perhaps the narrowest market asserted or utilized by the Department of Justice in the history of the enforcement of the antitrust laws.

THE QUESTION OF INTERSTATE COMMERCE

The narrowness of this market raised an important preliminary question. The antitrust laws apply only to interstate commerce. The hotel industry in general contended for years—including in particular the American Hotel Association under the leadership of its former general counsel, the Honorable Herbert Brownell—that the hotel business, involving basically housing and restaurant and bar service, is local in character and does not constitute interstate commerce. The National Labor Relations Board has consistently taken this view and the hotel industry as a whole has been exempted from the Fair Labor Standards Act. I am informed that a few years ago the Supreme Court held in the *Yellow Cab* case that a taxicab company engaged in transporting interstate travelers from railroad stations to hotels was not to be considered in the stream of interstate commerce and that, therefore, it was not subject to the antitrust laws. The Court, I am informed, held that the interstate aspect of travel had ended when the travelers had reached the railroad depot at the city of destination. If travelers are out of interstate commerce upon arrival at the railroad depot in the city of their destination, as was found in the *Yellow Cab* case, then it seemed to us that they were likewise out of the stream of interstate commerce in their dealings with the hotels which housed them. And, as indicated, this was the definite policy of the NLRB and also the rule under the Fair Labor Standards Act.

SETTLEMENT NEGOTIATIONS AND CONSENT DECREE

It soon became apparent to us that the antitrust litigation would, for an interminate period in the future, consume the attention and the energies of our executive personnel and would virtually disrupt our business operations. The burdensome and expensive character of antitrust proceedings, which take years to run their course, is recognized everywhere. The report of the Attorney General's National Committee to Study the Anti-Trust Laws, rendered March 31, 1955, states: "As the Judicial Conference Report of 1951 put it, then existing conditions, 'if permitted to continue * * *' might threaten the judicial process itself in respect to complex controversies." I have been informed, for instance, that the *Imperial Chemical* case consumed about 6 years in the trial court alone. The Government secured and examined over 20,000 documents in that case before filing its complaint. The actual trial took 3 months. The record and exhibits are voluminous. The *United Shoe Machine* case, I was informed, consumed over 3 years in the trial court. The Government's brief, summarizing what it intended to prove in that case, consisted of a shelf of books of almost 7,000 pages in 3 parts, including a 634-page summary of analysis of facts, an 87-page summary of the law, and excerpts from documentary evidence in 17 volumes with a total of 6,224 pages. The defendants submitted 15,000 objections which were passed on by the court. Similar examples could readily be cited. Rather than to risk the total absorption of our executive staff with court proceedings instead of business operations, we reached the decision to negotiate, if possible, a consent settlement with the Department. We entered into a settlement decree on February 6, 1956. That decree specifically disclaims any admission of any violation of the law by the defendants. It required the sale within a reasonable time by Hilton of the Jefferson Hotel in St. Louis, the Mayflower Hotel in Washington, D. C., and either the Hotel New Yorker or the Hotel Roosevelt in New York City. For a period of 5 years, the acquisition of certain specifically listed hotels in New York, Washington, D. C., St. Louis, and the Los Angeles-Beverly Hills area is prohibited, if any such acquisition would increase the number of such listed hotels operated by Hilton in excess of 4 operated in New York and 1 in each of the other communities. No restrictions are placed on the construction of new hotels or the remodeling of existing hotels in any of the four cities or upon the acquisition of hotels in other cities of the United States or in foreign countries.

An antitrust proceeding involves economic issues and such proceedings should be brought only when the economic issues involved are significant. These issues are never clearcut, never black nor ever white. The settlement of economic issues ought not to carry accidental and devastating tax consequences to the affected businesses. Such accidental and adverse byproducts in the form of tax consequences can only impede the settlement and consent decree process and prolong and embitter litigation and Government-business relations and, in the end, those byproducts forestall or at least interminably delay the resolution of the very economic issues which generated the controversy in the first place. The consumer and the public thus suffer. If economic issues affecting them are not significant, the proceedings should not be brought. If economic issues are significant to the public and the consumer, then they should be resolved quickly.

Senator FREAR. At the direction of the Chairman, I submit for the record a letter from Mr. Floyd L. Parks, executive director of the National Rifle Association of America, Washington, D. C., favoring enactment of amendment 2–19–58–M, proposed by Senator Everett McKinley Dirksen to H. R. 8381.

(The letter and copy of the amendment referred to follow:)

NATIONAL RIFLE ASSOCIATION OF AMERICA,
Washington, D. C., February 27, 1958.

Hon. HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

DEAR SENATOR BYRD: Senator Dirkson of Illinois has asked your committee to consider the amendment of H. R. 8381 to include the provision of Mr. Dirksen's bill, S. 1947, which was introduced in May 1957. I am writing on behalf of the National Rifle Association of America to endorse Senator Dirksen's request and to urge you to give it favorable consideration.

The National Firearms Act, popularly referred to as the "machine gun act," was enacted by the 73d Congress in 1934 to provide a making and transfer tax of $200 on machine guns and certain specified weapons which were national crime problems in the prohibition era. The weapons which are subject to control under this law are defined in section 5848, paragraph 1 of the act. Any weapon defined as a "firearm" in this section is required to be registered with the Department of the Treasury and becomes subject to the punitive tax provision of the act.

Two provisions in the definition of the term "firearm" have resulted in certain hardships on law-abiding gun owners and particularly on gun collectors without adding materially to the effectiveness of the act. It is the purpose of S. 1947 to amend the act in such a way as to remove the burden to which collectors and other gun owners are now exposed without weakening the act as a crime-prevention force.

Section 5848, paragraph 1, provides in part that a shotgun or a rifle having a barrel of less than 18 inches in length is a "firearm" except in the case of rifles of .22 caliber where the specified length is 16 inches. These are largely arbitrary measurements having the purpose of placing under strict Federal control the sawed-off shotguns and sawed-off rifles which at one time were popular gangster weapons. The difficulty arises from the fact that a number of popular sporting rifles have barrel lengths just slightly under 18 inches; hence, they must be classed as a "firearm" subject to the taxation provisions of this law. If the specified barrel length for shotguns and rifles is changed from 18 inches to 16 inches as it now is for .22 caliber rifles, no sporting-type firearms will be involved and the effectiveness of the act will not be lessened since a rifle or shotgun with a barrel 16 inches in length is hardly a concealable weapon in the sense that a sawed-off rifle or shotgun is concealable.

The other area of difficulty, from the standpoint of collectors and gun owners, arises from the provision which defines as a "firearm," in addition to a machine gun or sawed-off rifle or shotgun, "any other weapon, except a pistol or revolver, from which a shot is discharged by an explosive if such weapon is capable of being concealed on the person." It is clear from this language that Congress did not intend the taxing provision of this law to apply to pistols or revolvers. The law, however, does not define the term "pistol" or "revolver" and it, therefore, becomes a matter of administrative interpretation as to what is a pistol, excepted under the act, and what is "any other weapon," controlled under the act.

Highly valued items to gun collectors are the guns which mark stages in the development of firearms from their earliest beginning. In the process of experimentation, trial, and error which has led to the modern pistol and revolver, many strange firearms have had their brief moments on the scene; some are clearly recognizable as a step in the development of a modern pistol; others are not. Through recent and wholly arbitrary rulings by the Alcohol and Tobacco Tax Division of Internal Revenue Service, many now fall in the "any other weapon" category under the National Firearms Act and are, therefore, subject to its prohibitive controls.

Since pistols and revolvers make up the vast majority of weapons capable of being concealed on the person and, since for good and sufficient reasons the Congress felt that pistols and revolvers should not be included in the Machine Gun Act, we believe it would be desirable that the law not apply to the very small minority of concealable weapons which may be interpreted to be neither a pistol nor a revolver. We do not believe that the devices, concealable as they may be, which now fall in the "any other weapon" category are, or ever have been, a national crime problem. I believe that any reference to "any other weapon" should be deleted from this act and that the result will be that the interpretation and enforcement of the law will be facilitated and its effectiveness as an anticrime measure will not be impaired.

Sincerely,

FLOYD L. PARKS,
Lieutenant General, United States Army (Retired),
Executive Director.

[H. R. 8381, 85th Cong., 2d sess.]

AMENDMENT intended to be proposed by Mr. DIRKSEN to the bill (H. R. 8381) to amend the Internal Revenue Code of 1954 to correct unintended benefits and hardships and to make technical amendments, and for other purposes, viz: On page 69, after line 9, insert the following:

Sec. 60. Firearms.

(a) OCCUPATIONAL TAX.—The proviso at the end of section 5801 (a) (relating to the tax on manufacturers, importers, and dealers in firearms) is amended by striking out: "guns designed to be held in one hand when fired and having a barrel 12 inches or more but less than 18 inches in length, from which only a single discharge can be made without manual reloading, or guns of both types,".

(b) TRANSFER TAX.—The proviso in the first sentence of section 5811 (relating to the tax on the transfer of firearms) is amended by striking out: "or any gun designed to be held in one hand when fired and having a barrel 12 inches but less than 18 inches in length from which only a single discharge can be made without manual reloading,".

(c) DEFINITION.—(1) Paragraph (1) of section 5848 (defining the term "firearm") is amended to read as follows:

"(1) FIREARM.—The term 'firearm' means a shotgun or rifle having a barrel of less than 16 inches in length, or a rifle or shotgun made or altered to have an overall length of less than 26 inches, or a machinegun, and includes a muffler or silencer for any firearm whether or not such firearm is included within the foregoing definition."

(2) Section 5848 (relating to definitions) is amended by striking out paragraph (5).

(d) EFFECTIVE DATE.—The amendments made by this section shall take effect on the first day of the first month which begins more than 10 days after the date of the enactment of this Act and shall apply for all periods on or after such first day.

Renumber succeeding sections.

(By direction of the Chairman, the following is made a part of the record:)

FEBRUARY 28, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
Senate of the United States, Washington, D. C.

MY DEAR MR. CHAIRMAN: Your attention is respectfully requested to subsection 41 (b) of H. R. 8381, now under consideration by your committee. Section 41 is entitled, "Postponement of gain from sale or exchange to effectuate Federal Communications Commission policies."

Subsection (b) makes retroactive a substantive change in the law proposed in subsection (a) of section 41. It has long been the practice of the Committee on Finance to look with disfavor on all retroactive amendments to the tax law, except in cases where tax relief was plainly equitable and just. Rare, indeed, have been instances where taxpayers, relying on existing law, have been penalized by retroactive amendments.

It is true that it is proposed to make section 41 retroactive only to October 15, 1956, or a period of about 17 months, but this only makes the matter worse for it will affect very few taxpayers, while other taxpayers making sales or exchanges to effectuate FCC policies for the 13 years prior to October 15, 1956, have been granted a postponement of the recognition of gain from such sales or exchanges. It is obvious that no substantial revenue will be derived from this retroactive amendment.

It is clear the date of October 15, 1956 was selected in order to validate a ruling of FCC published on September 27, 1956, and made effective 18 days later on October 15.

A word as to this ruling—the Administrative Procedure Act requires that the Commission give prior notice of proposed rulemaking, with opportunity for interested parties to be heard. The act also requires that rules cannot become effective on less than 30 days' notice, and the Commission's order state the authority under which the rule is proposed. The September 27, 1956 notice of the FCC complied with none of these requirements and was therefore invalid on procedural grounds alone. It was also invalid on substantive grounds, for it represented an attempt to change the law itself, a power which rests only with Congress.

It is, therefore, urged that the last sentence of subsection 41 (b) be stricken from the pending bill H. R. 8381.

It may well be that your committee will deem it wise to strike all of section 41 from the bill. Section 41 amends section 1071 (a) of the Internal Revenue Code of 1954. This section and an identical section in prior law has been a factor in expanding the radio and television broadcasting industry. The amendment proposed will prevent many transactions so there will be no tax. Moreover, if expansion is curbed, there will be less income to tax at the present 52 percent rate.

Taxpayers do not buy, sell, or exchange radio and television broadcasting stations except for one purpose and that purpose is to make more annual profit. Since the Government gets 52 percent of this profit, what is good for the taxpayer is good for the Government. In my opinion, section 41 will in the long run decrease, instead of increase, the revenue.

Respectfully submitted.

LOVELL H. PARKER.

PENTLAND, PURVIS, KELLER & CO.,
CERTIFIED PUBLIC ACCOUNTANTS,
Miami, Fla., February 15, 1958.

SENATOR GEORGE SMATHERS,
United States Senate, Washington, D. C.

DEAR GEORGE: I am burned up over the provisions of section 24 of H. R. 8381, and hope you will lend a sympathetic ear to my grievance.

When the 1954 code was being drafted, one of the problems that affected many small and moderately sized taxpayers in the United States was that of technically being on the wrong accounting method for the purpose of computing their income taxes. A typical example of these taxpayers is a dairyman who started his operations on a cash basis and disposed of his milk wholesale. As his business developed and he established delivery routes and a processing plant, he became a distributor and thereby was no longer correct in following his cash receipts and disbursements method of keeping books and filing income-tax returns.

The Commissioner had been very aggressive in picking up taxpayers who were technically using the wrong method of accounting and dealing harshly with them. The taxpayers sought relief in the courts and found some protection from the Commissioner in cases such as the Dwyer and Hughes decisions. The situation was one of open conflict, so it was dealt with in the drafting of the 1954 code and I refer to section 481 thereof.

The history of 481 you will find was that your Senate Finance Committee rejected the draft submitted by the Ways and Means Committee of the House, and wrote in the specific provisions which appeared satisfactory to all concerned.

Since the enactment of the 1954 code, the Commissioner has defied the provisions of section 481 by refusing to grant any permission to taxpayers to change their method of accounting where it involved pre-1954 adjustments and by refusing to draft regulations for the administration of the section.

We now find that the Commissioner has prevailed in having section 24 written into H. R. 8381, and the effect of this section will be worse on the taxpayers than if section 481 was never written.

The minutes of the Senate Finance Committee will show that section 481 was drafted in its present form to give taxpayers the tax advantage that the courts had previously given and the Commissioner had denied them under the 1939 code for a limited period. The conclusions of your committee seemed to have fully recognized the necessity of a transition period within which time this mass of taxpayers throughout the country could, by their own initiative, correct their method of accounting without the confiscatory tax payment that the Commissioner had been requiring. In order to create this transition period, paragraph (a) (2) limited the adjustments to be made to those for 1954 and subsequent years. Now the provision in section 24 of H. R. 8381 adds to the paragraph just referred to the following words: "Unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer." This seems perfectly clear that any act of the taxpayer to change to the correct method of accounting will result in the punitive adjustments which the Commissioner has in prior years forced upon them.

Colin Stam's office attempted to justify the action of the Commissioner in his refusal to recognize section 481 by saying that it was an inadvertent drafting error. He has also said that not many taxpayers were involved. I completely disagree with these statements. The minutes of your committee will show that no error was made in drafting, and the number of applications for permission to change accounting methods that are now held up by the Commissioner will show that this affects many taxpayers. Also, representatives of the Commissioner proclaim loudly that the law as written would create a windfall in taxes which was never intended. I disagree with this statement. It is the same type of adjustment that was recognized in 1942-43 when individual taxpayers changed to the pay-as-you-go method and were forgiven 75 percent of the taxes for either 1942 or 1943, whichever was the lesser. This did not result in a loss of revenue in taxes, and we are here dealing with a change in method of paying taxes without an interruption of payment. The term "windfall" certainly does not apply.

I realize that H. R. 8381 should be enacted by March 15. This leaves practically no time for a revision or study of section 24, so I hope it will be completely pulled out of the bill. There were numerous subjects originally included in the draft of 8381 before it was submitted that were eliminated on the grounds that they were controversial. I think this section 24, which emasculates the taxpayers' equitable transition benefits in section 481, should be eliminated on the ground that it is controversial, if for no other reason.

I hope you are in sympathy with my position as expressed and can have this section 24 eliminated before it is acted upon by your committee.

Sincerely yours,

HUGH F. PURVIS.

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D. C., March 5, 1958.

HON. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR BYRD: We respectfully request that the Senate Finance Committee give consideration to the views set forth in the following statement in conjunction with the public hearings which have just been concluded on H. R. 8381 and that the statement be included as part of the record. We understand that the hearings were limited solely to the provisions already incorporated in the present bill and we have therefore not set forth our views concerning such items as reserves for estimated expenses and other equally important matters which we hope the committee will see fit to consider on another occasion.

Our recommendations are directed to two items—one section which we feel should be stricken from the bill and another which we believe should be retained despite certain objections by the Treasury Department.

SECTION 14. IMPROVEMENTS ON LEASEHOLD PROPERTY

The present IRS regulations require the cost of leasehold improvements to be amortized over the remaining term of the lease unless the useful service life of the improvement is shorter than the remaining term of the lease, in which case the lessee may depreciate the improvement over its useful service life in the same manner as any other capital asset under section 167. However, where the lease grants to the lessee a right of renewal or extension the current IRS regulations (sec. 1.162-11), which are still in proposed form, provide that whether the renewal period should be taken into account in determining the length of the remaining term depends upon the facts in the particular case. The regulations go on to state that unless the lease has been renewed, or such facts show with reasonable certainty that it will be renewed, the cost of the improvement is permitted to be recovered over the unexpired term of the lease without taking into account the rights of renewal.

Section 14 of H. R. 8381 would reverse this presumption by requiring the lessee to include within the term of the lease any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee "unless the lessee establishes that it is more probable that the lease will not be renewed."

This shift in the presumption apparently was occasioned by the concern within the Treasury that taxpayers in the recent past generally have ignored renewal options in writing off the cost of improvements. If such a situation has arisen it is due primarily to the regulations quoted above and Treasury Decision 4957 on which they are based rather than on the extensive case law which has developed over the years. If the Treasury has found it difficult to sustain the burden of proof under its present administrative rules, it will be similarly very difficult for the taxpayer under the proposed change in the code to prove that the option will not be exercised at the end of the term.

The institute recommends that section 14 be stricken from the bill as an unnecessarily restrictive resort to legislation in what we believe is primarily an administrative matter. It would appear that the Treasury's objective could more satisfactorily be achieved by amending the current regulations to indicate that there is to be no presumption either that the lease will or will not be extended, thus leaving the matter to be decided according to the particular circumstances of each case. These include the relationship of the unexpired term of the lease to the cost of the improvement, the availability of an option clause, the presence of any renegotiation provisions or rental adjustments for the renewal period, the nature of the lessee's business, etc. In the last analysis this is primarily a factual question which should be decided in the same manner as any other issue of fact arising under the Internal Revenue Code. In this case there is ample case law to guide both the taxpayer and the Commissioner.

It will be recalled that under present regulations the lessee already operates under a disadvantage in that if the unexpired term of the lease is less than the estimated useful life of the leasehold improvement the cost must be amortized rather than depreciated according to the provisions of section 167. Prior to the 1954 code this distinction was not of particular significance, since for all practical purposes the taxpayer was limited to straight-line depreciation accounting anyway. However, with the adoption of the more realistic sum-of-the-years' digits and double-declining-balance methods the lessee is placed at a serious disadvantage by this administrative limitation. Section 14 would presumably retain this disparity while unnecessarily restricting the lessee still further.

Finally, we believe that, regardless of the merits of this provision, its retroactive application to December 31, 1956, is wholly unjustified. While it is true that this bill has been made available to the public for some time, because of the fact that it consists primarily of technical amendments with which the average business taxpayer is not concerned it is quite likely that in many circumstances this provision would not become known until its adoption as law.

SECTION 37. CARRYBACK AND CARRYOVER OF FOREIGN TAX CREDIT

In order to avoid double taxation on income earned abroad, the Internal Revenue Code has long provided that foreign taxes paid or accrued are allowable as a credit against Federal income tax. This is subject, however, to the so-called per country limitation. This limitation restricts the foreign tax which can be claimed as a credit to an amount which is the same proportion of the taxpayer's total United States tax liability before credit as the taxable income from the foreign country bears to the total taxable income of the taxpayer for the same taxable year.

Unfortunately, this limitation has the effect of permitting double taxation in those situations where the methods of reporting income are different in the United States and the foreign country. Such differences in reporting frequently cause the same income to be reported in 1 year in the United States and in another year in the foreign country. To correct this situation section 37 of H. R. 8381 would permit foreign taxes which cannot be claimed currently as a tax credit by reason of the above-mentioned limitation to be carried back to the 2 prior years or forward to the 5 succeeding years and used in those years to the extent of any excess of the limitation over foreign taxes paid in those years.

There is no need for us to remind the committee of the many reason which prompted the inclusion of this amendment in H. R. 8381. These are spelled out at some length in the reports which were issued in conjunction with the original identical bills from which this amendment was adopted. We would simply add that our experience would support the reasoning and conclusions stated therein.

We would, however, like to comment briefly on the testimony submitted on behalf of the Treasury in opposition to this amendment. These views, presented by Mr. Dan Throop Smith, resolve themselves into two principal points—(1) that the amendment is not directed at an "unintended hardship," and

(2) that this amendment would provide an averaging device not available to domestic income.

Regarding the first point, we respectfully suggest that the amendment will correct a hardship, which we believe would have been termed as "unintended" if it had been considered at the time of the original adoption of the per country limitation because of its rather technical nature. The fact that this hardship has existed for some time under the prior code and did not result from the changes brought about by the 1954 code is no disability. Mr. Smith himself indicated that most of the unintended benefits for which corrections have been recommended by the Treasury Department arose under provisions of the 1939 code and were merely perpetuated by the 1954 code.

The second objection deserves more attention. It is contended that inasmuch as this amendment offers an income-averaging device not applicable to domestic income it is in effect discriminatory and serves to postpone the time when across-the-board tax relief will become available. First of all, there is no evidence that this change would result in any substantial revenue loss, and no policy ends are to be served by postponing corrective amendments aimed at removing special hardships created by the peculiar interaction by our complex tax system until such time as the Congress believes that our national budget will permit much-needed general tax rate reductions. Moreover, since this amendment is designed to correct a situation which is peculiar to foreign operations, the analogy to the averaging of domestic income for general income-tax purposes is not an accurate one.

Representing, as we do, the capital-goods manufacturers of this country, we have had special interest in recent years in the problems of United States manufacturers investing and operating abroad. We have devoted considerable attention to the means by which our tax structure might be improved to encourage sound foreign investment, and our recommendations in this regard were recently presented to the Ways and Means Committee during their recent public hearings on general tax policy. While we believe that basic reform in tihs area is desirable, the Congress should make every effort to insure that the present provisions are made as workable and as fair as possible. We believe that this amendment, while admittedly of limited impact, is an important step in this direction.

Respectfully,

CHARLES W. STEWART, *President.*

AMERICAN & FOREIGN POWER CO., INC.,
New York, N. Y., February 27, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR MR. CHAIRMAN: Your committee is now considering in public hearings H. R. 8381, the Technical Amendments Act of 1957. I am writing you with particular regard to section 37 of that bill dealing with foreign tax credits and wish to request consideration and treatment of the foreign tax credit problem on a broader basis.

Section 37 adds a new subsection to section 904 of the Internal Revenue Code and permits foreign taxes which cannot be claimed currently as a tax credit by reason of the country-by-country limitation to be carried back to the 2 prior years or forward to the 5 succeeding years and to be used in those years to the extent of any excess of the limitation over foreign taxes paid in those years. Since this measure would reduce the incidence of double taxation for some taxpayers, it would seem to be meritorious legislation.

In its present form, however, it does not meet the problem faced by other taxpayers with excess foreign taxes in some countries year after year because of the country-by-country limitation. In all fairness, such taxpayers should be allowed to treat the income taxes paid by them to all foreign countries collectively each year.

Section 37 would be beneficial to taxpayers who have taxable income from foreign sources which fluctuates radically between one year and another. It does not benefit taxpayers with fairly constant foreign income year after year who operate on a permanent basis in high and low tax countries.

Under present law the tax exacted from many United States foreign investors is considerably higher than the 52 percent United States rate. This penalizes them unfairly and seriously deters foreign investment.

Let me explain how this penalty hurts our company. We operate in 11 countries. This diversification is economically necessary to balance our risk in the face of fluctuating exchange and economic conditions abroad. Yet this very diversification is a handicap to us under the present tax law which doesn't allow us to treat our foreign tax credits as a whole.

For business purposes we must treat all of our operations in various countries as a unit. For example, in financing our companies, we must pledge the credit of our entire operation. This protects United States lenders, including the Export-Import Bank.

Requiring us to segregate our income-tax credits by countries for United States tax purposes is unnatural and unrealistic and causes us to pay a higher tax than if we operated wholly within the United States.

We cannot reconcile this situation with any concept of fair and equitable taxation. We believe the country-by-country limitation hurts foreign investment and trade. This is much more true today with the high tax rates than it was when this limitation was first inserted into the law. We believe it conflicts with United States foreign trade policy as laid down by this and previous administrations.

Our company alone should spend upward of $500 million abroad in the next 5 to 10 years if we are to keep up with the needs for electric power in the countries where we operate. Most of this would be spent on United States made equipment, much of it in the capital goods area now in the doldrums. I can say to you, Senator, that the country-by-country limitation in the present law is a serious deterrent in financing this program that should rightly be undertaken by us if we are to meet our obligations. For United States investors as a whole, you could multiply that figure many times.

We respectfully ask your committee to amend section 37 to modify the country-by-country limitation so that United States taxpayers with income from several foreign countries may treat their foreign income and foreign tax credits collectively each year.

The substance of this proposal is contained in identical bills, H. R. 6248 and H. R. 7247 introduced in the House during the first session of this Congress, and is readily susceptible to inclusion in section 37 of the Technical Amendments Act. This modification will in no way hurt the companies who will benefit from section 37 as it now stands. Rather, it would help them, and I believe they would give it their wholehearted support.

Although we derive our income from both high and low tax countries, we do not believe the modification of the country-by-country limitation, as proposed, would work a competitive disadvantage on companies that operate only in low tax countries. We have given serious consideration to this theory and have concluded it is not founded on fact since we have been unable to find a single actual case where it would occur.

On the contrary, the change we request would encourage companies to diversify their operations into several foreign countries. They would then be able to consider their foreign income from all sources collectively which would be consonant with the realities of doing business. This certainly would tend to promote foreign trade and investment and thus advance the foreign policy goals of this country.

The provision we propose has been endorsed by numerous companies and organizations concerned with United States foreign investment. Among organizations which have recently endorsed the proposal are the National Foreign Trade Council, Manufacturing Chemists' Association, and United States Council of the International Chamber of Commerce.

Section 37, amended as we suggest, would still provide ample safeguards. United States taxpayers would still be required to pay an income tax equivalent to the 52 percent United States tax rate, or higher, on all income from their foreign investments and could not offset foreign taxes against United States taxes on domestic source income.

I am certain that any revenue loss would be made up many times over by resulting employment and income in this country and from possible savings in United States foreign aid.

We respectfully request that this letter be included in the record of your current hearings.

Very truly yours,

HENRY B. SARGENT.

FEBRUARY 10, 1958.

GIBERT C. ST. CLAIR, Esq.,
St. Clair & St. Clair, Idaho Falls, Idaho.

DEAR SKINNY: There is presently pending before the Senate Finance Committee, H. R. 8381, the proposed Technical Amendments Act of 1957. Section 2 of this bill would amend section 37 of the 1954 Internal Revenue Code to eliminate for the consideration of retirement income credits the provisions of community-property laws.

I believe that this section is possibly objectionable as curtailing the purchasing power of retirees in Idaho. I would appreciate receiving from you as promptly as possible a letter or statement from the bar association concerning this matter, so that I may present it to the Finance Committee.

I am mindful of the status of our community-property system in Idaho, and the fact that Idaho may have more cause to complain about this particular section than some of the other community-property States.

Sincerely,

FRANK CHURCH, *United States Senator.*

BOARD OF COMMISSIONERS
OF THE IDAHO STATE BAR,
February 24, 1958.

Senator FRANK CHURCH,
United States Senate, Committee on Interior and Insular Affairs, Washington, D. C.

DEAR SENATOR: I have circulated your letter with reference to the act, to the other commissioners and Paul B. Ennis, the secretary of the bar commission.

It is the consensus of the bar commission that the amendment would certainly be objectionable as curtailing income of certain retirees in Idaho, and although we cannot as a commission voice the opinion of the entire integrated bar of Idaho, we feel that every lawyer in Idaho would take exception to the amendment and would object to its passage.

Please feel free to present the commissions' objections to the Finance Committee.

I am leaving for San Francisco early in the morning and therefore will not be able to read this letter, and have authorized my secretary to sign it for me. The replies from the other commissioners were just received this date.

With best regards, I am

Sincerely yours,

GILBERT C. ST. CLAIR.

STATEMENT SUBMITTED BY T. G. REDMAN, COMPTROLLER, SWIFT & CO., CHICAGO, ILL., IN SUPPORT OF SECTION 37 OF H. R. 8381, CARRYOVER AND CARRYBACK OF FOREIGN TAX CREDIT

We respectfully urge the retention in the technical amendments bill of 1958 (H. R. 8381), now being considered by the Senate Finance Committee, of section 37 relating to the carryover and carryback of foreign tax credits.

We are aware of the comprehensive memorandum submitted by the National Foreign Trade Council in support of this section, and will not attempt to duplicate in this letter their excellent coverage of the broad subject. We merely wish to bring to the committee's attention one instance in our own experience where the carryover and carryback of the foreign credit is necessary to achieve fairness and equity in tax administration and to carry out an expressed intent of Congress.

In this connection, it is significant that the relief afforded by section 37 is not necessarily correlative with the size of a taxpayer or the amount of foreign tax it incurs. Section 37 generally comes into play only where some unusual circumstance causes foreign taxes to accrue in different years from the United States taxes to which they relate.

Our company has a wholly owned subsidiary, a Western Hemisphere trade corporation, which conducts its business in one of the Latin American countries. This corporation, of course, is subject to the income tax of the foreign country in which it operates, as well as to United States income tax on earnings from the foreign operation. The top applicable income-tax rate of the foreign country has always been substantially lower than the Western Hemisphere trade corporation rate for the same year, so that it would appear in theory and in equity that the income tax paid to the foreign country should be entirely recoverable as a foreign tax credit against the United States income tax.

It is necessary that this be true if the corporation is to obtain the full benefit of the rate advantage accorded to it by Congress in 1942 when it enacted section 109 establishing Western Hemisphere trade corporations as a separate class of taxpayers. As the pertinent committee report states (Senate Finance Committee Report on the Revenue Bill of 1942, p. 32):

"American corporations trading in foreign countries within the Western Hemisphere are placed at a considerable competitive disadvantage with foreign corporations under the tax rates provided by the bill. To alleviate this competitive inequality the committee bill relieves such corporations from surtax liability."

It may be of some interest to note that it was the Senate Finance Committee which placed this relief provision in the law originally.

Unfortunately, the United States taxable income, by years, of our Western Hemisphere trade corporation diverges widely from its taxable income as computed by the foreign country. A number of factors are responsible for this:

1. The United States taxable year is the calendar year, but the taxable year in the foreign country is a fiscal year ending in October.
2. For United States tax purposes the company values its inventory on the LIFO method, but LIFO is the only allowable method in the foreign country.
3. Depreciation is required to be computed at different rates by the foreign country than are allowable for United States tax purposes.

As a result of these and other smaller differences, in some years this corporation will actually incur more foreign tax than United States, and in other years materially less, although over any 5-year span, as would be expected, the total United States tax before foreign tax credit exceeds the total foreign tax accrued by about the percentage which the difference in the two countries' rates would indicate.

Since its organization 13 years ago, our subsidiary has incurred foreign income taxes, not recoverable against United States tax for the same year, aggregating some $280,000, solely because due to circumstances beyond our control the 2 countries' taxes failed to mesh in the way that Congress must have expected they would when it adopted the preferential Western Hemisphere trade rate.

The result of this, under present law, is that instead of deriving the full benefit of the 38 percent Western Hemisphere trade corporation rate and thereby being able to compete effectively in the foreign country with local firms and branches of European businesses, our company must bear a total income tax burden (United States and foreign) averaging as high as 47 percent of the taxable income from this enterprise.

We believe testimony has been given, and not contradicted, to the effect that the revenue loss resulting from adoption of section 37 would be relatively small. In the interest of carrying out the original intent of Congress to help make United States enterprise competitive in Western Hemisphere markets outside our own country, we strongly recommend that your committee keep section 37 in its present form in the bill now before it.

GUNTHER SHEET METAL CO.,
America Fork, Utah, February 25, 1958.

Senator HARRY F. BYRD,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD AND MEMBERS OF THE SENATE FINANCE COMMITTEE: As a plain citizen, without the means to make a personal appearance at your hearings on the House bill on technical revision of the tax laws, I would like to direct this communication to you, with the hope you will read it before your committee. It has to do with an amendment concerning section 481 of the 1954 code, which appears to have been written by the Internal Revenue Service itself, and is entirely contradictory to the apparent intent of your committee and the Congress, in the 1954 code.

It appears to me from a study of section 481, of the 1954 code, and particularly your committee's report thereon, that it was your intent, in the wording of that section, to recognize the injustice of requiring income represented by inventory or receivables that were earned in previous years, to be "bunched" for tax purposes, as a result of a change in accounting from a cash to an accrual basis, whether done "voluntarily or involuntarily." You provided, in section 481, for a formula to be used in such adjusting for the years succeeding 1954, but cle· ly stated that the years prior to 1954 were not to enter into the accounting.

I would like to relate my personal experience in this matter, to demonstrate the unwillingness of the Revenue Service to abide by the law, and their apparent effort now to have you reverse the intent of the law.

In 1934, I began a part-time association with my father, in a very small business operation. In 1942, my father died, and I took it over full time, and continue to operate to the present.

From the beginning, I have kept good books of account. I have reported income on an accrual basis with one exception. Instead of reporting "sales." I have reported "receipts." This has resulted in an accumulation over the years of an amount as " accounts receivable" that has not been taxed. Twice prior to 1954, I was reviewed by the Revenue Service, and no criticism of this reporting was made.

In the spring of 1954, I was given another audit, and the agent discussed this matter with me, and told me my reporting should be on a strict accrual basis. I was agreeable to this. He made the necessary computations, and then recommended in his report, that my accounting be changed.

At that time, as a result of certain court rulings, the Revenue Service was prevented from going beyond the 3 open years, in assessing these accounts receivable.

A few days after making his report, this agent returned and informed me that his superiors had overruled him, and had decided to await the enactment of the new 1954 code, as they were expecting a section of the law more favorable to the department than the then Tax Court rulings.

After the 1954 code was passed, I noted with interest section 481 and your committee's report. I interpreted this to mean that I should change my reporting, for tax purposes, to a strict accrual basis for the 1954 year. I noted also the wording of your report "voluntary or involuntary." I attempted to get an interpretation of this section from the Internal Revenue Service, but they refused. I then wrote your council, Mr. Colin Stam, and he confirmed my interpretation.

Thereupon, I reported my income for 1954 on a strict accrual basis, and eliminated the accounts receivable that had accrued prior to 1954. I attached a notice to my return, calling attention to the Revenue Service, of my actions and referred to section 481 as authority.

In 1955, the same agent reviewed me again, this time with reference to the 1954 change. After making his report, he returned to say that the department had concluded that they could not challenge my action under the 1954 code.

About 3 weeks ago, another agent called with a request that I sign a waiver to extend the statue on my 1954 return. In discussing the matter with him, I learn that they are relying on the wording in the House technical amendments bill, that makes a distinction between how adjustments like mine shall be made when required by the Commissioner, and when made voluntarily by the taxpayer. They are expecting the Senate to pass this bill so they can then assess this entire amount in the year of change. They are now threatening me to assess this entire amount, unless I sign this waiver.

Now this seems very unjust to me. The Commissioner seems only willing to enforce the law when it is in the interest of the department, and to ignore it when in the interest of the taxpayer. I asked the agent what they would have done with me if I had not changed in 1954. He replied that they would have followed the wording of section 481, and changed me over in 1957, as provided therein.

With reference to the House bill before you, how can you justify the ex post facto aspect of a revision that becomes retroactive to 1954? I am not schooled in the law, but I recall the provisions of the Constitution, which provide that Congress shall pass no ex post facto law.

Here is a taxpayer who pays his taxes in 1954, according to the law in 1954, only to be threatened now by an amendment made retroactive to 1954. This cannot be right. I know the Commissioner will argue that I have done this voluntarily and therefore must accept the consequences, but whether voluntary or involuntary, right is right. The Commissioner recognizes that what I have done needed doing, and had you worded section 481 in his favor, he would have required the change immediately. Is this to be only a one-way street?

I know you are extremely busy, and this is a case of seemingly small proportions in the affairs of state, but to me it can mean the wiping out of my complete working capital, with which I keep myself and 10 other employed. I hope you will please take enough time of the committee to read this letter.

Thanking you for every consideration, I am,

Sincerely yours,

ORVILLE GUNTHER.

LAW OFFICES,
ALVORD & ALVORD,
Washington, D. C., March 5, 1958

Hon. HARRY F. BYRD,
Chairman, Senate Committee on Finance,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR BYRD: At present the provisions for crediting income taxes paid or accrued to foreign countries or United States possessions against tentative United States income-tax liability are applied to each taxable year separately. The result is unnecessary, and unintended, hardship in many cases where year-to-year fluctuations in foreign income taxes paid or accrued to not coincide precisely with the fluctuations in United States income-tax liability.

Commonly, this situation occurs where the timing of the reporting of taxable income to the foreign country differs from the timing of the reporting of this income to our own tax authorities. Whether the foreign taxes are paid or accrued in an earlier year or a later year than the year in which the tentative United States income-tax liability with respect to the same income is incurred, the effect is frequently to deny to the taxpayer—purely as an accidental result of this difference in timing—the benefit of the foreign tax credit. The same situation arises where, as a result of fortuitous circumstances, income is earned in a foreign country and foreign income tax is paid or accrued with respect to it in a year in which losses in other foreign countries or domestic losses result in a tentative United States income tax for the taxpayer's whole income which is less than the foreign tax paid or accrued on the income from the particular country or countries. In both these cases, under present law, the foreign tax credit is lost forever.

Section 37 of H. R. 8381, in the form in which it passed the House of Representatives, provides a 2-year carryback and a 5-year carryforward of unused foreign tax credits arising under either of the foregoing sets of circumstances. This is the same carryback and carryforward period provided for net operating losses in the present law, and the analogy of section 37 to the net operating loss provision is a striking one. Like the net operating loss provision, the carryback and carryforward of unused foreign tax credits will minimize discrimatory differences tax burdens arising from the fortuitous timing of events from year to year.

The committee on taxation of the United States council of the International Chamber of Commerce has endorsed the unused foreign tax credit carryover principle embodied in section 37 of H. R. 8381 and urges its enactment.

Respectfully,

ELLSWORTH C. ALVORD,
Chairman, Committee on Taxation, International Chamber of Commerce.

(Whereupon at 1:20 p. m., the committee recessed to reconvene at 10:15 a. m. the following day.

TECHNICAL AMENDMENTS ACT OF 1958

FRIDAY, FEBRUARY 28, 1958

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D. C.

The committee met, pursuant to recess, at 10:15 a. m., in room 312, Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd, Kerr, Frear, Long, Smathers, Douglas, Martin, Flanders, Williams, and Bennett.

Also present: Senators Johnston, Thurmond, Talmadge, and Bricker. Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The meeting will come to order.

We are honored today by the presence of three of our colleagues in the United States Senate.

I will ask Senator Talmadge to make the introduction he desires.

STATEMENT OF HON. HERMAN E. TALMADGE, UNITED STATES SENATOR FROM THE STATE OF GEORGIA

Senator TALMADGE. Thank you, Mr. Chairman and members of the Senate Finance Committee.

I appreciate this opportunity of appearing before you on a matter which I consider of grave concern not only to the peace officers of my State but also to those of the entire Nation.

If it meets with the approval of the committee, since Senators Johnston and Thurmond are present, after I present the witness from Georgia, Mr. Edwards would like to defer his testimony until you can hear from the two Senators.

Mr. Chairman, I appear in opposition to section 4 of H. R. 8381, which would make subsistence allowances received by peace officers subject to taxation as regular income.

At the outset I wish to state that I am speaking to you not only for myself, but also for my distinguished colleague, Senator Richard B. Russell. Senator Russell asked that I express to the committee his deep regret at his inability to appear in person, due to his own heavy load of committee work.

Each of you, I am sure, has received, as I have, communications from the law-enforcement officers of your State, stressing the great financial burdens which such a provision of law would place upon peace officers at every level of government in the country.

I have here a letter from Hon. Marvin Griffin, Governor of Georgia, stating that the enactment of section 4 would be a "blow to sound law enforcement" in Georgia.

With the permission of the committee, I would like to offer this letter for inclusion at this point in the proceedings.

The CHAIRMAN. If there is no objection, the inclusion will be made.

(The letter from Governor Griffin is as follows:)

ATLANTA GA., *January 3, 1958.*

Senator HERMAN EUGENE TALMADGE,
Senate Office Building, Washington, D. C.

DEAR SENATOR TALMADGE: Section 120 of the United States Internal Revenue Code provides that any statutory subsistence allowance received by police, not to exceed $5 per day, need not be included as income when filing a return for income-tax purposes. The House Ways and Means Committee has reported to the House of Representatives H. R. 8381, which is now pending on the House Calendar. Section 4 of this lengthy bill proposes to repeal entirely section 120.

To peace officers of this State, including State troopers, policemen, and other law-enforcement officers, perform hazardous work their entire lives and are entitled to all the benefits which our governments can furnish. It would be tragic indeed for Congress to repeal the provisions of the aforesaid section 120.

Of course, Federal legislation is a matter which addresses itself to your sound discretion, but I feel that the passage of this legislation would be a blow to sound law enforcement in this State, and feel compelled to acquaint you with my views.

With kindest personal regards and best wishes, I am,

Sincerely yours,

MARVIN GRIFFIN,
Governor, State of Georgia.

Senator TALMADGE. It is not necessary for me to point out to this committee that these valued public servants are already grossly underpaid. Their salary schedules can hardly be said to compensate them adequately for the risks they must take and the personal hardships they must endure as the result of the demands of their duties in preserving the public peace.

In Georgia a highway patrolman receives a subsistence allowance of $5 a day. He is on duty or subject to call 24 hours a day, many times 100 miles or more away from home. With that small allowance he must buy all of his meals, and if there is no patrol barracks in the area where he is serving, also his lodging.

Such allowances should not be subject to taxation any more than the reimbursement received by a Member of Congress for his food and expenses while he is away from the Capitol conducting an investigation, holding a hearing, or engaging in official Senate or committee business.

Mr. Chairman, to enact such a proposal as contained in section 4 of H. R. 8381 would be to legislate against a group which Congress rather should be legislating for.

I hope this committee will see fit to strike section 4 from this bill in its entirety, and I earnestly and respectfully urge that it do so. I fear that to fail to do so would result, in many instances, in making it financially impossible for men with valuable experience and proven devotion to duty to continue to serve in the various police agencies of the Nation.

And now, Mr. Chairman, it is my pleasure to present to this committee the Honorable Frank H. Edwards, assistant to the attorney general of Georgia, and attorney for the Peace Officers Association of Georgia.

Mr. Edwards is one of Georgia's brightest young attorneys and most dedicated public servants. As director of the bill-drafting unit of the Georgia State Department of Law, he has been intimately connected with the drafting of all beneficial legislation for the peace officers of Georgia during recent years.

Mr. Edwards knows the needs of peace officers and can testify as an expert on legislation affecting their welfare. He is prepared to discuss in detail the ramifications of this proposal as it affects peace officers everywhere and to answer any questions which the members of the committee may have.

The CHAIRMAN. Senator Talmadge, we are honored to have you.

Senator TALMADGE. I thank you for the honor of appearing here, Mr. Chairman.

The CHAIRMAN. We are also honored to have Senator Olin D. Johnston present.

STATEMENT OF HON. OLIN D. JOHNSTON, UNITED STATES SENATOR FROM THE STATE OF SOUTH CAROLINA

Senator JOHNSTON. Mr. Chairman and members of the Finance Committee, knowing the membership of this particular committee and seeing the ones that are here this morning, I realize that each of you know just what a peace officer has to do. Some of you who I am speaking to here know that we and our committee have made special provisions for the FBI for that reason, because of the risks they run in the occupation that they hold. Also, we know that peace officers in the United States Government and also in the States are underpaid to a very large extent.

And I think each one of you on this committee, when you look into this matter thoroughly, is going to find that probably if we keep the law and they are taxed on the different amounts that they receive, or that are paid out, that the States will probably in a great many instances have to increase the salaries.

So it is just taxation on taxation all the way through; that is what it amounts to in the long run.

The purpose of my appearance is to present Henry H. Edens, an attorney in Columbia, S. C., who is representing the peace officers in the State of South Carolina. They and other peace officers in other States are much concerned over the proposal to repeal the $5 subsistence-allowance exemption. This provision to exclude this allowance from taxable income was made because it is so often necessary that policemen make trips from their posts of duty. The exemption was and still is very fair. The policemen are still required to make many trips, and it is only right that the allowances paid not be taxable. The maximum allowance not taxable is $5 per day. If tax is taken from the $5, it is immediately reduced to an amount even farther from actual expenses incurred in the line of duty.

One provision of section 4 of H. R. 8381 is to make the repeal of the present law retroactive whereby the allowances received during 1957 will be taxed. This will add another tax burden on the peace officers. Since they are already underpaid in salary, many of them will have to borrow the money to pay their 1957 tax. I urge that the committee consider this section very carefully.

Now, I have here this morning a gentleman that was for about 14 or 15 years trial attorney for the Federal district court in my State. And he came in contact with all the peace officers in the counties and also the Federal peace officers.

I think if anyone in my State knows what they are up against at the present time, it would be Mr. Edens from South Carolina. So I am here this morning to introduce him.

Now, I do have also here this morning my colleague, Senator Thurmond of South Carolina, who will also probably make a statement. He, too, will tell you that Henry H. Edens is an authority, and you may be at liberty to ask him any questions; he will be frank, truthful with you, in answering your questions.

So I am glad to have this opportunity of bringing him around. I wish I could stay here and go into this matter thoroughly myself, but each one of you know that I have the floor, we are meeting at 10:30 this morning and there are several amendments there pending, and I want to study those amendments so that I can do what I think is right and just there.

I certainly thank you for the attention you have given me.

The CHAIRMAN. We appreciate your burdens, and we thank you for coming over, sir.

Senator JOHNSTON. I would like for Mr. Henry Edens to stand so you can see him.

The CHAIRMAN. We are also honored today by having Senator Strom Thurmond.

We will be glad to hear from him.

STATEMENT OF HON. STROM THURMOND, UNITED STATES SENATOR FROM THE STATE OF SOUTH CAROLINA

Senator THURMOND. Mr. Chairman, and gentlemen of the committee, Senator Johnston has presented Mr. Edens. I believe he mentioned that Mr. Edens had been assistant United States attorney and has a large law practice in South Carolina. We are pleased to have him here.

In addition we have two other gentlemen here. One is the chief of the South Carolina Law-Enforcement Division, Mr. J. P. Strom, and also Mr. L. K. Campbell, chief of police of the Columbia Police Department.

They are not going to speak, I believe Mr. Edens is going to speak on behalf of the group.

Chief Strom, will you stand up.

Chief Strom has been in police work for 17 years, and is a graduate of the FBI, and he has held high positions in the Association of FBI School Graduates, I believe he has been the president, and stands very high in our State.

Chief Campbell, would you stand up?

Chief Campbell has been with the police department for 29 years. He has been a chief there for a very long time and is a very capable and conscientious officer.

I want you gentlemen to see the caliber of the people who are coming from South Carolina up here on this particular matter.

I have already filed with the committee on February 11, 1958, a letter setting forth my views on section 4 of the bill under consideration.

(The letter referred to appears in the record at the end of Senator Thurmond's statement.)

I would like to reiterate, however, that the repeal of section 121 of the Internal Revenue Code would deal a severe blow to our underpaid policemen throughout the country.

The Federal Government has continually increased the number of revenue sources from which it takes taxes and the amount of revenue it derives therefrom. The local governments now find it difficult to raise sufficient revenue to provide essential service in an adequate form.

The police officers are doing a magnificent job, and are showing a high degree of devotion to duty in protecting the public despite the lack of pecuniary incentive.

I sincerely hope that this committee will not report favorably section 4 of this bill.

Mr. Chairman, while Governor of the State I worked closely with law-enforcement officers, and previous to becoming a lawyer and going into public life I taught school, and so have dealt with different segments of the population.

I frankly do not believe we have a more dedicated group of people than our law-enforcement officers. They are on call 24 hours a day. They work in the cold, they work in the rain, and it seems to me that the little amount that is allowed them here under this provision should be retained. I think it would be a great mistake, I think it would injure the incentive of our law-enforcement officers, if we attempt to repeal that.

I sincerely hope that the committee will take favorable action in accordance with the wishes of our law enforcement officers on this important point.

Thank you very much.

The CHAIRMAN. Thank you very much.

Senator MARTIN. Mr. Chairman, I would like to just note that all three of these Senators have been governors of their respective States.

The CHAIRMAN. That will have a special weight with the chairman, and also with the ranking Republican.

Senator Frear.

Senator FREAR. The only thing I would like to say, Senator Thurmond, is that it is mighty nice for the people here to recognize these police chiefs of your State, and we would just like to have that recognition when we go through the State of South Carolina.

Senator THURMOND. They will remember this, Senator.

Thank you very much.

The CHAIRMAN. We are glad to have you, Senator Thurmond.

(The letter previously submitted by Senator Thurmond follows:)

UNITED STATES SENATE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
February 11, 1958.

Re H. R. 8381, Technical Amendments Act of 1957.

Hon. HARRY F. BYRD,
Chairman, Finance Committee,
United States Senate, Washington, D. C.

DEAR SENATOR BYRD: It has come to my attention that H. R. 8381, which was passed by the House and has been referred to your committee, includes a provision for the repeal of section 120 of the Internal Revenue Code of 1954. This section in its present form excludes from the gross income of a police official of a State, Territory, or subdivision thereof, any statutory subsistence allowance paid to the police official not in excess of $5 per day.

Notwithstanding the need which we now face for additional revenue, I urgently request that the Finance Committee not report favorably section 4 of H. R. 8381 which repeals section 120 of the 1954 code. In any event, I feel that it would be a serious mistake to make this repeal retroactive as the bill presently provides.

I am sure that you are aware of the difficult time which the States and municipalities of our country are having in providing necessary services from the limited sources of taxation left to them by the Federal Government. Police service is one of the most basic and essential of all those provided at the State and municipal level. I doubt that anyone would contest the fact that law-enforcement officers are underpaid. Section 120 of the 1954 code, intentionally or otherwise, has given much needed assistance to the States and their subdivisions by enabling them to obtain better qualified officers.

Police officers have the most hazardous duty of any group providing service for the American public. In the course of their duty they often must risk death and injury. At the same time, these valiant officers are possibly the most poorly compensated of all public servants for the services they render.

With best wishes.

Sincerely,

STROM THURMOND.

The CHAIRMAN. I submit for the record a letter from Senator Styles Bridges enclosing a letter from Benjamin Thompson of the National Police Officers of America.

(The letters referred to follow:)

UNITED STATES SENATE,
COMMITTEE ON APPROPRIATIONS,
February 28, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR HARRY: I enclose photostatic copy of a letter I have received from Mr. Benjamin Thompson, Jr., 41½ South Main Street, Hanover, N. H., who is the New Hampshire secretary for the National Police Officers Association of America.

You will note that Mr. Thompson is appealing for deletion of section 4 of H. R. 8381, which is now before your committee for consideration. This letter is typical of the large number I have received from police officers throughout the State of New Hampshire who are requesting similar action.

I would appreciate your making this letter a part of the formal record of the hearings and also your serious consideration of this proposal when the committee marks up H. R. 8381.

With kindest personal regards.

Sincerely yours,

STYLES BRIDGES.

NATIONAL POLICE OFFICERS ASSOCIATION OF AMERICA,
NEW HAMPSHIRE STATE OFFICE,
Hanover, N. H., February 15, 1958.

Hon. STYLES BRIDGES,
United States Senate,
Washington, D. C.

DEAR SENATOR BRIDGES: In behalf of all the members of the Hanover Police Department and as State of New Hampshire field secretary of the National Police Officers Association of America, I strongly urge you to vote against H. R. 8381, which is pending before the Senate, or seek to amend the bill by deleting section 4.

This section would deprive police officers of an income-tax exemption which Congress granted as a subsistence allowance in section 120 of the Internal Revenue Code of 1954. The exemption is very important to us in view of our meager salaries which are already inadequate in today's high cost of living. This exemption can hardly be called unjustifiable in view of the many other exemptions being given to other people in the income tax law—for example, unearned incomes from stock dividends and depletion allowances for wealthy oil companies.

The repeal would not now be before Congress if it were not for the demand of the Internal Revenue Bureau. The Bureau has fought against the exemption ever since Congress gave it to us in 1954. Having failed in the courts, as shown by the decision of the United States District Court for South Carolina in *Shirah* v. *United States* handed down on October 4, 1957, the Bureau is now trying to accomplish its objectives by appealing to Congress.

I assure you that your support will be appreciated.

Respectfully,

BENJAMIN THOMPSON JR.,
State Secretary.

The CHAIRMAN. Our first witness will be Mr. Frank H. Edwards, of Georgia, a law enforcement officer.

STATEMENT OF FRANK H. EDWARDS, GEORGIA LAW ENFORCEMENT OFFICER

Mr. EDWARDS. Mr. Chairman, and members of the committee, I would like to say first that I am honored at having the opportunity to appear before your committee, and particularly in view of the fact that this is the first time that I have ever appeared before any congressional committee.

So I feel singularly honored this morning.

I would like to preface my statements toward section 4 of H. R. 8381 with a few brief remarks. I would first like to express my sincere appreciation to Senator Talmadge for his very kind introduction, and also for his statements relative to the bill.

I would also like to express my appreciation to Senator Russell for his concurrence in Senator Talmadge's remarks.

I would like to digress for a moment while we are talking about our two distinguished Senators from Georgia to say, with all due respect to the Senators from other States, whom I realize are very capable and efficient, we in Georgia always felt when Senator George was the senior Senator and Senator Russell was the junior Senator that we had the best senatorial team in the United States, and now that Senator Russell is the senior Senator and Senator Talmadge is the junior Senator, our thinking is still the same.

Senator Talmadge, as the old saying goes, knows whereof he speaks. For about 15 years the peace officers in the State of Georgia had been attempting to have legislation enacted creating some form of retirement benefits for the peace officers of that State. And it was only during his tenure as Governor of Georgia that that legislation was fiinally enacted.

And it is a well-known fact that without his support it would not have been enacted.

While we are on the subject of Georgians, we are also proud to note that your chief clerk is a native Georgian.

I have filed copies of my statement with her, and I will not go into detail of what is contained in there.

(Mr. Edward's prepared statement appears at p. 327.)

I would like to state very briefly that I realize the problems confronting this committee. It has been my privilege to work as the head of the State Bill Drafting Unit for the past 10 years, and I actually have worked more closely with members of the legislative branch of the Government than I have with the executive branch, and I know the problems that confront you.

We just completed our annual session this past Friday, and as usual we were confronted with a great many problems, and with a great many requests for special interests. And I know that you are also confronted every day with many requests for special consideration of individual groups.

I would like to ask you to please bear in mind that any assistance rendered to peace officers, even though they be one group, either directly or indirectly benefits every citizen of the United States in better law enforcement, better reduction of crime.

The very small amount that the repeal of section 120 of the Internal Revenue Code of 1954 would bring in really is hardly enough to pay for printing the bill, it does not amount to a great deal. But it would be of great help to the individual peace officers.

It is my feeling, and I hope yours, that the peace officers of this country should be given every possible benefit and assistance which our governments, including Federal, State, and local, can give. And this is something that the Federal Government has the opportunity to do for the peace officers and for better law enforcement.

I might say it is my feeling that the peace officers as a group are the most underpaid, hardest worked people in the United States. And if we are to have better law enforcement and better people going into the profession of law enforcement, it is imperative that we do something to make it more attractive to them. As I say, this is one small way that the Federal Government can make it more attractive to peace officers all over the country.

I might give you one example of the seriousness of the situation. And I believe what I say applies to all the other States.

Last year in Georgia we lost 31 men out of the Georgia State Highway Patrol who left for better paying positions in private industry. We estimate that it cost approximately $5,000 to adequately train a Georgia State highway patrolman. So you see that only last year that, roughly speaking, cost the State of Georgia about $105,000.

Now, our general assembly at this recently completed session took cognizance of this fact, and we passed legislation calling for longevity pay increases for the State patrol based on the length of service. We hope that that will make it more attractive for the men to stay on with the patrol.

But actually if this section 120 is repealed, that in effect will practically wipe out the benefits which the Georgia Legislature has seen fit to give the State patrol.

Looking at the situation from purely a financial viewpoint, I would conservatively estimate that anything that might be gained by the National Treasury in this small amount of income tax that these men would have to pay would be more than doubled by retaining that section and giving the men more incentive to do a better job where they would not have to worry over financial matters. As a result we would have better law enforcement, and a reduction in the crime rate which, as you know, benefits every citizen in the United States.

I would like to point out that section 4 of H. R. 8381 originally stems from a proposal of the United States Treasury Department. And what they originally proposed was that a cutoff date be tacked on to that section 120 to say that you could only exclude—let me put it this way—that only those persons who were receiving statutory subsistence allowances prior to August 16, 1954, which was the effective date of section 120, would be authorized to exclude this income for income tax purposes.

And you see that this bill proposes an outright repeal of section 120, which of course is more drastic than even the Treasury Department proposed.

Senator FREAR. How many people in your State would this affect other than your constabulary?

Mr. EDWARDS. Well, it would affect all of our Georgia State highway patrolmen, and several cities have enacted ordinances authorizing statutory subsistence. I frankly do not have the actual number, but it would affect a great number, in fact more and more as time goes on.

Senator FREAR. Didn't you have a statute in the State of Georgia that broadened that and included others than just State troopers and the city policemen?

Mr. EDWARDS. Not on a State level. In other words, our State statute only authorizes a subsistence allowance to be paid to State highway patrolmen.

Now, anything that would be paid to city police officers, for example, would be enacted as an ordinance by the city governing authority itself.

Senator FREAR. But they would be included in this section of the proposed bill?

Mr. EDWARDS. Yes; they would definitely be affected.

Senator WILLIAMS. How long have they been receiving this subsistence allowance?

Mr. EDWARDS. Since shortly after 1937. The patrol was originally created in 1937, and at first they thought they would be able to furnish meals in the barracks; they set up kitchens, but it was soon proved to be a practical impossibility to do that. So this was enacted to take the place of it.

Gentlemen, I would like to close my statement with an urgent appeal to you to earnestly consider the plight of law-enforcement officers, not only in my home State of Georgia, but all over the country, and in each of your respective States, and to realize that to strike out section 4 of H. R. 8381 would be a great boon to law enforcement, crime prevention, and the protection of the rights and property of all citizens wherever they may reside, and to also bear in mind that any benefits given to peace officers likewise benefits every citizen of the United States.

I thank you for your kindness.

The CHAIRMAN. Thank you very much, Mr. Edwards. You have made a good statement.

(Mr. Edwards' prepared statement follows:)

Mr. Chairman, I am honored at the privilege of appearing before your committee, particularly in view of the fact that it is my first opportunity of appearing before any committee of the Congress of the United States.

If I might be permitted to do so, I would like to preface my statements toward section 4 of H. R. 8381 with a few brief remarks.

I would first like to express my deep appreciation to Senator Talmadge for his very kind introduction and also for his statements relative to the bill. I also would like to express my appreciation to Senator Russell for his concurrence in the remarks of Senator Talmadge.

Senator Talmadge, as the old saying goes, knows whereof he speaks. He has probably done more for the peace officers of Georgia than any other one person.

The peace officers for almost 15 years had been attempting to have legislation enacted creating a retirement system for peace officers and such legislation was finally passed during Senator Talmadges tenure as governor of the State of Georgia. It is certain that it would not have been enacted had he not given it his full support and cooperation. He knows firsthand the problems that confront the peace officers of his State.

I also would like to state very briefly that I realize the problems confronting this committee. My main job in the Attorney General's Office is as head of the Bill Drafting Unit and I have worked very closely with legislators for the past 10 years. We have just completed only this past Friday our annual session and, as usual, were confronted with a great many problems and with a great many requests for special interests. I say this because I realize you also are confronted every day with many requests for special consideration of individual groups. Please bear in mind, however, that any assistance rendered the peace officers of this country benefits, either directly or indirectly, every citizen of our great Nation.

Compared to our national budget, the small pittance which the repeal of section 120 of the Internal Revenue Code of 1954 would bring into the National Treasury is hardly enough to pay for the printing of the bills and reports relative thereto. This particular matter, however, is one which I feel cannot be measured in dollars and cents.

It is my feeling, and I hope yours, that the peace officers of this country should be given every possible benefit and assistance which our governments, including Federal, State, and local, can afford them.

The peace officers as a group are the most underpaid, hardest worked people in the United States. If we are to have better law enforcement and better people going into the profession of law enforcement, it is imperative that we do something to make it more attractive to them. It is extremely difficult for a policeman to do his best at his job when he is continually worried with financial matters.

To give you an example of the seriousness of the situation, last year the Georgia State Highway Patrol lost 31 men who left to take better-paying jobs elsewhere. It is estimated that it costs the State of Georgia approximately $5,000 to adequately train a patrolman. You can see that this resulted in a loss of over $150,000 to the State. The general assembly of Georgia, at the recent 1958 session, took cognizance of this fact and passed legislation authorizing longevity pay increases for patrolmen based on length of service. It is hoped that this act will induce the men to remain with the patrol, but I fear that the good effect of that legislation will be pracically wiped out if section 120 is repealed. I reiterate that you gentlemen have a golden opportunity to make an outstanding contribution to better law enforcement and the reduction of crime by retaining the provisions of section 120.

Looking at the situation from a purely financial viewpoint, I would conservatively estimate that any monetary gain realized by the National Treasury pursuant to the repeal of section 120, would be less than half the amount saved over the entire Nation by retaining it and thus assuring better law enforcement and a reduction in the crime rate with all the resultant monetary benefits to every citizen of the United States.

It might be of interest to you to know that recently the Supreme Court of the United States refused to grant certiorari in the case of *Magness* v. *Commissioner of Internal Revenue*. This, of course, had the effect of upholding the decision of the Fifth Circuit Court of Appeals to the effect that under the law as it existed in 1952 the subsistence allowance authorized by statute to be paid to Georgia highway patrolmen in lieu of meals could not be excluded from gross income for income-tax purposes. Consequently, it is now settled that the only way in which this subsistence allowance can be excluded is pursuant to the provisions of section 120.

State highway patrolmen are on call 24 hours a day. They are stationed at places which in most instances are many miles from their homes. They must eat their meals at whatever time they are able and must keep their headquarters informed at all times as to their whereabouts. Surely they should be allowed the benefit which section 120 affords them.

The brief for the Commissioner of Internal Revenue in opposition to the petition for writ of certiorari in the Magness case was filed by the Department of Justice. One of the grounds used in opposition to the petition was the fact that the issue lacked substantial importance. A quote from that brief is as follows:

"By section 120 of the 1954 code (26 U. S. C., 1952 ed., supp. 4, sec. 120), Congress authorized the exclusion of an amount not to exceed $5 per day received as statutory subsistence by a police officer of a State. It would appear that the 1954 code provisions and particularly section 120 would settle for the future the question raised in the present case."

In other words, the Department of Justice used as one of its arguments the provisions of a code section which faces the prospect of being repealed within months of the decision. I feel certain that the Department did not contemplate that it would be repealed.

As a result of the Magness decision, Georgia patrolmen are now faced with the prospect of paying back income tax for the year 1952, in amounts ranging from $300 to $500. This is a considerable blow to highway patrolmen, who are making an extremely small salary as it is. These men experienced some hope when section 120 was enacted but now they are faced not only with the prospect of paying back income taxes but also with the prospect of being forced to reduce the standard of living for themselves and their families as the result of the repeal of section 120.

Let me point out that section 4 of the bill stems from a proposal by the Treasury Department. That Department did not advocate repeal of section 120 but suggested that the exclusion of subsistence allowances be limited to cases where such allowances were authorized by statute on or before August 16, 1954, which is the effective date of section 120. So you see that even the Treasury Department did not go as far as this bill does.

I would like to close my statement with an urgent appeal to you to earnestly consider the plight of law-enforcement officers, not only in Georgia but over the entire country and from each of your respective States, and to realize that to strike out section 4 of H. R. 8381 would be a great boon to law enforcement, crime prevention and the protection of the rights and property of all citizens wherever they may reside.

Mr. Chairman, I thank you.

The CHAIRMAN. The next witness is Mr. Henry H. Edens.

STATEMENT OF HENRY H. EDENS, SOUTH CAROLINA LAW-ENFORCEMENT OFFICER

The CHAIRMAN. Will you identify yourself and proceed?

Mr. EDENS. Senator Byrd, and other distinguished members of the committee, I am very grateful and proud of the opportunity to appear before you gentlemen. I realize how busy you are, and I will be very, very brief.

At the inception I would like to respectfully point out to the committee that this section and its interpretation is in litigation in the Federal courts, and it is not a dragging bit of litigation, it will be argued before the Fourth Circuit Court of Appeals on Monday in Charleston, S. C.—that would normally be in Richmond, that being the headquarters of the court, but it is purely a coincidence that the azalea season is just opening in Charleston—but the court from time to time over a period of years has sat in Charleston.

And it will be argued then. And I think it is inevitable, in the event the Government would lose, that the Supreme Court of the United States would grant certiorari.

I feel I am substantially accurate in saying that in a matter involving the finance of the United States in a question of this nature, in the event the Government is unsuccessful, certiorari is granted. And of course if the taxpayer would lose and the petition goes to the Supreme Court, if they accept it the matter will be passed upon, and if it is rejected, of course that would be the law of the case anyway.

In any event, just what this section means will have a very early interpretation by the highest Court of the land. And I might point out that the Government's position in this litigation is to the effect that this statute does not grant any exemption over and above that which is already given by the statutes existing when this was enacted.

So this matter would be, in the event the taxpayer is unsuccessful, it would be purely academic anyway. So that if this body or the Congress of the United States would seek to enact legislation that would further good law enforcement in a uniform manner throughout the United States, you would have to start all over again in order to do it.

And I do respectfully suggest that this section should be stricken from the bill, and that you await that decision by the Court to see just what the Court's interpretation is.

I am of counsel for the taxpayer, and the case is No. 7605, set down first or second for argument on the coming Monday in Charleston, S. C.

Now, passing on from the legal aspects of the bill, I was trial counsel in the United States attorney's office 13 or 14 years, I handled practically all of the criminal work and a lot of the civil, and throughout that time I came in constant contact with law-enforcement officers from the ground level of the local constable to the FBI at the Federal. And I respectfully suggest that it would be a tragic blow to good law enforcement in the United States, even before the benefits are interpreted by the Court and maybe granted under this section, when the Congress of the United States has taken such a wonderful step in the right direction by seeking to raise the level of good law enforcement in the United States through the whole country.

And I know of no possible legislation that could be passed that would be more evenly distributed or that would be more appropriately distributed and that would produce usch wonderful results as giving some encouragement to the law enforcement officers of this country.

And to do so, even the local magistrate or constable is no longer—he is not a local yokel, he is part of an international team.

Your police chief of Columbia, S. C. or of the smallest village outside of New Orleans, La., that is the person generally who arrests the most desperate criminal, and it is the FBI who comes in and chaperones him home.

The FBI—and I am not saying it critically—they are the liaison or the coordinating link in the law enforcement in this country, but they seldom catch anybody, they do not get one out of a hundred. It is some guy in the lower echelon somewhere that does that.

By nurturing and encouraging talented men and younger men to go in that profession you can give an immediate boost to the field of law enforcement and at a time when there is the greatest hue and cry in the history of this Nation about the youth of this Nation.

And it is just like the apple tree, it is already there, just a little bit of fertilizer placed there is the difference between a good apple season and a poor one. This is not a speculative matter, it is not an experiment like a new missile, you have already got your team. And whatever benefit is granted taxwise is the most uniform distribution, in my humble opinion, that could possibly be made. And it is taxpayers money at home that is paying that fellow, it is the taxpayers money wherever you go. He is a dedicated public servant. And there is no better investment—as I say, I respectfully submit these humble opinions to this body.

You are dealing with one group that is distinguishable from any group in these United States or these individual States, you are dealing with that group that handles the law enforcement of this country, with that group that has done more to train, to guide, to steer the youth of this country—which is the bedrock of it, that will make it great or not—than any other.

Senator MARTIN. It seems to me that the great unforgotten group in America is the general taxpayer.

Senator BENNETT. Let's say the forgotten group. There is nobody to represent them.

Senator KERR. You mean including us?

Senator MARTIN. I do not think they overlook anyone.

Mr. EDENS. I appreciate the courtesy of being here, and I wish to express my appreciation for the courtesy shown by our fine Senators from South Carolina.

And I assure you that I do not feel that it was any personal tribute to me, but a manifestation of their feeling about the righteousness of the cause which we advocate.

I thank you very much for your courtesy.

The CHAIRMAN. Our next witness is Mr. Royce L. Givens, secretary-treasurer of the National Conference of Police Associations.

STATEMENT OF ROYCE L. GIVENS, SECRETARY-TREASURER, NATIONAL CONFERENCE OF POLICE ASSOCIATIONS

The CHAIRMAN. Please proceed in your own way.

Mr. GIVENS. Thank you, Senator.

Gentlemen, I am a police officer in the city of Washington, D. C., also secretary-treasurer of the National Conference of Police Associations.

I represent about 135,000 policemen throughout the United States, including the Panama Canal, and the Territory of Hawaii.

I shall make myself very brief. We are opposed to section 4 of the bill H. R. 8381 as it now stands. And in order to conserve the time of you gentlemen, I would like to file my statement with you, and leave it stand, as we are opposed to it.

But you will notice in the back of my statement, I gave you a list of the members of the national conference.

Senator KERR. May I ask you a question.

You say "as it now stands." Did you have an amendment in mind that might be somewhere between the language of the bill as it now stands and the law as it is at this time?

Mr. GIVENS. We would like to follow along with the suggestion of the previous witness, sir, until the courts have determined what their interpretation of the law is as it is on the books today.

Then if it is not—if an interpretation is not what the Government thinks it should be, we would come back next year and try to work it out so that it would be satisfactory to all.

Senator KERR. We might not feel that we could wait for the decision of the court, and especially if you had a suggestion that we might be considering. I presume you know what the position of your group is with reference to litigation, what they are seeking to bring about, what decision they want to get. And if you had a suggested amendment as far as I am concerned, I would like to see it.

Mr. GIVENS. In the bill now before the committee we suggest that section 4 be stricken.

Senator KERR. Then the words you used "as it now stands" were redundant?

Mr. GIVENS. Yes, sir.

Senator KERR (now presiding). Thank you, Mr. Givens.

Senator BENNETT. May I ask a question. However, this witness may not be the one to answer it. I am sorry the chairman is out of the room. I had to be absent at the beginning of the session to present testimony in another committee.

In the report of the Committee on Ways and Means on page 7, the last paragraph, in discussing section 4, these words appear:

> Available information indicates that at the present time at least 2 states, Georgia and Indiana, have State police who qualify for this exclusion.

Do we have any record before the committee of the number of States in which local police qualify, or are there local police in every State, or are all local police in every State qualified?

Mr. GIVENS. No, sir. I will attempt to answer it this way, sir. Before the local police or the county police or the State police can participate or become subject to this deduction, they first must have a statute saying that they are entitled to it from their local governing body.

Senator BENNETT. Do you have any record as to the percentage of local police who have been givin the benefit of such a statute? Are there just a few policemen in the United States who are getting the benefit of this $5 exclusion, or is it 80 percent of the police officers?

Do you have any figures that will help us?

Mr. GIVENS. No, sir, I do not.

Senator WILLIAMS. I think those figures can be derived from the treasurers' estimate wherein they said that the estimated loss at the moment was around $300,000 a year, but would stretch to $50 million if it was extended to all law-enforcement officers.

Senator BENNETT. I had hoped that some of the witnesses who are appearing here opposing the amendment could tell us how widespread this problem is.

And if proper, Mr. Chairman, I wonder if any witnesses who have appeared on this subject have that information, even though they may have left the stand.

Senator WILLIAMS. I expect the treasury could furnish it better.

Mr. EDENS. I am Henry Edens, of Columbia.

I cannot give you the exact percentage, sir. This statute, knowledge of it has not been generally disseminated throughout the United States.

Senator BENNETT. The statute is 4 years old, isn't it?

Mr. EDENS. That is correct, sir. But amazingly, it has not been known and the various States have not availed themselves of it, but now, to be completely frank with you, sir, I can say that I am sure that the various States of the Union are alerted to this statute.

And you could certainly assume that the law-enforcement officers throughout the Nation would seek to avail themselves of it.

Senator BENNETT. Then we can assume that the Treasury's estimate is right, that it would not be very long before this would be costing us $50 million a year?

Mr. EDENS. As to what it would cost you, I cannot challenge the figures of the Treasury, sir, I do not seek to do that. But I think that that would be a reasonable estimate.

Senator LONG. The Treasury estimate includes all law enforcement officers, does it not?

Senator BENNETT. All law-enforcement officers.

Mr. EDENS. That is right, if everybody that was potentially able to avail themselves of this it would approach that figure.

Senator BENNETT. If I may do a little arithmetic, if the current loss is $300,000 a year, and the potential is $50 million, how many times will we multiply the present situation?

Senator WILLIAMS. A hundred and fifty.

Senator BENNETT. A hundred and fifty times. So less than two-thirds of 1 percent of the police officers are now covered by this program.

Senator KERR. That is on the basis of the report.

You see, the gentleman there is from South Carolina, and the report indicates that the $300,000 figure applies only to Georgia and Indiana.

And apparently the South Carolina situation is now in, so that that would indicate that there is a greater coverage even now than that indicated by the report.

Senator BENNETT. May I say to my colleagues that as I read this statement, Georgia and Indiana are covered by State police, while South Carolina is covered by local and other police.

So I assumed that there may be other States than South Carolina where local police are covered, but only two States where State police are covered also.

Senator KERR. This says "available information indicates that at the present time at least two States."

Mr. EDENS. They kind of count us out, sir, from time to time in South Carolina.

Senator BENNETT. No; I believe this is perfectly clear. As I remember, it was the police officials of South Carolina who presented this proposal in 1954 code.

And I assume that this reference to State police is limited to State police and does not cover local and law-enforcement officers.

Mr. EDENS. It can apply to any law-enforcement officers of any State or any political subdivision of the United States, sir, according to my interpretation of it.

Senator BENNETT. Mr. Edens, I appreciate your consideration. I think it is fair to say that the committee does not have available the accurate information as to the number of people now covered in relation to the potential coverage, and no way of checking the Treasury estimate that if this is allowed to operate as the people become alerted according to the suggestions of Mr. Edens, we may multiply it by a hundred and fifty.

Senator LONG. May I ask a question of Mr. Edens, as well as the witness? Mr. Edens, would you please come up and take the witness chair?

In the absence of this section, would the patrolmen have the right to claim their subsistence allowance for expenses when they are away from home, that is, on tour of duty away from their assigned post? Do they have the right to claim that as a deduction?

Mr. EDENS. It is a deduction that should not be claimed in the gross income, under the statutes as they decided before this legislation was passed, sir. In other words, if he was away from headquarters overnight, and had his meals and rooming expenses, if the State had such provisions for such reimbursement, sir, then they could reimburse him for that trip, and he would not have to include it in his gross income for tax purposes.

Senator KERR. Senator LONG, if the law-enforcement officer is away from home overnight now, he would not be affected by the repeal of this statute.

Senator LONG. This thought occurred to me. However, usually we set up a law with a withholding provision, and you hold a certain amount of a man's salary, and the Government just gets a lot of money by the fact that if a man has only got a small amount involved he doesn't fill out a return and ask them to send the money back. Now, would you be willing to accept as an amendment, that this subsistence allowance, not to exceed $5 a day, would be available to a person when he is actually away from the area where his home is, when he is actually away from home community?

It occurs to me that if a patrolman is working in his own hometown he doesn't have as strong a claim to this as a highway patrolman who happens to live in X city and has to be up to enforce traffic laws where they are holding a county fair a hundred and fifty miles away. Would you be saved if this were amended to exclude $5 of subsistence on that basis, rather than just the exclusion of $5 a day to everyone?

Mr. EDENS. I will be as direct as I can. There have been cases in the courts that have skidded from one side to the other in determining just where the line of demarcation lies under the old statutes before this legislation was passed. I think that the benefits given by the amendment which you suggest, sir, would be so infinitesimal in comparison with the overall picture that it would not be particularly beneficial legislation upon the whole.

Senator LONG. You can make a much stronger case for that type of situation than you can if you are saying that a $5 subsistence allowance should be available to a man who is away from home in a theatrical sense only, to a man who actually is not away from home, who is actually living at home at night, and eating his meals at home, or eating his meals downtown at a place provided for the patrolmen. That doesn't make nearly as strong a case as if you are saying that you want the $5 subsistence allowance when the man is actually away.

Senator WILLIAMS. Would the Senator yield? I think the amendment would put them in a worse position than they would be in an outright appeal, because with the outright appeal with no reference made they would under the existing law take all their expenses if they exceeded $5 or $4 or $10, and most of the time the expenses when they are away from home would be in excess of $5, and you would merely put a limitation on it, and you would not be giving them anything they haven't got under the law. And I think we should either repeal this outright or just leave it.

Mr. GIVENS. Mr. Chairman, I would like to make one further statement to the Senator about the number of policemen who are now taking advantage of it.

I would like to state this, that a number have advised me that they would not take advantage of it even if they had a statute in their own locality to permit it, for this reason, their pensions or retirement is based on percentage of salary. And if you gave the man $5 a day subsistence allowance, that would reduce his taxable or his deductible salary, and when he retired he would get far less money, and in the end he would make more money if he would go ahead and pay the tax on it as it is without claiming the $5 subsistence.

Senator WILLIAMS. It would not be possible to amend the statute law whereby they could make contributions even on the expense account?

Mr. GIVENS. It is possible, but you have still got to go back to the internal revenue and see how they are going to interpret that.

Senator WILLIAMS. They could raise the contributions on that portion that was left and mathematically get the same answer.

Mr. GIVENS. It is possible; yes.

Senator BENNETT. Now you raise a question in my mind. Is it possible under the present law for two patrolmen serving the same community in the same jurisdiction to make a different choice, so that one could choose to take the $5 subsistence allowance and the other choose not to take it? Or is that a decision of the ruling body of the jurisdiction?

Mr. GIVENS. I don't know specifically, but I would assume that when the ruling body passed an ordinance or a law for the $5 subsistence, all the policemen would have to take it.

Senator BENNETT. That is what I would say.

Mr. EDENS. I don't believe he would have to claim it, if he doesn't wish to avail himself of the exemption, he would return it all as gross income.

Senator BENNETT. Wait a minute. You mean to say that the $5 is available to him by his choice either to accept as salary and make it subject to the withholding for his pension, or he can say, "No, I want $5 to come to me as subsistence," in which case it becomes the choice of the individual rather than the community?

Mr. GIVENS. I think Mr. Edens was trying to say this, sir, that he would not have to report to the internal revenue service and claim the $5. He could report the whole amount, his salary plus the $5, as total gross income.

Senator BENNETT. But that doesn't affect the withdrawal for his pension?

Mr. GIVENS. No, sir. There are two different things.

Senator BENNETT. Because that is a deal between him and the local community, not between him and the internal revenue.

Senator KERR. Senator, I think the problem is being aggravated.

Senator BENNETT. I didn't intend to do that.

Senator KERR. By provisions in local statutes which say that $5 per day of this amount shall be regarded as subsistence, which doesn't change their salary, but which does give them an exemption to that amount in the Federal income tax under the provisions of the law as it now reads.

Senator BENNETT. And they still are able to apply the $5 subsistence in calculating their pension.

Senator KERR. Sure.

Mr. GIVENS. Some may and some may not.

Senator KERR. Senator Douglas.

Senator DOUGLAS. I understand that you are saying that a $5 a day subsistence allowance for policemen should not be repealed; that is correct?

Mr. GIVENS. Yes, sir.

Senator DOUGLAS. At present this allowance applies even to policemen; am I correct in that?

Mr. GIVENS. Well, you used the term "policemen," and I assume——

Senator DOUGLAS. Do you think this should be extended to firemen?

Mr. GIVENS. You are getting out of my category.

Senator DOUGLAS. If we apply this to policemen, say that we shall continue to apply it to policemen, how could we deny it to firemen?

Mr. GIVENS. Well, the policeman is required to leave his post of duty and go to other jurisdictions, whereas the fireman would probably never be required to go out——

Senator DOUGLAS. Senator Long has proposed that an allowance be granted only in those cases. And I understand that you have rejected that on the ground that you want to have the $5 apply during the entire time that the man was in the locality in which he is employed.

Let me ask you this: Are you in favor of applying it to firemen?

Mr. EDENS. I have not given it sufficient thought to answer you.

Senator DOUGLAS. We have got to give it thought. What about building inspectors?

Mr. EDENS. May I say this, this Senator——

Senator DOUGLAS. No: I would like an answer to that question. What about building inspectors?

Mr. GIVENS. I would like to make this statement. I am here at the direction of the board of directors of the National Conference of Police Associations and they set the policy. I can't go outside of that policy.

Senator DOUGLAS. We have to frame the public policy. Do I understand that you refuse to answer?

Mr. GIVENS. No, sir; I don't refuse to answer, I just don't have the answers.

Senator DOUGLAS. We have got to find the answer. What about municipal employees?

Mr. GIVENS. I would be glad to communicate with my board of directors and see what they have to say about it.

Senator DOUGLAS. What about municipal employees, are these to be a series of rhetorical questions addressed by me to you and to be met by stony silence?

Mr. GIVENS. No, sir. I don't have the answers you are asking for.

Senator DOUGLAS. What about members of the FBI here in Washington who don't travel, or members of the FBI out in the field?

Mr. GIVENS. I assume that they have—I don't know, I am not acquainted with them——

Senator DOUGLAS. Only to the extent the expenses are actually incurred. What about custom inspectors in New York and the other ports of entry of the United States?

Mr. GIVENS. I don't have the answers, Senator.

Senator DOUGLAS. What about collectors of internal revenue?

Mr. GIVENS. I regret that I do not have the answers.

Senator DOUGLAS. What about all municipal employees, all county employees, all State employees, all Federal employees, all private employees?

I have no more questions.

Mr. GIVENS. I would like to have the privilege of filing a letter at a later date on section 2.

The CHAIRMAN. We will be glad to insert that in the record at the appropriate place (see p. 143).

(The prepared statement of Mr. Givens is as follows:)

STATEMENT OF ROYCE L. GIVENS, SECRETARY-TREASURER OF THE NATIONAL CONFERENCE OF POLICE ASSOCIATIONS, OPPOSING SECTION 4 OF H. R. 8381

Mr. Chairman, my name is Royce L. Givens, secretary-treasurer of the National Conference of Police Associations, representing over 135,000 police officers, consisting of city, county, and State police throughout the United States.

Attached to this statement is a list of local and State police associations who are members of the National Conference of Police Associations.

We are opposed to section 4 of H. R. 8381, now before your committee.

In the report of this committee as well as the House committee on the 1954 Internal Revenue Act, it was stated, "Your committee's bill provides an exclusion from gross income, not to exceed $5 a day, for subsistence allowance paid to officers of a police department of a State, Territory, the District of Columbia, or a possession. There is no comparable exclusion under existing law. Your committee believes that this exclusion is desirable because State police officers are required to make frequent trips away from their posts of duty. Under present law these expenses cannot be deducted if the police officer is to use the standard deduction."

Gentlemen, the same applies today. I would like to restate a part of the previous statement from your committee report. "* * * because State police officers are required to make frequent trips away from their post of duty." Not only are State police required to make frequent trips away from their post of duty in 1954, but they are still required to do so. Also city and county police are required to make frequent trips away from their post of duty and jurisdiction. They are required to make trips to other jurisdictions to question persons suspected of committing a crime within their jurisdiction.

The Honorable George Bell Timmerman, Sr., United States district judge for the eastern district of South Carolina, in commenting on the case of W. J. and Cleopatra Shirah, said, "* * * it is manifest that the Congress of the United States had some feeling for federally overtaxed police officers, who night and day are on duty to protect the lives and property of individual citizens and who run great risks in doing so." He further stated, "* * * plainly what Congress intended was to reduce taxes to be levied on the meager incomes of police officers."

We believe the honorable judge rendered a just decision for which we sincerely thank him.

We are of the opinion that all police officers are grossly underpaid and in this small way policemen are given further consideration for their hazardous labors.

Gentlemen, just last week, during the snowstorm that hit the eastern part of the United States, the policeman was out there giving you the same protection as always. Remember, gentlemen, the Government closed down for 2 days. Did the police departments close down? No, sir; your policeman was out there making his rounds just the same as if it was a spring day.

We respectfully request that you amend H. R. 8381 by striking out section 4.

I thank you for the privilege of appearing here today.

MEMBER ASSOCIATIONS OF THE NATIONAL CONFERENCE OF POLICE ASSOCIATIONS

California Association of Highway Patrolmen
Los Angeles County Peace Officers' Protective Association
Los Angeles Fire and Police Protective League
Peace Officers' Research Association of California
San Diego Police Relief Association
San Francisco Police Officers' Association
Welfare Association of Oakland Police Department
Delaware Association of Police
Policemen's Association, District of Columbia
United States National Zoological Park Police Association
Chicago Patrolmen's Association
Policemen's Benevolent & Protective Association of Illinois
Policemen's Benevolent & Protective Association of Peoria, Ill.
Iowa State Policemen's Association
New Orleans Pension Board
Massachusetts Police Association
Baltimore City Police Association, Inc.
Detroit Police Officers' Association
Detroit Police Lieutenants and Sergeants Association
Minneapolis Police Officers' Federation
Minneapolis Police Relief Association
Duluth Police Pension Association
St. Paul Police Relief Association
Las Vegas Police Protective Association
Reno Police Protective Association
New Jersey State Patrolmen's Benevolent Association
Patrolmen's Benevolent Association, New York, N. Y.
Police Conference State of New York
Canal Zone Police Association
Fort Worth Police Officers' Association
Galveston Municipal Police Association
Houston Police Officers' Association
San Antonio Police Officers' Association
Texas Municipal Police Association
Fairfax County (Va.) Police Association
Milwaukee Police Officers' Protective Association
Police Retirement System of St. Louis, Mo.

The CHAIRMAN. I submit for the record at this point a letter from Mr. Gordon E. Brewer, civil-service counsel, American Federation of State, county and municipal employees, expressing the opposition of his union to section 4 also.

Also a letter from Senator Edward J. Thye, expressing opposition to section 52.

And also a telegram from R. K. Halstead president of the Virginia Beach Lodge of the Fraternal Order of Police.

Also a letter from Tom Scarbrough, commissioner of public safety of the State of Mississippi.

Also a letter from L. W. Hawkins, chairman, Board of County Commissioners, Twin Falls, Idaho.

Also a telegram from Fred Abrams, chief of police of Jerome, Idaho.

Also a telegram from Tony Skoro, Gem County, Idaho, and Paul Marsh, chief of police, Emmett, Idaho.

Also a telegram from Edward G. Bailey, mayor of Mountain Home, Idaho.

Also a telegram from Bill Bunn, Magic Valley Peace Officer Association, by Fred Abrams, secretary.

And a letter from Clark Hand, president of the Idaho Peace Officers Association, Boise, Idaho.

(The letters referred to follow:)

AMERICAN FEDERATION OF STATE, COUNTY, AND MUNICIPAL EMPLOYEES,
Washington, D. C., February 24, 1958.

Senator HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: The American Federation of State, County, and Municipal Employees, AFL-CIO, represents approximately 10,000 policemen throughout the county. We have in our federation a total of 74 police local unions and 44 other locals with some police membership.

H. R. 8381, which is scheduled for hearing before your committee on Tuesday, February 25, is of considerable interest to our police members because of the provisions in section 4 which provide for the repeal of section 120 of the Internal Revenue Code relating to statutory subsistence allowances received by policemen. A hardship for many police officers will result from this legislation if it is enacted and our people are deeply concerned with this prospect.

We are not opposed to H. R. 8381 in its entirely and only wish to be placed on record as being opposed to section 4. In case that section 4 is enacted, our police unions will have no choice but to go to their respective local legislative bodies and request salary increases to compensate for the loss which they will incur as a result of the removal of this section from the Internal Revenue Code. We do concede that if section 120 remains in the code there will be some loss of revenue to the Federal Government. Repeal of this section, however, will also result in a greater burden on the taxpayers insofar as local units of government, which are faced with an ever-increasing problem of finding revenue with which to operate, must raise additional funds for the increase of police salaries.

I have taken the liberty of setting forth our view by letter since Mrs. Springer, clerk of your committee, has advised that she has many requests from various policemen asking for the opportunity to appear and be heard on this bill. We are cognizant of the time limitations which face the Senate Finance Committee, and if we can assist by presenting our view by letter, we are happy to do so.

Thank you for your consideration of the views of our membership throughout the country on this matter.

Very truly yours,

GORDON E. BREWER, *Civil Service Counsel.*

UNITED STATES SENATE,
COMMITTEE ON APPROPRIATIONS,
Washington, D. C., February 27, 1958.

Hon. HARRY F. BYRD,
Chairman, Senate Committee on Finance,
Washington, D. C.

MY DEAR SENATOR: I regret that other committee business does not permit me to make a personal appearance before your committee in connection with its consideration of H. R. 8381. I feel that I must call to your attention, however, that section 52 of this bill causes me considerable concern.

This section wold repeal section 1361 of the Internal Revenue Code which provides an election for certain proprietorships and partnerships to be taxed as corporations.

During the hearings on the tax problems of small business which were conducted by our Senate Select Committee on Small Business last fall, many witnesses expressed the wish that they might exercise this election provided in section 1361. They have not been able to do so because although 3½ years have passed since the enactment of section 1361, administrative regulations have not been promulgated by the Secretary of the Treasury. It is apparent that the ineffectiveness of this section can be ascribed to the failure of the Treasury to promulgate regulations under section 1361.

Section 1361 of the code should not be repealed and therefore I hope that your committee will give serious consideration to removing section 52 from H. R. 8381 which is presently before you for consideration.

Although the intent of Congress as expressed in section 1361 would be sufficient basis for my concern, I feel that I should also point out that its repeal would be inconsistent with legislation which I have cosponsored during both sessions of this Congress. I hope to have the opportunity to appear before you committee in the near future to testify in behalf of S. 3194 which was introduced this session by Senator Sparkman and sponsored by 35 other Members of the Senate, including myself. A provision in that bill would permit certain corporations to be taxed as partnerships and it is intended to complement section 1361 of the code. Witnesses who appeared before our Small Business Committee tax hearings urge the implementation of section 1361 and the enactment of this other proposed election.

Finally, I would like to point out that H. R. 8381 is directed to the amendment or repeal of sections of the code which result in unintended tax benefits. It would see to me that section 1361 of the code is not properly included in this bill. It is a section which was specifically intended by Congress, and the fact that it has not been used should not require its repeal. If proper regulations are promulgated, small-business men throughout the Nation will be afforded an opportunity to use a tax election which was provided them by Congress.

My kindest regards.

Sincerely yours,

EDWARD J. THYE,
United States Senator.

VIRGINIA BEACH, VA., *February 28, 1958.*

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Member of Congress, Washington, D. C.:

Congratulations on your decision. The Virginia Beach Lodge of the Fraternal Order of Police requests that the committee reject section 4 of H. R. 8381.

Sincerely,

R. K. HALSTEAD,
President, Virginia Beach Lodge No. 7.

STATE OF MISSISSIPPI,
DEPARTMENT OF PUBLIC SAFETY,
Jackson, Miss., February 24, 1958.

Senator HARRY BYRD,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR BYRD: I am writing you this letter to protest section 4 of H. R. 8381, which proposes to tax all enforcement officers' expense accounts. As commissioner of public safety of Mississippi, and president of the Tennessee-Mississippi Sheriffs and Peace Officers' Association, I am speaking for a very large group of law enforcement officers of whom all oppose the passage of this section of the law.

I feel our Mississippi highway patrolmen are representativese of a good average of police forces throughout the United States. Our minimum pay at present is $250 per month. The maximum for officers who are qualified as investigators is $350 per month. In addition to the aforementioned salary, our officers receive $3.50 per day for meal allowances. They are required to be on duty 12 hours per day. They are allowed 4 days off each month. If the proposed section of the law, which has already passed Congress, is enacted into law, it will cost our men, in addition to what they are now paying, from $300 to $400 each per year, which they are not able to pay.

Our officers are already underpaid according to the salaries paid to employees of other occupations of similar qualifications. If this bill is permitted to pass, I feel it will be detrimental to good law enforcement. I believe we will have quite a few of our best officers resign to seek more profitable employment, because of their inability to support themselves and families on what they will be earning.

I am quite sure a great majority of officers in America are not abusing this section of the law which we are opposing. However, we do not object to having set by our Congress a maximum and minimum amount of expense which an officer is allowed, in order to halt any misuse which is now practiced, perhaps, by a few unscrupulous officers.

In view of the tremendous increase in crime throughout America, and knowing first hand our local officers must cope with this problem, of which I am sure you are most cognizant, I earnestly urge you to assist all good law enforcement officers in opposing this bill, as I sincerely believe to tax the meager expense accounts officers are allowed would be undermining good law enforcement.

We officers are not financially able to come to Washington to lobby against this bill. We do believe our United States Senators will do what is fair for us if they are informed as to our needs. I sincerely hope and trust you can see fit to oppose this bill, which I believe if passed will seriously jeopardize good law enforcement.

I would also like to take this opportunity to express my regrets in that you have made the decision not to run for reelection again. You have been a wonderful Senator for the whole United States, and you are going to be seriously missed.

Best wishes and kindest regards, I am,

Sincerely yours,

TOM SCARBROUGH,
Commissioner of Public Safety.

TWIN FALLS COUNTY BOARD OF COUNTY COMMISSIONERS,
Twin Falls, Idaho, February 7, 1958.

Hon. FRANK CHURCH,
United States Senator,
Senate Office Building, Washington, D. C.

DEAR SENATOR: It has recently come to the attention of the Twin Falls County Commissioners that there is now pending before Congress, House Resolution No. 8381. We understand that section 4 of this resolution would repeal in its entirety section 120 of the 1954 Internal Revenue Code which, in substance, provides that any statutory subsistence allowance received by a peace officer, not to exceed $5 per day, need not be included as income by the peace officer upon filing his Federal tax return. We are also aware that the United States Treasury Department has proposed that this section of the Internal Revenue Code be amended so as to make it applicable only in cases where the subsistence amount in question is specifically so designated by appropriate statute, ordinance, or resolution. Obviously, and perhaps needless to say, the House resolution goes much further than the Treasury Department proposal.

As each of you must be keenly aware, the current financial status of the typical peace officer in the State of Idaho is not good; in fact, the need for general salary increases in this area is most serious. With the limited funds available to most jurisdictions compensating law-enforcement officials in Idaho, it is urgent and in the interest of the public that nothing be done further to prejudice the Idaho peace officer's financial status.

The proposed change in section 120 of the Internal Revenue Code would certainly be damaging to many officers. Such a change would eliminate a legitimate deduction or exemption for many, and for others would foreclose the possibility of obtaining the same. Therefore, on behalf of the Twin Falls County commissioners we are requesting that you personally take an interest in section 4 of House Resolution No. 8381 and do all within your power to bring about its defeat.

L. W. HAWKINS, *Chairman.*

JEROME, IDAHO, *February 7, 1958.*

Hon. FRANK CHURCH,
United States Senate, Washington, D. C.:

We of the Jerome police department join with the other peace officers in recommending your opposition to section 4 of H. R. 8381. We of the police departments in Idaho are feeling the pinch of taxation and any slight relief will surely be appreciated.

FRED ABRAMS,
Chief of Police, Jerome Police Department.

EMMETT, IDAHO, *February 6, 1958.*

FRANK CHURCH,
United States Senator, Washington, D. C.:

Vote "No" on section 4 of House bill 8381.

TONY SKORO,
Gem County Sheriff,
PAUL MARSH,
Chief of Police, Emmett.

MOUNTAIN HOME, IDAHO, *February 7, 1958*.

FRANK CHURCH,
United States Senator, Washington, D. C.:

Re H. R. 8381, peace officers per diem in lieu of subsistence exempt for income-tax purpose. We are protesting any change in section 120. Further information will reach you.

EDWIN G. BAILEY,
Mayor, Mountain Home, Idaho.

JEROME, IDAHO, *February 7, 1958*.

Hon. FRANK CHURCH,
United States Senate, Washington, D. C.:

We of the Magic Valley Peace Officers Association strongly recommend your opposition to section 4 of H. R. 8381 insofar as the same proposes abolition of section 120, 1954 Internal Revenue Code. Salary scales for police in Idaho make it imperative that a slight relief of section 120, 1954 Internal Revenue Code, will remain in effect.

BILL BUNN,
President, Magic Valley Peace Officers Association,
By FRED ABRAMS,
Secretary.

IDAHO PEACE OFFICERS ASSOCIATION,
Boise, Idaho, February 5, 1958.

Hon. FRANK CHURCH,
United States Senator,
Washington, D. C.

DEAR SENATOR: It has recently come to the attention of the Idaho Peace Officers Association that there is now pending before Congress H. R. 8381. We understand that section 4 of this bill would repeal in its entirety section 120 of the 1954 Internal Revenue Code which, in substance, provides that any statutory subsistence allowance received by a peace officer, not to exceed $5 per day, need not be included as income by the peace officer upon filing his Federal tax return. We are also aware that the United States Treasury Department has proposed that this section of the Internal Revenue Code be amended so as to make it applicable only in cases where the subsistence amount in question is specifically so designated by appropriate statute, ordinance or resolution. Obviously, and perhaps needless to say, the bill goes much further than the Treasury Department proposal.

As each of you must be keenly aware, the current financial status of the typical peace officer in the State of Idaho is not good; in fact, the need for general salary increases in this area is most serious. With the limited funds available to most jurisdictions compensating law enforcement officials in Idaho, it is urgent and in the interest of the public that nothing be done further to prejudice the Idaho Peace Officers financial status.

The proposed change in section 120 of the Internal Revenue Code would certainly be damaging to many officers. Such a change would eliminate a legitimate deduction or exemption for many, and for others would foreclose the possibility of obtaining the same. Therefore, on behalf of the approximately 1,000 members of the Idaho Peace Officers Association, we are requesting that you personally take an interest in section 4 of H. R. 8381 and do all within your power to bring about its defeat.

LT. CLARK HAND, *President.*

The CHAIRMAN. The next witness is Mr. Timothy F. X. Sullivan, certified public accountant Quakertown, Pa.

STATEMENT OF TIMOTHY F. X. SULLIVAN, CERTIFIED PUBLIC ACCOUNTANT, QUAKERTOWN, PA.

The CHAIRMAN. Please proceed.

Mr. SULLIVAN. Thank you, Mr. Chairman and members of the committee.

Since the particular section, section 52 of H. R. 8381 which I am going to discuss this morning, was so ably covered by Senator John Sparkman of Alabama yesterday, I will try not to be repetitive.

Section 1361 of the Internal Revenue Code of 1954 permits certain proprietorships and partnerships having 50 or less members to elect to be subject to income taxes as a domestic corporation.

In the report of the Committee on Ways and Means, dated July 9, 1957, on section 52 of H. R. 8381, the reasons given for the repeal are:

(1) Administrative problems.

(2) The section as resulted in complexities such as the treatment of undistributed profits upon the section 1361 company reverting to a sole proprietorship or partnership.

The report further states that the repeal of this subchapter would result in an increase in revenue over the long run but is of such a nature that estimates of the current revenue gain from this provision cannot be made.

This provision would repeal section 1361, effective with respect to taxable years beginning after December 31, 1957. In addition, no election could be made to come under section 1361 for any taxable year ending after June 30, 1957.

We feel that the reasons given for the repeal of subchapter R of chapter 1 are not valid.

We fail to see why administrative problems can be considered a good reason for repeal. It is our understanding that administrative problems are quite common in day-to-day operation of any agency or business.

We feel that the complexities and the confusion can be eliminated by the issuance of regulations to the code section which treat section 1361 companies as though they were in fact corporations, as the code intended they are.

We cannot agree with the thought that repeal would result in an increase in revenue over the long run. We feel that the result would be very likely the opposite since section 1361 companies are not subject in some States to State income taxes while real corporations are, and since State income taxes are deductible before arriving at net profit subject to Federal income tax the resulting Federal revenue would be somewhat lower.

It appears that there is some authoritative thinking that is somewhat in contravention to a repeal of this section.

The Internal Revenue Service, according to Technical Information Release No. 61, dated October 10, 1957, has modified its position with respect to classification for Federal income-tax purposes of groups of doctors practicing medicine and other professional groups.

This release is contrary to the position of the Service maintained in an earlier Revenue Ruling 56–23 wherein the Service held that associations of doctors and other professional groups would not be treated as corporations for Federal tax purposes.

The Service in the technical information release states that tests will be applied in determining whether a particular organization of doctors or other professional group has more of a criteria of a corporation than a partnership.

We infer from this that unincorporated professional groups would, if they meet certain tests, be able to file as corporations for purposes of Federal income tax.

The small-business tax adjustment bill of 1958, S. 3194, among other provisions, would permit corporations with only one class of stock, and with no foreign stockholders, to elect to be taxed as partnerships (except for self-employment tax purposes). The bill further states this election would be for a period of 4 years, and that partnerships and sole proprietorships which elect to be taxed as corporations under existing code section 1361 would make the election also for a 4-year period instead of indefinitely and this change would be retroactive to 1954 and later years.

We oppose the inclusion of section 52 in the technical amendments bill of 1958 for the following reasons:

(1) Taxpayers who have exercised their privilege under section 1361 have planned their business operations on the basis that they would be paying their income taxes at corporate rates. They have budgeted their operations, especially in connection with expansion, giving weight to their estimated income taxes, which naturally are a major factor in any successful business enterprise.

(2) The said section 52 does not spell out in any detail what the tax consequences would be to a section 1361 company upon its (sec. 1361) repeal. This in turn would bring about costly litigation and it might well be many years before their tax status would be clearly defined as a result of the repeal.

(3) The effective dates in section 52 create a lame-duck period since a calendar year section 1361 company as of January 1, 1958, would be operating under a cloud as to its tax status.

(4) The administrative problems cited in the report of the Committee on Ways and Means are not the fault of the taxpayers who would suffer by the repeal of section 1361, since some of the section 1361 companies would have incorporated their businesses in recent years had section 1361 never come into being.

(5) Section 1361 is an equitable section. It has removed the inequity whereby certain types of businesses could incorporate in some States and therefore had an unfair Federal tax advantage over those businesses who were not allowed to incorporate due to certain State laws.

In summary, we feel that section 52 should either be eliminated from the bill or broadened to cover the exceptions taken above and allow a section 1361 company to convert to a real corporation or to its original status at any time during 1958 without any tax consequences, because of the conversion, to the individual taxpayers involved, the section 1361 company itself, or the newly created corporation, if any.

We wish to thank the committee for giving us this opportunity to express our views.

The CHAIRMAN. Thank you very much, Mr. Sullivan.

Are there any questions?

Thank you.

(The following letter was subsequently received for the record:)

QUAKERTOWN, PA., *March 3, 1958.*

MRS. ELIZABETH B. SPRINGER,
Chief Clerk, Senate Committee on Finance,
Washington, D. C.

DEAR MRS. SPRINGER: We return copy of testimony with corrections.

In connection with the statement of Dan Throop Smith, Deputy to the Secretary of the Treasury, before the committee on February 25, 1958, we note that in regard to section 52 of H. R. 8381 he has included said section under his exhibit headed "Provisions Which Remove Unintended Benefits."

However we fail to find in the particular paragraph relating to said section a statement of any unintended benefits.

We would appreciate it if the above would be added to our testimony.

Thank you.

Very sincerely yours,

TIMOTHY F. X. SULLIVAN.

The CHAIRMAN. I submit for the record two letters received from the Goodwill Industries, one signed by Mr. Robert C. Adair, of St. Petersburg, Fla., and the other by Mr. P. J. Trevethan.

(The letters referred to follow:)

GOODWILL INDUSTRIES,
St. Petersburg, Fla., February 20, 1958.

SENATOR HARRY F. BYRD,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: I am writing you, as chairman of the Senate Finance Committee, in regard to bill H. R. 8381, which has passed the House and is now before the Senate committee.

This provides for additional information being required of charitable agencies, donations to which are exempt from income tax.

Under this bill I notice that a subsection (8) would be added to section 6033 (b), which would read, "the total of the contributions and gifts received by it during the year."

I am sure the purpose of this bill is to have all organizations such as ours show the total amount of money that has been contributed to it during the previous year. This, of course, we would be glad to furnish.

It has been called to my attention, however, that "contributions and gifts" has been interpreted to mean not only those of money but also of materials; with this, our organization—Goodwill Industries—would have a bit of difficulty.

I represent just 1 of the 122 Goodwill Industries in the United States. We now have 67,000 families in this area who save materials for us; we have 11 trucks busy all the time collecting these donations and bringing them into our plant. We also have a gigantic Rotary-Boy Scout clothing drive the first week in December and last year we received over 79,000 bags of clothing in 1 afternoon.

To count these articles or to classify them would be almost impossible, and to place a value on each one in the condition in which it is received would not only be a tremendous amount of work but would be very inaccurate; there are no two articles received that are the same.

From an accounting standpoint, we list all materials on hand at a value of $1, as we have never been able to find any method of evaluating these items that would be even close to accurate.

As you likely know, Goodwill Industries reconditions all these articles by giving work to handicapped people. The finished articles are then sold in our Goodwill stores; the money received pays the wages of these employees, buys some of the supplies and care for a part of the overhead expense. Overall, we are about 90 percent self-supporting; the other 10 percent is received from United Givers, individual gifts from friends, foundations, etc.

If this wording in item 8 could be changed to "the total of cash contributions and gifts" or in some way eliminate this difficulty, it would be of great help to us.

If additional help is needed in regard to this, I will be glad to have you contact me or Mr. John C. Harmon, Jr., of Goodwill Industries of America, 1229 20th Street NW., Washington, D. C.

My thanks to you, Senator Byrd, in clarifying this proposed bill so it will not include the requirement of placing a value upon donated materials.

ROBERT C. ADAIR,
Executive Director.

GOODWILL INDUSTRIES OF AMERICA, INC.,
Washington, D. C., February 28, 1958.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D. C.

MY DEAR SENATOR BYRD: This letter is written on behalf of 118 Goodwill Industries throughout the country. It is concerned with H. R. 8381, which is now before your committee.

It has come to our attention that H. R. 8381 would amend the Internal Revenue Code of 1954 to add subsection (8) to section 6033 (b) (p. 76, line 24–25), "the total of the contributions and gifts received by it during the year." This, of course, would require this additional information to be provided in form 990A annually by exempt organizations defined in section 501 (c) (3) of the code.

Goodwill Industries receive charitable contributions in two forms, money and used materials (clothing, furniture, and other personal property). The above referred to amendment poses no problem in reporting money. In fact, we are glad to comply with such a requirement. But it will work a considerable hardship if Goodwill Industries are required to appraise the value of the donated material at the time of the gift.

At the present, the donor desiring income-tax exemption for donations made to Goodwill Industries of used material is responsible for making any appraisal of value. Goodwill Industries only acknowledges the receipt of designated material.

We want to recognize that deductibility of materials as charitable contributions for individual and corporation income-tax purposes has been a definite incentive for more contributions. It encourages the donation of the best "repairable material" which provides the type of work assignment necessary for better rehabilitation evaluation and training of the handicapped. This used material made possible rehabilitation services and employment for over 30,000 handicapped people during 1957.

In 1956, the handicapped workers in Goodwill Industries paid Federal income taxes amounting to $1,440,805 and social-security taxes amounting to $337,707. The 1957 amount, now being accumulated, will be about 16 percent higher.

The problem of individual Goodwill Industries under the H. R. 8381 language is to arrive at a reasonably accurate figure representing the total contribution of materials. The appraisal and accounting cost involved in meeting this proposed requirement would divert money otherwise available for services by Goodwill Industries to the handicapped. We are, therefore, calling the matter to the attention of the committee in the hope that some way can be found to avoid the necessity of reporting on the value of secondhand materials essential for the maintenance of our program.

If additional information is needed, please advise us.

Respectfully,

P. J. TREVETHAN.

The CHAIRMAN. The next witness is Mr. Richard P. Momsen, director of the American Chamber of Commerce of Brazil.

STATEMENT OF RICHARD P. MOMSEN, REPRESENTING AMERICAN CHAMBERS OF COMMERCE FOR BRAZIL

Mr. MOMSEN. Mr. Chairman and gentlemen, I wish to thank you for the opportunity of speaking on behalf of the American Chambers of Commerce for Brazil, which are located in the cities of Rio de Janiero and Sao Paulo.

As a resident of Brazil since 1913 I have been a member of both chambers since their inception and have held various offices including the presidency of the Rio Chamber, and of which I am now a director. The chambers have been of inestimable value in promoting business relations and in strengthening the friendly commercial and cultural ties between Brazil and the United States.

Before proceeding, I wish to say that I have just seen a copy of the Senate version of the bill H. R. 8381, which differs in two respects from the House version, and the reference E in my statement.

The first is that section 61 has been renumbered 60 and the title has been changed from the Technical Amendments Act of 1957 to the Technical Amendments Act of 1958.

Our members view with apprehension the provisions of section 61 of H. R. 8381 whereby American citizens residing abroad will in the future be required to file income tax returns if their gross income is $600 or more including earned income from sources outside the United States.

Since 1926 earned income of nonresident citizens has been excluded from reportable income—the bill now proposes to label it as deductible income so that even though such earned income will continue to enjoy exemption, it will have to be reported.

Permit me, first of all, to call the committee's attention to the fact that the bill is entitled "Technical Amendments Act of 1957" and that section 61 on which I am speaking provides that that section will apply to taxable years beginning December 31, 1956.

With returns for 1957 due to be filed up to April 15 or only 6 weeks from now it will be physically impossible for American citizens in distant lands to comply with this provision.

I earnestly suggest that the application of section 61, if finally enacted, be postponed for at least 1 year.

In the short time available to me it will only be possible to briefly mention some of the objections which our members find to the proposed legislation.

1. Most citizens abroad work for American companies which are in a position to and do keep their nonresident employees informed regarding their United States tax obligations. The information concerning their income is already available to the Internal Revenue Service in this country and the proposed requirement for them to file returns on nontaxable income would appear to be superfluous.

2. In cases where a citizen's entire income is earned income abroad he will be required to file a return though no tax will be due. Although one cannot argue inconvenience as an objection it is very doubtful whether the slight additional revenue which the Government might obtain, revenue which would be due irrespective of the proposed amendment to the code, would compensate for the additional paperwork required of both the taxpayers and the Government in the preparation, filing, and review of such returns.

3. In many countries there is censorship of mail, sometimes official, other times unofficial. There is a growing resentment abroad against the policy of the United States which levies income taxes on sources outside the United States. Foreign censorship of thousands of returns, without any tax benefit to the United States, will certainly place much desired information on this subject in the hands of inquisitive foreign governments.

4. In the opinion of our chamber, tax evasion by citizens deriving income abroad is at the most insignificant. If such cases do exist any deliberate evasion would not be eliminated by this bill. It would however put a burden on the innocent tax-exempt individuals requiring them to file returns with no compensating results to the Treasury.

5. In the case of a married taxpayer, involving a joint return, this proposal will in many instances be burdensome when one party is in this country or traveling and both signatures are required within the statutory period.

6. Much has been written and said in both the legislative and executive branches of our Government concerning legislation to encourage business and investment abroad through tax incentives. The trend has been in that direction but it appears to us that any course of action such as the proposed provisions contradict that trend and would discourage our citizens from foreign undertakings.

7. Inasmuch as the bill under discussion does not specifically propose to change the tax treatment on the earned income abroad of nonresident citizens it is perhaps improper to argue this point but I cannot refrain from saying that there is a feeling in our communities in foreign countries that the proposal may lead to further measures limiting the present exemption which would place Americans abroad on an even more unequal basis with their European and native competitors and do grave harm to our foreign-trade investments.

8. As an alternative to the proposed legislation our chambers are of the opinion that the same results could be achieved by requiring American citizens with no unearned income abroad to file a statement at the nearest American consulate to the effect that only earned (nontaxable) income has been received.

Consular officers, under instructions to be issued by the Treasury Department through the State Department, could be further empowered to make suitable inquiries and to assist in reporting any tax deficiencies or other problems arising

In conclusion I wish to state that I have received a cablegram from Brazil that the chambers of commerce are airmailing a more detailed statement to Chairman Senator Byrd and I respectfully request that that communication be inserted in the printed hearings.

I thank you.

The CHAIRMAN. Without objection the insertion will be made.

(The statement referred to is as follows:)

THE AMERICAN CHAMBER OF COMMERCE FOR BRAZIL,
São Paulo, February 25, 1958.

The CHAIRMAN AND MEMBERS,
Committee on Finance, United States Senate,
Washington, D. C.

Gentlemen: It is with considerable concern that the members of this chamber have learned of the approval by the House of Representatives of section 61 of H. R. 8381, whereby all United States citizens having income from services rendered abroad are required to file returns each year of their gross income, earned and unearned if in excess of $600 per year, income earned outside the United States of America being considered as a deduction rather than as an exclusion as heretofore.

The proposed change was mentioned in section 11 of a report submitted by the staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department to the Subcommittee on Internal Revenue Taxation, Committee on Ways and Means, House of Representatives, copy of which is attached hereto.

The members of this chamber are naturally sympathetic with the endeavors of the administration to insure that all taxpayers should meet their legal obligations, but feel very strongly that any measures taken toward attaining that objective should be reasonable—that is to say that the burden or inconvenience placed on the taxpayer should not be disproportionate to the eventual benefit to the Treasury. We consider that section 61 of H. R. 8381 as it now stands is objectionable and we feel it our duty respectfully to place before the committee our thoughts on this matter in as concise a form as possible.

1. Distinction must be made between bona fide nonresident United States citizens earning income abroad and those United States citizens who are absent from the United States of America 17 out of 18 months and who are more directly under the control of the revenue officials. Most of the difficulties arising in connection with the reporting of earned income (as enumerated in the report by the Joint Committee) apply exclusively to temporary absentees from the United States of America. We do not feel that there is room for misunderstanding to anything like the same extent on the part of bona fide nonresidents and it is their interests with which we are very much concerned.

With due recognition of the important contributions made by the United States Government through foreign aid and technical cooperation programs, publications, etc., toward the furthering of good relations with foreign nationals, it is generally accepted that the most effective means to that end are through the personal contacts of the American firms individual employees and their families established abroad. It is our belief that the inconveniences which would be created in connection with the reporting of all income earned abroad by nonresident citizens would constitute discouragement to foreign service, the eventual result of which might well be an appreciable reduction of the numbers of Americans working abroad. In consequence, to maintain the same degree of goodwill in foreign countries, the United States Government would have to increase very considerably the amounts allocated to the foreign aid and propaganda programs; even if this were done, there is some doubt as to whether the same result could be achieved.

From another angle, any roadblocks in the path of adequately staffing United States enterprises with American personnel would greatly harm the foreign-trade program which is so vitally important for the United States.

2. The reporting of income earned abroad by United States bona fide nonresident citizens would furnish to governments which maintain a censorship of mail information regarding United States business and personnel practices permitting them to compile dossiers on United States citizens which might be used to their detriment.

In consequence, United States citizens resident abroad and the United States enterprises for whom they work, would be placed in a disadvantageous position as compared with other foreign enterprises and their foreign employees none of whom, to the best of our knowledge, are required to file such returns.

3. Dissimilarity between United States of America and foreign tax laws would create confusion in preparing returns of earned income. The filing of joint returns where appropriate, would also create difficulties since service abroad frequently involves separation of husband and wife for extended periods of time.

4. The handling and auditing of returns, if all earned income were reported, would of course impose a tremendously increased burden on the Internal Revenue Service.

5. The great majority of United States citizens residing abroad are employed by large United States enterprises and in such cases full information regarding their incomes earned abroad (and in the United States) may readily be made available by the principals to the Internal Revenue Service.

Even so, because of the great variety of compensation patterns adopted by United States companies operating abroad, no uniform method of reporting could be established for earned income. Employees may be paid entirely in local currency, or in dollars, or part in one currency and part in the other, different rates of exchange being applied. "Fringe benefits" vary considerably between companies particularly in respect of allowances for education, traveling, housing, cost of living, etc. If the figures reported were required for statistical or other purposes, such variations in compensation would make the returns filed of little value.

6. With regard to alternative measures which might be taken to satisfy the revenue officials each year that there have been no cases of failure on the part of bona fide nonresident United States citizens to report taxable income, this chamber suggests for consideration the adoption of the following procedure:

(*a*) That all United States citizens bona fide residents abroad who do not report unearned income under existing law, be required to file each year a statement to the effect that they had no unearned income in excess of the legal exemption during the previous fiscal year.

(*b*) That each United States citizen bona fide resident abroad shall append to his return of unearned income or to his statement of no unearned income each year a signed statement that he was a bona fide resident of a foreign country during the full taxable year, and that his earned income was for personal services rendered outside the United States, and that it was not paid in whole or in part by the United States Government or one of its agents or instrumentalities.

The members of this chamber submit the foregoing objections to section 61 of H. R. 8381 with the earnest request that they be given full consideration by the Committee on Finance of the Senate.

Respectfully yours,

AMERICAN CHAMBERS OF COMMERCE FOR BRAZIL IN RIO DE JANEIRO AND SÃO PAULO,
H. MILTON MOHLER,
President, Rio de Janeiro.
FRANK L. MCCLURE,
President, São Paulo.

EXTRACT FROM REPORT SUBMITTED BY THE STAFFS OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION AND THE TREASURY DEPARTMENT TO THE SUBCOMMITTEE ON INTERNAL REVENUE TAXATION, COMMITTEE OF WAYS AND MEANS, HOUSE OF REPRESENTATIVES

"11. Deductions rather than exclusions for income earned abroad:

"Present law provides an exclusion from United States tax for income earned abroad in the case of United States citizens who are bona fide residents of a foreign country and an exclusion of up to $20,000 a year for United States citizens who are abroad for 17 out of 18 months. Because an "exclusion," as distinct from a "deduction," is provided for the above types of income, it not only is free of tax but also need not be reported for tax purposes, even though a citizen is otherwise required to file a return. However, some citizens mistakenly assume the exclusion applies no matter how short a time they are abroad. In addition other forms of income of United States citizens who are abroad are subject to United States tax (although with a credit for foreign taxes in the case of income derived abroad). This includes investment income, income from a taxpayers' business to the extent it is attributable to capital and not personal efforts, income from personal services rendered in United States, and income from personal services rendered in a foreign country to the extent it is in excess of $20,000 in the case of a citizen abroad for 17 out of 18 months but not a bona fide foreign resident. In all of these cases, in addition to some tax evasion, there is confusion among taxpayers as to whether the exclusion is applicable. Moreover, where taxpayers believe the exclusion to be applicable, they report no information relative to the income, which means that the Internal Revenue Service does not have an adequate basis of information to determine whether the exclusion is properly applied."

(The following communications relating to this subject were subsequently received for the record:)

AMERICAN CHAMBER OF COMMERCE IN LONDON
Adelphi London, W. C. 2, February 25, 1958.

Subject: H. R. 8381.

Senator HARRY F. BYRD,
Chairman of the Senate Committee on Finance,
Washington, D. C.

DEAR SENATOR BYRD: On April 12, 1957, the American Chamber of Commerce in London addressed a letter to the then Chairman of the Ways and Means Committee of the House expressing their views on a proposed change in the Internal Revenue Code which, if adopted, would have treated the foreign earnings of American citizens as deductible rather than excludible from their income.

We now have learned that the above-mentioned bill, H. R. 8381, is now under consideration by your committee from which we understand the new proposals will require any American citizen having income from services rendered abroad to file a return if his gross income, including such income from abroad, equals $600 per year.

We trust we may be permitted to high-point a few items in this regard and that we may respectfully submit that the proposed change is unwarranted and undesirable on the following grounds.

1. The proposed change would burden most American taxpayers overseas with a meaningless reporting responsibility

The proposed change is not intended to result in any increase in the amount of United States tax due from such taxpayers. The purpose of this change is, it seems clear, informational only. American taxpayers who earn their livelihood abroad are to be asked in great numbers to assume the considerable burden of filing information returns for the United States Treasury. We submit that the burdens to be placed on these taxpayers are not worth ostensible advantage the Treasury thinks will be gained by this proposal.

If the testimony of Commissioners Andrews, Delk, and Harrington before the Appropriations Committee is understood correctly, the basic problem that has been worrying the Internal Revenue Service with respect to American taxpayers overseas is the apparent evasion of tax by a few wealthy Americans who have taken refuge in the Rivieras of the world to enjoy an income tax sanctuary free of the long arm of the United States tax collector. (See, e. g., hearings before the Subcommittee on Appropriations, Treasury-Post Office Departments Appropriations for 1957, 84th Cong., 2d sess., pp. 455–456; same for 1956, 84th Cong., 1st sess., p. 694Q.) In one part of his testimony, Assistant Commissioner Delk called the committee's attention to an American who lived abroad for many years with a net worth of $200 million who had never filed a United States tax return although clearly he should have done so. (See hearings for 1956, supra, p. 498–499.) But this type of spectacular tax evasion is not typical—indeed, it is in decided contrast to—the activity and conduct of relatively low income, industrious American citizens who reside abroad in capacities as humble and varied as oilfield supervisors, bank clerks, commission agents, teachers, missionaries, and point 4 technicians.

It is apparent, moreover, that this proposed change, applicable to all citizens residing abroad, will not in any wise inhibit the tax evasion activities of a few wealthy expatriates. Already, these people are in almost all cases required to file United States tax returns, since all types of investment income, including income from a taxpayer's busines to the extent that it is attributable to capital, must be reported for United States tax purposes. The problem of the Internal Revenue Service with respect to overseas taxpayers is seen to be essentially that of evasion on the part of a few taxpayers already undoubtedly required to make returns of income.

A further consideration that ought to be taken into account in weighing the desirability of this proposed change in law is that the basic emphasis on collecting taxes overseas must be, in the words of Assistant Commissioner of Internal Revenue Winkle, "voluntary compliance." (See hearings for 1957, *supra*, p. 455.) Every taxpayer loyal to our existing system of self-assessment of tax is, of course, willing to do all that may be necessary to cooperate with his Government in making a return of, and paying, his tax. But many taxpayers living abroad will see in this meaningless requirement to file information returns, when living hundreds or thousands of miles from the closest office of the Internal Revenue Service, an unnecessary and unreasonable provision. It should be fair to state that the existence of such unreasonable redtape provisions will not generally improve the cheerful disposition with which taxpayers situated abroad will make voluntary returns of their income tax.

In addition to the above, a majority of American citizens who are residing abroad are employed by substantial American companies and full information concerning their incomes is already available to the Internal Revenue Service.

2. The proposed change would tend to discourage American employees from serving abroad, and, hence, would have an adverse effect on private American investment overseas

The exclusion of income earned abroad by American citizens residing abroad has been a part of our tax laws since section 213 (b) (14) of the Revenue Act of 1926. It has served a most useful purpose and, in the words of Dan Throop Smith, Special Assistant to the Secretary of the Treasury, has been "generally accepted as a sound and fair policy in this country." (Speech delivered before National Foreign Trade Convention, November 28, 1956.) This exclusion was intended to encourage investment and trade in foreign countries by United States citizens and organizations. (See H. Rept. 1., 69th Cong. 1st sess., p. 7.)

There can be no doubt but that the encouraging of private investment overseas is, and must continue to be, a cardinal principle of American foreign policy.

Secretary Humphrey himself has recognized the significance of this principle in the following words:

"* * * In the present state of international affairs, it is vital that the United States and the other capital exporting countries maintain good economic relations throughout the free world. This should be done as far as possible by the investment of private capital. * * *" (Statement before Senate Committee on Banking and Currency, June 6, 1955.)

Particularly, it is important to note that the extent to which American private industries and businesses are enabled to operate and invest in the underdeveloped areas of the world; to that extent also is alleviated the public burden of assisting these nations through large public foreign-aid programs. It is precisely in these areas of the world where it is most difficult for American businesses to recruit American personnel to work.

It is essential for American overseas enterprises that they be enabled to recruit and staff their foreign establishments with adequately trained American personnel. But it is precisely in these areas of the world where it is most difficult for American businesses to recruit American personnel to work.

It is essential for American overseas enterprises that they be enabled to recruit and staff their foreign establishments with adequately trained American personnel. But it is, and always has been, extremely difficult for these companies operating overseas adequately to staff these establishments for many reasons. American employees are unwilling to serve overseas because of uncertain political conditions abroad, prolonged absences from home and family, adverse sanitary and living conditions, and many other factors. Many employees are also concerned with the considerable load of paperwork involved in taking up a foreign domicile—passports, visas, health certificates, etc.—and the great personal burden involved in carrying on one's affairs at a far distance from home over a long period of time. It has been a common experience of American businesses operating overseas that the cumulative effect of these various factors serves as a substantial deterrent to recruitment of adequate personnel to work abroad.

The requirement that all American residents abroad earning more than $600 per year should file tax returns that are no more than information returns without doubt will add a substantial further burden to the life and work of many of these people. The unfortunate fact is that the Internal Revenue Service is unable to provide adequate information and other types of aid so as to service Americans overseas in the same fashion that it can perform this function at home. At the present time the Internal Revenue Service maintains only five permanent representatives abroad and the extent of its service is limited to periodically sending a small group of agents to a few large population centers throughout the rest of the world for the purpose of "assisting taxpayers."

But it should be pointed out that in most cases American businesses give careful tax advice to their employees going overseas. This step is taken to explain to them the fact of the earned-income exclusion itself, which is, as it was meant to be, a significant inducement to American employees to serve abroad. Therefore, although the average American abroad is generally in no position to avail himself of the foreign services of the Internal Revenue Service, he, nevertheless, is generally aware that if he is a genuine resident of a foreign country and earns all his income in that country, there is no necessity for him to take the time and trouble to obtain, fill out, and file the necessary tax forms. This fact is a great relief to many Americans going abroad.

3. The proposed change would discriminate against Americans working abroad in favor of other taxpayers similarly situated at home

This proposed change would not only fail to achieve the purposes which it ostensibly seeks to accomplish—namely, to prevent tax evasion by wealthy taxpayers living in tax havens abroad—and it would not only add a further unnecessary burden to thousands of low-income taxpayers working abroad, but it would also discriminate between Americans abroad and other taxpayers similarly situated at home. There are at present time many types of income which are treated as exclusions—for example, tax-exempt interest, social-security payments, disability and retirement payments to members of the Armed Forces, Veterans' Administration benefits, unemployment payments received from State agencies, combat pay in Armed Forces, certain awards and prizes and other types of recurring payments that hug the borderline between a return of capital and income (e. g., corporate distributions not out of earnings). There is no provision in the tax laws that taxpayers in receipt of these categories of income or quasi-income must file information returns for the benefit of the taxing authorities. To single out and place an informational burden upon the many low-income taxpayers presently earning their living abroad is not only to discriminate against this group but to do so with respect to those least able to discharge this additional bookkeeping responsibility.

4. The proposed change is particularly unnecessary with respect to those taxpayers who qualify for the earned-income exclusion on account of presence abroad 17 out of 18 months

Under existing regulations, these taxpayers must now file a return for the first taxable year of such presence abroad, even though income for a part or all of this year later is seen to qualify for the exclusion and a claim for credit or refund is accordingly filed. See section 1.911-1 of the proposed regulations. Thus, it is seen that each taxpayer qualifying under this section must in all events file an income-tax return sufficient to alert the Internal Revenue Service as to the taxpayer's status.

The real burden, therefore, of filing new information returns under the proposed law will fall on bona fide residents of a foreign country who earn their living abroad. It is on these taxpayers that the burden is most unfairly placed.

Conclusion: "The Paperwork Is Where the Impact Comes"

It is ironic that this proposal should emanate from the Treasury Department at a time when it recognizes the importance of—and is apparently trying to do something about—the enormous burden of filing papers that is presently placed upon the American taxpaying public. For example, the Treasury Department for several years has been interested in implementation of the so-called Andrews plan whereby millions of low-income taxpayers would be relieved of the obligation of filing any income-tax return whatsoever. The purpose of this plan is to accept W-2 statements in lieu of tax returns. (See hearing for 1956, supra, p. 455, and hearings for 1958, pp. 128-130.) Also, the Internal Revenue Service is considering another plan to combine income- and social-security tax reporting by employers on a single annual basis instead of a quarterly basis. (See hearings for 1957, supra, p. 432.) Although neither plan would have much effect one way or the other from a revenue standpoint, it has been stated by Assistant Commissioner Winkle that "the paperwork is where the impact comes" and that the advantage of the simplification of reporting inherent in these plans is highly desirable. (See hearings for 1957, supra, p. 440.)

The clear result of the proposed change would be to require the filing of thousands of information returns by taxpayers now under no obligation to do so. It is hard to reconcile this result, which would entail enormous additional paperwork, with the praiseworthy objectives of these other proposals to eliminate just such paperwork.

We submit that other and less harmful means are available for the accomplishment of the objectives of this measure. Therefore, we respectfully submit this letter in the earnest hope that it will receive favorable consideration as it is our profound belief that the enactment of the proposed bill would become a serious deterrent to the extension of American industry overseas. Further, it would be a very serious disincentive and discouragement to American technical and administrative personnel to accept invitations by their companies to serve overseas.

Yours very truly,

D. L. GILL, *Secretary.*

BARCELONA, *February 26, 1958.*

CHAIRMAN, SENATE FINANCE COMMITTEE,
United States Congress, Washington, D. C.:

Referring protest April 2, 1957, addressed to House Ways and Means Committee against Technical Amendments Bill of 1957, and specifically paragraph 11 thereof, to consider income earned abroad by bona fide residents as deduction rather than exclusion, the American Chamber of Commerce in Spain with largest membership any American chamber abroad, reaffirms its protest. Confirming letter follows.

KLEIN, *President.*

AMERICAN CHAMBER OF COMMERCE IN SPAIN,
Barcelona, February 26, 1958.

CHAIRMAN, SENATE FINANCE COMMITTEE,
Washington, D. C.

DEAR SIR: We confirm our cable of today as follows:

"Referring protest April 2, 1957, addressed to House Ways and Means Committee against technical amendments bill of 1957, and specifically paragraph 11, thereof to consider income earned abroad by bona fide residents as deduction rather than exclusion, the American Chamber of Commerce in Spain with largest membership any American chamber abroad reaffirms its protest. Confirming letter follows."

The chamber on April 2, 1957, wrote to Mr. Leo H. Irwin, clerk of the Ways and Means Committee of the House of Representatives stating its stand on paragraph 11 of the technical amendments bill of 1957, which we understand is before your committee, having passed the House. Our stand as expressed to the Ways and Means Committee of the House of Representatives remains exactly the same and we would appreciate your accepting the enclosed copy of our letter to Mr. Irwin as our point of view regarding this paragraph.

Sincerely yours,

MAX H. KLEIN, *President.*

APRIL 2, 1957.

Mr. LEO H. IRWIN,
Clerk, Ways and Means Committee,
House of Representatives, Washington, D. C.

DEAR MR. IRWIN: We understand that certain amendments to the Federal tax laws are being prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department and we refer more specifically to a list of substantive unintended benefits and hardships and additional problems for the technical amendments bill of 1957.

This document, in paragraph 11, recommends "Deduction rather than exclusion for income earned abroad" and our chamber, the largest American Chamber of Commerce abroad, wishes to record its protest against this proposed change.

We strongly believe that:

(1) Before any such drastic amendment is embodied in our Federal tax law, bonafide American residents abroad should be heard by your Committee, either personally or through their Chambers of Commerce.

(2) It is the policy of our administration to further trade with all friendly nations and that one of the best and most effective ways to encourage such trade and to make American methods known to foreign countries is through the promotion of American business and investments abroad. We also believe that the amendment proposed in paragraph 11, as above referred to, will act as a deterrent to the establishment of American firms and their employees abroad, thus resulting in an obstacle to the confirmed policy of our Government.

(3) Such tax legislation would make an unfortunate impression on most foreign governments.

(4) The necessity for filing returns for earned income abroad would certainly increase the amount of paperwork, not only for the taxpayer, but also for the Internal Revenue Service and would necessitate the creation of new jobs, the cost of which would definitely not find any compensation in taxes collected, as it is proposed that earned income be deducted. This would result in an additional burden on the taxpayer, which should be avoided.

We are informed that the proposed amendments will come up for a hearing very shortly and it is for this reason that we are rushing our protest, without entering into too many details. These details would be submitted if and when our chamber would be granted a hearing, which we believe is essential in the interest of American citizens residing in Spain.

Respectfully yours,

AMERICAN CHAMBER OF COMMERCE IN SPAIN,
MAX H. KLEIN, *President.*

The CHAIRMAN. Are there any questions?

Senator DOUGLAS. I would like to ask the witness what the present procedure is as to reporting by nonresident citizens of income derived from interest, dividends, royalties, and so forth.

Mr. MOMSEN. American citizen residing abroad whether he is a permanent resident or not, is required to report all interest and dividends received from foreign sources, the same as if he were a resident of this country.

There is no distinction.

The CHAIRMAN. Are there any further questions?

Thank you very much, Mr. Momsen.

I submit for the record cablegrams and letters received from the American Chamber of Commerce in France which relates to the same subject on which Mr. Momsen has just testified.

(The cablegrams and letters follow:)

PARIS, *February 25, 1958.*

CHAIRMAN, FINANCE COMMITTEE,
United States Senate, Washington, D. C.:

Informed your committee now considering technical amendments bill H. R. 8381. American Chamber of Commerce in France is strongly opposed to enactment of section 61 of said bill. Respectfully request your committee consider our letters of April 24, 1957, and December 18, 1957, addressed to chairman, House Ways and Means Committee, stating our objections, copies of which are being airmailed you today, and your consideration of protests previously made by American Chambers of Commerce in London, Brazil, and Madrid. As section 61 not a revenue-producing measure and in our view, will on contrary be costly to Government, respectfully request 10-day delay consideration this section to permit our chamber to file brief.

CHARLES E. VAN DER BURGH,
President, American Chamber of Commerce in France.

AMERICAN CHAMBER OF COMMERCE IN FRANCE,
Paris, February 27, 1958.

CHAIRMAN, FINANCE COMMITTEE,
United States Senate, Washington D. C.

DEAR SIR: As president of the American Chamber of Commerce in France, I cabled you on February 25 concerning our chamber's objections to enactment of section 61 of the technical amendments bill H. R. 8381.

As stated in that cablegram, I am sending you herewith eight copies of letters written by the American Chamber of Commerce in France to the chairman, House Ways and Means Committee, on April 24, 1957, and December 18, 1957. In view of the importance of these questions to the American business community abroad, it is our earnest hope that your committee will give full and favorable consideration to the material submitted herewith.

We are preparing a brief setting forth more particularly our position with respect to section 61 which we expect to send you in the next few days.

Respectfully yours,

C. E. VAN DER BURGH, *President.*

MEMORANDUM CONCERNING SECTION 61 OF THE TECHNICAL AMENDMENT BILL

This memorandum concerns proposals for new legislation that would require American citizens having nontaxable income from services rendered abroad to report such income to the Internal Revenue Service. There new proposals are contained in section 61 of H. R. 8381 as passed by the House of Representatives. Section 61 would, in effect, require any American citizen having income from services rendered abroad to file a return of such income if his gross income, including such foreign income, equals $600 per year. Individuals would have to report such income even though not taxable with respect thereto under the provisions of section 911 of the Internal Revenue Code.

The American business community abroad has from the beginning been strongly opposed to the Treasury Department proposals. The objections can be summarized as follows:

1. The policy of exempting from taxation income earned abroad by American citizens is generally accepted, according to Hon. Dan Throop Smith, Assistant

Secretary of the Treasury as a "sound and fair policy," a statement with which American businessmen abroad are in full agreement. Nevertheless, over the years attempts have been made to curtail and to modify the exemption. Although the change presently under consideration does not increase present tax liabilities of American citizens abroad, it causes apprehension as to the future plans of the Treasury Department. It is felt that the change may be the first step in the direction of restricting and abolishing altogether the exemption. Whether or not this apprehension has any basis in fact, it pervades the entire American business community abroad, has caused many Americans to consider abandoning their foreign activities and returning to the United States, and erects barriers of a psychological and practical nature to the recruitment of American personnel for service abroad, already a serious problem.

2. There are said to be approximately 250,000 American citizens residing abroad engaged in some type of gainful activity. It seems likely that at least 90 percent of these individuals are employed by large American companies and that nearly all of them are exempt from United States taxes with respect to their earnings. The proposed change is not intended to result in any increase in the amount of United States taxes due from citizens residing abroad. The purpose of the change is to obtain information. American citizens earning their livelihood abroad are to be asked to assume the considerable burden of filing information returns for the United States Treasury. The vast amount of paperwork and correspondence that the proposed change would entail for the individuals concerned, not to mention the additional burden imposed on the Internal Revenue Service in connection with the handling and auditing of the returns, is ample reason not to adopt the proposed changes unless there are important benefits to be secured.

Although the Internal Revenue Service has not furnished any statement of the number of additional employees that would be needed to handle and audit the new returns required under section 60, or the cost thereof to the Government, it is reasonable to believe that processing of hundreds of thousands of new information returns would be costly.

In this connection it is interesting to note that officers of the Internal Revenue Service testified before the House Subcommittee of the Appropriations Committee that 1,443 additional employees would be required to deal with 1,600,000 additional tax returns. In order to handle 500,000 other tax returns required to be filed under title II of Public Law 627 of June 29, 1956, Internal Revenue Service spokesmen said 234 additional employees would be required.

3. The Treasury Department does not take the position, so far as is known, that adoption of the proposed change would necessarily produce any increase in revenue to the United States Government.

While it is clear that the Treasury Department should exercise every reasonable means to collect taxes that are due under the law it is equally evident that the proposed change would not necessarily produce an increase in revenue sufficient to justify the detrimental effects.

4. The Treasury Department representatives have conceded that requiring American citizens living abroad to report their earned income will have no effect on willful tax evaders. Unintended evasion of the tax law as a result of confusion in the mind of taxpayers is thought to be extremely minor. The Treasury Department issues each year its Tax Guide for United States Citizens Abroad, which is available at all American embassies and consulates in foreign countries. In many foreign countries there are regularly assigned Treasury representatives qualified to give tax advice. In France alone, there are more than 30 practicing American lawyers who can be consulted by American citizens requiring tax advice. American employees of large American companies who constitute the majority of American residents abroad, have easy access to tax advice within their own organizations. It is difficult to believe that any appreciable number of American citizens residing abroad fail to report taxable income due to ignorance or confusion as alleged by the Treasury Department.

It appears therefore that the entire burden of the law would fall on innocent and tax-exempt individuals.

It should be emphasized that the proposed change would affect only tax-exempt individuals. Individuals who are not tax exempt are already required to file returns. It should also be emphasized that since a large majority of Americans living abroad are employed by large American companies information desired by the Treasury Department is in most cases already available.

The proposed change would therefore be burdensome to the individuals, expensive for the Government, and meaningless.

5. The proposed change would discriminate against Americans working abroad in favor of other taxpayers similarly situated at home. There are at present many types of income which are excludable and therefore need not be reported. Among these are tax-exempt interest, social-security benefits, disability and retirement benefits of members of the Armed Forces, Veterans' Administration benefits, unemployement payments received from State agencies, combat pay in the Armed Forces, corporate distributions not out of earnings, etc. The recipients of none of these kinds of income have to report the same to the Internal Revenue Service. Why is the American living abroad singled out for such treatment?

6. In order to reach the Internal Revenue Service, the returns required under the new law will have to pass through the mails. It is well known that certain foreign governments systematically censor the mails and the new proposal would expose American citizens to harrassment by such governments. In the tax conventions existing between the United States and most foreign governments it is provided that no information will be furnished by the American Government concerning the incomes of American citizens. Section 61 would in fact nullify such provisions by giving foreign governments access to the income-tax returns of the American citizens residing in their countries.

7. In summary, the disadvantages of the proposed change greatly outweigh any conceivable benefit. The stated objectives of the Treasury Department can be accomplished by other and less harmful means. It has always been extremely difficult for American business to find executives and staff for service overseas, due to uncertain political conditions abroad, separation from friends and family, adverse living conditions, and the problem of childrens' education. Section 61 will add one more discouragement to foreign service and result in an appreciable reduction in the number of Americans working abroad. This would be a deterrent to the maintenance or establishment of branches of American firms in foreign countries and would detract from the essential work done by the United States Government in furthering better relations with foreign nations.

AMERICAN CHAMBER OF COMMERCE IN FRANCE,
CHARLES E. VAN DER BURGH, *President.*

AMERICAN CHAMBER OF COMMERCE IN FRANCE,
Paris, December 18, 1957.

Hon. JERE COOPER,
Chairman, Ways and Means Committee, House of Representatives, Washington, D. C.

DEAR SIR: Earlier this year the American Chamber of Commerce in France as well as the American Chambers of Commerce in a number of other foreign countries wrote the chairman of the Ways and Means Committee of the House of Representatives to state their views on a proposed change in the Internal Revenue Code, which if adopted would have treated the foreign earnings of American citizens as deductible, rather than excludable, from income. The various chambers of commerce were uniformly of the opinion that the detrimental effects of the proposed change greatly outweighed any foreseeable benefits. The attitude of our chamber was set forth in a letter addressed to the chairman of the Ways and Means Committee of April 24, 1957, a copy of which is encolsed herewith.

It appears that the plan originally proposed to threat foreign earnings of American citizens as deductible rather than excludable from income, was found to be undesirable for technical and administrative reasons, which do not now concern us. As a substitute measure it was decided that it would be sufficient to amend other provisions of the Internal Revenue Code relating to the filing of returns. Under the present law, foreign-earned income need not be taken into account in determining whether a return must be filed. The new proposals are contained in section 61 of H. R. 8381, introduced into the House of Representatives on June 26, 1957. Section 61 would in effect require any American citizen having income from services rendered abroad to file a return if his gross income, including such income from abroad, equals $600 per year.

The American Chamber of Commerce in France desires to inform your committee that in its view the new proposals are no more acceptable than the old. Our chamber in strongly opposed to the enactment of section 61 of H. R. 8381 for precisely the reasons set forth in our attached letter of April 24, 1957. The report of the Ways and Means Committee, No. 775, recommending adoption of this measure does not reply to any of the objections raised in that letter or in the letters of the other American Chambers of Commerce abroad addressed to the committee. Our chamber is of the impression that the views of the American business community abroad have not been given due consideration.

We wish to summarize for your convenience our objections to the proposed measure:

1. Our chamber is deeply apprehensive that this may be a step in the direction or restricting or abolishing the exemption accorded for many years to American citizens residing abroad. If enacted this legislation will raise barriers of a psychological and practical nature to the recruitment of American personnel for service abroad.

2. The great majority of American citizens residing abroad are employed by large American companies and full information concerning their incomes is tional burden on the Internal Revenue Service.

3. The proposed change would create a vast amount of paperwork and correspondence for the individuals concerned and would complicate the filing of of joint returns in cases where foreign services separates husband and wife.

4. The handling and auditing of the additional returns would impose an additional burden on the Internal Revenue Service.

5. There is no indication that the proposed change would necessarily produce any increase in revenue to the United States Government, commensurate with with the cost of handling and auditing of the large number of additional returns that would be required.

6. In the opinion of our chamber, tax evasion by United States citizens earning income abroad is nonexistent or insignificant. Such cases as may exist would not in our view be affected by the proposed amendment and the entire burden would fall on innocent and tax-exempt individuals. On the other hand, unintended evasion as a result of confusion in the minds of taxpayers must be insignificant in view of the fact that United States citizens abroad have ample facilities for obtaining assistance in determining their tax responsbilities.

7. Requiring American citizens abroad to report their earned incomes would leave them at the mercy of foreign governments, some of which censor the mails systematically.

8. Our chamber is of the opinion that other and less harmful means are available for the accomplishment of the objectives of this measure.

It is requested that the matters discussed in this letter be given careful consideration by your committee, it being the view of our chamber that section 61 should not be enacted into law.

Respectfully yours,

C. E. VAN DER BURGH, *President.*

AMERICAN CHAMBER OF COMMERCE IN FRANCE, INC.,
Paris, April 24, 1957.

Hon. JERE COOPER,
Chairman, Ways and Means Committee, House of Representatives,
Washington, D. C.

DEAR SIR: The American Chamber of Commerce in France wishes to acquaint your committee with its views on a proposed change in the Internal Revenue Act which, if adopted, would treat the foreign earnings of American citizens as deductible, rather than excludible from income as at the present time.

The proposed change is contained in item 11 of the list of "Substantive Unintended Benefits and Hardships" contained in the release of the Subcommittee on Internal Revenue dated November 7, 1956.

Our chamber is strongly opposed to this proposed change in the law, for the following reasons:

1. The time-honored policy of exempting income earned abroad by American citizens is generally accepted, according to the Honorable Dan Throop Smith, Special Assistant to the Secretary of the Treasury, as a sound and fair policy, a statement with which we are in full agreement. Over the years attempts have been made to curtail and modify the exemption. Although the change which is presently under consideration does not increase the present tax liabilities of United States citizens abroad, our chamber is deeply apprehensive that this may be a step in the direction of restricting or abolishing altogether the exemption. This point of view pervades the entire American business community in France and other foreign countries, and the adoption of the change

would without doubt erect additional barriers of a psychological and practical nature to the recruiting of American personnel for service abroad, already a serious problem.

2. We understand that there are approximately 250,000 American citizens residing and working abroad. We would estimate that 90 percent of these individuals are employed by large American companies and that nearly all of these are not subject to tax on their earned incomes. Employment outside the United States frequently means separation of husband and wife, which obviously creates problems in connection with the filing of joint returns. The vast amount of paperwork and correspondence that the proposed change would entail for the individuals concerned, not to mention additional burden imposed on the Internal Revenue Service[1] in connection with the handling and the audit of the returns is ample reason not to adopt the proposed changes unless there are important benefits to be secured.

3. The Treasury Department does not take the position, so far as we know, that adoption of the proposed change would necessarily produce any increase in revenue to the United States Government. While our members feel that the Treasury Department should exercise every reasonable means to collect taxes that are due under the law, we are convinced that the proposed changes would not produce any increase in revenue to justify the detrimental effects. To our knowledge tax evasion by United States citizens earning income abroad is nonexistent or insignificant. Instances of deliberate evasion as may exist would not in our view be affected by the proposed amendment and the entire burden of the new law would fall on innocent and tax exempt individuals. On the other hand, unintended evasion as a result of confusion in the minds of taxpayers must, in France at least, be extremely minor. In France alone in addition to 8 regularly assigned Treasury representatives there are more than 25 practicing American attorneys. The Internal Revenue Service has made available to citizens residing abroad comprehensive printed information with respect to their American tax responsibilities. American employees of large American companies have easy access to tax advice within their own organizations. It is difficult to believe that any appreciable number of American citizens residing in France fail to report taxable income due to ignorance or confusion. We believe these comments apply to other foreign countries as well.

4. As has been pointed out, requiring Americans abroad to report their earned incomes would leave them at the mercy of foreign governments that censor mail, in some cases systematically.

In conclusion, we feel that the manifest detrimental effects of the proposed change greatly outweigh any hypothetical benefit that might be obtained. There are surely available other and less harmful means for the accomplishment of the stated objectives of the Treasury Department. The American Chamber of Commerce in France trusts that your committee in its deliberations on the proposed measure, will give full consideration to these observations and the opinions of other American business groups abroad.

Respectfully yours,

C. E. VAN DER BURGH, *President.*

The CHAIRMAN. The next witness is Mr. Leslie Mills of the committee of Federal taxation, American Institute of Certified Public Accountants.

STATEMENT OF LESLIE MILLS, REPRESENTING COMMITTEE ON FEDERAL TAXATION, THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. MILLS. Mr. Chairman and committee members, my name is Leslie Mills. I am from New York and I am speaking on behalf of the committee on Federal taxation of the American Institute of Certi-

[1] In this connection it is interesting to note that the officers of the Internal Revenue Service testified before the House subcommittee of the Appropriations Committee that 1,448 additional employees would be required in the coming year to deal with 1.6 million additional returns. In order to handle 500,000 other tax returns required to be filed under title II of Public Act 627 of June 29, 1056, Internal Revenue Service spokesmen said 234 additional employees would be required.

fied Public Accountants, which is the national professional society of C. P. A.'s.

There are five sections of the bill on which I would like to make brief oral comments.

First, section 1 (c)—Effective Dates: For the most part, the changes made by the bill are given retroactive effect. Under section 1 (c) of the bill, more than half of the sections in the bill will take effect as though originally enacted in the 1954 Code. This is proper where a change corrects an error in phrasing or a failure to properly reflect the clearly expressed intent of Congress.

However, retroactive application of substantive changes does not seem fair. Some of the changes are effective as of November 7, 1956. As you know, this date was selected because of the release at that time of a list of substantive unintended benefits and hardships.

Many of the items on the list are included in the bill. The list was not a statement of congressional decisions but a grouping of suggestions for legislative action made by the staffs of the Joint Committee on Internal Revenue Taxation, the Treasury Department, or both.

The release of this list was accompanied by a disclaimer that the list represented any congressional decisions.

There are numerous instances of legislation being made effective as of the date a congressional committee announces a decision with respect to such legislation. We know of no precedent for making legislation effective on the date of announcing the suggestions of committee staff.

Such a procedure does not seem adequate for purposes of an effective date. The announcement of a suggestion for legislation does not seem to be sufficient notice to a taxpayer as to what changes may be expected.

Generally, we suggest that the effective date of the substantive changes aimed at unintended benefits and hardships should be the date of enactment of H. R. 8381, but certainly no earlier than July 9, 1957—the date H. R. 8381 was reported to the House of Representatives by the Committee on Ways and Means.

Senator KERR. I interrupt at that point.

Generally you suggest that the effective date of the substantive changes aimed at unintended benefits should be the date of the enactment of the bill.

Now, would you submit to me a specific—would you just give us a list which would show your recommendation, the effective date of each section?

Mr. MILLS. Yes, sir, we would be glad to do that.

Senator KERR. Fine.

(The following was subsequently received for the record:)

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, COMMITTEE ON FEDERAL TAXATION, MEMORANDUM ON EFFECTIVE DATES OF H. R. 8381 SUBMITTED TO COMMITTEE ON FINANCE, UNITED STATES SENATE, MARCH 5, 1958

This memorandum has been prepared at the request of Senator Kerr and states our views as to appropriate effective dates for the various provisions of H. R. 8381. The dates have been selected on the assumption that the bill will be enacted within 1 or 2 months.

It should be understood that these suggestions for effective dates do not represent any endorsement of the provisions for which the dates are suggested.

I. The following sections in setting an effective date make reference to October 15, 1956, October 24, 1956, October 31, 1956, November 7, 1956, and December 31, 1956. We recommend that the dates in each case be changed to December 31, 1957: Sections 2, 3, 4, 6, 9, 11, 12, 14, 16, 19, 22, 23, 27 (b), 28 (b), 28 (c), 34, 36, 37, 41, 42, 43, 44 (a), 51, 60.

II. The following sections make substantive changes which are effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954. These sections should be effective for taxable years beginning after December 31, 1957: Sections 5 (b), 45.

III. Section 21: This section should be effective for taxable years beginning after December 31, 1957. If the provision is made applicable as in the bill, then taxpayers who took action consistent with the language of the present statute should be given a limited period in which to return to their former position.

IV. Section 52: This section should be changed to provide that no election may be made under section 1361 for any taxable year ending after the date of enactment.

V. Section 63 (b): This section should be made effective for taxable years beginning after December 31, 1957.

VI. All other sections should be effective as provided in the bill referred to the Committee on Finance. (In the case of sec. 13, which applies only to certain fiscal years ending in 1954, there should be an extension of the statute of limitations on refunds for such years. In the case of section 70, it should be made clear that the section applies retroactively to the date of enactment of the 1954 code. This is needed to reopen an expired period for refund for those taxpayers where the period for assessment is still open.)

Mr. MILLS. A number of substantive changes are keyed to December 31, 1956. This date was probably based on the bill becoming law in 1957. The effective dates of these provisions should be changed to December 31, 1957.

Section 14—Improvements on leased property.

We believe that existing case law and the income tax regulations dealing with improvements on leased property are adequate to deal with the problem of section 14. We have heard of abuses of the present rules. We do not condone any abuses but we believe that section 14 is an attempt to cure an administrative problem which will result in greater hardships for taxpayers than are now suffered by the Government.

Typically, when a lease is signed, neither party can say whether the lease will be renewed. The erection of an improvement does not necessarily change this. The lessee believes the use which may be made of the improvement during its original term will be sufficient to compensate for the possible loss in the event the lease is not renewed. The option to renew merely furnishes protection to the lessee if he wants to continue the use of the property.

At the time the lease is signed, it is difficult to state whether property will be useful to the lessee beyond the original term. The possibility of economic changes, such as population shifts, improvements in transport facilities, regulatory action, market developments, et cetera, make the future value of a leasehold unpredictable.

We believe this provision will have a restrictive effect on many legitimate business transactions. A taxpayer may want a 25-year lease with a 25-year optional renewal period. If he dislikes controversy, he may conclude that he must use a 40- or 50-year life. The longer period may be an unrealistic economic life.

Senator KERR. Don't you think it is even more unrealistic to assume, say, that 5 years might be the economic life of the property, and if you do feel that it is, I would like to ask you if it is not possible under the law as the law now stands for the owner of a leasehold interest maybe to depreciate the entire amount of his investment in 5 years if the original lease either was for that period or has only that to run when he acquires his leasehold estate, and that that might be true even though it is apparent to anyone that would study it that the economic life of this leasehold might be 30 years?

Mr. MILLS. Sir, if there is no renewal period, of course there should be no problem.

But it seems to us that if there is a 5-year lease with a renewal period of substantially more than that, and the taxpayer puts a substantial improvement on the leasehold, that the present administrative powers are adequate to prevent the deduction over the 5 years, because it is unrealistic.

Senator KERR. Suppose it is a 5-year primary term or even a 10-year primary term, and he does not put any substantial improvement on it, but just starts in to depreciate it off, let's say, in the 5 or 10 years initial period.

Mr. MILLS. Is there a renewal period in the lease?

Senator KERR. Sure.

Mr. MILLS. It seems to me, sir, that in most of the cases we are dealing with, these are arm's-length transactions and there is a lease period——

Senator KERR. When you say these are arm's-length transactions, they are between the one who creates the leasehold estate and the landholder, or between the initial leaseholder and the owner, but where could you get the Treasury into the cost of being at arm's length in that thing?

Mr. MILLS. Well, it was our observation that if the transaction is unrealistic on its face, and there is a first term which under all the circumstances is unrealistically short for the intent of the parties, that the Treasury can knock it down, and has been successful in knocking these down.

What we are concerned about——

Senator KERR. That is a matter, though, that you can only speculate about, and I believe that there have been efforts on the part of the Treasury to knock some down, as you say, which to the Treasury appeared unrealistic, but which efforts have failed by reason of the fact that some court might not agree with the Treasury.

Mr. MILLS. Well, they have not won all the cases, but it seems to me that those that they have won have been all right, and in those that they lost, the transaction has not been unrealistic as they have suggested.

Senator KERR. In other words, you think that we should depend upon the infallibility of the court as it exists rather than remedial language by the Congress because of the fact that you think that while the courts are infallible the Congress is incompetent.

Mr. MILLS. No, I would not want to say that. I do not feel that at all, Senator. I do feel that the suggested amendment is seeking to cure an evil which we do not think is as important as has been suggested and that the amendment will cause more trouble to legitimate taxpayers.

Senator KERR. Even if it is a minor evil, maybe it ought to have some treatment.

Mr. MILLS. May I point out the effect that we see on legitimate transactions—which I do not think should be criticized, because it is quite common for a business, let's say a business that wants to open a store, to lease property and to improve the property at its expense.

Now, when a businessman operating a chainstore or an independent grocery improves the property, he has to decide on the economic usefulness to him of the improvement, which means he has to decide on population shifts and future markets and so on.

The improvement, however, maybe useful physically for a considerably longer period.

An investor, an individual, or a large investor for that matter, may feel that he must get his money back in 20 years, but the improvement has a physical life of 40 years.

Now, under the present law, if he has a 20-year lease with provision for a 20-year renewal, I think he should write his lease off in 20 years.

But under the proposed amendment he will have to demonstrate to the Internal Revenue Service, that he did not have an intention to renew the lease.

I think that is an unfair burden on legitimate business.

I presume that every year he is examined he can be asked the question, "Was it your intention at the beginning and the end of this year to renew or not to renew?"

It seems to me that in many legitimate situations we are imposing a burden which does not now exist and which is unrealistic. That is the basis for my comment.

Senator KERR. The burden is entirely on the Government now; isn't it?

Mr. MILLS. Well, that may be on the Government in words——

Senator KERR. It may or may not be; is it?

Mr. MILLS. I do not know whether the burden is or is not.

Senator KERR. You mean that you are here representing 35,000 public accountants and you cannot tell whether the present law puts the burden on the Government or not?

Mr. MILLS. The present laws?

Senator KERR. Yes.

Mr. MILLS. I am sorry, I thought you meant the proposed law. The present law is on the Government; yes.

Senator KERR. The present law puts the entire burden on the Government?

Mr. MILLS. Yes, sir.

Senator KERR. Let's say—and I speak only for myself—I might agree with you that the proposed language would need some change, don't you think that the present law needs some change?

Mr. MILLS. Well, I think it needs some change with respect to situations where there is a relationship between the parties. But I do not think that it needs any change with respect to the legitimate business transactions which are at arm's length between unrelated parties.

Senator KERR. Under the present law let's say that you own a leasehold estate which is a 15-story building down here in Washington, that was built on leased ground, and that the builder of that had a 99-year lease for a term of 30 years with four 15-year renewable options—I do not believe that is mathematically correct.

Senator BENNETT. That is 90 years?

Senator KERR. Ninety years, yes; I believe I can correct the total rather than correct the proportional parts. And we will say you had had that leasehold estate for 10 years. And then we will say that Senator Long comes along—no; we had better not use him—say I come along, and I buy that leasehold estate, which at that time has 15 years of the initial 30 to run, and four 15-year renewable options in the original lease.

Now, under the present law, if I understand it—if I am wrong, you can correct me—I can charge off the entire cost of that leasehold estate that I paid you in that remaining 15 years.

Mr. MILLS. Sir, if I were advising you on taxes, I think I would advise you that you would not be permitted to do that under the present law. The Internal Revenue Service could contest it with a fair measure of success.

Senator BENNETT. But they would have all of the burden on it; would they not?

Mr. MILLS. Yes, sir.

Senator BENNETT. And if they did not contest it, or if they contested it, or the tax or some other appellate court decided in my favor, I could then carry out my purpose to charge off the entire investment that I had made in purchasing it from you in the 15-year period.

Mr. MILLS. Yes; but my understanding of the present law is that under those circumstances you should amortize that cost over the useful life to you.

If the court decides that the useful life to you under the circumstances was 15 years, I cannot cavil with it. But I do not think that the law says categorically that if the first period was only 10 years that the Government is whipsawed by having to allow it.

Senator BENNETT. But the entire burden is on the Government to change it if I elect to make that effort.

Mr. MILLS. I think it is a little exercise in semantics to say it is on them. If the agent just insisted on saying I use 15 years, the burden is on the taxpayer.

Senator BENNETT. Under the present law the burden is on the Government to show a renewal intent as my purpose; isn't it?

Mr. MILLS. Yes, sir.

Senator BENNETT. And you do not think that it should—let's say I did that and got away with it, and at the beginning of the next 15-year period I sold that leasehold estate to Senator Long here, let's say the property had gone up and the rent had increased, and he paid me as much for the leasehold estate as I had paid for it, that would be possible; would it not?

Mr. MILLS. Yes, sir.

Senator BENNETT. And then all I would owe on that amount of money I got from him on the leasehold estate would be capital gains; would it not?

Mr. MILLS. Yes, sir.

Senator BENNETT. And this section is calculated to prevent that?

Mr. MILLS. I do not see how the section would prevent the possibility of capital gains on the lease sale.

Senator BENNETT. It would not, but it would in my judgment change the basis upon which I could find myself or any other purchaser of the leasehold estate in the posture of having entirely depreciated out the cost of his leasehold estate and then be able to sell it, in which event would be a capital-gains transaction.

Mr. MILLS. Yes, sir. Well, in considering this Senator, we, as I said before, are under no circumstances trying to help taxpayers evade their just taxes.

Senator BENNETT. Well, we have had a lot of witnesses before us who are in this business, and they have not asked for an outright elimination, most of them, of this section, which you do. They indicate they think there is a field here for corrective legislation. And, as I get the impact of your evidence, you do not think there is.

Mr. MILLS. I do not think there is with the unrelated taxpayers. But in considering this we do have suggestions which might make it easier for both parties to administer the law.

There are many parts of the statute where objective tests are put, and we suggest two tests which might be enacted into the statute which would limit the application of this state-of-mind rule to situations where they may be some tax leakage.

For example, we do suggest, where the initial term is at least 50 percent of the estimated useful life of the improvement, the taxpayer should not have to prove that it is more probable that the lease will not be extended than that it will.

And we pick 50 percent just as a suggestion—the useful life of property as physical property is generally much longer than the useful life to an investor who has to consider getting his money back.

That is one test we suggest for the committee's consideration.

Another test is to consider the relationship of the costs of an improvement to all payments a lessee is required to make under the lease. Where an improvement amortized over the original term would not increase the annual cost of occupying a property by more than, say 25 percent, it would seem fair and reasonable not to place the burden of proof on the taxpayer.

As far as the section itself is concerned, we think it should be made clear that where the taxpayer must recover his cost over the estimated useful life of the improvement, he is permitted to use accelerated methods of depreciation.

There are other problems which we ask you to consider.

Senator KERR. Can he do that now under the law?

Mr. MILLS. Not if he is recovering the cost by amortization under the leasehold. The Internal Revenue Service does not consider that to be depreciation.

We think it should be made clear that where the lease is not renewed, the taxpayer has the right to deduct the unrecovered cost of improvement.

It should be made clear that if an improvement is sold, gain or loss generally will be computed under section 1231.

Senator KERR. You recommend that in case we need the section in the bill?

Mr. MILLS. Yes, sir.

Senator KERR. I would say you are getting around to making some worthy suggestions as to how the bill might serve a useful purpose—at the beginning of my questions I had concluded from what you said that your alternative was to take it out.

Mr. MILLS. We would like to have you consider that if a taxpayer is required to lengthen the term of cost recovery as a result of an examination of the tax return, the taxpayer should be permitted a retroactive election of depreciation methods. That is a real problem for taxpayers, because a lease agreement does not come before the Internal Revenue Service sometimes for several years.

So far as the suggestion on related parties is concerned, we agree that stricter rules are needed.

We do ask consideration of one problem in the area covered by the amendment, which is the treatment of unrecovered costs where the lease is not renewed.

The next section I want to comment on is section 24, "Adjustments Required by Changes in Method of Accounting."

Prior to the enactment of the 1954 code, there was considerable uncertainty as to the adjustments to be made when a taxpayer was required to change his method of accounting. Section 481 was intended to remove this uncertainty. However, the likelihood of escaping tax on adjustments attributable to years prior to 1954 has delayed the issuance of regulations.

The section has been largely ineffective since its passage because of lack of regulations. Action has been delayed on requests for permission to change accounting methods where there is a possibility of an adjustment under section 481. We understand that over 3,000 applications are now pending on which no action will be taken until the problem of pre-1954 adjustments is settled. In the interest of the public, it is important that obstructions to normal changes and developments in business accounting be removed.

We are in favor of the principle of section 24 of H. R. 8381; namely, adjustments attributable to years prior to 1954 should not escape tax.

However, it should be realized that retroactive application of this provision of the bill will injure those taxpayers who relied on section 481 as originally enacted. Therefore, in all fairness, taxpayers should be given a limited period, 6 months for example, after enactment in which to return to their former position. Because some of the taxable years involved may be closed, the statute of limitations should be kept open for this purpose.

Senator KERR. In other words, you don't believe, as one witness before us yesterday appeared to believe, that if a taxpayer has done what that witness referred to as making an honest mistake, and go ahead and make returns under 481 as it was passed, as they interpreted it, and by so doing escaped entirely the paying of some tax for some years, you think that if we do pass this that we should give them time to make the adjustment, but you don't concur in the recommendation that we should do that which would amount to forgiving the tax.

Mr. MILLS. I personally do not. I am just asking for an opportunity for taxpayers to go back to where they were before.

Section 24 (a) would permit the spread of an adjustment over the 9 succeeding years or a shorter period if the taxpayers had not been engaged in business for that many years prior to the enactment of the 1954 code. This seems to be an unnecessary complication. It is recommended that other conditions being met, the spread should be over the year of change and the succeeding 9 years in all cases.

The present law permits the taxpayer to allocate his adjustment for post-1954 adjustments to the years preceding the change of method. The only allocation permitted under the bill for pre-1954 adjustments is to the succeeding years. It seems reasonable that if the taxpayer's records are sufficient for him to compute income under his new method for earlier years, an allocation to those earlier years should be permitted.

The next section I would like to comment on is section 52, which was covered by a previous witness—"Election Permitting Certain Proprietorships and Partnerships To Be Taxed as Corporations."

Taxes should not be an influencing factor in selecting the form of business enterprise. Accordingly, we favor an option which would permit a partnership to be taxed as a corporation and vice versa.

Thus, the principle of section 1361 seems desirable. Thus far, taxpayers and their advisers have been handicapped by the lack of regulations which if issued would enable them to assist in improving the statute. We believe more difficulty will result from repeal now and a later reenactment in a changed form than from revision of the present law.

We would rather see the section left in the code revision considered after the Treasury's position is made clear.

Senator KERR. Suppose the Treasury advises us—if I understand the effect of their advisement, they don't believe they can make a set of regulations to administer the law as it now exists. Would you regard that as too quick a give up on their part after just about 3½ years, or would you give them a little more time to try?

Mr. MILLS. I think it would be reasonable to ask them to say more than that they don't believe they can make regulations. I would like to know why they think they can't.

Senator KERR. Do you think your association could help them on that?

Mr. MILLS. Sure we could. But the normal procedure we have been following on all their regulations is that when they issue their regulations in proposed form we consider them very carefully and make suggestions on them. We would feel much more competent to advise this committee and others on this part of the law if we had an idea of the Treasury's position on the section, and the difficulties they saw. We see some difficulties ourselves.

Senator KERR. Don't you think there is some basis for an attitude that a corporation or people that used to operate as a corporation should operate as a corporate and be taxed as a corporation?

Mr. MILLS. There are many compelling reasons for choosing one form or another which we don't think should affect the tax burden. For example, some businesses may not by State law, or by their own disciplinary action, operate as a corporation. Some businesses must operate as a corporation for business considerations, risks, and so on, which are not at all related to taxation. So we think that they ought to be able to pick one or the other.

Senator KERR. Don't you think that that fixes it so that they kind of have their cake and eat it too?

Mr. MILLS. I don't think so, Senator. Another committee, I believe, is considering a bill to help small business, and is suggesting that certain corporations be allowed to be taxed as partnerships. We are for that, and we are for the reverse. We think that the choice of business form should be available without regard to tax burden.

Senator KERR. I would agree with you there, if they are going to do it for one they are going to do it for both. And that is your position, as I understand it?

Mr. MILLS. Yes, sir. When H. R. 8300 was under consideration in 1954, there was a provision—there were two provisions to allow——

Senator KERR. Either to operate taxwise or the other?

Mr. MILLS. And the Conference Committee took out the provision to permit corporations to be taxed as partnerships.

Senator KERR. But, as I say, I think I agree with you that if they are going to do it for either to be taxed as the other, they ought to do it for both to be taxed as it is for the other, but you are positive and have developed in your conclusion that it should be available to both?

Mr. MILLS. Yes, sir.

Senator KERR. All right.

Senator LONG. I would like to ask some questions at that point.

Actually the election to operate as a corporation or a partnership historically was based on whichever happened to be the best form of doing business, wasn't it? Of recent date the election has come to be more of an election as to which way would be more desirable taxwise?

Mr. MILLS. In some cases, but not in all cases.

Senator LONG. But in a great number of cases, especially for some small corporation and for businessmen who are not in the particularly large income bracket, doesn't oftentimes the tax sitation require that they organize their business as a partnership whereas it might have been more desirable from an organizational point of view to have done business just the other way around?

Mr. MILLS. Yes, sir.

Senator LONG. That is the point I had in mind. And the thought occurs to me that there are a number of cases involving small corporations or small partnerships where it would be desirable to let them do business in one form and be taxed as though they were doing business in the other form.

Mr. MILLS. As a partnership?

Senator LONG. Yes.

Mr. MILLS. And that is the Small Business proposals. I think all have included that one suggestion.

Senator KERR. Does the witness think that there may be as many or more individuals deciding to do business as corporations because of elements of personal liability as there are because of elements of taxation in this country?

Mr. MILLS. I think more because of personal liability, Senator, and also ability to transfer an interest in the business without going through an individual estate.

Senator KERR. I agree with the witness that there are many more considerations influencing people to make the decisions as to whether they operate as individuals or partnerships on the one hand or corporations on the other than the tax liability.

Mr. MILLS. We have 1 or 2 comments directed to the situation, if section 52 is included in the bill. One is that retroactive revocation of the election should not involve any interest or penalty if the prior election was bona fide under the statute.

A previously electing partnership or proprietor should have the right to effect a nontaxable transfer of net assets to a new corporation. Alternatively, the partnership or proprietor should have the right to be taxed as a liquidating corporation as of the the last day under the prior election.

Senator WILLIAMS. Do you have any estimate as to how many different taxpayers have made this election?

Mr. MILLS. No, sir. In my own experience there have been very, very few, because of the lack of regulations?

Senator WILLIAMS. But there have been a few?

Mr. MILLS. There have been some, yes, sir.

The final section I wish to comment on is section 70—"Limitation on credit or refund."

Under present law, the limitation period for refunds starts with the required filing date of the return without regard to any extensions granted. The limitation period for assessment begins with the actual filing date but no earlier than the statutory due date.

Thus, in any case where a return is filed after the due date, the 3-year refund period and the 3-year assessment period do not coincide. The refund period ends before the assessment period, since the refund period begins with the statutory due date, while the assessment period starts with the actual filing of the return.

Senator FREAR. Which makes a person want to file at the last minute?

Mr. MILLS. It doesn't help there either, Senator. It probably would be cured by Section 70, but we feel——

Senator FREAR. But you are filing the tax April 15, and for those who file January 15, you can have the penalty inflicted on January 15 in lieu of April 15.

Mr. MILLS. On March 15, 1958, 2 weeks from today, the refund period will expire on the 1954 calendar year returns for many corporations. On April 15, the refund period will expire on other taxpayers' 1954 returns. But the statute of limitations will not expire with respect to Government's ability to assess, if these individuals or corporations filed late. And that is the whole problem we are asking to be cured, and it is cured in section 70. But one thing concerns us very much—if H. R. 8381 cannot be enacted into law within the next 2 weeks then there will be a period when corporate taxpayers are not protected on refunds and the Government still has the period open on assessment.

We believe that if H. R. 8381 cannot be enacted prior to March 15, section 70 should be taken out of the bill and passed separately. If that is not possible, it should be made clear that section 70 applies retroactively to the date of enactment of the 1954 code. This is needed to reopen an expired period for refund for those taxpayers where the period for assessment is still open.

Mr. Chairman, this concludes my statement. I would like permission to file within the next few days a statement of position on other matters.

The CHAIRMAN. Very well. We will put it in the record.

(The following was subsequently submitted for the record:)

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, COMMITTEE ON FEDERAL TAXATION, MEMORANDUM ON VARIOUS SECTIONS OF H. R. 8381 SUBMITTED TO COMMITTEE ON FINANCE, UNITED STATES SENATE, MARCH 5, 1958

This memorandum is offered for the record as a supplement to our oral statement of February 28. Further comment is made on section 14 of H. R. 8381, improvements of leased property, as well as on other sections of H. R. 8381.

SECTION 2. RETIREMENT INCOME CREDIT

The proposed change seems proper and would eliminate an unintended difference in the tax treatment of taxpayers residing in community property States and those in noncommunity property States.

We suggest a further change to eliminate the maneuvering on stockownership so as to qualify for the two credits. Regardless of stockownership, the two credits should be granted if both spouses had earned income and a joint return is filed.

SECTION 11. LIMITATIONS ON CHARITABLE CONTRIBUTIONS DEDUCTION

This section of the bill can be divided into two parts—the adjustment of the charitable contributions deduction on account of prepaid interest, and the adjustment of the contributions deduction because of current interest. We agree with the first part relating to prepaid interest.

We question the desirability of an adjustment because of current interest. In a situation of this sort, the taxpayer subjects himself to a risk of loss. He commits his credit to the transaction. Under the circumstances, we believe the transaction has economic reality and there should be no adjustment of the contributions deduction.

Furthermore, detailed study is needed of the whole area of contributions of property which represents in whole or in part unrealized income. This particular question is only a minor segment of a broad problem. Any changes of law in so complex an area should be made with care and only in situations where there is no doubt as to the lack of substance to the transaction.

SECTION 13. NET OPERATING LOSS DEDUCTION

This section will affect only certain taxable years ending in 1954. The statute of limitations for refunds will expire shortly on such taxable years. An extension of the statute of limitations, say for 6 months, should be granted for claiming refunds arising out of this section.

SECTION 14. IMPROVEMENTS OF LEASED PROPERTY

These comments are in addition to those made in our oral testimony.

The burden of proof is not clear in a situation where the taxpayer is willing to go along with the intent of the bill and use the estimated useful life. Take as an example a 25-year lease with a 25-year optional renewal period. Assume the lessee erects a building and, to avoid controversy, adopts a 40-year life for depreciation purposes. Then suppose the lessee does not renew the lease. Presumably he is entitled to deduct the remaining undepreciated cost as an ordinary loss at the end of the 25th year. But suppose it happened in an unusually high tax bracket year, and that the Service challenges the deduction on the grounds that the building should have been amortized over the original term of the lease. Where does the burden of proof lie, and how must it be sustained? Must the Service prove that the taxpayer did not intend to renew or must the taxpayer prove that he did intend to renew? Must the fact be proved for each year of the 25-year period? Obviously, under the assumed circumstances, the intent of the taxpayer may have changed, but must he prove the exact time of the change?

Discussion of this problem has dealt chiefly with the timing of the deduction for amortization or depreciation of leasehold improvements. There is also the related problem of the renewal of a lease after amortization of improvements over the original term, followed by the sale of the leasehold with the gain being taxed at capital gain rates. If that is the abuse at which the proposed legislation is aimed, it might better be corrected along the lines of section 1238 of the code. In any event, this situation is only a small segment of the vast problem of capital gains taxation.

While we do not favor the proposed change in the statute, we are convinced that if there must be a change it should be made less objectionable. Accordingly, we have suggested in our oral statement that consideration be given to the use of "escape formulas."

With respect to the burden of proof, it is our opinion that the procedure established by section 534 of the code to shift the burden of proof to the Government in the case of corporations improperly accumulating surplus would be fair and reasonable here. Upon challenge by the Service, it should be sufficient for the taxpayer to file an adequate statement of the grounds on which he relies.

It seems clear that if the taxpayer is required to depreciate the cost over the estimated useful life, he is permitted to use accelerated methods of depreciation. (In recognition of this, a cross-reference to sec. 167 should be supplied in order to remove any uncertainty whether sec. 167 (b) would be equally applicable to the proposed new section.)

It is important that the statute permit the taxpayer to elect to consider his improvements as separate properties regardless of his practice for other depreciable properties. He should not be restricted by his method of accounting for retirements in accordance with regulations 1.167 (a)-8. Thus, if an improvement is depreciated over a period longer than the original term there will be no question about a deduction for the full unrecovered cost upon abandonment.

The proposed section should not apply unless the "option exercisable by the lessee" permits renewal on the basis of all substantial terms and conditions of the original lease. For example, the section should not apply where there are provisions for the renegotiation of rent for the renewal period. Where renewal terms appear in the original lease but rentals are subject to factors not under the lessee's control, e. g., price indexes, this section should not apply. This is extremely important because such uncertainties in the terms of the possible renewal lease make the renewal have the effect of a new lease. A taxpayer should not be required to prove that he would not make a new lease, the terms of which are presently unknown.

With respect to the provisions for related parties, the principles of section 267 are not adequate to control the problem. For example, under section 267, the term "related parties" does not include two corporations, more than 80 percent owned by the same individual, if neither corporation is a personal holding company or a foreign personal holding company. While a lease between such parties would be subject to the strict provisions of subsection (a), it does not seem proper to exempt it from the stricter rule of subsection (b).

SECTION 19. TAXATION OF EMPLOYEE ANNUITIES

Section 19 (a) relates to the taxation of employee annuities purchased by tax-exempt organizations under a plan which is not qualified. A typical situation at which it is directed involves the doctor who agrees to work for a hospital without any compensation other than a nonforfeitable annuity which will not begin to pay off until a specified age level is reached.

Section 19 (a) would limit the amount of tax deferral obtainable to 20 percent of the currently taxable compensation based on a full year of service plus a past service allowance. It would be necessary to aggregate part-time service in order to arrive at the equivalent of a full year of service. Obviously, it will be difficult to determine what constitutes a full-time equivalent for doctors and others who do not operate on a regular working day.

If section 403 (a) were amended so as to benefit only members of the clergy (for whom it usually is difficult to synthesize a qualified plan), it seems that the way would be clear for requiring that section 501 (c) (3) employers would have to qualify under section 401 with nondiscriminatory plans. This would be a better solution than section 19 (a) of the bill which represents a complex effort to moderate a loophole rather than close it.

Section 19 (c) deals with forfeitable annuities payable by tax-exempt organizations but is not limited to seciton 501 (c) (3) organizations.

The employee of a tax-exempt organization would be taxable at the time his rights change from forfeitable to nonforfeitable on the full value of the annuity contract at that time, less any contributions he has made. However, taxability in full in the year of vesting would not apply to employees of section 501 (c) (3) organizations. For them the 20 percent exclusion allowance would come into play, even for forfeitable annuities. The exclusion would apply in the year in which vesting occurs, as contrasted with nonforfeitable annuities, where the application would take place in the year of purchase. Thus, a doctor employed by a tax-exempt hospital would be more favorably treated than an executive secretary of a chamber of commerce whether the annuity is forfeitable or nonforfeitable.

The taxation of forfeitable annuities in the year in which they become nonforfeitable can cause great hardship. For instance, it is possible for some nonforfeitable interests to be divested by death or for other reasons. Hence, it would seem that a restrictive definition of the word "nonforfeitable" would be required so that in no instance would an individual be taxed for an interest which may be lost to him or to his estate. In the interest of consistency, we recommend a spread-back of amounts which would be piled up in 1 year's taxable income but relate to services rendered during prior years.

SECTION 22. VARIABLE PRICE RESTRICTED STOCK OPTIONS

We question the language in the proposed section 421 (d) (7): "* * * if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised." As now written, an option should only be exercised on the last day of the calendar month, otherwise an increase in value after the date of exercise could disqualify the option.

The interests of the Government would seem to have ample protection if the words "during the 30 days previous" were substituted for the "calendar month."

SECTION 23. TRANSFERS OF INSTALLMENT OBLIGATIONS TO CONTROLLED INSURANCE COMPANIES

Actually, this appears to be part of a larger problem of transfers to corporations, but if the loophole exists, it is desirable to close it.

We suggest that the word "controlled" should be eliminated from the title of the section and from the committee reports. The statutory text makes no mention of the need for control. Apparently, the section applies to any type of nonrecognition section if the transferee is a life-insurance company or a partnership with a life-insurance company as a partner. While the title of a section may not have great statutory significance, the word "controlled" is misleading and should be dropped.

SECTION 24. ADJUSTMENTS REQUIRED BY CHANGE IN METHODS OF ACCOUNTING

As stated in our oral testimony, we are opposed to the retroactive effect of the change in treatment of pre-1954 adjustments.

An additional problem in section 481 which should be considered is the treatment of adjustments which may cause a substantial reduction in income. The decrease in income in the year of change should be spread in the same manner as increases.

SECTION 25. DENIAL OF EXEMPTION TO ORGANIZATIONS ENGAGED IN PROHIBITED TRANSACTIONS

Present restrictions on the use of debentures by a corporation in borrowing from a pension trust are quite severe. This section of the bill would ease the situation.

However, as worded, the bill would not furnish relief to many taxpayers. The percentage limitations set forth in the proposed subsection 503 (h) are not realistic since many smaller companies are unable to find more than one source of credit. For similar reasons, the criteria for eligible debentures do not apply to smaller companies. Debentures of such companies would not be sold on the open market or through an underwriter, but only by the issuer direct and then only to the single source of long-term credit he may have.

It should be sufficient if the obligations are acquired at fair market value on a basis which would be acceptable to an independent lender.

SECTION 31. PERCENTAGE DEPLETION RATES FOR CERTAIN TAXABLE YEARS ENDING IN 1954

We recognize that the purpose of this section is to place fiscal-year and calendar-year taxpayers on the same basis. However, it seems clear that the problem was known at the time the 1954 code was enacted. Extension at this time is not the correction of a technical flaw. We question the desirability of this section and recommend that it be removed from the bill.

SECTION 32. RETENTION OF 1939 CODE RIGHTS WITH RESPECT TO TREATMENT OF MINERAL INTERESTS

As worded, it is not clear what this section would do. It would seem preferable to spell out what is being done rather than incorporate by reference a large number of rulings and court decisions.

SECTION 37. CARRYBACK AND CARRYOVER OF FOREIGN TAX CREDIT

This amendment would eliminate hardships which arise from the accounting requirements of certain foreign countries. For example, some countries have mandatory fiscal years. A United States corporation, filing Federal tax returns on a calendar year, often discovers that profits in such a country are reportable to the United States for one year while the foreign tax accrues in a later year for purposes of the foreign tax credit.

Thus, part or all of the credit may be lost. The taxpayer can't claim the lost credit as a deduction without surrendering the right to a tax credit for other foreign operations. Because of operations in various countries, the United States corporation cannot conform its year for United States tax purposes to the fiscal years of the foreign countries.

Similar difficulties arise from mandatory accounting methods of some countries.

We recommend passage of this section.

SECTION 41. POSTPONEMENT OF GAIN FROM SALE OR EXCHANGE TO EFFECTUATE FEDERAL COMMUNICATIONS COMMISSION POLICIES

This provision should only apply where there is not a substantial question as to the interpretation of FCC rules or policies or of their legality. A taxpayer who has raised a substantial question should not be penalized for having made an incorrect interpretation.

SECTION 42. BONDS ISSUED AT A DISCOUNT

This section attacks the avoidance of tax by the issuance of bonds with an artificially large discount. However, in order to avoid tax it is necessary to have a seller willing to issue the bonds and accept the risk of a long-term commitment to pay interest and redeem the bonds at the increased price. In view of the seller's commitment, the transaction is entered into either because of collusion between the buyer and seller or because the seller is forced to make his loan under such terms.

If the seller is forced to issue his bonds under such terms, the change in the law will make his bonds a poorer investment. Thus he will be penalized. We believe that in cases of this sort, the problem is sufficiently controlled by market conditions.

Where there is collusion between the buyer and seller, existing rules or sham transactions ordinarily would be adequate to deal with the problem. It may be necessary to have a rule presuming collusion where the parties are related. Any such presumption should be rebuttable.

SECTION 76. BANKRUPTCY AND RECEIVERSHIP PROCEEDINGS

The amendment is a helpful clarification of the code. However, in order not to make past efforts useless, it would be helpful if the petition could be followed through in those cases where the petition was filed prior to enactment of H. R. 8381.

Senator Bricker is here for the purpose of presenting to the committee a witness and we will now recognize him.

STATEMENT OF HON. JOHN W. BRICKER, UNITED STATES SENATOR FROM THE STATE OF OHIO

Senator Bricker. Mr. Chairman, I just came over to introduce to the committee a good friend and a representative of one of the Short Line Railroads in Ohio, at Akron and Canton. They have a suggestion to make here as to the amendment to the second section, section 82. The first section they have no opposition.

I just want to commend him to the committee and introduce him to you, Mr. Chairman.

This is Dr. Zeis.

Senator FREAR. Mr. Chairman, may I say to the distinguished senior Senator from Ohio that your Congressman, Congressman William Ayres, who was previously in the room, I am sure would concur in the statements you have made on behalf of Mr. Zeis.

Senator BRICKER. Thank you very much.

It is a small railroad in Ohio, it is a feeder line, but it is ably represented by Mr. Zeis.

The CHAIRMAN. Thank you very much.

Senator BRICKER. Thank you, Mr. Chairman, and members of the committee.

The CHAIRMAN. The next witness is Mr. Barron K. Grier.

STATEMENT OF BARRON K. GRIER, SAFE HARBOR WATER POWER CORP.

The CHAIRMAN. Will you proceed, please, sir.

Mr. GRIER. Mr. Chairman, my name is Barron K. Grier, of 1001 Connecticut Avenue, Washington, D. C. I represent the Safe Harbor Water Power Corp. of Safe Harbor, Pa. We propose an amendment to section 80 of H. R. 8381, entitled, "Income Taxes Paid by Lessee."

That section would eliminate a practice of the Internal Revenue Service relating to lessor-lessee contracts in which the lessee agrees to pay the income taxes of the lessor. The practice which this section would stop requires, in the computation of the lessor's income-tax liability, the use of an algebraic formula or a large number of computations resulting in the complete pyramiding of taxes to the point where less than 1 cent is due. We submit that the amendment ought not to be limited to the lessor-lessee relationship but should be extended to cover the situation of other corporations where one pays money to another and pays the income taxes on it as well.

Safe Harbor generates electrical energy which it sells to other corporations under a rate schedule which requires the purchasing corporations to pay for the energy and to pay the Federal income taxes of Safe Harbor. In 1941 the facts were presented to the Internal Revenue Service with a request for advice as to how Safe Harbor should compute its Federal income tax liability. In reply the Internal Revenue Service issued a ruling, dated December 17, 1941, the pertinent part of which reads as follows:

> It is well established that the payment of a tax by a person other than the taxpayer constitutes income to the taxpayer in whose behalf the tax is paid. In such cases it is the practice of the Bureau to include such payment as additional income to the person on whose behalf the payment is made, but beyond that point the Bureau will not pyramid liability. Accordingly, in the case you submit there should be but one addition to the income of the Safe Harbor Water Power Corp., by reason of the taxes paid on its behalf * * *.

The effect of this ruling may be illustrated by the following example, in which a 50 percent tax rate is assumed for purposes of simplicity:

Paid to Safe Harbor for electrical energy	$100
Paid to Safe Harbor as tax on $100 payment	50
Paid to Safe Harbor as tax on $50 tax	25
Total paid to Safe Harbor	175

In accordance with the ruling Safe Harbor would report income of $150 and pay a 50 percent tax of $75, all of which was paid, of course, by its customer.

The ruling issued to Safe Harbor was in conformity with a well-settled administrative practice which the Internal Revenue Service had been following for many years. The practice was referred to in the Government's brief in *Old Colony Trust Company* v. *Commissioners* (279 U. S. 716), decided by the Supreme Court in 1929, as follows:

There is attached hereto as appendix C a letter from the Commissioner of Internal Revenue showing that it has always been the practice of the Treasury Department to compute total income by adding to the amount actually received by the taxpayer, the amount of any tax which another has paid for his benefit under an agreement between the parties. It is true that in earlier years there was a lack of uniformity in treatment and that in some cases the amount of additional taxes paid by another was in turn added to the taxpayer's income. Since 1923, however, the practice has been settled and the Treasury Department has added only the original tax paid by another, and abandoned any attempt to treat the additional tax as additional income.

For 30 years the Service consistently followed the practice of requiring a taxpayer to include in his income only the original tax paid by another. In 1952, however, the Service changed the rule. In March of that year it issued Mimeograph 6779 (1952-1 C. B. 8) which said, in effect, that where a lessee agreed to pay the income taxes of a lessor, all such tax payments must be included in the lessor's income. It was brought to the attention of the Internal Revenue Service that Mimeograph 6779 applied only to lessor-lessee situations and left the old rule in effect in situations like that of Safe Harbor where a lessor-lessee relationship does not exist. Accordingly, in October 1952, the Service amended Mimeograph 6779 to make it applicable to all situations where one party paid the income tax of another (Mimeograph 51, 1952-2 C. B. 65).

The result of these mimeographs was to require the complete pyramiding of tax liability to a point where less than 1 cent was due. The following illustrates the effect of the change on the example used above:

Payment	$100
Tax on payment	50
Tax on 1st tax	25
Tax on 2d tax	12.50
Tax on 3d tax	6.25
Tax on 4th tax	3.125
Tax on 5th tax	1.5625
Tax on 6th tax	.7813
Tax on 7th tax	.3906
Tax on 8th tax	.1953
Tax on 9th tax	.0977
Tax on 10th tax	.0489
Tax on 11th tax	.0245
Tax on 12th tax	.0122
Total	199.9880

In accordance with the changed rule Safe Harbor would report income of $100.99 and pay a 50 percent tax on that amount.

The purpose of section 80 of H. R. 8381 is to restore the old, 30-year rule to the years 1952 and 1953. However, as presently worded section 80 would restore the old rule only with respect to lessor-lessee situations, leaving the changed rule, requiring complete pyramiding, applicable to other contractual arrangements which, for this purpose, are the same as lessor-lessee contracts.

The pre-1952 administrative practice was applied to Safe Harbor and its customers as well as to lessors and lessees. The change made in 1952 was applied to Safe Harbor as well as to lessors and lessees. Since section 80 provides for reinstating the pre-1952 rule for lessors and lessees we submit that it should be broadened to cover situations like that of Safe Harbor.

You will observe, Mr. Chairman, that section 80 of H. R. 8381 would reinstate the old rule only to the years 1952 and 1953. The reason for this is because section 110 of the 1954 Code provides a third method for handling income taxes paid by a lessee corporation on behalf of a lesser corporation.

Under the 1954 Code the lessor is required to include in income only the amount of the rental payment, and only this amount is allowed as a deduction to the lessee. The lessee is not allowed to deduct any income taxes paid on behalf of the lessor. Safe Harbor's arrangement meets all of the tests prescribed by section 110 of the 1954 Code except that its relation with its customers is not that of lessor-lessee.

I cannot understand why a distinction should be made, either in the 1954 Code or in section 80 of H. R. 8381, for the sole reason that a legal relationship of lessor-lessee does not exist.

Therefore, it would be consistent with the suggested change in section 80 of H. R. 8381 to also amend section 110 of the 1954 Code so as to make it cover other contractual arrangements, which are not materially different from lessor-lessee contracts.

Mr. Chairman, I have attached to my statement a proposed amendment to section 80 of H. R. 8381 which I would like to have inserted in the record, if I may.

The CHAIRMAN. Without objection, it will be inserted in the record.

(The proposed amendment referred to is as follows:)

PROPOSED AMENDMENT TO SECTION 80, H. R. 8381

At the end of section 80 (a) of H. R. 8381 insert the following:

"For purposes of this subsection the term 'lease' shall include an arrangement whereby one or more corporations are required to pay or to reimburse another corporation for the tax imposed by this chapter with respect to income derived by such other corporation under such arrangement, the terms 'lessee' and 'lessor' shall include the corporations which are parties to such arrangement, and the term 'rentals' shall include payments made under such an arrangement."

Senator BENNETT. I would like to ask a question.

I notice in the proposed amendment you refer only to the relationship between corporations. If the situation should involve on one side or the other a partnership or an individual, should that be covered also?

Mr. GRIER. It would not be as section 80 is presently drafted, nor are they covered under section 110 of the 1954 Code. Both of those apply only to corporations, sir. Our proposed amendment would not change the situation either under section 80 of H. R. 8381 or under section 110 of the 1954 Code.

Senator BENNETT. I see. Thank you.

The CHAIRMAN. Thank you very much, Mr. Grier.

The next witness is Mr. Samuel H. Hellenbrand, of the Association of American Railroads.

STATEMENT OF SAMUEL H. HELLENBRAND, ASSOCIATION OF AMERICAN RAILROADS

The CHAIRMAN. Will you proceed, Mr. Hellenbrand.

Mr. HELLENBRAND. Mr. Chairman and gentlemen, I represent here today the Association of American Railroads, and I am here to testify in favor of section 81 of H. R. 8381 in its present form.

I expect to be very brief, and we respectfully request permission to file a full statement, which I think has been distributed to you.

(The complete statement of Mr. Hillenbrand is as follows:)

STATEMENT OF SAMUEL H. HELLENBRAND, REPRESENTING ASSOCIATION OF AMERICAN RAILROADS

Mr. Chairman and gentlemen, my name is Samuel H. Hellenbrand. I represent the Association of American Railroads, a voluntary association of railroads, including in its membership railroads operating approximately 95 percent of the mileage of all railroads in the United States and having operating revenues which are approximately 95 percent of the total operating revenues. I am here to testify in favor of section 81 of H. R. 8381. The language of this section is the result of many months of drafting work between the Treasury Department, the staff of the Joint Committee on Internal Revenue Taxation, and a committee of this association.

GENERAL STATEMENT

Section 81 of H. R. 8381 is intended to provide an equitable settlement of a problem which has existed for a number of years, and has presented difficulties in tax administration. The controversy is as to the basis on which depreciation should be computed. Section 81 is designed to settle the problem which has arisen in the situation in the case of taxpayers who, during the period between January 1, 1941, and December 31, 1955, changed from the "retirement" to the "straight line" method of accounting for depreciation. They will be allowed substantially the same amount of deductions in the aggregate which would be allowed to taxpayers who had at all times used the "straight line" method. Section 81 contains certain important safeguards to the Government, provides uniform treatment to all taxpayers affected and, by restricting refunds for past years, affords protection to the revenue.

BACKGROUND

For a great many years, in accordance with the accounting regulations issued by the Interstate Commerce Commission, nearly all railroads employed the so-called "retirement" method of accounting for depreciation on certain roadway property. The same method was followed for tax purposes and was accepted by the Commissioner of Internal Revenue and the courts as a proper method of determining the annual depreciation allowance under the Internal Revenue laws. (See *Chicago & Northwestern Railroad Co., et al.* v. *Commissioner* (C. C. A. 7, 1940), 114 F. 2d 882; *St. Paul Union Depot Co.* v. *Commissioner* (C. C. A. 8, 1941), 123 F. 2d 235.) Under this system of accounting the cost of certain assets is charged against income at the time such assets are retired from service. The taxpayer's annual allowance for depreciation is made up of the aggregate cost of all items retired in the particular year together with the cost of certain repairs and minor replacements which, under the "retirement" method of accounting, are charged directly to expenses and never reflected in the capital account. The courts have held that the deductions taken each year for assets retired together with the items charged to expense currently (but which would be capitalized under the "straight line" method), are a reasonable measure of the annual depreciation allowance on all property subject to retirement accounting (*Commissioner* v. *Union Pacific Railroad Co.* (C. A. 2, 1951), 188 F. 2d 950; *Boston & Maine Railroad* v. *Commissioner* (C. A. 1, 1953), 206 F. 2d 617). The "retirement" method taxpayer maintains no "reserve for depreciation" account, as such, but credits the cost of the assets retired directly against the capital account.

A taxpayer using the "retirement" method was not permitted to claim "straight line" depreciation on the same kinds and classes of property. (See *Chicago & Northwestern Railroad Co., et al.* v. *Commissioner, supra; St. Paul Union Depot Co.* v. *Commissioner, supra; Central Railroad Company of New Jersey*, 35 B. T. A. 501; and the *Cincinnati Union Terminal Company*, 44 B. T. A. 905.)

In the early 1930's, the Internal Revenue Service took the position that the amount of the deduction to which a "retirement" method taxpayer was entitled, was to be reduced by depreciation sustained prior to March 1, 1913. Recently the courts of appeal for both the first and second circuits have held that adjustment for depreciation sustained prior to March 1, 1913, is not proper under the retirement system (*Boston & Maine Railroad Co.* v. *Commissioner, supra; Commissioner* v. *Union Pacific Railroad Co., supra*).

RAILROADS REQUIRED TO CHANGE THEIR ACCOUNTING METHOD

In 1942 the Interstate Commerce Commission, with respect to most roadway property, ordered class I railroads to change, not later than January 1, 1943, from "retirement" to the "straight line" method of accounting for depreciation. For a number of compelling reasons, the railroads applied to the Commissioner of Internal Revenue for permission to make the same change for tax purposes.

The change ordered by the Interstate Commerce Commission occurred in a war period, when property was required for wartime transportation needs and when it was not in the national interest to permit retirement of any part of this property. Failure to change to the "straight line" method for tax purposes would have resulted in a substantial distortion of income, not only during the war period but also in the postwar period when the necessary retirements were made. Furthermore, to have maintained 2 sets of accounting systems, 1 for tax purposes and 1 for Interstate Commerce Commission purposes, would have necessitated the use of an increased staff of highly skilled personnel at a time when they were needed for more productive work in connection with the war effort.

The Commissioner, relying on what he then understood to be the nature of the "retirement" method of accounting, granted permission to change to the "straight line" method, but prescribed certain conditions. One of these was that there be established a reserve of 30 percent of the cost of the assets involved in the change of accounting methods, and that the remaining sum to be recovered by way of depreciation be limited to the cost or other basis of the property reduced by the amount of such reserve. The railroads objected to this reserve on the ground that it was not proper under the law since proper adjustments had already been made and no part of such 30-percent reserve had theretofore been either "allowed" or "allowable" as a deduction for Federal tax purposes. The Commissioner persisted in his position, and required the railroads to agree to a 30-percent reserve (along with certain other terms and conditions) before he would grant them permission to change to the "straight line" depreciation method. Faced with the necessity of obtaining the Commissioner's approval of the change, and since it appeared that due to the circumstances set forth above a change was imperative for practical reasons, the railroads generally had no choice but to accept the Commissioner's terms and conditions.

DEVELOPMENTS IN THE COURTS

Subsequent litigation has contributed much to an understanding of the "retirement" method of accounting as it relates to Federal income taxes. In the Boston and Maine and Union Pacific cases, the courts set aside the Commissioner's attempt to require an adjustment to a retirement deduction for depreciation sustained prior to March 1, 1913. In *Kansas City Public Service Co.* v. *U. S.* (D. C. W. D. Missouri, 1951) (100 F. Supp. 105) and in *The Akron, Canton & Youngstown Railroad Co.* (1954) (22 T. C. 648) (appeal (C. A. 6) dismissed by stip. 1956) a Federal district court and the Tax Court of the United States, respectively, have now held that as a matter of substantive tax law a change from "retirement" to "straight line" depreciation does not warrant establishment of the equivalent of the 30-percent reserve. The Tax Court pointed out in the Akron case (p. 657) that establishment of such a reserve "would, in effect, duplicate what already was done by its predecessors under the retirement method * * * the effect of the adjustment would be to require a double adjustment." Cases are still pending in the courts and before the Internal Revenue Service, and the railroads generally stand by ready to file refund claims, upon the same grounds. Other cases are still pending in the courts and before the Internal Revenue Service.

INVALID CONDITIONS

While the Commissioner of Internal Revenue may have authority to prescribe conditions to a change in accounting methods, he may not prescribe unlawful conditions. (See *Union Pacific R. Co.* v. *Public Service Com'n.*, 248 U. S. 67, 70; *U. S.* v. *Bethlehem Steel Corp.*, 315 U. S. 289, *Manhattan General Equipment Co.* v. *Commissioner*, 297 U. S. 129; *Arkansas-Oklahoma Gas Co.* v. *Commissioner*, 201 F. 2d 98; *United States* v. *Chicago, etc., R. Co.*, 282 U. S. 311.)

The 30-percent reserve has been held to be unlawful as a matter of substantive tax law (*Kansas City Public Service Co.* v. *U. S. supra; The Akron, Canton & Youngstown Railroad Co., supra*). It must follow that the 30-percent reserve condition is void. (See also H. Rept. 1337, 83d Cong., 2d sess., pp. 50, A164; S. Rept. 1622, 83d Cong., 2d sess., p. 307.)

PROPOSED SOLUTION

Section 81 provides for settlement of the problem. It will eliminate a dispute already many years old which, if not otherwise disposed of, is certain to continue on for many more years, with all of the attendant costs and expenses both to the Government and the taxpayers.

TO WHOM SECTION 81 APPLIES

Section 81 applies only to taxpayers who changed from "retirement" to "straight line" depreciation during the period January 1, 1941, and January 1, 1956, under the so-called terms letter. Section 81 does not apply to a taxpayer who is still on retirement accounting.

EFFECT OF SECTION 81

The effect of section 81 will be to allow to a taxpayer (to whom this section applies) who changed from "retirement" to "straight line" depreciation substantially the same amount of deductions in the aggregate for depreciation (except for the special obsolescence matter discussed later), as would be allowed to a taxpayer who had at all times used "straight line" depreciation.

TO WHAT ASSETS DOES THIS SECTION APPLY

Section 81 applies only to those roadway assets which were on hand at the time the railroads changed to straightline depreciation which is most cases was in 1943. Section 81 has no application to any assets acquired after that time.

THEORY ON WHICH SECTION 81 IS BASED

The theory of section 81 is that the railroads affected will settle the dispute by obtaining substantially the same amount of deductions in the aggregate for depreciation as would be allowed to a taxpayer who had always followed the straight-line method.

In applying this theory, it is necessary to consider separately the problem of depreciation sustained prior to March 1, 1913, and of depreciation between February 28, 1913, and the date of the change to the straight-line method. Each of these problems has been met in section 81.

PROBLEM OF DEPRECIATION PRIOR TO MARCH 1, 1913

Under the applicable provisions of the 1954 and 1939 codes, the cost of the property of taxpayers using the straight-line method must be reduced for depreciation sustained prior to March 1, 1913. The courts have held that this may not be done in the case of taxpayers using the retirement method. However, it is provided in section 81 that a reserve be established for such depreciation.

PROBLEM OF DEPRECIATION SUBSEQUENT TO FEBRUARY 28, 1913

The second question is whether any reserve should be set up for depreciation between February 28, 1913, and the time of the change to straight-line depreciation, which in most cases was in 1943. Applying the theory of the proposed settlement that the taxpayer who had originally followed the retirement method and changed to straight-line depreciation is entitled to recover substantially the same amount of depreciation as the taxpayer who had always followed straight-line depreciation, no such reserve is proper. To establish a reserve would work an unwarranted double adjustment for the same item. Therefore under section 81 no provision is made for such a reserve.

SPECIAL OBSOLESCENCE PROBLEM

Section 81 provides that in computing the amount of the deductions due to sale, casualty, or abnormal retirement during the period January 1, 1941, and December 31, 1955, taxpayers electing to come under this section will reduce the losses otherwise allowable by the full 30 percent reserve. Moreover, the 30 percent reserve allocated to such special obsolescence deductions will be lost to the railroads forever. This is an important concession to the Government made by the affected railroads since it will prevent refunds for such items for past years.

PROSPECTIVE EFFECT OF SECTION 1 OF SECTION 81

Section 81 provide for the elimination of the 30-percent reserve, effective only for years beginning after December 31, 1955, except for that portion of the 30-percent reserve applicable to assets disposed by sale, casualty, or abnormal retirement between the date of the change and December 31, 1955.

In determining basis for taxable years between the date of the change and December 31, 1955, the 30-percent reserve will, in effect, be "frozen in" as an adjustment to basis for depreciation and for gain or loss. Taxpayers electing to come within the provisions of section 81 will forego the right to file claims or suits for refund for any of those years with respect to the validity of the 30-percent reserve as an adjustment to basis for depreciation and gain or loss purposes. This feature of the bill would afford substantial protection to the revenue, since in many instances taxable years of railroads are "open" for the filing of claims or suits for refund as far back as 1942. This period covers a span of years involving not only income taxes but also excess-profit taxes imposed during World War II and the Korean conflict. Any refund would also require the payment of interest, in some cases in excess of 84 percent.

In addition to the income-tax provision just described, the bill provides that in the case of taxpayers subject to the provisions of chapter 1D or 2E of the Internal Revenue Code of 1939 (relating to excess-profits taxes) no reduction in accumulated earnings and profits shall be made with respect to the 30-percent reserve, but in lieu thereof the specified adjustment shall be made for depreciation sustained prior to March 1, 1913.

CONCLUSION

The railroads affected believe that under the court decisions they are entitled to a deduction through depreciation for the entire cost of their property. Nevertheless, the railroads affected are willing to make the concessions provided for in section 81 in order to terminate a dispute which is already 15 years old. The enactment of this section will permit the closing of the audit of tax returns from 1942 to date.

The following estimates which we have made illustrate the settlement which the railroads offer in the proposed bill:

Comparison of deductions and taxes under court decisions and under the proposed bill

Adjustment of taxes for prior years	Under court decisions	Under section 81
Income-tax refunds, years 1943-55	$197,000,000	0
Interest on tax refunds	76,000,000	0
Total income-tax refunds and interest for prior years	273,000,000	0
Reduction in income taxes, years after 1955:		
Tax reductions in each year 1956-95	[1] 10,000,000	[1] $8,710,000

[1] Per year.

NOTE.—The assumed tax rate is 52 percent. It is recognized that in some prior years the normal and surtax rate was lower, but the excess profits rates would have been applicable in some years so that the rates in those years would have been much in excess of 52 percent.

It can be seen from the foregoing that under section 81 as to the taxpayers electing to come under this section, there will be no income-tax refunds for prior years, whereas under the Court decisions there could be refunds of income tax and interest in excess of $270 million. In addition, the deductions over the next 40 years would be less under section 81 than the deductions would be under the Court decisions.

SECTION 80 OF H. R. 8381

I am also here in support of section 80 of H. R. 8381. This section relates to a complicated problem involving the computation of income taxes in a situation where a lessee has undertaken the obligation to pay the lessor company's income taxes.

Prior to 1952 the Internal Revenue Service followed a method which was consistent with the representations made by the Government to the Supreme Court of the United States and which, as the Court of Claims recently stated, "* * * the Court published that representation to all who were interested" (*Connecticut Railway and Lighting Co. v. United States*, 142 F. Supp. 907, 909 (Ct. Cl. 1956)).

Despite the representation made to the Supreme Court (see *Old Colony Trust Company* v. *Comm'r*, (279 U. S. 716, 730–731 (1928)) the Internal Revenue Service, effective with taxable year 1952, changed its prior practice and began to pyramid the taxes.

This situation was rectified by section 110 of Internal Revenue Code of 1954. This still left the situation with 3 different methods of computing taxes in a 4-year period. Since the 1954 code recognizes the inequity of pyramiding in the circumstances involved in the lessee-lessor situation, railroad witnesses suggested two possible solutions to the problem. One method was to permit the taxpayers affected to elect to apply the rules applicable under section 110 to the tax years 1952 and 1953. The other suggestion was to follow the pre-1952 rules for the computation of taxes for the taxable years 1952 and 1953.

By the adoption of section 80 of the Ways and Means Committee and the House of Representatives have recommended the second suggestion.

We strongly urge the adoption of section 80 of H. R. 8381.

Mr. HELLENBRAND. Section 81 provides a solution to a problem which has existed for a number of years relating to allowances for deductions for depreciation for those railroads which changed from the retirement to the straight line method of computing depreciation on certain fixed assets.

In subsequent litigation the courts have held that a change from retirement to straight line depreciation does not warrant establishment of a 30-percent reserve.

Other cases are still pending in the courts and before the Internal Revenue Service. The Treasury Department and the railroads have now reached agreement as to the applicable principles involved. Those principles are embodied in section 81.

Mr. Smith, Deputy to the Secretary of the Treasury, has already appeared before your committee and recommended enactment of section 81.

The railroads also strongly favor section 81 as a proper solution to the problem, and strongly urge its enactment.

Section 81 applies only to taxpayers who changed from the retirement to straight line depreciation during the period from January 1, 1941, and January 1, 1956. The section does not apply to a taxpayer who is still on retirement accounting.

I am also here in support of section 80. This section relates to a problem involving the computation of income taxes in a situation where a lessee has undertaken the obligation to pay a lessor's income taxes.

For taxable years prior to 1952, the Internal Revenue Service did not pyramid the taxes. However, for 1952 and 1953 a pyramiding of the taxes was required in such cases.

The 1954 code provided a new and third rule. Thus there are presently three different methods of computing taxes in a 4-year period.

Since the 1954 code recognizes the inequity of pyramiding in the circumstances involved in the lessee-lessor situation, railroad witnesses suggested two possible solutions to the problem. One method was to permit the taxpayers to elect to apply the rules applicable under section 110 to the years 1952 and 1953.

The other solution was to follow the pre-1952 rules for the computation of taxes for those years.

In section 80 the Ways and Means Committee and the House of Representatives have adopted the second suggestion.

We believe that this is a proper solution to the problem, and strongly urge the adoption of section 80.

The CHAIRMAN. Thank you very much.

Senator Douglas.

Senator DOUGLAS. Mr. Hellenbrand, did you represent the Association of American Railroads in the negotiation of the agreement which resulted in section 81?

Mr. HELLENBRAND. I participated as a representative of the committee.

Senator DOUGLAS. Was there any evidence on this submitted to the House Ways and Means Committee?

Mr. HELLENBRAND. A subcommittee of the House Ways and Means Committee held a hearing for, I believe, a full morning, at which I testified.

Senator DOUGLAS. Was it included in the original bill submitted by the House Ways and Means Committee to the floor?

Mr. HELLENBRAND. It was not.

Senator DOUGLAS. It was added as a floor amendment, by Congressman Mills.

Mr. HELLENBRAND. Yes, sir.

Senator DOUGLAS. Does this represent an agreement between the Treasury and the Association of American Railroads?

Mr. HELLENBRAND. Well, it represents the result of the efforts of the representatives of the Treasury Department and the committee representing the association.

Senator DOUGLAS. How many cases are in litigation now, Mr. Hellenbrand, on this point?

Mr. HELLENBRAND. I know of two at least. And the Treasury Department, as I understand it, and the Department of Justice, have deferred moving the trials on these cases pending resolution of this question by legislation, so that the cases have not progressed further for that reason.

Senator DOUGLAS. How much do you think is involved?

Mr. HELLENBRAND. Senator Douglas, I think in the statement before you I have a table in the back, on page 11, which shows the effect of the situation as it now is, and as it would be under the court decisions as we interpret them.

And you will notice, sir, that the effect of the bill is to deny refunds entirely for the prior years. And the further effect of the bill is to reduce the amount of allowable deductions which would be available to us under the statute, as compared, to what they would be if the court decisions were applied.

I might add——

Senator DOUGLAS. I do not think your answer was very responsive to my question. What I am trying to get at is, What is the estimated total amount that either was in litigation or would be in litigation if section 81 were not passed?

Mr. HELLENBRAND. Well, I have those figures before me. We estimate that the total reserves amounted to about $1.2 billion. The pre-1913 depreciation which the railroads would be giving up under this section, which they have been successful in winning in courts, amounts to $400 million, leaving a total of $800 million which would be recovered.

The railroads——

Senator DOUGLAS. By the railroads?

Mr. HELLENBRAND. Yes, sir.

Senator DOUGLAS. Are the taxes already paid?

Mr. HELLENBRAND. I am talking about the gross figures. The taxes already paid would amount to $273 million.

Now, the railroads under this section would be required to give up still one other item which amounts to $100 million. And so that what started out as a reserve—I am talking about deductions, not taxes now, sir—so that what started out as deductions of $1.2 billion under this bill would be reduced to $700 million in deductions spread out over approximately 40 years, all prospectively, as compared to an actual refund in interest as we calculate it of $273 million for past years alone.

Senator DOUGLAS. Who kept the $273 million?

Mr. HELLENBRAND. Various railroads around the country.

Senator DOUGLAS. In other words, the railroads kept a cash refund of $273 million?

Mr. HELLENBRAND. Not under this bill; this bill prevents that from happening.

Senator DOUGLAS. You say that the Government recoups that amount.

Well, what do the railroads get out of it?

Mr. HELLENBRAND. Well, the railroads receive deductions of about eight and three quarters of a million dollars a year in the future only.

Senator DOUGLAS. Roughly $9 million a year. For how many years?

Mr. HELLENBRAND. About 40 years.

Senator DOUGLAS. $350 million?

Mr. HELLENBRAND. That is correct.

You see, what started out—and under the court decisions, as we see it, we would be entitled at a 50 percent rate, let us say, to $600 million in taxes to recover in the past and in the future, which has now been cut to about $350 million under this statute.

But we have been struggling with this problem since 1943. I do not want to seem humorous, but we have, as far as I know, only one accountant left who struggled with it in the company that I am connected with, and he is in the hospital with a heart attack.

And I am a comparatively young man, I hope, but I am the senior man who is familiar with this problem. And we have been struggling with it now for 15 years, and we hope at some point this problem could be resolved.

Senator DOUGLAS. Where did you get your figure of $1.2 billion?

Mr. HELLENBRAND. That was a survey which we made of the industry trying to find out how much the reserves were that were prescribed by the Treasury Department.

The Treasury Department, as we understand it, who have the letters which they sent out, made a similar survey from their own records, and I think this conforms to their figures.

So that we, working on our side, without access to the Treasury papers, arrived at this total by adding up each individual road's figures that were available to us, and the Treasury Department, which had the information available internally, made a similar computation and arrived at the same result.

Senator DOUGLAS. Then both sides agree that a reserve of $1,200 million should have been set up?

Mr. HELLENBRAND. No, no, both sides agree that that was what was set up.

Now, both sides agree that what would be given—what the proper reserves should be—should in effect be some $500 instead of the $700 million.

Let me put it another way. The Treasury required us to give them $1.2 billion in reserves.

Senator DOUGLAS. Has that reserve been accumulated?

Mr. HELLENBRAND. This is only bookkeeping, and this is simply a prohibition against the railroads taking deductions in that amount for the cost of assets which they have purchased.

In effect, the railroad purchased, let us say, a freight station, and spent $100 to put it up. The Treasury Department says to us, that although everybody in America can deduct $100 as cost, you are permitted to deduct only $70 for that cost.

It has now developed, in the light of the decisions that the courts have made, that the requirements for the railroads to give up this $30 was a double adjustment for the same item which was not apparent to the people involved at the time that it was required.

And so we are now adjusting the situation to meet the rules as the courts have explained them to us, and are setting up a reserve only equal to that which would be required if we had been on straight-line depreciation right from the beginning of time.

Senator DOUGLAS. Let's see if I understand the situation. In effect an out-of-court settlement has been made between the Treasury and the railroads which the Congress is now asked to legitimatize by enacting into law?

Mr. HELLENBRAND. I think that is substantially what the chairman of the Ways and Means Committee said when he presented the bill in the House.

I should add, however, Senator, that this agreement, as it has been characterized here, we are fully satisfied is entirely consistent and applying the principles that have been laid down by the courts in this very complex system of group accounting and the refund problem that is involved.

As a matter of fact, the railroads have given up, in one area particularly, an item to the Treasury amounting to $100 million of deductions in this process which we think is perhaps beyond that which the courts have done, and we feel quite sure of that.

But in order to expedite the disposition of this problem, which is already old, we have been willing to do this.

Senator KERR. Will the Senator yield?

Senator DOUGLAS. Yes.

Senator KERR. Is it correct to say, not that the Treasury and the railroads have made an agreement as to what the law ought to be, but that they have arrived at the conclusion jointly that this would be the method of complying with the law as declared by the courts?

Mr. HELLENBRAND. Yes, sir.

Senator DOUGLAS. I think this issue should be raised before the committee, Mr. Chairman, rather than addressed to the witness. I think there is a very real question here whether this is a settlement that should be put into statute law or a settlement which could be arrived at between the attorneys for the Government and the railways directly without constitutional sanction.

And if it is desired to put it into law, then I think we ought to ask the attorneys for the Internal Revenue—who are the Government attorneys in this case.

Mr. HELLENBRAND. The Treasury Department and the Internal Revenue Service.

Senator DOUGLAS. I think we ought to ask the attorneys for the Government to come down here and give an account of this, and find out how much we got, how much the taxpayers got, how much the railways got, and what the prospects would have been of recovery if suit had been carried on, and so forth.

Part of this can be in public session, and part can be in executive session, but I think we ought to hear from these attorneys on this matter, because it is obviously one that involves huge sums of money, and upon which I think the House record is very incomplete. There is an added statement on the floor by the chairman of the Ways and Means Committee, who is a fine gentleman, which I am sure did not receive attention by the House. It appears to be one of those committee amendments put through at the last minute without real discussion and debate, and was accepted on faith.

And so, Mr. Chairman, I am going to ask that appropriate attorneys of the Government be invited to appear and submit a very careful statement on this subject.

The CHAIRMAN. I think the Senator is absolutely correct about that. The matter was brought up before the Joint Committee on Internal Revenue Taxation, and the Commissioner of Internal Revenue made a very strong statement about it, but I think other members of the committee should have the same opportunity that the Joint Commitee has had.

We will arrange for that hearing before the committee.

Senator DOUGLAS. Thank you very much.

The CHAIRMAN. Thank you very much, Mr. Hellenbrand.

The next witness is Dr. Paul M. Zeis, of the Akron, Canton & Youngstown Railroad Co.

STATEMENT OF PAUL M. ZEIS, THE AKRON, CANTON & YOUNGSTOWN RAILROAD CO.

The CHAIRMAN. Doctor, you may proceed.

Dr. ZEIS. Mr. Chairman, before I come to my prepared statement—and I may skip parts of it—I would like to ask that it may be included in the record.

The CHAIRMAN. Without objection it may be included.

(The prepared statement of Dr. Zeis is as follows:)

STATEMENT OF PAUL M. ZEIS, FINANCIAL VICE PRESIDENT OF THE AKRON, CANTON & YOUNGSTOWN RAILROAD CO., CONCERNING SECTION 81 AND SECTION 82 OF H. R. 8381

My name is Paul M. Zeis and I am financial vice president of the Akron, Canton & Youngstown Railroad Co., located at 12 East Exchange Street, Akron, Ohio.

The Akron, Canton & Youngstown Railroad is a small class I railroad operating across the State of Ohio between Akron and Delphos, a distance of approximately 175 miles. Our gross revenues in 1957 were $8,472,000 and our net income was $362,000. Thus, in comparison with other railroads interested in this legislation, we are quite small. It is our belief, however, that while the proposed legislation will benefit most railroads, it will work a serious injustice upon us, and accordingly we strongly oppose section 82 of the bill in its present form.

Sections 81 and 82 of H. R. 8381 are designed to handle the tax problems which arose as a result of the change in accounting methods from retirement to depreciation accounting made by most of the class I railroads back in 1943. These changes were ordered by the Interstate Commerce Commission but the order of the Commission did not, of course, in itself affect the tax position of the railroads. Before changing their methods of accounting for tax purposes the railroads were required to obtain the approval of the Internal Revenue Service. Most railroads obtained this approval after entering into agreements—so-called terms letters—which in effect provided for a writedown in their roadway assets by some 30 percent as a condition of the change from retirement to depreciation accounting. The predecessor corporations to the Akron, Canton & Youngstown Railroad Co. did not change their method of accounting but in accordance with the law continued for tax purposes to use the retirement method.

These predecessor corporations were consolidated to form a new taxpayer, the present Akron, Canton & Youngstown Railroad Co., which came into existence on February 1, 1944. This new company elected to use straight-line depreciation accounting in its first tax return. The agreement of the Treasury Department was not required because a new taxpayer is entitled to elect whatever established method of accounting it desires. The tax returns of our company were challenged by the Revenue Service which insisted that we write down our assets by some 30 percent, as provided in the terms letter agreements, although no agreement was executed by our company and none was necessary. We refused to make an arbitrary writedown of our assets and the matter was fully litigated in the Tax Court which held in our favor on every point, including the adjustment for pre-1913 depreciation. The Government appealed this decision to the Sixth Circuit Court but this appeal was dissolved by a stipulation after our company agreed to forego $388 of tax refunds, an amount which in the words of Government counsel "was less than the cost of printing a brief in the case." This stipulation was made without prejudice to the principles of law established by the Tax Court decision. I mention this brief past history since it appears to us that section 82 of the present bill has as its primary purpose the reversal, at least so far as the future is concerned, of one of the principles for which we contended and which the Tax Court endorsed.

Both section 81 and section 82 apply to the railroad depreciation problem but the application is completely different. Section 81 deals with the so-called terms letter railroads. This section is presented as an agreed measure between the major railroads and the Treasury Department. We have no objection to section 81 as such. We should like to point out, however, that section 81 simply involves legislative confirmation or approval of an administrative settlement that has been worked out between the major railroads and the Treasury Department. In other words, what is being asked is congressional sanction for an administrative compromise or modification of the terms letter agreements which could be affected without legislation by closing agreement or otherwise.

More to the point, section 81 of the bill is permissive in character and in effect provides that the terms letter roads may elect to avail themselves of its provisions. Since most of the railroads affected by section 81 are supporting it, the permissive character of section 81 obviously provides benefits for these railroads, and should the legislation be passed it can, of course, be anticipated that most, if not all, of the railroads affected will avail themselves of these benefits. In other words, section 81 gives benefits to most railroads. It gives no benefit whatsoever to the Akron, Canton & Youngstown Railroad Co. and others similarly situated.

While section 81 deals with the terms roads, that is those who entered into agreements with the Treasury Department, section 82 deals with reorganization railroads as to whom no such agreements were required and none was proper. The Akron, Canton & Youngstown Railroad Co. is one of the relatively few in this category. In strong contrast with section 81 which is elective, section 82 is mandatory and requires that the basis of the assets of the reorganization roads shall be reduced by depreciation sustained prior to March 1, 1913. In other words, most railroads will be given a choice to avail themselves of this proposed new legislation if they believe that its benefits exceed its burdens; but in our case no such choice is given, and the burden of the bill would be imposed upon us without any compensating benefits. If section 82 were made elective as is section 81, we would of course choose not to elect it and we would be happy to withdraw our opposition to the bill. Since the Treasury Department has agreed to make section 81 elective we see no good reason why they should not also be willing to make section 82 elective. It certainly appears discriminatory to offer a choice of action to most railroads while you compel action by the few remaining ones. In short, the bill is designed to confer financial benefits upon nearly all of the Nation's railroads who reached past agreements with the Treasury but it is also designed to impose financial penalties upon us and other reorganization roads.

In our case the legislation would require that the basis of all our roadway assets now in existence should be reduced by an amount equivalent to depreciation sustained on these assets prior to March 1, 1913. This is precisely what the Revenue Service tried to make us do in the years from 1944 on and what we contended was improper. The Tax Court agreed with us and this bill would in effect overturn for the future the decision of the court.

In addition to being penalized unfairly on the assets which are still in existence, we would also be penalized on assets which had been discarded long before the present company came into existence. As we read the bill, pre-1913 assets which our predecessor corporations retired after March 1, 1913, would now be depreciated for depreciation sustained prior to March 1, 1913, and our present basis would be reduced by an amount equivalent to this depreciation. The implication here is that our predecessor corporations in following the retirement method of accounting were somehow gaining unfair advantages despite the fact that they were operating under a method of depreciation almost universally followed, which everyone conceded was proper and despite the fact that all of those tax returns were accepted as final and complete and correct by the Revenue Service. We believe this to be grossly unfair.

As we understand the legislation, section 82 would now penalize us for retirements of our predecessors from 1913 to 1930 even if those retirements produced no tax benefits for our predecessors. It would further penalize us on retirements from 1930 through 1943 when those retirements produced some tax reduction at much lower tax rates than now apply. What is actually involved then is not only an unfair application of a principle which the courts denied but also a retroactive application of higher tax rates to a period when much lower rates prevailed. Any such procedure appears to us to be most inequitable and arbitrary.

Our valuation engineer has been making an extensive study in an effort to appraise the effect of this legislation upon our small company and we are convinced that it will be substantial although we are unable as yet to measure the complete impact. We have gone far enough along the line to convince ourselves that the cost of this bill to our company will probably involve well over $100,000. While this amount is insignificant so far as the Treasury is concerned, for a small company such as ours I assure you it is a significant amount.

As I stated at the outset of my remarks, we are not objecting to section 81 of the bill. Our entire objections are concerned with section 82. With respect to this part of the bill we would first recommend that it be eliminated entirely as unrelated to the subject matter of section 81. As an alternative we suggest that section 82 be made elective as is section 81. If for reasons which we do not perceive it still seems necessary to enact section 82, we urge that a new subjection (c) should be added to section 82 reading as follows:

"(c) EXCEPTION.—The amendments made by subsection (a) shall not apply to any taxpayer which, prior to the effective date of this Act, shall have established by decision of the Tax Court of the United States or of any other court of competent jurisdiction its right to use the straight-line depreciation method of computing the annual depreciation allowance for Federal tax purposes for any year notwithstanding that such taxpayer or its predecessor corporation or corporations in reorganization may have used the retirement method of computing the annual depreciation allowance for Federal tax purposes for some or all prior years."

Section 81 of the bill is not applicable to the Akron, Canton & Youngstown Railroad Co. The effect of the addition which we propose would be to make section 82 not applicable to our railroad or to any other which has established its rights in court. In other words, we would gain no benefits and suffer no penalties from the bill if the proposed amendment is added, and our legal status would continue to rest as it now does upon the decision reached in the Tax Court. Congress has frequently excepted from legislation and preserved intact the effect of the judicial principle of res judicata. This is all the proposed amendment would do.

I wish to thank you for your courtesy in giving us an opportunity to present our views.

Dr. ZEIS. But before proceeding with that prepared statement I would like to come to the previous witness $100 illustration as to a station, because that illustrates our position exactly and shows how we differ from the situation of all of the other railroads who have participated in the agreement on section 81.

The railroads who have participated in the agreement on section 81 agreed to write down that 100 station to $70. They agreed to give away $30 of their depreciated assets and not take depreciation on it.

Senator KERR. That is, give away the benefit that they would derive by depreciating that part of the costs?

Dr. ZEIS. That is right, they agreed to that. Our railroad made no such agreement. We insisted from the beginning, which was in 1944, that we were entitled to the $100 station. Now, the Treasury Department attempted to make us reach the same type of agreement that the other railroads made. They attempted to make us write down our assets by the $30 for tax purposes. We said "No." We went to court. We litigated the matter. And the court held in our favor in every respect, first, that we had a right to choose the depreciation method of accounting; second, that we were entitled to our $100——

Senator KERR. Base.

Dr. ZEIS. That is right, that we were entitled to our $100 base—and that was true both with respect to post-1913 depreciation and pre-1913 depreciation.

Now we come to the nub of the matter. In this agreement which has been reached between the revenue service and most of the railroads of the country, what has happened, if I understand it, is this. They have agreed to give back to the railroads approximately $20 out of that $30 reduction in base. The railroads have agreed that they wouldn't fight about the other $10, which leaves them roughly with $90 out of the $100.

Now, in our case, there were no negotiations between the Treasury Department and ourselves on this matter. Instead of making any such agreement, they have said arbitrarily, "We are going to take away from you the $10. That way you will all have $90, and you will all be on an equal status."

Well, Mr. Chairman, I submit that we weren't on an equal status before, and that when they get through, we are not on an equal status, because in the one case they are giving back something; in our case, they are taking away something.

Now, that basically is our position. And what they are taking away from us is the benefit——

Senator KERR. Is something that you have already won in the courts.

Dr. ZEIS. That is correct.

Now, in essence, that is our position.

Senator KERR. Your position, then, would be that if this becomes effective, it would relate only to those railroads who are in the posture of contesting the $30 item from the start?

Dr. ZEIS. That is correct. As far as we are concerned, we are through, we have contested it, we have won our case, at least we thought we had until this provision——

Senator KERR. You have won your case.

Dr. ZEIS. That is right.

Senator KERR. This would be a law, a piece of legislation to take away from you something which you won in court?

Dr. ZEIS. That is correct. That summarizes our position in a nutshell.

And it would do more than that. It would take away from us not only depreciation on the assets which we still have in existence, but it would also reduce our base by something that our predecessors may have done 25 or 30 years ago.

In other words, as I understand the bill, the basis of our assets now would be reduced by pre-1913 depreciation on retirements which our preceding corporations may have retired back in 1915, or 1920, or 1925. And all those tax years were settled—they filed their taxes, the returns were accepted, it was considered a normal practice, and the courts sustained it in the cases that came up, and we, a new company, we, the child so to speak, are now in a position of being penalized for what they did years ago, and it was legal when they did it.

Senator KERR. What you are asking the committee to do, I assume, is if we leave this section in this statute, that we specify something in there that it will not apply except as to those whose position was in mind when the section was written?

Dr. ZEIS. That is substantially what we are asking, Senator. We are asking one of three things. We are asking either that section 82 not be adopted at all, or as an alternative, that it be made optional.

Now, section 81 is optional. In other words, the railroads may or may not accept the benefits of section 81, so we think it is only fair to make section 82 optional.

And if neither of those alternatives are acceptable to you, then we ask a specific exception to the bill reading as follows:

> Exception: The amendments made by subsection (a) shall not apply to any taxpayer which, prior to the effective date of this act, shall have established by decision of the Tax Court of the United States or of any other court of competent jurisdiction its right to use the straight-line depreciation method of computing the annual depreciation allowance for Federal tax purposes for any year notwithstanding that such taxpayer or its predecessor corporation or corporations in reorganization may have used the retirement method of computing the annual depreciation allowance for Federal tax purposes for some or all prior years.

Now, in effect, that is our position. We feel that this bill is unfair to us. We are not asking for a tax loophole not to be closed; we are just asking not to be penalized. We regard this bill as punitive taxation so far as we are concerned.

Senator BENNETT. Dr. Zeis, are there other railroads in your position?

Dr. ZEIS. I have tried to find that out. There are several other reorganized railroads. I don't know whether there are any other railroads exactly in our position.

In other words, railroads which are on a reorganization basis and which have litigated through the courts. I am not sure that there are any others in that position. So we are almost unique, and there are not more than half a dozen reorganized railroads in the whole group.

Senator KERR. Has your litigation been decided by a court of final jurisdiction?

Dr. ZEIS. Our litigation went to the Tax Court. It was then appealed by the Government to the court of appeals, the appeal was withdrawn and the case was settled by stipulation, without sacrifice of any principle involved.

The case involved the years from 1944 through 1949. The Treasury Department has settled our returns for 1950, 1951, 1952, and 1953. We have not been audited for any years subsequent to 1953.

Senator BENNETT. But they have settled it on the basis of the decision?

Dr. ZEIS. That is right.

Senator FREAR. You think if we pass that they could bring you back into the picture and they could put you on a 90 percent base rather than the 100 percent?

Dr. ZEIS. Not only that they could, but they would. And they could make it mandatory in our case. Other railroads could decide in their particular cases whether they were going to get the extra assets, they could decide in each case whether they would add up to the $90.

Senator FREAR. If the present proposal, let's say, becomes law, you would have taken away from you 10 percent of your depreciable capital assets, and other railroads not in the same position as you will be given the privilege of retaining 20 of their reserve 30 percent?

Dr. ZEIS. They will be getting 20 additional, and we will have 10 taken away from us. That is substantially the situation.

Senator KERR. You would be satisfied if we just eliminated section 82?

Dr. ZEIS. We would be delighted.

Senator DOUGLAS. You say section 81 is elective? You mean by that that the railroad can choose——

Dr. ZEIS. It can choose whether to adopt the provisions of section 81.

Senator DOUGLAS. And if it chooses that, the choice is binding upon the Government?

Dr. ZEIS. That is right, and upon it, too.

The CHAIRMAN. How much would be involved in the case of your railroad?

Dr. ZEIS. In the case of our railroad—we have been trying for 6 months to figure this out. Our records go back to 1895, and they are not very satisfactory records. We think that in our case it would involve somewhere between $100,000 and $200,000.

Now, that is not much money, but for us that is a lot of money, because we are a small railroad. So I would say somewhere between $100,000 and $200,000.

The CHAIRMAN. Thank you very much, Dr. Zeis.

I submit for the record letters from William J. Quinn, president, and Leo T. Crowley, chairman of the board, Chicago, Milwaukee, St. Paul and Pacific Railroad Co.

(The letters referred to follow:)

CHICAGO, MILWAUKEE, ST. PAUL & PACIFIC RAILROAD, CO.,
Chicago, Ill., February 17, 1958.

Hon. EDWARD J. THYE,
United States Senate,
Washington, D. C.

DEAR SENATOR THYE: The recent testimony given before the Interstate and Foreign Commerce Subcommittee on Surface Transportation which, as you know, is headed by Hon. George A. Smathers, makes it entirely clear, I am sure you will agree, that the American railroad industry requires urgent and prompt legislative relief.

I am, of course, aware that there is almost no chance that all of the program suggested by the railroads can or will be adopted at this session of Congress. I am writing to you, however, to request your support of H. R. 8381, which is titled "The Technical Amendments Act of 1958."

Section 81 of that bill would permit the railroads to recover a substantially greater portion of depreciation than is presently possible under the prevailing ruling of the Internal Revenue Service which, briefly speaking, requires a 30-percent depreciation reserve to be deducted from the value of the property.

Section 81, as you undoubtedly know, represents a compromise to a complex and annoying problem which has for some time been in issue between the railroad industry and the Justice and Treasury Departments. The courts have dealt from time to time with the problem piecemeal, but this has not resulted in a solution of the entire matter.

Unfortunately, some public utilities, and especially the Consolidated Edison Company of New York, have felt that the legislative relief embodied in section 81 of H. R. 8381 should extend to the public utility field. The railroad industry, of course, has no objection to such an extension, but the Treasury Department is seemingly unconvinced that the case of the utilities has the equity of that of the railroads.

The bill is now before the Senate Finance Committee and since any efforts that may be made by the utility industry to be included within its terms may result in a Presidential veto because of the Treasury Department's strongly held views, I should like to urge you to do whatever is possible to secure the passage of the bill as presently worded.

I shall not burden you with a detailed recital concerning this measure or its history. It was, however, described at length publicly before the Smathers' subcommittee on January 17, 1958, by Mr. Cedric A. Major, president of the Lehigh Valley Railroad Co., as well as in public testimony last spring before Representative Mills' Ways and Means Subcommittee on Internal Revenue Taxation. Chairman Mills made a statement which appears in the Congressional Record for Tuesday, January 28, 1958, at pages 1051–2. I shall be happy to explain our industry's situation at greater length, however, should you desire.

There is no doubt that section 81 would be extremely beneficial to the Milwaukee Road as well as to the railroad industry generally, and I know that the Treasury and Justice Department are both satisfied of the fairness of this solution to a difficult problem. May I ask your help in securing enactment of the legislation as now phrased, without the addition of amendments which it seems likely will result in its defeat.

Very sincerely yours,

WILLIAM J. QUINN, *President.*

CHICAGO, MILWAUKEE, ST. PAUL & PACIFIC RAILROAD CO.,
Chicago, Ill., February 19, 1958.

Hon. HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

MY DEAR SENATOR: I am very sorry that you have decided not to seek reelection to the Senate. Through our mutual friend, John Townsend, I knew you had it in mind, but had hoped that as the time came for a decision that you would decide to stay.

I can readily understand your thinking and I know the great responsibilities that you have carried for so many years, but it worries me to see men like you leave the Senate with all of the complicated problems we have today. I fear for the future when men like you retire and I am afraid that the Senate is not made up of the same type of citizens that you and I knew when I was in Washington.

I hope that your retirement will give you an opportunity to relax and enjoy yourself and your family for many, many years to come.

I am enclosing a copy of a memorandum on House bill, section 81 of H. R. 8381. If in your wisdom you can support this legislation I know it would be helpful to the railroad industry. As you know, the railroads are having considerable difficulty and this would be of some economic help.

With kindest personal regards.

Sincerely,

LEO T. CROWLEY.

MEMORANDUM

Section 81 of H. R. 8381 which is a part of the Technical Amendments Act of 1958, was passed by the House on January 28, 1958.

HISTORY

In 1942 when the railroad industry applied to the Commissioner of Internal Revenue for approval of a changeover from the retirement method of computing depreciation to the straight-line method of accounting for service losses on railroad property, the Commissioner gave approval provided there was established a reserve of 30 percent of the cost of the assets involved. In other words, except for certain irrelevant accounting factors, an asset could not be depreciated for an amount greater than 70 percent of its cost.

EFFECT

In brief, the proposed bill by section 81 would allow a reserve to be established for depreciation prior to March 1, 1913, and eliminate the 30 percent depreciation reserve referred to above, except that no adjustment will be made for the period from 1942 to the time of enactment of the bill.

The recent well publicized testimony given before the Interstate and Foreign Commerce Subcommittee on Surface Transportation, the head of which is Hon. George A. Smathers, has made abundantly clear that the American railroad industry must have prompt relief in the form of legislation.

There seems to be almost no chance that all of the suggestions made by the railroad industry can be embodied in legislation at this session. Urgent, however, is the above summarized section 81 of bill H. R. 8381.

Section 81 of the bill represents a compromise to a problem which has been in issue between the industry and the Justice and Treasury Departments for some time. Courts from time to time have dealt with the problem but no comprehensive solution has been reached.

The bill, if it is to have any chance of success, must remain in its present form. This is for the reason that the Consolidated Edison Company of New York, supported by various other public utilities, has made strenuous efforts to have the utility industry included in the relief. The railroads do not object, but the Treasury Department is adamant that the relief be granted only to the railroads. For this reason, any change in the bill seems certain to result in a Presidential veto.

The bill was discussed at length before the Smathers' subcommittee on January 17, 1958, by Mr. Cedric A. Major, president of the Lehigh Valley Railroad Co., and Representative Mills made a most enlightening statement concerning it, which appears in the Congressional Record for Tuesday, January 28, 1958, at pages 1051 2.

Not only would the railroad industry generally benefit from the passage of this bill, but the Milwaukee Road would secure considerable tangible relief. The Treasury and Justice Departments are both satisfied that the solution embodied in the bill is a fair one.

The CHAIRMAN. The next witness is Mr. J. Milton Edelstein.

STATEMENT OF J. MILTON EDELSTEIN, ASSOCIATION OF ADVANCED LIFE UNDERWRITERS, ACCOMPANIED BY J. MILTON COOPER, AND LEONARD L. SILVERSTEIN, COUNSEL

Mr. EDENSTEIN. Mr. Chairman and members of the committee, my name is J. Milton Edelstein of Chicago, Ill. I appear before this committee as chairman of the legislative committee of the Association of Advanced Life Underwriters. I am accompanied by our counsel, J. Milton Cooper and Leonard L. Silverstein.

The subject of my testimony involves so-called loan-financed life insurance.

Senator KERR. Now, as I understand it, you are talking about something that is not in the bill?

Mr. EDELSTEIN. Yes, sir.

Senator KERR. All right.

Mr. EDELSTEIN. More accurately, the question at issue involves the right of taxpayers to deduct on loans incurred in connection with life-insurance policies in the same manner as interest deductions are taken for all other purposes under the code.

Senator KERR. Let me stop you right now. Can't you do that right now?

Mr. EDELSTEIN. Under the present law?

Senator KERR. Yes.

Mr. EDELSTEIN. Yes, we can.

Senator KERR. Are you seeking to get it affirmed in this?

Mr. EDELSTEIN. The purpose, as I understand, of the Treasury's proposal, which was brought up in the Ways and Means Committee and was not passed at the Ways and Means Committee level——

Senator KERR. And it was brought up here but it is not in the bill.

Mr. EDELSTEIN. That is correct, sir. We do not want it in the bill, so we are appearing to explain——

Senator KERR. If you can already do it why do you want it in the bill?

Mr. EDELSTEIN. We don't wish it in the bill. The Treasury is requesting, as I understand it, that you amend the bill H. R. 8381.

Senator KERR. So as to prevent you from being able to do what you now do?

Mr. EDELSTEIN. That is correct, sir.

Senator KERR. Your posture here is preserving the status quo insofar as your situation is concerned?

Mr. EDELSTEIN. That is right, sir.

The CHAIRMAN. Mr. Smith of the Treasury Department asked that you be heard so that you would have a chance to express your view.

Mr. EDELSTEIN. Thank you. I have had meetings with Mr. Smith, and I appreciate his sincerity.

The CHAIRMAN. The only reason that you were permitted to do this was because the Treasury had proposed the amendment.

Mr. EDELSTEIN. At this hearing, I understand that.

Senator WILLIAMS. Do you consider that this is a loophole in the law or a tax avoidance possibility?

Mr. EDELSTEIN. We do not consider it so, Senator.

Senator WILLIAMS. Is it so considered in insurance circles?

Mr. EDELSTEIN. I do not believe it is, sir.

Senator WILLIAMS. I have before me the Law Journal, the Insurance Journal of April 1957. Is that a reliable publication?

Mr. EDELSTEIN. I am not familiar with the Insurance Law Journal.

Senator WILLIAMS. I was reading on page 287 of this journal, in which they describe it as a tax-avoidance device, and one which perhaps would be corrected ultimately by the Treasury Department. And I was wondering if they know what they are talking about, and you concur. I will quote from page 237 of this Law Journal. It is the April 1957 issue.

> I have seen a number of proposals of the plan, and have yet to find a case where it was offered on the basis of an analysis of the prospect's needs. Always the plan was submitted as a tax-avoidance device.

And all but 3 of such proposals were for $100,000 or more that they examined. And they said that this would go on, and take the position in the editorial column that it should be corrected.

Mr. EDELSTEIN. Mr. Silverstein, do you have a statement to make.

Mr. SILVERSTEIN. Senator, may I ask, is that Brown's article? At any rate, there has been controversy within the insurance industry——

Senator WILLIAMS. It does not have any name as to who wrote it, it is just in the News and Opinions.

Senator KERR. Is he the editor of the magazine?

Senator WILLIAMS. It just says "News and Opinions," and it discusses the bank-loan plan.

Senator KERR. It is quoting somebody.

Senator WILLIAMS. They don't attribute it.

Senator KERR. You said "I."

Senator WILLIAMS. I assume that the editor was writing it, but he doesn't attribute it to any body special.

Senator KERR. Does the magazine show who the editor is?

Senator WILLIAMS. Yes; I will have that put in here.

Mr. EDELSTEIN. This is one man's opinion.

Senator WILLIAMS. It says the Insurance Law Journal is published by the Commercial Clearing House in Chicago.

Mr. EDELSTEIN. I know the Commercial Clearing House.

Senator WILLIAMS. Are they reliable?

Mr. EDELSTEIN. Yes, sir.

Senator WILLIAMS. Do you think a publication put out by that group would be acceptable and reliable?

Mr. EDELSTEIN. I would say that is an opinion, an editorial comment.

Senator WILLIAMS. It may be an opinion that may be different, but is it an opinion which you recognize as coming from a reliable source?

Mr. EDELSTEIN. It is an opinion shared by Mr. Smith.

Senator WILLIAMS. And it is their opinion, you don't question that, that they consider this as a tax-avoidance device?

Mr. EDELSTEIN. I do not consider it as a tax-avoidance device.

Senator WILLIAMS. I appreciate that, but the point I am making is that in some cases, in some insurance cases, it is so recognized by some insurance companies; is that not right?

Mr. EDELSTEIN. Yes.

Senator KERR. Regarded?

Mr. EDELSTEIN. That is true, but many companies who regarded it so a year ago do not so regard it this year.

Senator WILLIAMS. I understand. And I have talked to some of them, and they say that is due to the fact that they have seen fit to use it. And I have also talked to several others who have said that if Congress doesn't correct it, they are going to use it. And I don't believe it.

Mr. EDELSTEIN. If this statement is on the basis that Congress corrects it, I think that is perhaps a misleading statement. They might use it whether it is corrected or not, because we hope to be able to prove to you that the theory basically is built upon the wrong hypothesis, and if that is so, then perhaps there is no room for correction of anything which is not in default.

Senator WILLIAMS. Well, I should be interested in your statement, and I appreciate that fact, but I am merely trying to set up the fact that not only the Treasury Department, but it is also recognized in many insurance circles as being a tax-avoidance device. I have a pamphlet here which we will identify in the record and put it in, and I would like to read from this pamphlet. It is put out by the Synnestvedt Agency in Jenkintown—I wish they would use a shorter name—but anyway it is an insurance pamphlet:

> It has been proven possible for individuals or corporations to own live insurance under the "direct with insurance loan plan" without any cost whatever if the policy is held for a sufficient length of time. The cash value of the contract increases and ultimately reaches the point where the owner may recover his initial outlay for the first annual premium and also the total net cost of his interest payments after tax credits.

Do you think that it is possible under any circumstances for that to happen?

Mr. EDELSTEIN. It is possible for that to happen.

Senator WILLIAMS. Under the existing law you think that it is possible for an insurance company to arrange a premium for a policy whereby the taxpayer could buy it and ultimately own it without any cost whatever?

Mr. EDELSTEIN. That is true of policies, Senator, that have been issued for years and years, a 10-payment, a 20-payment life contract, all at the reasonably lower ages. By that I mean under age 50, and they will recover 100 percent of the cash value by the terminal point of the policy, indicating, then, that the insurance per se, if you wish to cash it in, would cost you nothing.

Senator WILLIAMS. I am not speaking of it from that angle, and I don't think they were either. They were speaking from the angle that it was possible for a man to purchase it and to own it, and carry it without any cost whatever.

Mr. EDELSTEIN. Without liquidating the contract, sir?

Senator WILLIAMS. No; by carrying the contract.

Mr. EDELSTEIN. Yes; but he must liquidate.

Senator WILLIAMS. Ultimately, yes.

Mr. EDELSTEIN. Whenever you add something to the cost you must—there is no 100 percent tax bracket; therefore, if a man were even in a 90 percent tax bracket, it must cost him 10 cents on the dollar for the interest, over and above the premium charge. The premium must be paid by someone. It is fallacy, sir, if you believe that the premium is never paid. It is either paid by the individual during his life or it is taken from the proceeds at death, but it must be paid.

Senator WILLIAMS. That is true, but this is built up on the basis that the individual would be in an upper tax bracket and that, on the loan plan, the interest would be a deduction from his personal taxation.

Mr. EDELSTEIN. But it still represents a cost, as long as we don't have a 100-percent tax bracket.

Senator WILLIAMS. That is true. But allow me to finish. But by taking that deduction on individual tax return, and converting the money over into the insurance fund where the tax rate is substantially lower, he can build up a credit which, over a period of time, does not cost him anything.

Mr. EDELSTEIN. If he does not convert anything, sir. May I take you through a case. A man purchases a life-insurance policy. Now, he is going to borrow against the cash value of that policy. We will just use that as an example. Until such time as the cash value of that policy equals the sum total of the premiums paid out—and if I might use a 20-payment-life contract to exemplify it—during the 20 years the cash value ultimately equals the 20 payments. He borrows those payments as he goes along. Now, if he were to liquidate the contract at the end of 20 years, and he got the money back, by getting his money back he is merely paying off the loan.

Senator KERR. You mean he gets his note back?

Mr. EDELSTEIN. He merely gets his note back, but in the meantime he has paid money all these years which has increased his cost, and it doesn't matter what tax bracket he is in.

Senator WILLIAMS. Is this not a relatively new procedure for the companies to use?

Mr. EDELSTEIN. No, sir. I am going to take you back before the turn of the century, when the automatic premium-loan provision was part and parcel of every life-insurance policy, and it is conceived on the fact that a man may borrow against a contract as soon as he has a cash value, and shall continue utomatically to borrow against that policy as long as he lives.

Senator WILLIAMS. Most of the insurance magazines and men that I have talked with have told me that there were just a very few companies that have used this plan in the selling of insurance, and that many of them haven't used it as yet.

Mr. EDELSTEIN. Senator Williams, perhaps we are bandying words when we say "companies". I don't believe that any life-insurance company sells this plan. Agents sell this plan. I am an agent, a broker. I have the right to sell with any company that will license me. I can use any contract they issue. The company is not selling it. If I sell it, I do, and I use that company's policies.

Senator KERR. The company writes the policy. This is nothing more than a method of paying. If I have the cash to pay the full premium, and I pay the full premium, I am going to do it because I have no need or desire to invest that money or to purchase capital goods with it.

Senator WILLIAMS. Don't you think it is unfortunate to have something that is being sold and described and recognized both by the seller and the buyer as a tax-avoidance device?

Mr. EDELSTEIN. I think that that is a terminology that has been placed upon it by Dr. Smith. Now, when we say "tax avoidance," after all what was a tax avoidance, back to 1941, when the original section 264 was put in the code? It dealt only with a single premium policy.

Senator KERR. Off the record.

(Off the record.)

Senator WILLIAMS. I want to make it clear that I am not criticizing in any way, shape, or form any insurance policyholder that uses this program, that has used it in the past or will use it in the future; we don't want to criticize them.

Mr. EDELSTEIN. The question of whether there is a loophole, the mere fact that a tax avoidance is taken, there is no argument about that.

Senator WILLIAMS. None whatever.

Mr. EDELSTEIN. Our present system permits us to do so.

Senator WILLIAMS. I appreciate that.

But, at the same time, when something is recognized as a loophole, a method of avoiding taxes, it becomes our responsibility, and I think that of the Treasury Department likewise, to recognize it and correct that particular tax-avoidance procedure.

Mr. EDELSTEIN. I understand, sir.

Senator WILLIAMS. That is what we are considering here. I don't say that the Treasury is right, but I do think it is unfortunate that we have this situation.

I have here a pamphlet of Mr. Benjamin Bricker and Mr. David M. Sloan, a recent pamphlet. It is reprinted in the November 1957 issue of Tax Magazine and published and copyrighted by the Commerce Printing House in Chicago, which I suppose is a reliable organization.

On page 849 of that report they use somewhat similar language here to describe it. They are speaking of this same plan:

> Thus the plan is at best a compromise permitting the maximum retention of the employer's funds for ordinary business purposes without a complete loss of benefits of the tax-free dividends.

And it goes on and refers it all to being a vehicle under the existing tax laws. And, again, I think they are correct in pointing out the possibility—I don't criticize them for that—I don't criticize anybody for using it. But we are merely recognizing that such does exist.

Mr. EDELSTEIN. The Mills bill was taken up in 1956, if I recall correctly, and it had a name on it, the name of the bill—I don't have it handy—it was to correct the unintended benefits, whatever the terminology was, the unintended benefits. That was merely a classification that was placed upon everything that came under that bill. I have never heard that—and I have been in this business, in the financing of life insurance, since 1939—and at no time did I ever hear that it was an unintended benefit before.

Now, anybody who has picked it up since—and everything that you have given us, sir, has been since 1956——

Senator WILLIAMS. That is all right.

Mr. EDELSTEIN (continuing). All follows the lead in the form of words, semantics, as was brought out by the Treasury Department.

Now, if they had brought it up as a separate bill other than the unintended benefits bill, it wouldn't be so classified.

Senator WILLIAMS. I might go back to the original quotation I was reading in the Law Journal.

I find in the early part of this they are referring to a Van Cleave as being of the opinion that they are referring to.

Mr. EDELSTEIN. I know Mr. Van Cleave very well.

Senator WILLIAMS. And I think when they refer to his statement, they are quoting Mr. Van Cleave, although it doesn't say that directly in there.

Mr. EDELSTEIN. I am very familiar with Mr. Van Cleave's opinion.

Senator KERR. Who is Mr. Van Cleave?

Mr. EDELSTEIN. He is a broker the same as I am, from Los Angeles.

Senator WILLIAMS. He is a reputable and responsible broker?

Mr. EDELSTEIN. Yes. I have known him for many years.

But his opinion is his opinion.

Mr. Silverstein, did you want to say anything?

Mr. SILVERSTEIN. If I may, sir.

I think the difficulty, Senator, that is troubling you and troubling many people in this area involves the general principle of tax under the Internal Revenue Code, principally the fact that you can borrow and deduct interest for all purposes, personal as well as business ones.

Senator WILLIAMS. No; I don't think so. And if you read Mr. Smith's testimony before the committee, he made it very clear that he was not trying in any way to interfere with the normal loans against policies by the individuals, and he said it was the intention of the Treasury Department to separate the two. Now, whether they have been able to do it or not, I am not a lawyer—I am not passing on that.

Mr. EDELSTEIN. Senator, I would like to use as an example a man who uses capital or borrows capital for the purpose of purchasing a home versus the purpose of purchasing life insurance or anything else.

Now, it is an established practice that there is nothing wrong with buying a home, borrowing the capital necessary to put it up and securing a mortgage against the home in order to be able to live in it.

Now, if you purchased life insurance and you did the same identical thing, you put up whatever capital you had, and borrow the rest of it against the collateral value of the property, it is no different than if you used the same borrowing capacity to buy the home.

Secondly, if you were to follow the lead of the Treasury, and you were to purchase a life-insurance contract and borrow against it in order to purchase a home, and found yourself unable to pay back the premium borrowed, and continued to borrow thereafter, then you would, in effect, be following a system, or if you took in a life-insurance policy included in the policy an automatic premium loan, and in order to keep from losing that policy the following year borrowed the cash value directly from the company on the automatic premium loan, and consistently followed the same practice though it were never intended in the first place, you would be following a system just as Mr. Smith states.

And yet—and I wish to quote here from Mr. Smith's statement. He says:

> All that is proposed is a denial of the interest deduction to the purchaser of a policy who buys it under a plan to have it carried largely by special loans made for the purpose.

I don't believe, gentlemen, that it is your intent to dictate to a man as to the reason why he borrows money and what he can do with it after he borrows it.

What is the difference whether he buys a home with it or he buys life insurance or he buys a fur coat for his sweetheart, or anything else?

Senator WILLIAMS. You are speaking of loans and notes.

Are there instances where a few companies are selling this to the policyholders with the understanding that they don't even have to sign the notes?

Mr. EDELSTEIN. Not to my knowledge. If they are, I have never seen one.

I might also add, Senator, that the big majority of the loans that are made are not made with the insurance companies. The insurance companies, again I wish to state, are not selling this plan. The insurance companies provide the policy contract. We can use any contract.

Senator WILLIAMS. Well, that is my understanding, because I have talked to several of the officials of the different companies and they don't want to take the position, from the standpoint of their own business, of being opposed to this, yet they recognize it, their agents go out and sell it, and you can't stop it—as you say, an agent can explain it and put it over very properly, stress the advantages—but I know of 1 major company that said that they had never confirmed but 3 or 4 of these policies, and in each instance they called the prospective policyholder in and advised him against going into it, because there was a technicality in the law which would perhaps be corrected, and, therefore, they thought the prospective policyholder would be poorly advised to take advantage of it.

Mr. EDELSTEIN. Senator, this is not a technicality.

Senator KERR. Would the Senator yield?

Senator WILLIAMS. Yes.

Senator KERR. I would like to ask this witness this:

A policyholder whom you have said follows this plan is not taking advantage of the technicality of the law; he is just operating under the general provisions of the law?

Mr. EDELSTEIN. That is correct.

Senator WILLIAMS. That is true.

But they were pointing out to them that the law perhaps would be amended whereby this would no longer be possible, and then the policyholders might have life-insurance policies that might not be as advantageous as some others.

Mr. EDELSTEIN. Aren't they merely advising clients that they fear there might be legislation in a direction which would impair the insurance they already own?

Senator WILLIAMS. Yes.

Senator KERR. The only suggestion they could possibly make to the prospective policyholder would be that Congress might pass a law which would deny a citizen a right he now has to deduct from the amount of taxes he now has on income that amount that he had paid interest with as to this specific purpose.

Mr. EDELSTEIN. That is right, sir.

Senator KERR. A similar situation would arise if we were to consider the passage of an act which would say that a man would not be permitted to deduct as an expense the interest he paid on any loan that he contracted to buy stock on which he subsequently made a profit.

Mr. EDELSTEIN. That is right, sir.

Senator KERR. Or that he would not be permitted to deduct interest on a loan he contracted if he used it to buy a leasehold estate in a piece of real estate and subsequently made a profit.

The thing the Treasury proposes, as I understand it, is to change the basic law of deductibility of interest payment as an expense against income, if the taxpayer used the proceeds of that loan or the effect of that loan to acquire the life-insurance estate.

Mr. EDELSTEIN. That is right; a subjective rule of intent, pure and simple.

And if the intent is for any purpose other than to purchase life insurance, then it is perfectly all right to deduct interest.

Senator KERR. Or if the original intent was for some other purpose than life insurance, but by reason of changing either one of these positions he got to the point where he had to borrow money, and the life-insurance policy was the only thing he had to borrow it on, then he would be put in the position of not being able to deduct the interest from that.

Mr. EDELSTEIN. That is right, as long as he continued to do it in a systematic way; as long as he found himself unable, after taxes, to pay back the loan and thereafter continued a borrowing procedure.

Senator WILLIAMS. However, as Mr. Smith said, he submitted the language that would protect that taxpayer and close the loophole, and I assume he would have no objection if we could protect the type of case that you have described.

Mr. EDELSTEIN. I would object, because there is no loophole, there is no tax avoidance at all.

Senator KERR. Evasion.

Senator WILLIAMS. If the situation which you have described can be adequately protected, as were described by the Senator from Oklahoma, if those can be adequately protected, and, at the same time, this other measure which other gentlemen in the Department of the Treasury have described as a loophole was——

Mr. EDELSTEIN. No, I will not agree with you, Senator, because if the inclusion——

Senator WILLIAMS. The reason I asked that, I thought I understood. But let's keep our argument——

Mr. EDELSTEIN. I merely exemplified further what the Senator from Oklahoma has said.

Senator WILLIAMS. In those cases you have described, I don't think there has been an expression on the part of the Treasury to deny it.

Mr. EDELSTEIN. There should be a subjective test on the representative of the Bureau to come in and examine a man's return, and he could very well hold that the reason that he did not borrow at the beginning but began to borrow at the end of 5 years would not change it from a systematic procedure; it would be a very difficult thing for me to say that I would be willing to pay the premiums for perhaps 4 years and borrow thereafter under a systematic plan, and how could they prove that I didn't start to do that in the first instance?

But what is most important, and I think that the point that you gentlemen and the Senator from Oklahoma just brought out so very, very ably, is that this is a denial of a right which applies to any deduction no matter what the equity is, no matter what the use of the money is, if you are going to deny the right to borrow money against the collateral value of life insurance or anything else and pay the proceeds over to a life-insurance company, what is the difference whether you deny that right of deduction for that purpose as against any other purpose?

If we are going to make it broad, then let's deny the interest deduction for any purpose whatsoever.

Senator WILLIAMS. I might say that it has not necessarily been agreed by all concerned that the denial of the interest would be the way to close this.

This is one of the recommendations of the Treasury.

Mr. EDELSTEIN. This is one of the recommendations, yes.

Senator KERR. I think an observation in point is this:

Any time the Government fixes a tax rate up to 90 percent of the income of the taxpayer, it is going to create a situation where the taxpayer is going to seek legitimate ways and ways recognized and in accordance with his right as a citizen to lessen the impact of that blow upon him.

Senator WILLIAMS. I respect that, and I respect the right of groups to advise him how to do that, as long as they are following the law. I respect that also. But I think that perhaps the correction of this 90 percent tax rate, which is a confiscatory rate, would be maybe to work toward reducing that down across the board for everybody, rather than to just create loopholes where it can only be taken advantage of by somebody who has corporate advice.

I agree fully. I am not defending the high rate. Don't get me wrong on that.

Mr. EDELSTEIN. The purpose of all life insurance, Senator, is protection. Let's start out with that basic premise.

The young man who wishes to buy life insurance and is after tax dollars today, even though he is in a 25 percent tax bracket—and I don't want to misconstrue—to be misconstrued in any statement that

I recommend a man in a 25 percent tax bracket buy this. That is not important.

Senator KERR. That is up to him.

Mr. EDELSTEIN. That is, it would not be important.

Senator WILLIAMS. Let's get his straight:

It would not be advantageous for him to buy it?

Mr. EDELSTEIN. It doesn't make any difference whether it is advantageous.

My point is: If I personally wish to loan a young intern an amount of money necessary to buy the policy because he has got a good future, I can make that loan to him; and that has been done for years and years, whether he had equity or not, and he merely signed the note. He followed that up when he had the ability to pay the premium. Then he came along and had to open his office. And he found that in order to open his office, he had to use his capital so he couldn't pay it back; so he borrowed against the life insurance policy in order to meet his note.

And, as he grew, and his family grew, his requirements increased, and he never paid back that loan. And years went on and he still had a loan up to the maximum cash value of the policy.

Now, I believe that it is almost impossible to discern the difference as to whether or not he made that loan to carry the life insurance policy, whether he made the loan to provide protection for his family or whether it was to buy office equipment or to complete his education. But he never made a payment other than that which he had to, over and above the cash value.

Now, the same thing is very true today, insofar as many, many businesses are concerned. They are in a 52-percent tax bracket, they are undercapitalized, their requirements are tremendous for capital. But in order to preserve the entity of that business in the event of the death of either 1 or 2 of the principals in that business, they require that they enter into a buy-and-sell agreement.

Now, to tie up collateral in the cash value of a life insurance policy, and use it for the effective capitalization of their business is utterly ridiculous. Now, what is wrong with their using the equity of the life insurance policy as against any other equity?

The CHAIRMAN. Could I ask you this: Are these loans evidenced by any notes?

Mr. EDELSTEIN. Yes, sir.

The CHAIRMAN. Do they bear a date of maturity?

Mr. EDELSTEIN. Yes, sir.

Senator WILLIAMS. Are they evidenced by notes in all instances?

Mr. EDELSTEIN. If it is a bank they are evidenced by notes. If it is with an insurance company they are also evidenced by another form, which is a premium loan form and is in effect the same as a note owing to the insurance company.

Senator WILLIAMS. Does the company have the right on that note to file a lien against the individual and collect?

Mr. EDELSTEIN. Automatically, it is a lien.

Senator WILLIAMS. I know, but they have a right to file it only against his insurance equity?

Mr. EDELSTEIN. The insurance equity.

Senator WILLIAMS. Can you show us some of those forms?

Mr. EDELSTEIN. Every insurance policy—it is only a collateral loan taken against the policy.

Senator KERR. The collateral is an obligation for the company to the man, it is just like you and I had a contract under which I had the right to get $10,000 any time I wanted to, and you agreed to lend me $10,000 any time I wanted it, and I do, and give you the note, and you keep that as collateral against this agreement, your obligation to pay me the $10,000, and any time I don't pay you off you automatically cancel what you owe me.

Mr. EDELSTEIN. That is right. The insurance company is the grantor.

Senator WILLIAMS. But are these loans arranged with insurance companies at times whereby the insurance company by their contractual agreement recognize the accumulation of the dividends which have not been refunded solely as the collateral, and my name may not be on any notes, any contingent liability.

Mr. EDELSTEIN. If there has already been a note using the collateral value of a life-insurance policy with a bank or with an insurance company that does not describe that you are the borrower, I have never seen it, and I don't believe that any fiduciary institution would take such an obligation on, they have no recovery.

Senator WILLIAMS. In their descriptions here they have so indicated that it has been done.

Senator KERR. If they did it would more nearly be a guaranty of approaching insolvency on the part of that insurance company than it would a tax evasion, wouldn't it?

Mr. EDELSTEIN. I most assuredly would believe so.

Senator KERR. In other words, the only way that they could fix it so that it wouldn't be an absolute obligation and would be payable either by cash or by recalling from the borrower that which was a liquid asset to him, would be to put the insurance company in the position of giving insurance to people without a consideration?

Mr. EDELSTEIN. That is right, denying the payment of the asset——

Senator WILLIAMS. You would have your original payment as collateral in addition?

Mr. EDELSTEIN. No. In the first place you never have 100 percent in the first year of your premium.

Senator KERR. Or anything like 100 percent?

Senator WILLIAMS. But your original payments in your initial years are made.

Mr. EDELSTEIN. Not necessarily. They can be borrowed.

Senator WILLIAMS. They can be borrowed, but at least they are made in a bona fide transaction, either borrowed or assigned.

Mr. EDELSTEIN. They are always made in a bona fide transaction with a note, and they are either borrowed or paid for out of capital, always.

Now, whatever cash value there is to be borrowed from the insurance company must be implemented with a capital investment in addition, because you don't have a 100-percent recovery in an earlier year.

The CHAIRMAN. What is the average percent you would have?

Mr. EDELSTEIN. Well, some companies have none. Other companies, they will go up to about 50 or 60 percent.

Senator KERR. Not the first year?

Mr. EDELSTEIN. Yes, the first year, some can go up that high. You see, your short-term paper, your short term like 10-payment life, for example, will have a very high first year cash value.

Senator KERR. But it has a very high first year premium.

Mr. EDELSTEIN. Yes, much higher, your cash value is always geared to your premium, basically they use different methods of funding, I am referring to commissions and other costs, different companies use different methods, some may pay them out over a period of 10 years, and others are over another period of years, and that may change initial cash values.

They may change their commissions and pay more in subsequent years than in the first. So there is no uniform rule as to what one company does as against the other, nor does it affect the borrowing procedure, because whatever cash is there is always there, and you can always borrow it for any purpose.

Senator WILLIAMS. I respect your position, and we will certainly view your full testimony, along with that of the gentlemen to follow. I do think it is unfortunate that we have something here that is being used and advertised in insurance circles as a tax avoidance device, and certainly that is unfortunate to advertising to say the least.

And it is certainly a misunderstanding on the part of many of the officials of these companies if they likewise don't recognize it as being—I mean who do likewise recognze it as being a loophole in the tax laws.

Mr. EDELSTEIN. I should like to point out two other things. The Treasury has not in this particular testimony mentioned anything about loss to the revenue.

Now, the Treasury has stated in the past, Dr. Smith has, that there is a loss sustained to the revenue. I should like to submit to you, it is not in our report, but I should like to submit a supplementary chart which I drew up very carefully to indicate that to deny the right to deduct the interest you would definitely have a loss in the revenue, in other words, there is a profit to the revenue on the basis of permitting the borrowing, because more people can own the kind of life insurance that they should have by having the capital, the usage of borrowed capital with which to purchase their insurance.

If they were denied that interest deduction and therefore did not do it, it would increase the cost of their insurance, and they could not afford as much insurance.

Another point: that if the cash value——

Senator KERR. I should like to have you put that chart in the record.

Mr. EDELSTEIN. I should like to put it in the record.

Senator KERR. Without objection, it may be placed in the record.

(The chart referred to is as follows:)

EXHIBIT A.—*Chart illustrating revenue gain as a result of sale of $1,000,000 of life insurance at age 45, projected over 10 and 20 years, wherein a borrowing procedure is used to pay the premiums*

Estimated earnings over 10 years			Taxes paid
Agent or broker, commission	$33,900	(40 percent bracket).	$13,500
General agent, overriding commission	6,300	....do....	2,520
Medical and inspection fees	600	....do....	240
Insurance company earnings on investments (5 percent)	17,000	(7.8 percent bracket).	1,360
Lenders' earnings (5 percent on average loan of $120,000)	60,000	(52 percent bracket).	31,200
Total	117,800		48,880
One-half of proceeds taxed at death in estate of insured ($500,000) (30 percent bracket)			150,000
Total taxes collected by the Bureau in 10 years			198,800
Interest paid and deducted by borrower	$60,000	(Revenue loss 50 percent bracket).	[1] 30,000
Revenue gain in 10 years			168,880
Total taxes collected by the Bureau in 20 years			312,000
Revenue loss on interest deducted by borrower in 20 years (5 percent on average annual loan of $275,000).			[1] 137,500
Revenue gain in 20 years			174,500

[1] The same loss of revenue would exist if loans were made for any other purpose.

Mr. EDELSTEIN. Secondly, I would like to point out that under the present law that if the cash value of the policy, including the dividends, exceeds the premiums paid so that there is a profit——

Senator KERR. That would be at what stage, ordinarily, in the life of the policy?

Mr. EDELSTEIN. It would be in the latter years, 18, 17. It would be any year. In 20-payment it might be the 11th. In an endowment, it might be the ninth. In any year, there could be a profit that is taxed as ordinary income.

Therefore, what is the benefit?

If we want to concede that it is only good for a 90 percent taxpayer, with which I don't agree——

Senator WILLIAMS. I just used that as an example.

Mr. EDELSTEIN. Let's use a very high taxpayer.

If he is going to receive all this benefit in the earlier years and he has a so-called tax gain, which the Treasury objects to, he has to pay an income tax on the gain as high as the deduction he took; so, he hasn't gained anything.

Senator WILLIAMS. He may be taxable later?

Mr. EDELSTEIN. That is right.

And if he dies—and all this so-called tax gain is built up in the policy, he isn't going to get it. The face of the policy is paid off. I don't care what the cash value is. It is merged with the face of the policy, and any recovery existing goes to the insurance company, not to the borrower, and you, as a buyer of a life-insurance policy, you do not own that cash value. You have a letter of credit against your life-insurance company. The life-insurance company sustains and owns it.

Senator WILLIAMS. You don't think you would be able to persuade those fellows that have been buying it that they are actually losing money by buying it?

Mr. EDELSTEIN. I don't say that they are losing money, but I say this: that sometimes somebody must pay that premium. They have the protection at the time they need it, and the cost, or the payment, if they die, comes out of proceeds.

Senator WILLIAMS. And do I understand that you are trying to describe it as a tax-deferment policy?

Mr. EDELSTEIN. I am not trying to describe it in another way. I am trying to describe the method at which it is purchased.

Senator KERR. Mr. Chairman, off the record——

(Off the record.)

Mr. EDELSTEIN. Now, all of a sudden it has become a loophole, because certain people do not agree with the basic concept; since they feel that savings in life insurance is more important than the protection of life insurance; therefore, if you take the savings factor out, you are destroying the old concept of savings plus insurance.

Well, I am not so sure that I can agree with that, because I find that the tax dollar or the remainder of the dollar that I have left is quite different than it was 20 years ago.

So, I may have to change my entire concept and how I live, too, based upon those things.

Our friend that you quoted a moment ago: He has not learned the difference between the value of the investment dollar and the value of the debts. It is swallowed by the insurance company in the face of the contract when he died.

Senator WILLIAMS. I have another letter here from another insurance agent that says:

> I have been in the insurance business for 28 years, and when it first came to the market I had no occasion to investigate thoroughly the merit and otherwise of the whole proposition—

And it goes on, and it encloses a copy of a letter that he sent to one of his policyholders that he later sold because he insisted on buying it, because he pointed out in asking this question:

> Is it generally good business to enter into a financial deal, the ultimate success of which hinges on the present technicality in the law—

And he went on and pointed out to him why he felt that it was a loophole in the law; and he says it was sure to be recognized by Congress.

However, he closed his letter, and properly so:

> If you are going to buy, my company would like to sell you.

And I don't blame him. And he did sell him.

I just give that as an example. I have left the individuals out. It isn't fair to them. But there is a difference of opinion in the insurance circles, and many insurance companies have recognized this; and, frankly, many of them would like for it to remain as is. But at least they want it clarified so that Congress, by leaving it as is, will definitely establish the policy that it is not a technicality in the law, but one which was intended by the Congress.

And I think that it is very important that we—and I was the one member of this committee to urge Mr. Smith to bring this before this committee at this time and outline his recommendations for corrections, with the thought that either we should accept it or reject it, and by doing it publicly, put you gentlemen on notice that you can either sell it or not sell it, but you will know that we have taken notice of it.

And that was the whole purpose of bringing it in.

Mr. EDELSTEIN. Senator, if it is not included in bill 8381, then we would then conclude that it is not an unintended benefit. Do I understand correctly?

Senator WILLIAMS. You can assume this, that if it is not included in 8381, it will be because Congress does not want it.

Senator KERR. You know that that action would not be binding on any future Congress.

Senator WILLIAMS. That is true, and at any future time it could be brought up, but at least you would be on notice that it was not something that we have not overlooked in the law, you will be on notice that we have discussed it, and it is being weighed, and right or wrong our decision would have been made.

And I repeat, I don't think it is necessary that anything that I have said in any way be construed as any reflection on you or anyone who has sold it or anybody that has bought it, it is nothing wrong, the law is the law.

Mr. EDELSTEIN. Rather than complete my written testimony, because a great deal of this, Mr. Chairman, has been brought out in my discussion, I would like to merely submit the testimony.

(The complete prepared statement of Mr. Edelstein is as follows:)

STATEMENT OF J. MILTON EDELSTEIN ON BEHALF OF THE ASSOCIATION OF ADVANCED LIFE UNDERWRITERS

Mr. Chairman and members of the committee, my name is J. Milton Edelstein. I appear before this committee as chairman of the legislative committee of the Association of Advanced Life Underwriters. I am accompanied by our counsel, J. Milton Cooper and Leonard L. Silverstein.

The subject of my testimony involves so-called loan-financed life insurance. More accurately, the question at issue involves the right of taxpayers to deduct on loans incurred in connection with life-insurance policies in the same manner as interest deductions are taken for all other purposes under the code.

This subject has already been exhaustively considered by both the Subcommittee on Internal Revenue Taxation to the House Ways and Means Committee in 1956 and by the Ways and Means Committee itself in the spring of 1957 when H. R. 8381 was considered by that body. The Ways and Means Committee flatly rejected the Treasury's proposal at that time.

Earlier this week Dr. Smith, appearing before your committee, again seeks restrictive legislation which would in effect impair, if not destroy, the use of credit to finance life insurance protection.

The nub of the Treasury's contention would disallow as a deduction interest on indebtedness incurred to carry a life insurance, endowment, or annuity policy under an arrangement or plan which contemplated that a substantial number of premiums would be paid by means of such indebtedness.

The same suggestion was made by the Treasury to the House Ways and Means Committee and rejected by that body.

I am sure that while most of you are doubtlessly familiar with the type of insurance program here at issue a brief illustration may be helpful. Assume that a young professional man, earning income but lacking capital, needs life insurance protection for his growing family. Assume further that term insurance does not suit that man's needs since such insurance runs out at an early age and that the premium cost of permanent insurance, such as whole life, approximates $2,000 per year. The insured is faced with the same tremendous financial burden in connection with this vital insurance purchase as faces him in connection with the purchase of a home. His course of action seems obvious. Just as he borrows to purchase his home, he borrows to furnish adequate life insurance. In the case of the home purchase, the house itself is utilized as collateral for the loan. In the case of life insurance the policy is collateral for this similar type of loan.

We submit that if the interest deduction is to have any meaning whatsoever it should be available with respect to loans used to acquire life insurance protection for the very same reason that it permits deductions on loans used to finance home purchases. Indeed, the entire history of the interest deduction for personal borrowings makes no distinction whatsoever respecting the use to which the borrowed funds are put. An improvident borrower, whatever his bracket, may borrow funds to go to the races, to purchase the most extravagant luxuries, or for any other purchase which comes to mind. The consequence of the Treasurer's proposal would continue the interest deduction for these purposes but deny the family man the right to borrow to provide insurance protection for his family.

Your committee may well ask why the Treasury has persisted in its position. As noted, the Treasury is concerned with the fact that financed insurance plans are allegedly of "negligible cost" to high-bracket taxpayers. We are eager to respond to this contention. In the first place, the chief users of loan-financed plans are not high-bracket taxpayers but others needing insurance protection generally who cannot otherwise acquire adequate or proper protection without borrowing. In addition, as to those taxpayers who are in high brackets, is there any reason why the interest deduction should be denied these persons any more than low-bracket taxpayers.

The next point of concern to the Treasury is the fact that the policies develop cash values, that is, a so-called inside buildup, which are not taxed to the insurance companies. We deny that this so-called buildup is tax free since insurance companies are taxed on their income. In addition, all policyholders, whether the premiums are financed or whether the premiums are paid outright, receive whatever benefits accrue to the policyholder. We respectfully submit that if the Treasury is concerned about taxfree buildup in insurance policies that this be considered by your committee when it takes up the question of the proper mode of taxation of life insurance companies themselves. It is no solution to seek to solve life-insurance-company tax problems by discriminating against policyholders—particularly those who cannot afford to purchase outright permanent insurance in the first instance.

We wish to note finally the Treasury's suggested legislative approach to cure the alleged difficulty. Under this plan, the precise language of which has never been made public, a line would be drawn between borrowings on insurance policies made supposedly in the ordinary course of events and loans made openly to acquire insurance protection. We submit that this is a legislative line which is too fine to be drawn with administrative workability. In other words, the wealthy taxpayer can borrow independently from his bank against stock or other collateral and use these same funds to purchase his life insurance. Tracing loans of this nature will foster further abuses of the tax laws and actually promote devious schemes. Moreover, morally, is there any difference between the person who, in the supposed ordinary course of events, borrows to go to the races and another person who openly and aboveboard borrows to acquire life insurance protection for himself and family. If anything, the Congress should encourage the acquisition of life insurance by any means, including by borrowing or investment of capital.

We feel sincerely that in these times of continued inflation and high personal income tax rates that it is extremely difficult for an individual to provide adequate insurance protection for his family. We urge that this committee take no action which would in any way restrict or impair a person's right to protect his family by any legitimate means.

In summary:

1. The primary purpose for which life insurance is purchased is protection. To deny or limit one's right to protect his requirements is not the purpose of tax law.

2. There is no inside tax-free enhancement belonging to the policyholder.

3. Adoption of the Treasury's proposal would classify life insurance as underprivileged property.

4. Moreover, adoption of further restrictions would actually bring about loss in revenue.

5. The tax bracket of the taxpayer permits him no greater benefit from this type of loan than for any other.

The Association of Advanced Life Underwriters appreciates the opportunity to testify before this committee concerning this important subject and stands ready to furnish any additional information or answer any questions of your committee or its staff.

Mr. EDELSTEIN. Do any counsel have anything to say?

Mr. SILVERSTEIN. Mr. Chairman, if I may, just 30 seconds.

Senator Kerr, I believe, pointed out the nub of this entire problem. Now, the Treasury has been concerned about the so-called inside buildup, that you can borrow against the policy while internally the policy is increasing in value, which value is not being taxed because of the fact that the life insurance tax rates are different from other rates.

Now, accepting that as a fact, there still is no difference between the purchase of life insurance with borrowed funds and the purchase of any item which increases in value during the time the funds are borrowed, such as real estate. The person who borrows or buys real estate with a mortgage and then sells it may have no costs or may have some cost, depending upon the cost to him of the borrowed money during the period when he held the real estate.

That is precisely what the situation is in the case of life insurance.

Senator WILLIAMS. I think you will agree that there is this difference in describing this as a real-estate transaction on the one hand which can appreciate in value. Here we have something which we know would appreciate in value as a result of a lower tax rate which is being paid by the insurance companies than which is being paid by the corporations or the policyholder on the outside; I am not getting into the merits or demerits of the tax rate, but that is a mathematical situation which does not exist whereby you can compare this with real-estate taxation.

Senator BENNETT. Also, in fairness, this same power to appreciate exists for the insurance policy purchaser who buys his insurance policy and pays cash for it.

Senator WILLIAMS. That is true.

Mr. EDELSTEIN. That is true. And therefore the denial exists in both instances if it is to be denied.

Senator BENNETT. If that is offered as a reason why it is a tax avoidance device, then it becomes a tax avoidance device——

Senator WILLIAMS. I just mentioned that you can't exactly compare this to a real-estate transaction.

Mr. EDELSTEIN. You might compare it to the purchase of a Government bond purchased below the par. There we have the guaranty of the Government that it will be redeemed at maturity at par, then you do have a definite guaranteed enhancement inside that enhancement, and the interest is deductible.

Senator KERR. In that situation when the Government bonds got down to 84 a year and a half ago was one that many an investor took advantage of, channeling off the interest that they paid on the loans against their income as a tax deductible item, and then I believe in 12 months sold their Government bonds enhanced in value by 10 points.

Senator WILLIAMS. I might say, perhaps this is a good place to leave it, when we get to the point that we agree that this plan is almost a sure winning investment for the man that bought it as a Government bond, I think we can agree on that.

Senator KERR. I don't think there is any doubt that people regard an insurance contract from a good insurance company as good as a Government bond. And that is one of the reasons I have always been a sucker for life insurance. I remember the first life insurance policy I ever owned, Mr. Chairman. My father, when he was making $150 a month, and I was 18 years old, called me in, and he said, "Now, Bob, I have bought a $1,000 20-year life insurance policy for you," and he named a certain cost, and he said, "I am going to pay the premium on it for you," either for 3 or 4 years, and he said, "After that you can borrow against the cash surrender value of that policy enough to pay the annual premiums, and if you die, there will be enough there to bury you."

Mr. EDELSTEIN. Thank you very much.

The CHAIRMAN. Thank you.

The next witness is John Z. Schneider.

STATEMENT OF JOHN Z. SCHNEIDER, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

Mr. SCHNEIDER. Mr. Chairman and gentlemen, I am John Z. Schneider, of Baltimore, Md., and I am appearing before you today as chairman of the committee on Federal law and legislation of the National Association of Life Underwriters, which is a trade association of over 73,000 life insurance agents. My purpose in appearing is to reply to, and urge you to reject, a recommendation that Mr. Dan Throop Smith made on behalf of the Treasury Department during the course of his testimony on February 25 with respect to H. R. 8381, the Technical Amendments Act of 1958.

I refer to Mr. Smith's proposal that your committee write into this bill a section that would restore in the Internal Revenue Code a modified version of what is commonly known as the premium payment test of ownership of life insurance policies for estate-tax purposes.

Senator KERR. Let me ask you right there, you say "would restore in the Internal Revenue Code." Was that ever in the code, or was that a matter of regulation by the Department?

Mr. SCHNEIDER. That was in the code, sir. The premium payment test.

Senator KERR. The premium payment test was in the law or in the regulation?

Mr. SCHNEIDER. Yes; I think we cite that later on, sir.

That appeared in the 1939 code, and it was eliminated by 2042 of the 1954 code.

Under the Treasury's proposal, as presented by Mr. Smith, all or part of the proceeds of a life-insurance policy would be includible in the insured's taxable estate solely by reason of the fact that he had paid the premiums either directly or indirectly. This result would follow even though the insured had divested himself of all incidents of ownership in the policy during his lifetime or, indeed, had never owned the policy at any time.

The amount required to be included in the insured's taxable estate would be the amount by which the total death proceeds paid under the policy exceeded the cash value of the policy at the date of his death.

As Mr. Smith indicated in his testimony the other day, this recommendation is certainly not new. The very same proposal was made by the Treasury Department to the House Ways and Means Subcommittee on Internal Revenue Taxation back in November 1956, just prior to the hearings which led to the drafting of H. R. 8381.

We opposed it then as we do now. Of more importance, however, is the fact that both the Ways and Means Subcommittee and the full Ways and Means Committee, after carefully studying the problem for many days, rejected the Treasury's proposal as being unsatisfactory. Therefore, we respectfully submit that this particular proposal does not deserve further study by your committee.

It is true that the House Ways and Means Committee ultimately wrote into H. R. 8381—as section 56—its own version of a limited premium payment test. This provision was entirely different from the Treasury's discarded proposal and, we understand, was just about as unsatisfactory to the Treasury as it was to my association, although admittedly for quite different reasons.

It is also true, as Mr. Smith has pointed out, that section 56 was deleted from H. R. 8281 by an amendment offered by the Ways and Means Committee on the floor of the House on January 28.

However, I should like to stress that in asking for the deletion of section 56, Chairman Wilbur D. Mills, of the House Ways and Means Committee, clearly indicated that his own committee wanted to give this "very complex and perplexing problem" further study and intended to do so.

Of course, we are completely aware that this action on the part of the Ways and Means Committee does not, and should not, deprive your committee of the right to review the problem.

Nevertheless, we do suggest that in view of the fact that the Ways and Means Committee does intend to study the issue further and that H. R. 8381, as it now stands, contains a substantial number of tax revision proposals of importance to both the Government and the taxpayers, its consideration and enactment should not be impeded, or possibly prevented, by further controversy over the question of restoration of the premium payment test at this time.

However, if your committee should decide to review the problem in connection with H. R. 8381, then I want to take this opportunity to acquaint you with my association's basic objections to the premium payment test in any form. These objections, which I shall now briefly touch upon, are that the test is (1) illogical and discriminatory, (2) of doubtful constitutionality, and (3) highly detrimental to the conservation of small-business enterprises.

1. PREMIUM PAYMENT TEST ILLOGICAL AND DISCRIMINATORY

The premium payment test contained in the 1939 code required that the entire proceeds payable under policies on the life of an insured to beneficiaries other than his executor be included in the insured's gross estate if, and to the extent that, he had directly or indirectly paid the premiums on such policies. The test applied, of course, even though the insured had divested himself of all incidents of ownership in a policy or, indeed, even though he had never had any such incidents of ownership to begin with.

Thus applied, the premium payment test resulted in life insurance being the only form of asset that an individual could not remove from his taxable estate by means of inter vivos gifts.

Even the stanchest advocates of the premium payment test now concede that the old test went much too far. This is borne out by the fact that the Treasury's current proposal would make the test applicable only to the difference between the total death proceeds paid under a policy and the cash surrender value at the time of the insured's death, rather than to the entire death proceeds. As I have already indicated, however, we feel that any form of the test would be basically objectionable.

Senator BENNETT. May I ask a question at that point?

You have compared the 1939 law to the present law. As I understand it, under the 1939 law, if it could be shown—a calculation was made which related to proportion of the total premiums paid by the insured to the total recovery from the policy, and that proportion which was directly related to his payment was included in the estate.

Mr. SCHNEIDER. To the extent that he paid directly or indirectly, that is correct.

Senator BENNETT. You are probably not the man to ask this question, but suppose we had the situation under the proposed amendment of the Treasury where the insured paid half the premiums and somebody else paid the other half, is it your understanding, then, that—I will put it in another way.

If the insured paid any of the premium, would that bring into effect this proposal that the difference between the cash surrender value and the amount realized at death be included in the estate, or would this same proportional relationship continue, or don't you know?

Mr. SCHNEIDER. I don't know. I would have to refer to the total proposal.

Senator KERR. Under the proposal made by Mr. Smith, what would be the answer to the Senator's question?

Senator BENNETT. His answer was, he didn't know.

Senator KERR. Do you know what it would be under the amendment that the Ways and Means Committee put into the bill and then took out?

Mr. SCHNEIDER. The amendment that the Ways and Means Committee, I believe, put into the bill, was the so-called 5-year rule. Under this rule, if a policy had been transferred by the insured within 5 years prior to his death, or had been acquired by a third party on the life of the insured within 5 years of his death, the proceeds would be included in the insured's estate to the extent that during that 5-year period he had paid the premiums.

Senator KERR. I think the same thought has occurred to me that I believe may have occurred to the Senator from Utah, that the Treasury now proposes a most drastic revision than was in the 1939 code.

I believe there is a member of the staff here that can answer that for us, Senator.

Senator BENNETT. The theory, according to my advice, is that the proportional situation would continue, although that was not made clear to us in the presentation of Mr. Smith.

Mr. SCHNEIDER. In addition to the fact that the premium payment test discriminates against life-insurance policies as being proper subjects of inter vivos gifts, it also ignores the fact that a life-insurance policy is, among other things, a contract of indemnity. This was recognized by the Supreme Court of the United States in *U. S.* v. *Sup-*

plee-Biddle Hardware Company (265 U. S. 189), where the Court said:

Life insurance in such a case is, like that of fire and marine insurance, a contract of indemnity. * * * The benefit to be gained by death has no periodicity. It is a substitution of money value for something permanently lost, either in a house, a ship, a life.

Similar reasoning may be found in *Newell et al* v. *Commissioner* (66 F. (2d) 102) and *Emeloid Company, Inc.* v. *Commissioner* (189 F. (2d) 230).

Thus, for example, where a wife holds all of the incidents of ownership in a policy on her husband's life, nothing is transferred from him to her upon his death. Rather, his death is simply the event which matures the right that she already possesses to be indemnified against the economic loss that she has suffered. Therefore, it is both inequitable and illogical to say that what is clearly an asset of hers must be included in his estate.

Furthermore, we wish to point out that restoration of the premium payment test would do more than simply discriminate against life-insurance owners generally. It would also bring back into the law discriminatory tax treatment as between individual policyowners.

Senator KERR. Mr. Schneider, we will have to go now to vote on the floor. Do you wish to come back, or would you rather put the remainder of your statement in the record?

Mr. SCHNEIDER. I will put the remainder of my statement in the record.

Senator KERR. It will appear in the record.

(The unread portion of the statement of Mr. Schneider is as follows:)

For example, if a wife should buy a policy on her husband's life with gifts of money furnished by him, the proceeds would be includible in his gross estate. If, however, she happened to have independent means of buying the policy, none of the proceeds would be taxable in the husband's estate. Obviously, therefore, the test would, as it did in the past, discriminate heavily in favor of wealthier families and against those whose need for protection is more pressing.

Before leaving this point, let me add that we are well aware of the conviction apparently held in certain quarters, including the Treasury Department, that the elimination of the premium payment test by section 2042 of the 1954 code has provided a "loophole" whereby wealthy taxpayers can have a field day at Uncle Sam's expense. Let me assure you that this is just not so. By and large, the premium payment test never did bother the wealthy. However, it did—and would again—adversely affect people of more moderate means, such as small-business men. But I shall get to them in a minute.

2. PREMIUM-PAYMENT TEST OF DOUBTFUL CONSTITUTIONALITY

With respect to the highly questionable constitutionality of the premium-payment test, we can add little to what has already been said on this point by the United States Court of Appeals for the Seventh Circuit in the case of *Kohl* v. *United States* (226 F. (2d) 381), decided on October 13, 1955. We do want to emphasize forcefully, however, that in that case, the court held, in substance, that the test was unconstitutional whether applied to policies transferred before the date of enactment of the 1942 statute imposing the test or to those transferred thereafter. In short, it is completely clear that the Kohl case stands squarely for the proposition that the premium-payment test cannot, in any event or in any form, be other than unconstitutional.

We are, of course, aware that a contrary result has since been reached by the Tax Court in *Loeb* v. *Commissioner* (29 T. C. No. 4), decided on October 11, 1957, in which the Tax Court refused to follow the Kohl decision. The Loeb case is now being appealed. Even if the Tax Court's decision should be affirmed, however, the serious constitutional question will remain unresolved unless and until settled by the Supreme Court.

In addition to the grounds relied upon by the court in the Kohl case, we believe that there may be still another reason why the premium-payment test will be found wanting in constitutionality. Such a test in effect lays down a conclusive presumption that a life-insurance policy is testamentary in character. We call to your attention that the Supreme Court of the United States, in *Heiner* v. *Donnan* (285 U. S. 312), held to be unconstitutional a statute which purported to provide such an irrebuttable presumption in the case of transfers made in contemplation of death. We believe that the same principles of law are equally applicable to the premium-payment test.

3. PREMIUM-PAYMENT TEST PARTICULARLY UNFAIR AND HARMFUL TO SMALL BUSINESS

I have already made reference to the fact that the premium-payment test is discriminatory and unfair as applied to owners of life insurance generally. I should now like to stress that the test is particularly harmful to the economic health of small business and, consequently, to the overall national economy.

For years, both Congress and the executive department have repeatedly shown much concern over the economic well-being of small business concerns and have devoted a great deal of time and study to devising ways and means of preventing their destruction or their absorption by larger enterprises. Apropos of this, in its final report to the 81st Congress (Rept. No. 46), the Senate Special Committee To Study Problems of American Small Business, stated the following very significant and pertinent conclusion:

"It is the combined pressure of the income- and *estate tax* structure which forces independent owners of business of this size to sell out to larger companies. The Treasury forces these mergers and the Federal Trade Commission complains about them and seeks to set up a legal barrier." [Emphasis ours.]

To relieve the harmful effect of the estate tax pressure it found to exist, the Senate committee recommended the elimination of the premium-payment test from the 1939 code and gave the following reason for this recommendation:

"Removal of this discrimination against one type of property, life insurance, would facilitate putting the heirs of owners of independent businesses in a position to meet estate tax obligations and to carry on the business free of extraordinary obligations."

Restoration of the premium-payment test would, to a large degree, resurrect the estate tax pressure on small business referred to above. Accordingly, we believe that it would have a marked tendency to bring about the extinction of many small business enterprises and the accompanying loss of the income tax revenue obtained from them and their owners and employees. Moreover, the proposal would, in all probability, produce only an insignificant amount of additional estate taxes. Indeed, we think it extremely likely that any resulting gain in estate tax revenue would be much more than offset by the loss in income tax revenue which I have mentioned. Thus, we are convinced that the premium-payment test is both socially and economically unrealistic and unsound.

In making this particular argument against restoration of the premium-payment test, we wish to call to your attention that there are now pending in both Houses of Congress a number of bills designed specifically for the purpose, among others, of easing the impact of estate taxes on small business enterprises. Under these bills, the estates of deceased owners of small businesses would be given the opportunity to pay Federal estate taxes in installments over a period of up to 10 years. This is one of the provisions recommended by both the President's Cabinet Committee on Small Business and the Senate Small Business Committee.

Thus, on the one hand, we find one agency of the executive department, namely, the President's Cabinet Committee on Small Business, recognizing the need for and recommending legislation in the estate tax field to give relief to the small-business man. On the other hand, however, we find another agency of the executive department, namely, the Treasury, calling for legislation that would make his plight all the more acute. Now, we may be naive, but it looks to us as if the Government perhaps unwittingly, may be undertaking the impossible task of trying to ride the same horse in opposite directions.

Incidentally, let me make it clear that even if the law should be revised to permit the estates of deceased small-business men to pay estate taxes in installments, there would still remain the need for continuation of the tax relief provided by the absence of the premium-payment test. I say this because while the installment arrangement would undoubtedly make the payment of taxes less burdensome, it would not necessarily insure that an estate had sufficient liquidity. Only section 2042 provides the means whereby this liquidity can best be achieved. Therefore, it should be retained in any event.

In conclusion, I should like to express to you my deep appreciation for giving me the opportunity to appear before you on this important matter on behalf of my association. If you wish further information from us, I hope that you will not hesitate to get in touch with our headquarters staff or me at any time.

Senator KERR. Thank you very much for being here and for the statement that you have read and put into the record.

Mr. SCHNEIDER. Thank you.

Senator KERR. That concludes the schedule of witnesses but before adjourning the committee, the Chair submits the following letters for the record.

(The letters referred to follow:)

KENT AND BROOKES,
San Francisco, February 4, 1958.

Re: H. R. 8381.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

MY DEAR SENATOR BYRD: I have been examining the text of the so-called technical amendments bill of 1958 as passed by the House on January 28, 1958, which your distinguished committee will doubtless soon be considering.

The stated purpose of the bill is to amend the Internal Revenue Code of 1954 to correct unintended benefits and hardships and to make technical amendments, and for other purposes.

So far as the substance of the bill is concerned, it seems meritorious and I find no grounds for criticizing most of its provisions. But there is one aspect of the bill which I respectfully suggest raises a serious question of legislative policy and procedure. That is that the bill is replete with provisions giving much more than the normal retroactive effest, i. e., to the beginning of the year in which enactment occurs, to many of its provisions, not only to relief provisions intended to cure unitended hardships to taxpayers, for which there is ample precedent, but also to remove so-called unintended benefits to taxpayers.

It is absurd to say the 82 sections of this bill are mainly directed at the mere correction of clerical errors. The provisions of a majority of the sections are definitely substantive and can have important and far-reaching effects on the tax liabilities of many taxpayers. Many sections, of which sections 3, 12, 16, and 34 represent a few examples, change the substantive law otherwise applicable to transactions as far back as November 7, 1956.

The foregoing is the date, I believe, when the report of the Mills subcommittee to the Committee on Ways and Means was published. It should be noted that the report was made to a prior Congress no longer in existence and was not then acted upon. The publication of the report of the Mills subcommittee was not notice to the world of what the Congress was going to do but only of what the subcommittee was recommending. Any other view would imply that the Senate would act merely as a rubber stamp in the matter, whereas the teaching of history is that the Senate has always and properly exercised its own independent judgment in such matters. The recommended bill has now been resurrected with few, if any, material changes, and is on its way to passage by a new Congress.

It is my earnest belief that the enactment of this bill with its present retroactive clauses would be a serious mistake not only because of the heavy burdens it may impose retroactively on many taxpayers but also because of the very dangerous precedent it will create for the future. It is one thing, as has been done in a few instances, to provide for retroactive application of a provision to prevent tax avoidance by making it applicable to transaction consummated after the date a revenue bill is reported to the House by the full Ways and Means Committee. Even this practice has its dangers. But it is a much more radical procedure to go back to a date when a subcommittee report is filed with the full committee. History shows that full committees, much less the Congress, are not wont to be mere rubber stamps to endorse whatever a subcommittee of one House, however able and conscientious, may see fit to recommend. The removal of so-called unintended benefits does not justify radically retroactive changes in substantive law. Such substantive changes should be made prospective in their operation.

It would be better in my judgment to make the whole bill applicable to taxable years beginning after December 31, 1957, or transactions consummated after the date the bill was reported to the House, than to establish a precedent for substantive changes increasing the tax liabilities of taxpayers retroactively to dates in 1956.

Respectfully submitted,

ARTHUR H. KENT.

STATEMENT OF WESLEY E. DISNEY, WASHINGTON, D. C.

My name is Wesley E. Disney. I am a lawyer with offices at 501 World Center Building, Washington, D. C., and at Tulsa, Okla. I appear for Peat, Marwick, Mitchell & Co., accountants, representing certain banks, namely: Commonwealth Trust Co., Union City, N. J.; First Trust & Dposit Co., Syracuse, N. Y.; The Trust Company of New Jersey, Jersey City, N. J.; and West Hudson National Bank, Harrison, N. J.

During the bank holiday of 1933 the Reconstruction Finance Corporation (RFC) went to the aid of some hundreds of banks, which issued their preferred stock for cash advanced them by the RFC. As time went on most of these banks got into better shape. With reference to a very few of those banks, including those interested in the amendment hereinafter discussed, and which banks continued in a weakened condition, and after the Federal Deposit Insurance Corporation (FDIC) became operative, it became necessary for the RFC to again go to the aid of these banks with additional funds during the period 1938 to 1940.

RFC required that the banks, some of which were merged with other banks in weakened condition, issues to the RFC new preferred stock for the old bank holiday money as well as for the new 1938–40 money advanced by RFC. These banks were required to pay, out of their earnings, amounts sufficient to retire the stock issued for both the old and new money. In the 13 years to 1953 these banks were able to retire little of the "old" stock and no cash dividends were paid on the common stock to the stockholders of the banks; consequently, reorganization of the banks prior to 1954 and the procuring of new private capital was substantially impossible.

We are proposing an amendment to allow these banks to deduct from gross income the amount paid in retirement of the RFC "old" stock—that is, the stock which represents the amount of money the RFC had already lost in these banks prior to the time it went to the aid of these banks in 1938–40. That was the bank holiday money advanced. We do not ask for the right to deduct from gross income the amount of money paid in retirement of the new (the 1938–40) money advanced by the RFC.

This presents no new or novel idea. The question arose in 1938 when Congress recognized the hardship that had been imposed on certain banks and their depositors. These were banks which were permitted to reopen on a restricted basis and went through reorganization whereby the depositors agreed to take preferred stock in lieu of specified percentages of their deposits in their banks, and the banks worked out for themselves a sound financial structure. As I said, Congress recognized the hardship and enacted an amendment to section 22 of the act of March 1, 1879, by means of section 818 of the Revenue Act of 1938. This amendment of 1938 exempted those banks from Federal income taxes so long as their net earnings were required for the retirement of the preferred stock for the satisfaction of depositors' claims against the banks. It was included in the Internal Revenue Code of 1939, with a minor amendment, as section 3798, and is in section 7507 of the Internal Revenue Code of 1954.

Again the question arose in 1951 when Congress added section 23 (dd) to the Internal Revenue Code of 1939, which now is section 592 of the Internal Revenue Code of 1954. These sections were designed to aid mutual savings banks not having capital stock represented by shares, domestic building and loan associations, and cooperative banks without capital stock organized and operated for mutual purposes and without profit.

Congress had something like this in mind in 1934 when it enacted a provision similar to the present section 583 of the Internal Revenue Code, which reads as follows:

"SEC. 583 DEDUCTIONS OF DIVIDENDS PAID ON CERTAIN PREFERRED STOCK.

"*In computing the taxable income* of any national banking association, or of any bank or trust company organized under the laws of any State, Territory, possession of the United States, or the Canal Zone, or of *any other banking corporation* engaged in the business of industrial banking and under the supervision of a State banking department or of the Comptroller of the Currency, or of any incorporated domestic insurance company, there shall be allowed as a *deduction from gross income, in addition to deductions* otherwise provided for in this subtitle, any dividend (not including any distribution in liquidation) paid, within the taxable year, to the United States or to any instrumentality thereof exempt from Federal income taxes, on the preferred stock of the corporation owned by the United States or such instrumentality. The *amount allowable as a deduction* under this section shall be deducted from the basic surtax credit otherwise computed under section 561." [Italic ours.]

This establishes to us that the Government did not and does not expect financial institutions to pay their earnings to the United States Government or instrumentalities thereof without receiving tax benefits on the payment thereof.

Now in view of these legislative precedents which I have cited, it seems to me that we are by precedent and in equity entitled to the proposed amendment.

The following background may be helpful in understanding the problem.

During the depression years following the stock market crash of 1929, a great many banks in this country found themselves in unsatisfactory financial position, and the various State and Federal banking authorities arranged a number of forced mergers of unsound banks into supposedly sound banks in an attempt to protect the interest of the depositors in all banks. Congress, in recognition of the situation which developed, created, in 1932, the Reconstruction Finance Corporation, hereinafter sometimes called RFC, for the purpose, among others, of extending financial aid to banks and insurance companies in need thereof. This period of financial distress for banks and other financial institutions culminated in the bank holiday which began on March 4, 1933.

Following the bank holiday, the majority of banking institutions in the country were allowed to reopen on an unrestricted basis. Most of these institutions had sufficient capital with which to operate, but in the case of some 300 banks it was found, either shortly after reopening or over the next few years, that they did not have sufficient capital to satisfy the requirements of State and/or Federal banking authorities. In the majority of cases where this condition prevailed, the RFC, in the exercise of its powers, made advances, either for debentures or preferred stock, to the banks involved and in most cases such advances have been repaid in full. Certain of the banks which had been closed on March 4, 1933, were ordered liquidated, while others were allowed to reopen on a restricted basis. A number of the banks which were permitted to reopen on a restricted basis went through reorganizations whereby the depositors agreed to take preferred stock in lieu of specified percentages of their deposits in the banks, and the banks worked out for themselves a sound financial structure.

In 1933, as a further protection to the depositors of banks against such catastrophes as had previously occurred, Congress amended the Federal Reserve Act to allow for the creation of the Federal Deposit Insurance Corporation, hereinafter sometimes called FDIC, which corporation was activated in that year. The main purpose of the Federal Deposit Insurance Corporation was to create confidence in the banking structure by insuring the deposits of member banks to the extent of $5,000 per depositor. This insurance protection has since been increased to $10,000 per depositor.

Since FDIC was created it has gone to the aid of over 200 banks and has used 4 means of providing protection. Briefly stated, they are:

(1) Permit the regulatory authorities to liquidate the weak banks and discharge its insurance liability to the depositors.

(2) Liquidate the weak banks through its own staff and discharge its insurance liability to the depositors.

(3) Transfer the acceptable assets and the liabilities of the weak banks to sound going banks by sale, and discharge its insurance liability by paying to the going banks an amount necessary to make the acceptable assets equal to the liabilities of the weak banks, retaining the unacceptable assets of the weak banks for liquidation.

(4) Arrange a merger of two or more weak banking institutions, advance funds to make the acceptable assets of the merged institutions equal to the liabilities, and take over the unacceptable assets through "loan" or "purchase" as security for the advances.

As I have stated, some weak banks which FDIC was required to assist had previously received funds from the RFC for debentures or preferred stock. In those situations where the FDIC elected to follow plans 1, 2, or 3 above, the RFC lost its investment, except where the liquidation of the unacceptable assets by FDIC resulted in the accumulation of funds in excess of those required to repay the FDIC's advance, plus costs of liquidation and interest on the advance.

In substantially all of the banks assisted by FDIC under plan No. 4, the merger method, the RFC had advanced funds for either debentures or preferred stock. At the merger dates all of the advances were represented by preferred stock. These are the institutions for which we ask relief. All of these plan 4 mergers were consummated between January 1, 1938, and December 31, 1940. In each case the banks involved in the mergers were deemed to have deposits and other liabilities in excess of assets acceptable to the supervisory authorities. FDIC met its insurance liability by advancing to the continuing institution cash exactly equal to the excess of deposits and other liabilities over acceptable assets. In no case was there any equity remaining in the continuing bank, either for preferred or common stockholders, at the merger dates. You must keep in mind that the RFC had voting control of all the banks involved in the mergers and the individual stockholders were not permitted to raise new capital for the operation of the continuing banks. The new capital required was supplied by the RFC and the banks were required to issue new preferred stock for this new capital as well as for the bank holiday money. The newly issued RFC preferred stock, which was issued for the bank holiday money, was of no value at the merger dates.

The agreements provided for a sinking fund to be established from future earnings of the bank for the retirement of the new RFC preferred stock.

In the agreements provision was made for the payment of annual dividends on the RFC preferred stock at progressively increasing rates (eventually amounting to 4½ percent), and in every case these annual dividends were paid.

In addition to assisting commercial banks and insurance companies by the provision of capital funds, RFC provided funds for several savings banks through the purchase of debentures therefrom. This aid by RFC to the savings banks was because losses and shrinkage in asset values had seriously weakened the financial structures of such institutions (the case of the commercial banks). Since the losses which weakened the financial structures of the savings banks were sustained in years when the savings banks were not subject to tax (and therefore created no tax benefit) it was felt that taxing income which must be used to reimburse the RFC would be onerous to the savings banks and highly inequitable. As a result of this feeling, and as I stated before, Congress enacted section 313 (g) of the Revenue Act of 1951 and added section 23 (dd) to the 1939 Code, which now is section 592 of the 1954 Code, which reads as follows:

"SEC. 592. DEDUCTION FOR REPAYMENT OF CERTAIN LOANS

"In the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, amounts paid by the taxpayer during the taxable year in repayment of loans prior to September 1, 1951, by (1) the United States or any agency or instrumentality thereof which is wholly owned by the United States or (2) any mutual fund established under the authority of the laws of any State."

The commercial banks involved in plan 4 mergers were subject to Federal income taxes, but the losses which brought about the entire dissipation of the funds advanced by the RFC prior to the 1938–40 mergers, as well as all of the funds invested by the common stockholders, resulted in no tax benefit to the banks. First, the losses sustained exceeded the banks' taxable income. Second, although commercial banks were subject to Federal income tax, exemptions granted to certain classes of income, received mainly by banks and other financial institutions, created a situation where a very few commercial banks were liable for any Federal income tax, even without the deduction of the extraordinary losses which occurred in the 1930's.

The "old" RFC stock (I mean by that the preferred stock issued prior to the 1938-40 arrangement), due to economic events which occurred prior to the 1938-40 arrangement, had lost all value. Hence payments on the "old" stock in reality represent payments of losses previously sustained by the RFC. We think that in all equity these institutions should be allowed to deduct such payments from their gross income for Federal tax purposes and urge that H. R. 8381 be amended to carry out the provisions of H. R. 1161.

The proposed amendment is made effective beginning in 1954. A bill incorporating substantially the provisions of this amendment was introduced in January 1954, and was considered in connection with the enactment of the new code in that year. However, the Treasury submitted a report on the bill stating that they required more time to study it. Some payments have been made on the old preferred stock in the intervening period, and we feel that the banks which made them should not be prejudiced by reason of the long period of time that the matter has been under consideration.

A draft of the proposed amendment is attached.

AMENDMENT Intended to be proposed to the bill (H. R. 8381) to amend the Internal Revenue Code of 1954, and for other purposes, viz: Insert at the proper place the following new section:

"SEC. —. DEDUCTION PAYMENTS OF CERTAIN PREFERRED STOCK.

"(a) AMENDMENT OF 1954 CODE.—Section 583 of the Internal Revenue Code of 1954 is amended to read as follows:

"'SEC. 583. DEDUCTIONS ON CERTAIN PREFERRED STOCK.

"'In computing the taxable income of any national banking association, or of any bank or trust company organized under the laws of any State, Territory, possession of the United States, or the Canal Zone, or of any other banking corporation engaged in the business of industrial banking and under the supervision of a State banking department or of the Comptroller of the Currency, or of any incorporated domestic insurance company, there shall be allowed as a deduction from gross income, in addition to deductions otherwise provided for in this subtitle, the following:

"'(a) Any dividend (not including any distribution in liquidation except as provided in subsection (b)) paid, within the taxable year, to the United States or to any instrumentality thereof exempt from Federal income taxes, on the preferred stock of the corporation owned by the United States or such instrumentality; and

"'(b) In the case of any institution referred to in this section which was a party to a merger between January 1, 1938, and December 31, 1940, in accordance with arrangements made with the Federal Deposit Insurance Corporation, amounts paid, within the taxable year, to the United States or to any instrumentality thereof exempt from Federal income taxes, in retirement of preferred stock issued, between January 1, 1938, and December 31, 1940, in exchange for preferred stock previously issued by any of the parties to the merger to the United States or any such instrumentality.

"'(c) For the purposes of paragraph (b) any amounts paid, whether before or after the enactment of this Act, to the United States or to any instrumentality thereof exempt from Federal income taxes, in retirement of preferred stock shall be treated first as payment of preferred stock not issued in exchange for preferred stock previously issued, to the extent of new funds invested in preferred stock, at the time of merger, by the United States or any instrumentality thereof exempt from Federal income taxes.

"'The amount allowable as a deduction under this section shall reduce the deduction for dividends paid otherwise computed under section 561.'

"(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954. If refund or credit of any overpayment resulting from the application of the amendments made by subsection (a) is prevented on the date of the enactment of this Act, or within six months from such date, by the operation of any law or rule of law (other than Section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than Section 7122 of such Code, relating to compromises), refund or credit of such overpayment, may, nevertheless, be made or allowed if claim therefor is filed within six months from such date. No interest shall be paid on any overpayment resulting from the application of the amendments made by subsection (a)."

THE NEW YORK COMMUNITY TRUST,
New York, N. Y., February 27, 1958.

Hon. HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

DEAR SENATOR BYRD: The Finance Committee, I am informed, is likely to hold hearings on the Technical Amendments Act (H. R. 8381) about which I took the liberty of writing you on February 11. I earnestly hope the committee may be willing to have either an oral or written statement submitted for its consideration in support of the proposal that H. R. 8381 should include the substance of a bill introduced by Senator Humphrey (S. 1349) and referred to the Finance Committee, for the purpose of correcting an inequitable provision of section 170 (b) (1) (A) of the Internal Revenue Avt of 1954. Senator Humphrey's bill is described in the enclosure.

In the event that testimony should be taken by the committee with respect to H. R. 8381, it would be greatly appreciated, if, either by appearance or by memorandum, a statement might be put before the committee relative to its inclusion of the substance of S. 1349 in the Technical Amendments Act. For any assurance you might deem it possible and proper to give, I would be warmly thankful.

Sincerely yours,

RALPH HAYES.

FEBRUARY 11, 1958.

Hon. HARRY F. BYRD,
Senate Office Building,
Washington, D. C.

DEAR SENATOR BYRD: In late January the House passed and sent to the Senate a bill entitled "Technical Amendments Act" and described by the New York Times as one "designed to deal with loopholes, errors, and unintended hardships in the Federal revenue laws." Senator Hubert Humphrey introduced in the previous session of the present Congress S. 1349 which is pending before the Finance Committee and which is described in the attached memorandum. I believe it will be found that the substance of S. 1349 does eliminate an inequitable provision that is now a part of section 170 (b) (1) (A) of the Internal Revenue Act of 1954.

You were kind enough to write me regarding this bill on April 9, 1957. Senator Humphrey wrote on January 17, 1958, that "You can be sure I will continue to work for action by Congress on my bill, S. 1349."

I am well aware that many applications and proposals must be coming in to your committee with reference to revenue legislation but I venture to believe that you will find S. 1349 is designed to serve the very purposes the Technical Amendments Act would further and I most earnestly hope that you and your associates on the Finance Committee may be disposed to incorporate the substance of S. 1349 as an amendment to the Technical Amendments Act.

With great respect, believe me

Sincerely yours,

RALPH HAYES, *Director.*

MEMORANDUM SUBMITTED BY THE NEW YORK COMMUNITY TRUST RE CHARITABLE CONTRIBUTIONS—SECTION 170 (B) (1) (A) OF THE INTERNAL REVENUE CODE OF 1954

INTRODUCTION

The Congress has for many years recognized that, as a matter of continuing public policy, donors should be accorded certain tax benefits on account of their contributions to charitable and eleemosynary purposes and organizations. In a degree unknown elsewhere or heretofore, the United States may boast of notable support of charitable organizations from private sources. It becomes increasingly urgent to encourage and stimulate such aid as the need of funds for health, education, research, and other purposes becomes enormously and critically enlarged.

The revision of the Federal income tax laws in 1954 by H. R. 8300 (the Internal Revenue Code of 1954) affirmed the national importance of charitable gifts by individuals and, generally speaking expanded the tax benefits arising from gifts to churches, recognized educational organizations and hospitals. Since 1954 additional tax benefits have been granted to individuals for gifts to medical research organizations.

This memorandum is designed to call the attention of the Subcommittee on Internal Revenue Taxation of the Committee on Ways and Means of the House of Representatives to an inequitable discrimination resulting from the failure of the 1954 code to extend commensurately additional tax benefits to gifts made to and through community trusts when the donors of such gifts nominate churches, schools, and hospitals as beneficiaries and when such gifts are in fact paid to such beneficiaries by such community trusts.

SECTION 170 (B) (1) (A), INTERNAL REVENUE CODE OF 1954

Prior to the enactment of the Internal Revenue Code of 1954, individuals were permitted to deduct charitable contributions not in excess of 20 percent of adjusted gross income. Section 170 (b) (1) (A) of the Internal Revenue Code of 1954 provided an additional deduction, not to exceed 10 percent of adjusted gross income, for contributions to a church or a convention or association of churches, an educational organization, or a hospital. Qualified educational organizations and hospitals are defined in sections 503 (b) (2) and 503 (b) (5). In 1956, the Congress, by Public Law 1022, 84th Congress, 2d session, broadened section 170 (b) (1) (A) to include gifts to certain medical research organizations.

The Internal Revenue Service in its proposed regulations interprets the Internal Revenue Code of 1954 to mean that a contribution made to a community trust, community chest, or other organization referred to in section 170 (c), which in turn makes the contribution available to a church, school, or hospital, will not qualify under the 10 percent limitation. Thus, under the 1954 code, a donation through a community trust does not qualify for the additional 10 percent allowance even though (1) specific churches, schools, or hospitals are nominated by the donor as recipients and (2) payment to such designated recipients is effected by the community trust within the year of the gift. This interpretation imposes a hardship on individuals who select their local community trust as a vehicle for distributing their charitable contributions.

THE NATURE OF COMMUNITY TRUSTS

Individual donors of charitable gifts have come to recognize, over the years, that social benefits and efficiencies are obtainable from making philanthropic contributions through established and responsible agencies whose function is the effective management, disbursement, and followup of such charitable funds. Community trusts have developed in the United States as recognized mechanisms for the administration and consummation of the charitable purposes of individuals.

Community trusts have been established and are operative in more than 80 localities of widely varying sizes located in 28 States. Their aggregate resources have grown as follows: $12 million in 1925; $40,818,000 in 1935; $67,041,000 in 1945, $141,276,000 in 1955; and $158,573,803 at the beginning of this year. Though they were affectionately termed "poor men's foundations" by the late Frederick P. Keppel, president of the Carnegie Corp., they are currently managing more than 1,300 funds, averaging slightly over $120,000 and the development of these organizations in number and size has been continuous and impressive. The New York Community Trust is comprised of 115 funds having a market value of approximately $27,729,942 and has disbursed appreciably over $16 million. Distributions were made last year to 448 agencies in 108 cities in 30 States and 5 foreign countries.

A community trust, allowing for local variations, usually has the following characteristics: (1) it consists not of one fund but of many; (2) its "founders" may be as numerous as its funds (or much more so when many persons contribute to one fund); (3) the fiscal administration of the funds held is decentralized among various corporate trustees, the trustees of each fund being selected by the founder thereof; (4) a founder may limit disbursements to income or may direct that principal also be expended at any rate of speed he indicates; (5) the philanthropic allocation of all funds is supervised by a central distribution committee designated, as to a minority, by the associated trustee-banks and, as to a majority, by holders of positions of public trust—namely, in the case of the New York Community Trust, by the senior judge of the United States Court of Appeals, the mayor of New York and the presidents of the association of the bar, Academy of Medicine, chamber of commerce and Brooklyn Institute of Arts and Sciences; and (6) the founder of any fund dedicates it—permissively—to any specific charitable purpose, or agency and—necessarily—to broader and basic charitable uses, with instructions to the distribution committee to carry out the more detailed application as long as practicable but to exercise remedial discretion, in the unlikely event that literal adherence to an originally expressed purpose becomes impossible or unfeasible in unforeseen future conditions.

Following is the procedure by which a unit-fund in the New York Community Trust is created: a founder (1) chooses any eligible bank or trust company as the trustee of his contemplated fund; (2) entrusts the fund by will or deed of trust to that trustee-bank for administration under the terms of a published and officially recorded Resolution and Declaration of Trust; (3) gives the fund a name, instructs the trustee regarding investment policy, indicates whether the fund should be permanent or not and whether income only, or income and principal, shall be expended; (4) nominates (in supplementation of the fundamental charitable objectives to which all funds are dedicated) the specific institutions or uses he wishes to benefit; (5) divides the administrative responsibility so as to leave custodial and investment duties to the trustee and disbursement tasks to the distribution committee—with authorization to the latter to exercise corrective discretion if unforeseen future conditions should so require.

A community trust ordinarily declines to accept a rigid and mandatory direction to pay, and continue paying, to a particular organization without provision for future review and appraisal. It does accept a donor's specific expressions of desire when these are coupled with a grant of discretionary authority sufficient to prevent a possible future miscarriage of funds. In actual practice this discretion is exercised with the most extreme rarity. In any event, this aspect has no relevancy in connection with the amendment herein proposed, which relates solely to instances in which (1) the donor has specifically nominated the ultimate beneficiary institutions and (2) actual payment has been made thereto in the taxable year of the grantor during which the gift to the community trust is made.

The descriptive references in this memorandum are taken from the operations and organization of the New York Community Trust and the representations herein are presented solely on its behalf. While there are local variations in the procedures of community trusts, there is an underlying similarity among the generality of them.

The concrete citation of the workings of a single fund will be informative to the subcommittee. The founder concerned makes contributions into his fund, usually at annual intervals. These donations are irrevocable and can in no event be employed for other than public charitable uses. Payments from this fund are consequently made in varying amounts to a diverse list of charitable agencies. These payments are in accord with the expressed desires of the founder. They are authorized by the distribution committee and disbursed by the trustee. In the last calendar year the payments from the fund included:

New York League for the Hard of Hearing	$25
National Foundation for Infantile Paralysis	100
Federation of Jewish Philanthropies of New York	4,000
American National Red Cross, New York Chapter	250
American Red Cross, Mineola, N. Y.	250
Salvation Army	25
Children's Aid Society	25
Boy Scouts of America, Greater New York Councils	50
United Negro College Fund, Inc	25
American Cancer Society, New York Committee	500
New York Heart Association	5,200
Monmouth Memorial Hospital Association, Long Branch, N. J.[1]	25
Cornell University, Ithaca, N. Y.[1]	10,000
Lenox Hill Hospital[1]	5,000
Memorial Center for Cancer and Allied Diseases[1]	5,000
New York Association for the Blind	1,000
Spence School[1]	2,000
Greater Hartford Community Chest, Hartford, Conn	1,000
Girl Scout Council, Westbury, Long Island	25
New York League for the Hard of Hearing	50
Girl Scout Council of Greater New York	75
United Hospital Fund of New York	300
YWCA of City of New York	25
Boy Scouts of America, Nassau County Council	100
Muscular Dystrophy Association of America	500
U. S. Naval Hospital, St. Albans, Long Island[1]	100
The Seeing Eye, Inc., Morristown, N. J	25
New York University-Bellevue Medical Center[1]	250

[1] Believed to be such organizations as are referred to in sec. 170 (b) (1) (A), Internal Revenue Code of 1954, relating to additional deduction not exceeding 10 percent of adjusted gross income.

The public nature of the community trust brings about the distribution and application of charitable gifts in a way conforming to the desires of individual founders and at the same time in a manner consistent with the needs of the social community as a whole. Because community trusts now occupy such a distinctive and serviceable position as vehicles for charitable giving, donors of gifts actually paid through such trusts to qualifying churches, educational organizations, hospitals and medical research agencies nominated by such donors should be entitled to the same tax treatment accorded donors of direct gifts to such organizations.

THE INEQUITY OF DENYING THE ADDITIONAL 10-PERCENT DEDUCTION TO DONORS OF GIFTS ACTUALLY PAID THROUGH COMMUNITY TRUSTS TO QUALIFYING CHURCHES, HOSPITALS, AND EDUCATIONAL INSTITUTIONS NOMINATED BY INDIVIDUAL DONORS

Where an individual transfers property to a community trust and nominates a qualifying church, school, or hospital as the beneficiary and payment is actually made to the beneficiary so nominated, it is unjust to deny the extra 10-percent deduction to the grantor. This is so since the donor of a direct gift to such a qualifying beneficiary is currently eligible to receive the 10-percent additional deduction. The present law results in discriminatory hardship to grantors who select this recognized means of making charitable gifts through a community trust, to and for the same qualified recipients now mentioned in the law. The denial of the additional 10-percent deductions has a tendency to discourage charitable gifts which the Congress has otherwise recognized should be fostered.

This situation could be rectified by clarifying section 170 (b) (1) (A) of the Internal Revenue Code of 1954. An amendment of substantially the following character would eliminate the current discrimination against gifts made and paid, through community trusts, to nominated and qualifying churches, hospitals, and educational institutions:

"SEC. —. Section 170 (b) (1) (A) (relating to the additional 10-percent deduction for charitable contributions, is amended to read as follows:

"'(b) Limitations.—

"'(1) INDIVIDUALS.—In the case of an individual the deduction provided in subsection (a) shall be limited as provided in subparagraphs (A), (B), (C), and (D).

"'(A) SPECIAL RULE.—Any charitable contribution to—

"'(i) a church or a convention or association of churches.

"'(ii) an educational organization referred to in section 503 (b) (2),

"'(iii) a hospital referred to in section 503 (b) (5) or to a medical research organization (referred to in sec. 503 (b) (5)) directly engaged in the continuous active conduct of medical research in conjunction with a hospital, if during the calendar year in which the contribution is made such organization is committed to spend such contributions for such research before January 1 of the fifth calendar year which begins after the date such contribution is made, or

"'(iv) a community trust exempt under section 501 (c) (3), if the contribution is irrevocable and if the donor nominates as the recipient of the contribution one or more of the organizations described in subparagraphs (i), (ii), and (iii) of section 170 (b) (1) (A), to the extent that such contribution is actually paid to and received by one or more of such organizations in the taxable year of the grantor during which the gift to the community trust was made,

shall be allowed to the extent that the aggregate of such contributions does not exceed 10 percent of the taxpayer's adjusted gross income computed without regard to any net operating loss carryback to the taxable year under section 172'."

Respectfully submitted.

THE NEW YORK COMMUNITY TRUST,
By RALPH HAYES, *Director.*

NOVEMBER 23, 1956.

STATEMENT OF CARL C. BARE, CHAIRMAN OF THE NATIONAL LEGISLATIVE COMMITTEE OF THE FRATERNAL ORDER OF POLICE ON H. R. 8381

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE. The Fraternal Order of Police, representing policemen from all parts of the United States, respectfully requests your consideration of section 4 of H. R. 8381. This section would repeal section 120 of the Internal Revenue Code of 1954, relating to statutory subsistence allowance received by policemen. We feel that this section should not be repealed.

Prior to 1939 policemen were not required to pay income tax. The money saved thereby was considered a part of their salary. The required payment of income tax then actually reduced these salaries. Salaries and wages in private industry since that time have continued to increase considerably faster than those of policemen, until today we find ourselves in a very disadvantageous position incomewise. The small benefits that were made available to police officers under section 120 were very badly needed.

It has been said that this section gives police officers an unfair tax advantage. We do not believe this to be true. Members of municipal and State police departments are in an entirely different category than any other worker, including other public employees. No one will deny that it is the responsibility of the Federal Government to enforce Federal laws and protect Federal property. Members of local police departments spend a tremendous amount of time providing protection for Federal post offices, armories, banks, housing projects, and various other Federal property. They also spend a great deal of time enforcing Federal laws and apprehending and prosecuting violators.

Arrests and prosecution for violations such as robberies of national banks, post offices, transporting stolen automobiles across State lines, larcenies from Federal property, and other Federal laws consume many hours. The Federal Government does not pay any part of the salaries of local and State policement, therefore the cost of these activities is borne by the State and local governments. By taking advantage of the provisions of section 120 these local governments can provide much needed additional compensation to their policemen without cost to them. The Federal Government in this way assumes a small part of an obligation which is rightfully theirs. Certainly this cannot be considered unfair tax treatment for policemen. It merely helps to bring the income of police more nearly in line with private industry. This is certainly necessary if we are to attract the responsible type of men we need in law enforcement.

Repeal of section 120 would also take away benefits that members of some police departments have had for many years. Some departments, particularly State police, have provided a subsistence allowance which was exempt from income tax under Treasury Department rulings. The Michigan State police is a typical example. Repeal of section 120 would force them to pay income tax on this subsistence allowance and would, in effect, give them a reduction in pay. I do not believe that any member of this committee would want to see this happen.

Policemen are also subject to other expenses which the average worker does not have and which cannot be considered business expense under Treasury Department rules. They must not only bear the expense of going to and from their regular station house or place of assignment, but must also spend a considerable amount for transportation, etc., in making necessary court appearances. Most police departments work 3 shifts of 8 hours each. Courts are in session only during the day shifts, therefore policemen who are working afternoons and nights, when most of the arrests are made, must appear in court in the daytime when they are off duty. They not only have this extra transportation expense, but very often cases are delayed or consume a great amount of time requiring them to buy lunches away from home, adding additional expense. They also have to cover many special assignments which require traveling in addition to going to and from their regular stations.

Most workers report regularly to their place of employment, work the shift required, and return to their homes. They are able to carry lunches or are provided lunches at approximately cost in a company owned cafeteria. This keeps their cost of eating away from home at a minimum. Policemen cannot do this. The nature of their assignments prevents them from carrying their lunches and reduced rate cafeterias are not provided by their employers. All these things certainly indicate that a policeman has more expense in connection with his employment than the average worker.

When we consider all the foregoing facts I believe it is evident that section 120 does not provide an unfair tax advantage for policemen, but merely recognizes these additional expenses in connection with their employment. We believe it also recognizes the obligation of the Federal Government to assume a small part of the costs of enforcing Federal laws. We therefore respectfully urge you to give consideration to all these facts and recommend that section 4 of H. R. 8381 be stricken from the bill. This will certainly be appreciated by all policemen and be a boost to good law enforcement.

LAW OFFICES,
ROBERTS & HOLLAND.
New York, N. Y., March 5, 1958.

Mrs. ELIZABETH SPRINGER,
Clerk, Senate Finance Committee,
Washington, D. C.

DEAR MRS. SPRINGER: I am transmitting to you herewith two statements with respect to the provisions of H. R. 8381, which are respectfully submitted to the Senate Finance Committee.

The first statement is addressed to section 14 of the bill, improvements on leased property. The second statement is addressed to section 25, denial of exemption to organizations engaged in prohibited transactions.

Respectfully yours,

WILLIAM C. WARREN.

RE AMORTIZATION AND DEVELOPMENT OF LEASEHOLD COSTS AND IMPROVEMENTS (SEC. 14)

1. GENERAL COMMENTS WITH RESPECT TO SECTION 178 (A)

Although the enactment of section 178 (a) may be necessary to allow the Treasury to deal with certain avoidance situations, it would seem that the application of its very severe rules should be restricted to those cases where taxpayers have taken advantage of artificially accelerated writeoffs of leasehold investments to avoid tax. At the same time, there seems to be no justification for applying section 178 (a) to cases where little, if any, tax avoidance potential exists.

Section 178 (a) is bound to have an unsettling effect on the value of every leasehold to which it applies, or may apply. Potential investors will be loath to acquire leaseholds where the tax consequences of those investments are highly uncertain. Clearly, therefore, we should try to restrict the application of this section to those cases where real tax avoidance possibilities exist so as to minimize this effect on present values.

For instance, where we have traditional long-term leases with physical improvements that have been in place for a number of years and where renewal terms were arrived at in the past in arm's-length bargaining, tax avoidance has obviously not been an important factor in determining the terms of the lease. If section 178 (a) is applicable to these leases it will place an extremely heavy burden on investors who purchase or improve such leaseholds since it may well change the entire economics of every such investment. Congress clearly should not apply this provision to leaseholds where the terms of the original transaction were obviously not tailored with a tax avoidance motive in mind, when this would have the effect of reducing the values of these leaseholds by millions of dollars.

It is submitted that section 178 (a) can be so modified that the rule in force under the present Treasury regulations will continue to apply to those cases where tax avoidance is not a significant possibility, while at the same time leaving the heavy burden of persuasion imposed on the taxpayer by section 178 (a) to apply to cases where tax avoidance is a significant possibility. In this manner Congress can effectively deal with the tax avoidance problem in this area and at the same time avoid radically reducing the value of many presently existing leaseholds. The approach taken should be similar to that which Congress has used in other areas, namely, that of providing clear benchmarks, by which cases which clearly do not involve avoidance possibilities can be put to one side, leaving a more rigorous statute to apply to cases where avoidance potential does exist. This has been done, for instance, in the case of the 3-year and 70-percent exceptions in the collapsible corporation area (I. R. C. sec. 341 (d)), and in the case of the 80-percent test applied to corporate redemptions (I. R. C. sec. 302 (b) (2)).

The exercise of caution in applying section 178 (a) to nonavoidance cases seems particularly justified if we recognize just how heavy a burden of persuasion for the taxpayer this section in its present form actually writes into the law. This caution would seem further justified by the fact that section 178 (a) adopts a rule that will frequently lead to substantial distortions of the taxpayer's income and deductions over a period of years.

The severity of the burden of persuasion that is being placed on the taxpayer, and the possibilities of distortion, can best be seen if we examine a single case. Assume that A pays $150,000 for a ground lease which has 21 years to run, and contains a further option to renew for 21 years. As is quite common, the renewal rent is at 5 percent of fair market value at the time of renewal. A is willing to pay $150,000 for the ground lease because the first term rentals are low in relation to the value of the land, and the lease is therefore valuable. A then constructs a building having a 25-year useful life. He is willing to put up the building because it is the only type of building which would be economic for the site and he feels that he will recover his capital and a sufficient return during the first term to justify his investment, even if he does not exercise his option to renew. Under section 178 (a), the burden will be on A to establish that it is more likely than not that he will not renew his lease. A would have difficulty meeting this burden, because of his building's 25-year life and because the rent during the second term is a fair one. Thus, because of the small part of the building's value that will remain to be used during the renewal term, which indicates, at least theoretically, that he will renew the lease, A would have to amortize his leasehold acquisition costs over both lease terms. This would be required despite the fact that the price paid for the leasehold was primarily attributable to its first term. Thus, under section 178 (a) he would have disproportionately high taxable income during the first term of the lease and, if he did renew, disproportionately low taxable income thereafter.

To avoid applying a set of rules that can give rise to such severe results to cases that plainly do not involve significant avoidance possibilities the following limitations should be placed on the application of section 178 (a), if it is to be enacted.

First, there would seem to be very little chance of avoidance if, at the time the lessee acquires or improves a leasehold the fair market value of the renewal term in qu .tion and succeeding renewal terms, taken together, is less than some minimum portion, perhaps 15 percent, of the value of the entire leasehold. In any such case, the vagaries of the economic situation being what they are, particularly when one is trying to peer 20 or 30 years into the future, it does not seem reasonable to require a taxpayer to operate for tax purposes on the assumption that he will renew his lease. In this group of cases he should be allowed, in the absence of unusual factors, to operate on the more conservative assumption, and write off the full cost of the leasehold over its first term, unless it becomes reasonably certain that the option to renew will be exercised. Where substantial improvements are made in the property from time to time during the lease term, the determination of the value of the subsequent renewal terms could be made as each such improvement was made. If the value of the renewal terms was more than this minimum percentage at the time a substantial improvement was made, then the lessee would have to establish that it was more probable than not that he would not renew his lease for a particular renewal term before he could ignore that term in writing off the improvement.

Second, where there is a comparatively long-term lease, such as the 21-year leases which are widely used in connection with commercial properties in large cities, it would seem possible to put aside the rules of section 178 (a), without significant avoidance possibilities in the following types of cases. First, if when a particular term of the lease commences the following conditions are present, section 178 (a) should not be applicable: (1) the useful life of the improvements during the next succeeding renewal term is not more than 50 percent of the length of the current term; and (2) the next renewal term is at least twice the length of the expected useful life of the improvement during that term. Thus, if he current term of the lease was for 21 years, the useful life of the improvements 30 years, and the renewal term 21 years, section 178 (a) would be inapplicable, and only the "reasonably certain" test of the present regulations would apply. However, if the useful life of the building was 35 years or the second term of the lease was only 15 years, section 178 (a) would apply. If, thereafter, the lessee made an improvement which was substantial in relation to the total value of the leasehold, then this test could be reapplied at the time the improvement was made, to determine whether section 178 (a), or the "reasonably certain" test of present law was to be applied. If the lessee then sold to another investor, that investor would, in effect, step into the shoes of his predecessor for purposes of this test. If the threshold met the test outlined above at the beginning of the lease term, and no subsequent substantial improvements had since been made, then section 178 (a) would remain inapplicable to the purchaser. If on the other hand substantial improvements had been made during the current term, and if at that time the lease did not meet the conditions of this exception to section 178 (a), then the current lessee would also be fully subject to section 178 (a). On the other hand, if when the prior lessee made his improvement the lease met the requirements of this exception, section 178 (a) would continue to be inapplicable to the leasehold until the current lessee made an improvement which was substantial in relation to the total value of the leasehold.

This test alone would serve to screen out and protect from the rigors of section 178 (a) a vast number of traditional long-term lease, negotiated without thought of future tax-avoidance potential. It would on the other hand protect the Treasury's interest in those cases where substantial improvements have altered the economic character of the leasehold.

Of course, in every one of these cases, the Treasury would still have at hand as additional protection the reasonably certain rule of present law, and the related case law.

The determination as to whether or not either of the two foregoing exceptions applied to a particular leasehold, would, of course, be made on the basis of the facts existing when the leasehold was acquired or when a major improvement was made, and not on the basis of facts which developed during later years. If 1 of these 2 exceptions was applicable at that time, then the leasehold in question would in effect be marked as standing outside the scope of section 178 (a), and would thereafter be subject only to the reasonably certain rule of the present regulations. Once the Treasury was sure that a case fell within

1 of these 2 exceptions to section 178 (a), and was therefore unlikely to involve a significant avoidance potential, it would seem that the taxpayer should then be allowed to proceed to write off his leasehold investment over the current lease term, unless thereafter he made a substantial improvement in the property or unless major changes in his situation thereafter made it reasonably certain that he would renew his lease.

2. EFFECTIVE DATES

The bill in its present form would be inapplicable to [illegible]ements made or which were contracted for prior to December 31, 1956. It would seem to be equitable to treat leasehold acquisition costs which were incurred prior to December 31, 1956, or pursuant to a binding contract entered into before that date, in the same manner. A taxpayer who purchases a leasehold is frequently simply stepping into the shoes of a prior lessee who actually improved the property. Because the economic position of the two taxpayers is the same, it would seem only equitable to treat them in the same manner under section 178 (a). Of course, even in these cases the Treasury has in reserve the reasonably certain test of the present regulations.

If this step is not taken, it may lead to anachronous results in certain cases. For instance, if an investor both purchased a valuable ground lease and contracted to construct a building on the leased property before December 31, 1956, the bill in its present form would apply to the cost of the ground lease, but would not apply to the cost of the improvement. There would seem no justification for this divergence of result.

3. DEPRECIATION OF PURCHASED LEASEHOLD IMPROVEMENTS

Not infrequently a lessee who constructs a building on leased property will thereafter sell the leasehold, including the building, to an investor. The weight of present authority is that the purchaser in such cases may depreciate the part of his purchase price which represents his economic interest in the building (*Cogar* v. *Comm'r*, 12 F. 2d 425 (6th Cir. 1930)). However, the point has not been considered by the courts squarely for some years, and there is one recent Tax Court decision, *David Dab* (28 T. C. No. 103 (1957)), which implies that a purchasing lessee is only entitled to amortize his leasehold costs over the term of his lease, and may not take depreciation.

Up to the present this question of whether a purchasing lessee may depreciate or amortize the part of his leasehold cost attributable to his economic interest in leasehold improvements has not been too important. Purchasing lessees amortized their costs over the first term of their leases and were therefore not too concerned about the fact that they did not obtain depreciation.

However, this problem will become much more important if section 178 (a) becomes law. This can be best illustrated with a single case. Assume that A leases land at a fair rental and puts up a $1 million building on the property. The lease is for 25 years with a renewal term of 25 years, and the building has a 40-year useful life. Shortly thereafter, he sells the leasehold and the building to B for $1,100,000. B has obviously paid at least $1 million for the building. Let us assume that it would be found to be more probable than not that B will renew his lease. If B is only entitled to amortize his investment, he will have to amortize his $1,100,000 over a period of 50 years, even though the building has a useful life of but 40 years. It seems only right that B should be able to write off his investment in the building which he has purchased over its real economic expectancy—40 years. Moreover, since B is in a very real sense the economic owner of the building, B should be entitled to take depreciation on the building rather than simply amortize his investment. This will allow him to make use of the 150 percent declining balance method of computing depreciation, as he would have been able to do had he purchased a building erected on a fee.

It would be highly desirable that B's right to depreciate his economic interest in the building be specifically recognized by the code. If this is not feasible, then it would be highly desirable that this result be recognized as correct in the committee reports.

WILLIAM C. WARREN.

MARCH 4, 1958.

RE INVESTMENT BY PENSION AND PROFIT SHARING TRUSTS IN EMPLOYER DEBENTURES (SEC. 25)

The Internal Revenue Code of 1954 extended to exempt employee trusts the "prohibited transaction" limitations which had theretofore been applicable to many eleemosynary organizations. The term "prohibited transaction" is defined in section 503 (c) (1) to include the lending of income or corpus to the employer corporation "without the receipts of adequate security and a reasonable rate of interest." The purpose of this provision is to preclude non-arm's-length dealings between an exempt entity and a taxpayer which may be in a position to derive substantial benefits from such dealings (S. Rept. 2375, 81st Cong., 2d sess. at pp. 36 and 37 (1950); H. Rept. 2319, 81st Cong., 2d sess. at p. 42 (1950).

The legislative history of the "prohibited transaction" provisions does not indicate whether the "adequate security" requirements affirmatively requires security in every case, or whether on the other hand security is required only in those situations where it would have been demanded by an outside lender dealing at arm's length with the borrower. While the latter interpretation would have effectuated the expressed legislative intent and the policy of the provision, the Treasury Department has taken the narrower position that security is required in every case.

Unsecured loans between employee trusts and employer corporations had not been uncommon, as was recognized by the report of this committee accompanying H. R. 8300 (S. Rept. 1622, 83d Cong., 2d sess. at p. 58 (1954)). The making of such loans can be highly salutary to both parties if the arrangement is fair and if no overreaching is present. It is obvious that unsecured loans may be fair or unfair—just as secured loans may be fair or unfair. There would not appear to be a sufficient correlation between security and fairness to justify lack of security as an independent criterion of a prohibited transaction.

The stringent interpretation of section 503 (c) (1) adopted by the Treasury Department would be ameliorated by section 25 of H. R. 8381. This provision would amend section 503 by adding a new subsection "(h)" providing special rules for determining when a loan from a section 401 (a) trust to an employer corporation is made without adequate security.

Under this proposed provision, all unsecured obligations held by an employees' trust would be required to meet conditions establishing an arm's-length purchase price; diversification of holdings of particular issues of debentures among persons independent of the employer; and diversification of trust investments. These conditions, which would represent objective criteria of the fairness of an investment, appear sound and proper.

As to unsecured obligations of an employer acquired after November 8, 1956, the following additional condition would be required to be met:

"(4) * * * such obligation is issued pursuant to an indenture or other written agreement which provides that, if the issuer mortgages (or otherwise subjects to lien) substantially all of its property after the issuance of such obligation, such obligation will be secured by a preference no less adequate than that afforded by such mortgage (or lien)."

Indenture provisions of this type are known as negative pledge clauses and in appropriate circumstances may furnish a substantial degree of protection to debenture holderrs. The inclusion of a negative pledge clause in an indenture is not, however, the sine qua non of protection for unsecured creditors; and in many cases may afford far less protection to the lender than other more appropriate provisions and covenants drawn in the context of the particular business exigencies.

Thus, for example, a negative pledge clause would be almost meaningless if applied to a corporation in the financing business. Similarly, a negative pledge clause would be without substance in the case of a personal service corporation, such as an insurance agency, since the mortgaging of its office equipment would be neither a likely nor a consequential eventuality. A negative pledge clause would be inappropriate and burdensome in the case of debentures issued by a corporation in the real-estate business. Persons in the real-estate business generally view real-estate investments in terms of equity values, and the normally prudent conduct of their business frequently involves the mortgaging, at least seriatim, of substantially all of their properties. The requirement of a negative pledge clause would also be extremely burdensome to some common carriers, such as airlines, which frequently subject substantially all of their assets to lien in connection with chattel mortgagee or equipment trust financing.

In situations where negative pledge clauses are inappropriate or burdensome, many other types of indenture provisions are available for the full and adequate protection of debenture holders. Such provisions might, for example, consist of:

(a) Antimerger covenants;
(b) Covenants restricting dividends and stock redemptions;
(c) Covenants restricting other unsecured borrowings; or
(d) Covenants requiring the maintenance of specified asset ratios.

It would not appear feasible to require particular indenture covenants of the foregoing types under section 503 (h), because of the wide diversity of business circumstances under which unsecured loans might be made. However, precisely the same considerations, arising out of lack of predictability of business circumstances, would appear to militate against mandatory inclusion of a negative pledge clause in all indentures which are to qualify under section 503.

It is respectfully submitted that the requirements of proposed sections 503 (h) (1), (2), and (3), providing for both arm's-length dealing and diversification, amply guarantee the fairness of unsecured loan transactions between an employer corporation and an employee trust. Thus, proposed section 503 (h) (4), in addition to affecting different types of businesses differently and therefore inequitably, appears to be wholly unnecessary.

That the business judgment and legal considerations which enter into the formulation of a bond indenture should be required to give way to a fixed requirement of a negative pledge clause, appears difficult to justify as a matter of tax policy. This is particularly true in light of the fact that an employee trust is free to invest in the stock of the employer corporation—an investment practice which has long been approved in proper cases by the Treasury Department, and one which generally serves the highly salutary purpose of supplementing the basic incentive features of a deferred-compensation plan. It seems rather incongruous to subject debentures purchased on the open market to the requirement of a negative pledge clause, and at the same time to permit purchases of common and preferred stock of the employer corporation.

It is accordingly submitted that this committee should recommend that section 503 (h) (4) be deleted from H. R. 8381, and that the provision as so amended be enacted.

Respectfully submitted.

WILLIAM C. WARREN.

FEBRUARY 26, 1958.

BANGOR & AROOSTOOK RAILROAD CO.,
EXECUTIVE DEPARTMENT,
Bangor, Maine, February 5, 1958.

HON. MARGARET CHASE SMITH,
United States Senate,
Washington, D. C.

DEAR MRS. SMITH: Further to our correspondence regarding the railroad situation and the recent hearings, the chances that the major portion of thhe program requested by the industry will be adopted at this session of the Congress now seems somewhat remote. As to certain important phases of that program, however, the legislative outlook seems decidedly bright, and it is with respect to one such aspect, of very real significance to the Bangor & Aroostook that I write to enlist your aid. The legislation in question is a tax measure and was passed by the House on Tuesday, January 28, 1958, as section 81 of H. R. 8381, the Technical Amendments Act of 1958.

Section 81 represents a compromise solution to an involved problem which has long been in issue between the industry and the Justice and Treasury Departments, with piecemeal solutions being slowly ground out by the courts. To resolve the entire matter, the industry and the two executive departments concerned have reached a compromise agreement upon a legislative solution of the entire matter. Section 82 was similarly added to apply like treatment prospectively to certain other roads and is regarded by Treasury representatives as in integral part of the legislation.

Unhappily, the public utility industry, or at least the Consolidated Edison Company of New York, felt that this legisaltive compromise should extend to it as well as the railroads. Although the railroad industry, of course, had no objection, the Treasury Department has never been convinced of the justice of the utilities' case and has opposed their inclusion in the measure with the utmost vigor. Only this month did the House Committee on Ways and Means, at Treasury insistence, vote the measure out properly limited to the railroad industry. The bill (H. R. 8381) is now before the Senate Finance Committee, and I sincerely trust that any efforts which the utility industry may make to be included within the terms of section 81 will be resisted by that body since informed quarters advise that a Presidential veto may be expected if the Treasury's strongly held views on this matter are ignored. The Treasury Department will also oppose any attempt within the railroad industry to alter the language substantially or restrict the scope of the present measure. If, for example, section 82 were eliminated, Treasury would oppose section 81.

In this connection I am advised that the Boston & Maine, while not directly affected by the proposed legislation, has sought and may again seek in the Senate to secure an amendment which is not acceptable to the Treasury Department. Boston & Maine, unlike most railroads, still follows the retirement method of accounting for income-tax purpose. It now takes the position that the legislation is unfavorable to it since it will authorize the commissioner to impose a condition, presently precluded by judicial decision, if and when it elects to change from retirement to percentage depreciation accounting. Such a request for legislative immunity from the remote consequences of some future contingency seems out of line with sound legislative practice. In any event, it should not be allowed to jeopardize the interests of the vast majority of railroads (including this company) which presently need the relief under the compromise measure which has been developed through extensive conferences with representatives of the Treasury Department, Internal Revenue Service, and the joint committee staff. Chairman Mills of the Ways and Means Committee ably pointed out on the House floor that the present proposal would not affect a company such as Boston & Maine. (See Congressional Record for Tuesday, January 28, 1958, at pp. 1051–1052.)

I have purposely refrained from a detailed exposition of this complex measure since it was described at length publicly before the Smathers' subcommittee on January 17, 1958, in the testimony of Cedric A. Major, president of Lehigh Valley Railroad Co., in public testimony last spring at hearings before Representative Mills' Ways and Means Subcommittee on Internal Revenue Taxation and in the floor statement of Chairman Mills of the House Committee on Ways and Means, in the Congressional Record on Tuesday, January 28, 1958, at pages 1051–1052. If, however, you should desire to have the matter explained at greater length, please do not hesitate to let me know.

Section 81 would be highly beneficial to my road and to the railroad industry generally. The Treasury and Justice Departments are both satisfied that the legislation represents a fair and equitable solution to a difficult and involved problem. May I now enlist your aid in securing enactment of this legislation without crippling amendments?

Very sincerely yours,

GORDON ROBERTSON

NORFOLK, VA., *March 4, 1958.*

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

On behalf of the police officers of Commodore Lodge No. 3, Fraternal Order of Police, Norfolk, Va., we humbly request that you reject section 4 of H. R. 838. We were certainly relieved that you have reconsidered and will run again for the Senate.

With best regards for your continued good health, I remain,

Sgt. ROBERT E. KOWALSKY,
Secretary, Commodore Lodge, No. 3.

GARLAND & GARLAND,
ATTORNEYS AT LAW,
Gastonia, N. C., March 6, 1958.

Hon. SAM J. ERVIN, Jr.,
United States Senate, Washington, D. C.

DEAR SIR: I am writing to you in behalf of the entire police force of the city of Gastonia, N. C., in regard to the proposed repeal of section 120 of the Internal Revenue Code of 1954. The bill in particular is referred to as the Mills bill which is now before the Senate Finance Committee. Please allow me to explain the situation which has developed because of section 120. May I preface my remarks with this known fact that in order to take advantage of any tax law a situation must have existed at the time of or during the year, and a subsequent status only applies to a subsequent year.

In 1954 the city of Gastonia was considering a pay raise to its policemen. The Internal Revenue Code of 1954 offered them an opportunity to give them this pay raise without an increase in the city budget, said pay raise resulting from the proper use of section 120. These policemen have been under section 120 since November of 1954. A repeal of section 120 as it now stands with the provision making it retroactive to December 31, 1956, would mean that these men have been receiving more money in their pay than they should for the last 14 months, the reason for the excess amount being attributed to insufficient withholding of taxes because of section 120. Surely equity alone should demand that if this law is repealed, it should be repealed as of the present time and certainly not be retroactive.

The Revenue Service contends that section 120 should be retroactive to December 31, 1956, as that is the date at which they first began to question the use of section 120; and, therefore, it is not a hardship to date it back to that date. Let me paraphrase their statement in this way. What the Revenue Service said was, in effect, that they are boss of this country, a virtual dictator of our finances, and that the moment they begin to have any qualms or questions about interpretation of laws, then that moment you become absolutely liable to them for any subsequent changes in that law. Surely that grates on you as it grates on me and on every other free-thinking American.

The Revenue Service in 1954 issued regulations regarding this section 120, which if followed, would have completely repealed section 120 by Treasury regulations. I voted for my Congressman and I respect the laws of Congress. I did not vote for the Treasury Department and I do not intend to respect their opinion when it is in direct contrast with the laws of Congress. The courts of this country have held time and time again that Treasury regulations do not have the status of law and until they do, I will have the same opinion of such regulations. I am not alone in my opinion. Very recently the Federal courts struck down the Commissioner's ruling as to section 120. Chief Judge John J. Parker of the Fourth Circuit Court of Appeals said on March 3, 1958, in a case concerning section 120, "I expect the Commissioner did not read the statute too closely." The word of such a great jurist should be honored.

It is my understanding that the Ways and Means Committee wants to repeal the law because there is an attempted abuse of this law. There has been since time immortal an attempted abuse of every law on the books of any government. The fact that some wish to abuse is no reason for taking away the privileges of another. There are laws providing adequate means of redress against those who abuse a law. Let me put it this way. A policeman rides in a police car but I may not. It would be foolish to take away the policeman's right to the police car simply because I do not have the right to ride in it. Yet, such is the Ways and Means Committee's argument.

The policemen who are not now under section 120 and who have never been under section 120 have, it is my belief, received their increased income by local appropriations; whether or not section 120 is repealed and/or retroactive will not injure them at all. But those who received their increased income in the form of exclusion offered under section 120 will now not only lose the amount of back taxes that they must pay but will also lose the pay raise that they might have gotten had it not been for section 120. Of course, the cities where such policemen are now facing such a dilemma could extend to them this lost income, but you and I both know that such a great expense of municipal funds would be out of the question. To give you a concrete example, section 120 involves a question of approximately $50,000 in taxes to the 54 policemen in Gastonia alone. Since we might presume that it also involves the loss of a pay raise that would have been equivalent to the tax benefit, the figure is now $100,000. No one would suggest that the city come forward with $100,000 to "make the policemen whole" or to return the policemen to the status quo had they not made the proper use of section 120.

Section 120 was law—law passed by the Congress. The city of Gastonia relied on that law. The retroactive repeal would create a hardship upon those very people who had faith in the law as written. No one should be put in such an unpleasant position because they had faith in the law of the land.

I therefore most sincerely ask that you exert your efforts to prevent the repeal of section 120 if at all possible; and if it is impossible to prevent the repeal of section 120, then equity and a sense of fair play would demand that the repeal not be made retroactive.

Very truly yours,

HENRY M. WHITESIDES.

COMMERCE & INDUSTRY ASSOCIATION OF NEW YORK, INC.,
New York, N. Y., March 4, 1958.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: We deeply appreciate your letter acknowledging our communication of February 27, 1958, in which we stated our opposition to section 14 (a) of H. R. 8381.

There is another feature of the bill which we commend to your careful consideration. In many sections retrospective application of the changes are provided. Where retroactive dates are provided with respect to removal of benefits to the taxpayer they should not be effective prior to date of enactment.

A taxpayer should not be held to be bound by a change in tax consequences resulting from a change in law subsequent to a transaction. Otherwise, the businessman would be put in the position of gambling on future tax enactments or alternatively would have to avoid transactions which he is advised may be treated differently taxwise than under current law. Neither the examination of the problem nor the preparation and introduction of a bill should be constituted a notice to the taxpayer that he may be in trouble.

Accordingly, Commerce & Industry Association urges that H. R. 8381 be amended so that in the case of the removal of beneficial provisions under the Internal Revenue Code of 1954, the provisions removing such benefits should be made applicable not earlier than to taxable years commencing on and after enactment.

Sincerely,

THOMAS JEFFERSON MILEY,
Executive Vice President.

UNITED STATES SENATE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
March 4, 1958.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR MR. CHAIRMAN: Mr. Harley A. Watkins, a lawyer in Toledo, Ohio, has written to me several times within the last year about the technical amendments bill of 1958 on which your committee is now holding hearings. Enclosed are copies of the letters I have received from Mr. Watkins.

You will note that Mr. Watkins is strongly opposed to the Treasury suggestion that interest deductions be disallowed to purchasers of insurance policies who finance them by special loans made for that purpose. I understand that the House Ways and Means Committee considered, but did not approve, the Treasury suggestion. I would appreciate your considering Mr. Watkins' arguments in connection with the proposed amendment of the Treasury Department.

Sincerely yours,

JOHN W. BRICKER.

TOLEDO, OHIO, *February 27, 1958.*

Senator JOHN W. BRICKER,
Senate Office Building,
Washington, D. C.

DEAR SENATOR BRICKER: Last November I wrote you in connection with a proposal of the Treasury Department to disallow deductions of interest paid on loans to carry premiums on insurance policies.

I see again since the Senate Finance Committee is holding hearings on the technical amendments bill of 1958, commonly called the Mills bill, and that the Treasury has suggested "that interest deductions be disallowed to a purchaser of an insurance policy who buys it under a plan to have it largely carried by special loans made for that purpose."

Interest paid for borrowed money ought to be a legitimate interest expense and deductible for income-tax purposes irrespective of what the purpose is, or all interest should be disallowed as a deduction. With respect to interest on loans that carry life-insurance policies, this is one of the few ways in which a self-employed individual, who cannot obtain group insurance, can acquire adequate insurance, since he cannot provide himself with any pension benefits or deferred income benefits such as are available to employees of associations, partnerships, and corporations. Except possibly where the loan is to pay the premium on a single premium policy of life insurance, there is no reasonable excuse to deny the deduction of the interest on an income-tax return. I will appreciate it very much if you will give this matter your sincerest consideration and see that the Treasury Department does not get away with its suggestion. Incidentally, I urge you also to support the Jenkins-Keough bill which will attempt to give self-employed individuals some of the advantages available to other segments of the economy.

Sincerely yours,

HARLEY A. WATKINS.

TOLEDO, OHIO, *November 11, 1957*.

Hon JOHN W. BRICKER,
Senate Office Building,
Washington, D. C.

DEAR SENATOR: I see from the Wall Street Journal of November 6 in the tax report column on the first page that Secretary of the Treasury Anderson, is reported to attempt to present to Congress a recommendation to amend the Internal Revenue Code "to stop what it calls 'abuse' in the use of borrowed funds to carry life insurance." I wrote you on this same subject during the last session of Congress, and while the subject was not considered by Congress at that time, it again appears that it will be requested to do so.

It seems to me that if interest is to be deducted in computing net income that any legitimate interest expense, and certainly an interest expense to carry life insurance so long as it is not the single premium policy is entitled to the deduction. With the high income-tax rate borrowing of part or all of the annual premium is in many instances the only way that an individual can adequately provide family insurance. This is particularly true in the case of all self-employed where they cannot obtain group insurance, and where they do not have the advantages of pension plans, stock-option plans and many other of the so-called fringe benefits available to employed individuals, particularly of corporations, partnerships and associations.

I trust that when this matter comes before Congress, if it does, that you will be able to give it thorough consideration.

Sincerely yours,

HARLEY A. WATKINS.

TOLEDO, OHIO, *May 31, 1957*.

Hon. JOHN W. BRICKER,
Senate Office Building, Washington, D. C.

DEAR SENATOR: I have information from several sources, including Research Institute, that it is proposed, as a part of the loophole closings, to provide that interest payments will not be deductible in cases where the interest charge is incurred upon borrowings or indebtedness for the purpose of carrying a life-insurance endowment or annuity policy. It is proposed, according to my understanding, that this apply even to instances where the borrowing is for the purpose of carrying a substantial number of premiums secured by the cash value of the policy.

While the above has been true in the past as to single premium annuity policies, it seems to me that it is a hardship to extend the rule to apply to the annual borrowings to pay the premium on a life-insurance policy. This is particularly true in the case of self-employed individuals for the reason that in view of the high income-tax rates it is practically impossible for the self-employed individual to have sufficient after-tax savings to carry an adequate amount of life insurance, the premiums on which he would have to pay out of after-tax savings. For this reason it has become quite prevalent for the self-employed individual to protect his family and estate by borrowing a substantial part or all of the premium money and secure it by a pledge of a policy and other assets. In fact, this is practically the only method available to the self-employed individual, since he cannot qualify for any of the deferred compensation or retirement pension plans available under the Revenue Code.

You will thus see that if the proposal is passed into law, it will be a terrific hardship on the self-employed individual. This leads me to the proposal which I wish to make. There has been pending before the Congress for several years the adoption of the Keogh-Jenkins bill, which would give self-employed individuals an opportunity to defer income tax on a part of their earnings by putting them into a voluntary pension program qualifying under the bill. Each time it seems the Government is so hard pressed for revenue that Congress has never seen fit to extend this equal opportunity to self-employed individuals. If the Congress is going to deprive the self-employed individual of his interest deduction on premium borrowings, then it should not be done until the Keogh-Jenkins bill is passed.

I call this to your attention in order that you will have the benefit of my views on this proposal, and so that you and your colleagues may keep in line the so-called loopholes closings. Some of the proposals do in fact close loopholes, but not every so-called loophole is a loophole, unless it be deemed that any deduction from gross income creates a loophole. I scarcely believe that any fair view can consider the interest deduction as an unwarranted escape from taxation.

I would be glad if you could advise me what the status of the proposals, and whether it is dangerously close to being adopted without the Keogh-Jenkins bill being adopted also. For those who are familiar with the situation, this is an opportunity to hit hard on adoption of the Keogh-Jenkins bill.

Very truly yours,

HARLEY A. WATKINS.

BARNES MANUFACTURING CO.,
Mansfield, Ohio, February 28, 1958.

Senator JOHN W. BRICKER,
Senate Office Building, Washington, D. C.

DEAR SENATOR BRICKER: I am writing you in connection with the Mills bill (H. R. 8381) which I understand was passed by the House on January 28 and is now before the Senate Finance Committee for consideration.

My particular interest is in section 9, and I am writing you as a member of the board of trustees of Albion College. It is our belief that Albion College and all similar non-tax-supported schools and charities would be severely harmed if the provisions under the Mills bill are adopted.

I have given this matter considerable thought and study. As you know, under the present Revenue Code of 1954 a person can make a gift to a charitable organization of securities for a specified length of time, and at the end of the period or at the death of the donor, have the securities go to designated persons, usually members of the grantor's family. This is of particular use to owners of closely held corporations, giving them some of the advantages held by owners of securities in publicly held corporations.

The existing situation is of substantial benefit, both to charities and to individual taxpayers. Trusts of this type permit taxpayers to make larger charitable contributions than would otherwise be possible.

The taxpayer whose funds are invested in a family corporation finds it possible under the present situation to make substantial charitable gifts while still retaining control of the business. He is not going to sell stock in his family corporation to make charitable gifts; in many cases sales of such unlisted and closely controlled stock could not be made at a fair price. But under the existing situation, he can make very substantial contributions which are, in effect, a charge against his interest in the corporation.

The charitable organization benefits because it can count upon income over a fixed period of years. This permits the organization to erect buildings and other facilities, borrowing money, if necessary, on the security of the future trust income. It is a method which has contributed largely to the recent building expansion programs of educational, religious, and charitable organizations.

The present situation encourages the individual to make charitable trusts of this type. Frequently, the individual who has built up a large corporate business, has little available cash, after taxes, with which to make substantial charitable contributions. He is in no position to make contributions from capital. The present situation offers the opportunity of making such contributions and an incentive to do so. The charitable deduction which is allowed to the individual provides cash which the individual can use to pay the gift tax on the remainder interest.

The proposed amendment will leave no incentive to make long-term charitable commitments.

It is undoubtedly true that if taxes alone are to be considered, the probable effect of the proposed legislation will be to increase the income taxes paid by individuals (because charitable deductions will be reduced), to increase the estate taxes paid by individuals (because fewer gifts will be made), and to decrease the gift taxes paid by individuals (because this type of trust will not be made, and also because the new type of gift which will take its place will provide exclusions not available under this type of trust). It will also tend to hurt medium-sized family businesses and increase mergers because of the greater estate tax payable at the death of the founder.

The net result of the legislation may be to increase to some small extent the revenues of the government. But this will be at the cost of depriving charitable organizations of the income from this type of trust which, in the past, has been substantial. It will deprive the charities and charitable-minded individuals of the principal means of assuring the payment to charity of sufficient income to permit large capital improvements. Under the present law, the trust provisions assure the charity of income for a period of years. Under the proposed law there will be no incentive to undertake to make payments to charity for a long period of years.

Your interest in this matter on behalf of Albion College and her sister institutions throughout the Nation will be deeply appreciated.

Yours sincerely,

M. H. PRYOR, *Chairman.*

J. A. WHITE & Co.,
Cincinnati, Ohio, March 4, 1958.

Hon. HARRY F. BYRD,
Senate Office Building, Washington, D. C.

DEAR SENATOR BYRD: As you may recall, I have written you numerous letters over the past several years, but none of them was to ask any consideration from you, but rather to compliment you upon your actions and principles.

However, at the present time there is before the Senate Finance Committee a bill which is of vital concern to me, and I should like to submit to you some thoughts about this bill. It is H. R. 8381 and the section which is of deep concern to me is section 3. This bill is supposed to make certain so-called minor changes in the internal revenue laws.

But one of the changes which this bill would make if it becomes law, as passed by the House, is far from minor in its effect on dealers like myself in municipal bonds. As passed by the House, the bill would require that a dealer in municipal bonds amortize all premiums paid for all such municipal bonds unless he disposes of the bond within 30 days after its acquisition and he sells it for an amount higher than the adjusted cost of the bond. Moreover, as presently drawn, this provision would apply to all such bonds acquired by dealers after December 7, 1956. This provision would require a tremendous burden of bookkeeping on all the several thousand dealers around the country who handle municipal bonds, and yet the revenue gained by the Treasury would be insignificant. It is my understanding that the purpose of changing the present law with regard to amortizing premiums paid by dealers in municipal bonds is to close a so-called loophole, whereby a few dealers have been securing an undue advantage to themselves by trading amongst themselves within 30 days of each transaction, municipal bonds for which these dealers have paid premiums, and charging to their taxable income as a loss the difference between the price paid and the price secured for the bond when sold, which in effect would really be the amortization of such premium. There has been a good deal of discussion of this subject amongst the municipal bond dealers around the country and we conscientiously made what we thought was both a satisfactory and honest suggestion to the House Ways and Means Committee to close the loophole and yet not create an intolerable burden of bookkeeping. That suggestion was accepted by the House Committee only in part.

The suggestion which we made was that amortization of premiums be required only when the sales price was less than the purchase price of the bonds. Obviously the benefit derived from the so-called loophole was in selling bonds for less than the purchase price and charging the difference as a loss, whereas it really represented merely a return of a portion of the premium and the interest collected during the period that the dealer owned the bonds, or in brief, amortization. If the bond is sold at a profit, then of course the dealer has no "loss" to charge against his other taxable income.

Apparently the House Ways and Means Committee recognized the effectiveness of this suggestion, but unfortunately, the committee for some reason saw fit to retain in this section of H. R. 8381 the added provision that the dealer must amortize premiums unless he disposes of the bonds within 30 days after his acquisition of them. This 30-day provision obviously results in the other provision being applicable only to bonds disposed of within 30 days; whereas this other provision, requiring amortization unless the bonds are sold at a profit, accomplishes the alleged purpose of closing the so-called loophole and does so without any need whatsoever for this additional 30-day provision.

As the legislation is now drawn, a dealer would have to amortize all premiums on all bonds which he owns for more than 30 days, regardless of whether there is involved any loss which he might want to apply against his other taxable income. Those of us in this business who actually underwrite loans to municipalities and school districts, many times find that we are unable to dispose of this merchandise within 30 days. We have to buy the bonds when they are put up for sale, and in most cases we have to make the highest bid in competitive bidding in order to buy the issue. In practically all cases the issue matures over a period of years ranging generally from 10 to 25 years, with a certain portion of the issue maturing in each year. As you can well imagine, we sell some of the maturities promptly, while we must carry many of the maturities much longer in order to dispose of them.

As the legislation now stands with this 30-day provision in it, we would have to amortize any premium on any of these bonds which we are unable to dispose of within 30 days after acquisition. Frankly, I can see no benefit to anyone from this requirement, as it certainly provides no loophole, and the so-called existing loophole is effectively closed by the provision in the legislation providing amortization when bonds are sold at a price less than their cost. I am sure you can understand that, although, as I have stated, this 30-day provision does no good, it will create quite a hardship on dealers by requiring a considerable amount of bookkeeping in order to amortize premiums on the bonddealers' merchandise.

Let me also demonstrate how little is involved in this matter insofar as revenue to the Treasury would be concerned. During the course of a year our organization will probably underwrite about $15 million worth of bonds of Ohio municipalities and school districts. As I indicated earlier in this letter, these bonds are purchased by making the highest bid at competitive sales. We normally bid a moderate premium over the par value of the bonds, in order to make the highest bid. But before bidding a considerable premium for a bond issue, we should instead bid a lower rate of interest. In other words, instead of bidding a considerable premium for an issue of bonds to bear an interest rate of 3¼ percent, we should instead bid a smaller premium for the bonds to bear interest at a rate of 3 percent.

In effect, then, probably the average premium that we pay for such bond issues would not exceed 1½ percent of the par value, which would mean an average premium of not over $15 per $1,000 bond—and please remember that in many cases the amount of the premium would perhaps be only $1.50 per $1,000 bond. Yet, regardless of how small the premium is, under the proposed legislation we should be required to amortize even this small premium if we are so unfortunate as to be unable to dispose of the bonds within 30 days after their acquisition. Moreover, let us assume that the average premium is $15 per $1,000 bond, and the average life of the issue is 10 years, both of which assumptions are quite logical and probable, this would mean that the full amortization, even to the final maturity of the bonds, would only average about $1.50 per year for a $1,000 bond. If we owned the bonds for 6 months before we are able to dispose of them, then we should have to charge as amortization an average of probably not over 75 cents per $1,000 bond. In the case of a bond owned only 2 months, the amortization would be only 25 cents per $1,000 bond.

I hope I am successful in my efforts to demonstrate to you that this amortization will largely amount to pennies only, so far as the Treasury is concerned. Yet, as you will readily admit, the bookkeeping, of course, would be the same, or perhaps even greater, when we have to figure the amortization in pennies.

Finally, I certainly feel that a man of your principles will realize fully that it is grossly unfair to permit this bill to become law with a provision that would make it retroactive to the date now in the legislation, November 7, 1956. Not only is this retroactive provision wholly unfair, but also it would necessitate a dealer going back to recheck all of his transactions since that date, computing amortization wherever necessary and recomputing his income tax liability for 1956, and subsequent years.

I sincerely hope you will give this matter the serious attention I feel it deserves.

Thank you, and with best regards, I am.

Sincerely yours,

J. AUSTIN WHITE.

STATEMENT OF THE AMERICAN HOTEL ASSOCIATION, WASHINGTON, D. C.

The American Hotel Association objects to part of section 14 dealing with improvements on leased property. Specifically, an objection is raised to placing a lessee in a position of having to forecast what he might do in connection with renewal of a lease in circumstances where the decision to renew could not practically be made at the time when depreciation of improvements is commenced. To illustrate: Assume a taxpayer leases land for 20 years with an option to renew the lease for an additional 20 years. Assume further that the taxpayer constructs a building with a useful life of 30 years. At the commencement of the first 20 years of the lease the taxpayer must determine the depreciation rate on the building. According to section 14 the taxpayer is placed in the position of proving that he will not do something 20 years hence. We submit first that legislation should not require taxpayers to be fortune tellers, and, second, that there is virtually no way in which a taxpayer can conclusively establish that he will or will not do something at the expiration of a 20-year period.

THORNTON, MOHR & FARISH,
Montgomery, Ala., March 4, 1958.

Hon. LISTER HILL,
United States Senator,
Senate Office Building, Washington, D. C.

DEAR LISTER: We are very much concerned with certain provisions of section 3 of H. R. 8381, which passed the House on January 28 and which we understand is now before the Senate Finance Committee. This section would require a dealer in municipal bonds to amortize premium unless disposed of within 30 days after acquisition and would apply to all bonds acquired after November 7, 1956. The vice president of our Investment Bankers Associatio. of America has testified before the committee on February 26. We are urging that section 3 be amended:

(1) To provide that dealers shall not be required to amortize premium on a tax-exempt bond sold at a profit, regardless of how long the bond is held by the dealer;

(2) To make the effective date subsequent to adoption of H. R. 8381.

The so-called loophole involves only the sale of premium bonds at a loss—this has been closed, and we are concerned mainly about the elimination of the amortization requirement where premium bonds are sold at a profit (we pay full taxes as ordinary income on profits derived from bonds selling at a discount). Further, the amount involved on amortization is very small indeed, and would certainly be burdensome if we were required to reexamine and amortize on all transactions since November 7, 1956—we therefore hope the effective date can be amended as outlined above.

My partners join me in trusting that you will give careful consideration to these requests should this bill come to your attention.

With kindest regards to you and Henrietta, in which Louise sincerely joins me, I am

Cordially yours,

SIDNEY J. MOHR.

UNITED STATES SENATE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
March 7, 1958.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR MR. CHAIRMAN: It is my understanding that your committee now has before it for consideration H. R. 8381, the Technical Amendments Act of 1958. This, of course, is a comprehensive and complex bill and the purpose of this letter is only to mention my interest in two particular sections of the bill.

Sections 81 and 82 of the bill as it stands before your committee were added in the House of Representatives by floor amendment. These amendments, as you know, are intended to settle a long standing dispute between certain railroads and the Bureau of Internal Revenue over the depreciation treatment to be given certain property. By the terms of the two sections their application is carefully limited to the railroads involved in the controversy and the legislative history of the sections on the floor of the House clearly indicates that they are not intended to give the Commissioner of Internal Revenue authority to impose the conditions of the sections on railroads not now involved.

It is rather unusual for a settlement of a tax controversy to take legislative form though in this instance the record clearly shows the need for legislation. In a situation, such as this, where the sections involved are a settlement between parties wise legislative policy would seem to dictate that the applicability be carefully restricted to only the parties involved.

Recently it has been brought to my attention that efforts may be made to broaden sections 81 and 82 to, in effect, make them generally applicable as tax policy. It is my understanding that if any action of this nature were taken the Treasury Department would strenuously oppose sections 81 and 82, which it now supports, on the basis that they would go far beyond the purpose intended.

Inasmuch as sections 81 and 82 of H. R. 8381 as passed by the House of Representatives are acceptable to the Treasury Department and the railroads involved as a satisfactory solution of a long standing controversy, it is my hope that your committee will approve these sections without change so that this difficult problem may at long last be resolved.

Sincerely yours,

FREDERICK G. PAYNE,
United States Senator.

UNITED STATES SENATE,
COMMITTEE ON ARMED SERVICES,
March 6, 1958.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
United States Senate, Washington, D. C.

DEAR MR. CHAIRMAN: Mr. J. Everett McCluhan, executive director of the Goodwill Industries of Greater Kansas City, writes as follows with respect to their problem connected with the proposed legislation in House bill 8381:

"House bill 8381, if it were to pass and we were required to put a money value on contributions as they are picked up, would work a considerable hardship on Goodwill Industries. If this had to be done, it would be necessary to place someone on each truck capable of evaluating the materials, and this probably would have to be staff level. You could not depend on truckdrivers to properly evaluate material. In my opinion, it would be impossible to place a valuation on every contribution as it is picked up. We could, at the end of the fiscal period, arrive at the value of contributed materials by adding retail sales, and salvage sales together, thereby arriving at total value of contributed materials from which would have to be deducted: promotion, transportation, administrative and sales expense. Or perhaps to get a better picture only production expense should be deducted to determine the original value of materials picked up. When the original value is determined in either of the above methods, that value could be divided by the total units collected during the year, which would give an average value of each unit. If this would be acceptable to the Internal Revenue Department, it would not be too hard to secure. Our records show this value now, secured in the above manner, and it is carried on our balance sheet as inventory of unsorted material on hand.

"In my opinion it would be entirely too expensive to attempt to value the contributions as they are picked up, but an average value of the contributions could be determined at the end of the fiscal period. It seems to me an exemption should be written into this bill exempting discarded or salvaged materials, such as we, the Salvation Army, and other organizations use in our industrial program. Perhaps if the congressional committee was aware of the cost involved to secure this information they might be willing to approve the above-mentioned exemption."

Mr. McCluhan will appreciate your consideration of this matter.

Sincerely,

STUART SYMINGTON.

STATEMENT OF HERBERT FILER, VICE PRESIDENT, PUT & CALL BROKERS & DEALERS ASSOCIATION, INC.

Section 44 of H. R. 8381 proposes to amend section 1233 of the Internal Revenue Code of 1954. The amendments would clarify the rules applicable to short sales by dealers in securities and would rephrase the provision exempting from the rules of section 1233 hedging transactions in commodtiy futures. The purpose of this statement is to request that section 1233 be further amended so as to change the provisions in subsections (b) and (c) thereof relating to the income-tax consequences of "the acquisition of an option to sell property at a fixed price." The suggested wording for the changed provisions is as follows:

1. Eliminate the last sentence in subsection (b), which reads: "For the purposes of this subsection, the acquisition of an option to sell property at a fixed price shall be considered as a short sale, and the exercise or failure to exercise such option shall be considered as the closing of such short sale."

2. Eliminate the present subsection (c), which reads:

"(c) CERTAIN OPTIONS TO SELL.—Subsection (b) shall not include an option to sell property at a fixed price acquired on the same day on which the property identified as intended to be used in exercising such option is acquired and which, if exercised, is exercised through the sale of the property so identified. If the option is not exercised, the cost of the option shall be added to the basis of the property with which the option is identified. This subsection shall apply only to options acquired after the date of enactment of this title."

and subsitute he following:

"(c) CERTAIN OPTIONS TO SELL.—

"(1) GENERAL RULE.—For the purposes of subsection (b), the acquisition of an option to sell property at a fixed price shall be considered as a short sale, and the exercise, or sale or exchange of, or failure to exercise, such option shall be considered as a closing of such short sale.

"(2) EXCEPTION TO GENERAL RULE.—If,

"(i) on the date of the acquisition of an option to sell property at a fixed price, property substantially identical to that which is the subject of the option has been held by the taxpayer for not more than 6 months, or if, after the taxpayer has acquired such option and on or before the the date of the closing thereof, property subtsantially identical to that which is the subject of the option is acquired by the taxpayer, and

"(ii) the taxpayer identifies such substantially identical property as intended to be used in exercising such option, and

"(iii) such option, is either (A) permitted to expire unexercised or, (B) is exercised through the sale of such substantially identical property, the acquisition of the option shall not be considered as a short sale.

"(3) TREATMENT OF COST OF OPTION.—If the acquisition of an option is not considered as a short sale under paragraph (2) of this subsection and the option is not exercised, the cost of the option shall be added to the basis of the property with which the option is identified."

In order that the committee may pass upon this request with a full understanding of the problems involved, we present the following history of the provisions sought to be amended:

1. In 1948, the Committee on Ways and Means of the House of Representatives became aware of the fact that, under existing law, short sales could be used to reduce income-tax liability. If a taxpayer had purchased 100 shares of X stock at a price of 50 and within 6 months of acquisition the market price had risen to 70, he could make a short sale at 70. The making of the short sale would have no immediate income-tax consequences. The taxpayer would then wait unt'l the

shares acquired had been held by him for more than 6 months. If, at that time, the market price was not in excess of 70 (the price at which he had sold short), he would use the shares which had been purchased by him at 50 to close the short sale, thus realizing a long-term capital gain of 20 points, or $2,000. If, however, the market price was in excess of 70, for illustration let us say 95, he would sell in the market at 95 the 100 shares purchased at 50, thus realizing a long-term capital gain of 45 points, or $4,500. He would then purchase in the market 100 shares at 95 and use such shares to close the short sale, thus realizing a short-term capital loss of 25 points, or $2,500. Since, under the law then in effect $1 of short-term capital loss could offset $2 of long-term capital gain, the result of these transactions was that, although the taxpayer had made an economic gain of $2,000, he had no taxable income from these transactions but, rather, a $250 excess of short-term capital loss over recognized long-term capital gain, which excess could be applied against other capital gains or, to a limited extent, against other income.

2. The House of Representatives attempted to close this loophole by providing in section 151 of H. R. 6143, 80th Congress (the tax revision bill of 1948 which was passed by the House but was never acted upon by the Senate) that, in a situation such as that described above: (*a*) The gain on the closing of the short sale would be deemed to be a short-term capital gain, even though the stock used to close the short sale had been held for more than 6 months, and (*b*) the holding period of the stock first purchased would not commence until the short sale had been closed. Thus, if the taxpayer used his first purchased stock to close the short sale the gain would be short term. If he sold his first purchased stock in the market and closed his short sale with newly purchased stock, the gain on the sale of the long position would be short term and the loss on the closing of the short sale would also be short term. Thus, whichever procedure the taxpayer used in closing his long and short position he would have a net short-term capital gain of $2,000, the amount of his economic gain.

3. At the same time the Committee on Ways and Means learned that there were dealt in in the financial community options to buy and sell securities, known as "puts" and "calls." A "put" is a contract which gives the buyer thereof the option to sell to the other party to the contract (generally referred to as the "writer") a specified quantity of a specified stock at a specified price at any time within a specified period of time. Thus, a 30-day "put" on 100 shares of United States Steel at 60 dated March 1, 1948, would give the purchaser of such "put" the option to sell to the "writer" at any time in the period from March 1 to March 31, 1948, 100 shares of United States Steel at 60.

4. Apparently, the House Committee on Ways and Means felt that a put might be used to create long-term capital gain and short-term capital loss in the same manner that a short sale could be used. Without stopping to analyze whether or not such loophole could be closed without interfering with the legitimate uses of puts, the committee inserted in section 151 of H. R. 6143 a sentence (clause (B)(ii) of subdivision 3 of subsection (a)) which reads as follows: "An option to sell such property at a fixed price shall be considered as a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale."

This sentence was part of section 151 of H. R. 6143 as passed by the House. As stated above, H. R. 6143 was not acted upon by the Senate.

5. In 1950 the Committee on Ways and Means held hearings on a proposed Revenue Act of 1950. The Secretary of the Treasury filed with said committee a statement dated February 3, 1950, and a supplemental statement dated February 6, 1950, in which there was listed as one of the loopholes which should be closed the use of short sales to reduce tax liabilities.

6. There was submitted to the Committee on Ways and Means a statement by Herbert Filer, chairman of the Committee on Taxation of the Put & Call Brokers & Dealers Association, Inc. (of New York, N. Y.). This statement called attention to the manner in which the committee had sought to close the loophole with respect to short sales in section 151 of the tax revision bill of 1948 and to the provision in such section that the acquisition of a put should be deemed to be the making of a short sale. Mr. Filer's statement urged that the sentence dealing with puts (i.e., options to sell) be eliminated from any provision of the Revenue Act of 1950 dealing with short sales. The statement gave the reasons for this request and contained a full explanation of the differences between the making of a short sale and the acquisition of a put. Mr. Filer was questioned by members of the committee with respect to various parts of his statement.

There was also submitted to the Committee on Ways and Means at this time a statement by George H. Heyman, Jr., of Abraham & Co. (members of the New York Stock Exchange). Mr. Heyman's statement also recommended that the reference to puts (i. e., options to sell) be omitted from my section dealing with short sales and gave reasons for such recommendation. Both statements appear in the record of the hearings before Committee on Ways and Means, House of Representatives on Revenue Act of 1950, Part 1, pages 720 et seq. It is respectfully suggested that these statements be read by the members of the Committee on Finance.

7. The Committee on Ways and Means presented to the House of Representatives what ultimately became the Revenue Act of 1950. Said Revenue Act of 1950 made various amendments to the Internal Revenue Code of 1939, section 211 (a) of the act amending section 117 of the code by adding thereto a new subsection, subsection 117 (1). The wording of section 117 (1) was substantially the same as that of section 151 of the tax revision bill of 1948. The sentence relating to puts reads as follows:

"For the purposes of this paragraph, the acquisition of an option to sell property at a fixed price shall be considered as a short sale, and the exercise or failure to exercise such option shall be considered as the closing of such short sale."

8. Section 1233 of the Internal Revenue Code of 1954 is, in substance, a reenactment of section 117 (1) of the Internal Revenue Code of 1939. The differences in the wording of the two sections result, primarily, from the difference in the treatment accorded short sales by dealers in securities. The concept that the acquisition of a put is to be treated as the making of a short sale was continued, the wording of the sentence so providing being identical with that in section 117 (1) except for a change of the word "paragraph" to the word "subsection."

9. However, Congress gave some recognition to the fact that, as pointed out in the statements of Messrs. Filer and Heyman (referred to in par. (6) above) the acquisition of a put is essentially a form of insurance. It added a new subsection, subsection (c), which provided that, if a put and stock identified as being intended to be used in exercising the put were purchased on the same day, and certain other requirements were met, the acquision of the put would not be considered to be a short sale and the stock would not lose its holding period.

Thus, under the present law, if a taxpayer buys stock at 50 and, on the same day, he buys a put at 50, he will not be deemed to have made a short sale. The result will be that, if after having held the stock for more than 6 months, he sells it, let us say at 70, his 20 point gain will be long term. On the other hand, if 10 days after having bought stock at 50 and while the market price of a stock is 52 he buys a put at 52, he will be deemed to have made a short sale, with the result that if, 6 months later, he sells the stock at 70 his gain will be short term.

We respectfully submit that—

(1) The differences between the economic consequences of making a short sale and the economic consequences of acquiring a put are such that there is no justification for giving the same income-tax consequences to the acquisition of a put as to the making of a short sale.

(2) The acquisition of a put is essentially the purchase of insurance. It should be recognized as insurance whether the loss insured against be solely a loss of the cost of the stock or a loss of such cost and the loss of an unrealized profit in the stock.

(3) The fact that a taxpayer has insured himself against loss of an unrealized profit on property held for not more than 6 months should not cost him the right to treat as long-term gain the profit he realizes after holding the property for more than 6 months.

(4) The requirements in the present subsection (c) of section 1233 which we recommend be included in the new subsection (c) that, if the put is not permitted to expire it be exercised by sale of the related stock, is sufficient protection against the use of a put to avoid tax liability, and

(5) The proposed amendment would not result in any loss of revenue and would, in fact, increase the revenue.

1. The differences between the economic consequences of making a short sale and the economic consequences of acquiring a put are such that there is no *justification for giving the same income-tax consequences to the acquisition of a put as to the making of a short sale.*

The following explanation of the mechanics of the making and closing of a short sale and the acquisition and disposition of a put will permit of a clear understanding of the differences in the economic consequences of the two types of transactions:

The mechanics of the making of a short sale are as follows: The short sale is made on the floor of an exchange in the same manner as a regular sale is made (except for certain restrictions, under rules of the Securities and Exchange Commission, as to the price at which the sale may be made). The buyer of the stock is not concerned with the question of whether or not the sale to him is a short sale. Unless he is present on the floor of the exchange when the purchase is made and the seller announces (as required by the rules of the Securities and Exchange Commission) that the sale is a short sale, the purchaser will not know whether or not the sale to him is a short sale. Whether the sale be a regular sale or a short sale, the seller is obligated to deliver to the purchaser on the settlement day (presently the fourth business day following the date of the sale). If the seller has made a short sale, he must, in order to make delivery, borrow stock from someone who owns stock. The purchaser pays for the stock, but the seller does not receive the proceeds of his sale. The person who has loaned the stock requires that there be deposited with him, as security for the return of the stock loaned, the full market value of the stock. Thus, the proceeds of the sale are deposited with the lender. Furthermore, if the market value of the stock loaned increases, the short seller is required to increase his deposit with the lender, so that at all times the deposit with the lender will be not less than the market value of the stock loaned.

When the short seller wishes to close his short sale he returns to the lender stock which he (the short seller) owns. Such stock may be stock which the short seller owned when the short sale was made, or it may be stock which was purchased for the purpose of closing the short sale.

The mechanics of the acquisition and disposition of a put are as follows:

A put is a contract between the purchaser thereof and another party to the contract known as the "writer." Under the terms of the contract the purchaser has the option to sell to the writer, at any time during the life of the contract, the number of shares of the particular stock and at the particular price stated in the contract. The name of the "writer" usually does not appear in the contract. Instead, the contract is endorsed by a member of a national securities exchange on which the stock which is the subject of the contract is traded. By such endorsement the member of the exchange guarantees that the writer of the contract will meet his obligation thereunder, i. e., accept delivery of, and pay for the stock if the purchaser of the put exercises his option.

Since the buyer of the option does not know who the writer is, the purchase of a "put" option is arranged through a put and call broker or dealer. Such broker or dealer upon being informed by a prospective purchaser of a put of the latter's desire to purchase will communicate with a possible writer of the desired put and ascertain at what price such person would be willing to "write" the put. The put and call broker or dealer will add to the quoted price a commission or profit for himself and will then quote to the potential purchaser a price at which he (the put and call broker and dealer) will supply the desired put. If this price is satisfactory, the put will be written and delivered to the purchaser and the purchase price, less the put and call dealer's commission or profits will be paid to the writer. It is for this consideration that the writer assumes the obligation to accept and pay for the stock if the holder of the contract exercises his option to sell stock to the writer.

The differences in the economic consequences of the two types of transactions described above are these:

(*a*) Where a holder of stock has made a short sale he has terminated his economic interest in any subsequent fluctuations in the price of the stock. This is because, if the market price of the stock goes up, any increase in the value of the stock held long will be offset by an increased liability with respect to the short sale. Conversely, if the market price of the stock goes down, any decrease in the value of the stock held long will be offset by an increased liability with respect to the short sale.

By making this statement we do not intend to imply that the making of a short sale by a person who is long the stock sold short is the same as selling the long stock. It is not. The fact that a short sale does not affect a sale of an offsetting long position has been recognized by the courts and this fact gave rise to the loophole which section 1233 is intended to close. What we do say is that once a taxpayer has both a long and a short position in the same quantity of the same stock, subsequent fluctuations in the price of the stock will neither increase nor decrease his economic gain from the closing of the two transactions. If a taxpayer bought stock at 50 and while he has the stock so purchased he makes a short sale at 70, he is saying—economically I am willing that my profit be limited to 20 points and I do not care whether hereafter the price of the stock goes up or down. Under these circumstances we see nothing wrong in Congress providing that the two separate transactions may not be manipulated to create a long-term capital gain of more than 20 points and a short-term loss of the difference between the long-term gain and 20 points. Nor, where the short sale is made at a time when the long position has been held for not more than 6 months, do we see anything wrong in Congress providing that the gain on closing the positions shall be short terms.

(*b*) When a taxpayer has a long position in a stock and purchases a put on the stock exercisable at the then market price he is not making a sale of any kind. He is buying insurance and the cost of the put is the premium he pays for the insurance. The insurance he gets is a protection against loss resulting from a decline in the market value of the stock below the then market price.

The buyer of a put has not limited the profit he may make. Let us take the case of a person who buys stock at 50 and who, when the market price is 70, buys a put at 70. Let us assume that thereafter, and during the life of the put, the market price of the stock rises to 95. The buyer of the put is under no obligation to sell any stock to the writer of the put. Obviously, it would be ridiculous for him to sell his stock to the holder of the put at 70 when he can sell it in the market at 95. Likewise, it would be ridiculous for him to buy stock in the market at 95 for the purpose of selling it to the writer of the put at 70. What the buyer of the put does under these circumstances is to sell his stock in the market at 95 for a gain of 45 points and to permit the put to expire unexercised. Or, if he so desires, he may hold his long position and purchase a new put at 95.

Contrast this with the person who has bought stock at 50 and made a short sale at 70. Again, let us assume that the market price of the stock rises to 95. By the short sale he has limited his profit to 20 points. The only way he can make more (or less) than 20 points is to close out only one side of his position. But if he does this he is, in effect, creating a new economic position on either the long side or the short side of the market.

Because of these differences in the economic consequences of the two types of transactions, we feel warranted in stating that, while there may be justification for the imposition of sanctions, such as loss of holding period, which section 1233 imposes as a consequence of the making of a short sale, there is no justification for imposing such sanctions in the case of the acquisition of a put.

2. *The acquisition of a put is essentially the purchase of insurance. It should be recognized as insurance, whether the loss insured against be solely a loss of the cost of the stock or a loss of such cost and the loss of an unrealized profit in the stock.*

Congress has recognized the insurance nature of the acquisition of a put by providing that if the taxpayer acquires both stock and a put on the same day and he identifies the stock as intended to be used in exercising such option, the acquisition of the option will not be regarded as the making of a short sale. In other words, if a taxpayer buys stock at 50 and on the same day he buys a put to sell the stock at 50, he will not be deemed to have made a short sale, with the result that, if more than 6 months after his acquisition of the stock he sells his stock for more than 50, he will be permitted to treat his gain as long term. On the other hand, as the law now stands, if a taxpayer buys stock at 50 and 20 days later he buys a put to sell the stock at 60, he will be deemed to have made a short sale with the result that, if, after having held the stock for more than 6 months, he sells the stock at 60, through the exercise of the put, or at more than 60 through a sale in the market at more than 60, his gain will be short term.

Why should what is recognized as insurance in the first situation become a short sale in the second situation?

Although the reason for this distinction has never been stated, we believe it to be as follows: In the first situation, the taxpayer has no unrealized profit when he buys the put. Therefore, he is insuring himself only against loss. In the second situation, the taxpayer had an unrealized profit when he bought the put;

consequently, he was (a) insuring against the loss of all or part of his cost and (b) insuring the realization of a profit of 10 points (i. e., the excess of 60 over 50). Since he insured this profit at a time when he had not held the stock for more than 6 months, the profit, when realized, should be treated as short-term capital gain. This reasoning is fallacious.

It confuses an insurance against the loss of an unrealized profit with the economic realization of a profit. Where the taxpayer has made a short sale, he has fixed and, in the economic sense, realized his profit. As hereinbefore explained, price changes after the short sale will neither increase nor decrease his economic gain. The only way he can change the amount of his gain is by closing only one side of his position and thereby creating a new economic risk.

But the taxpayer who buys a put instead of making a short sale has not fixed the amount of the profit. If, after having bought the put at 60, the market goes up to 90, he will let his put expire and sell his stock in the market at 90, making a profit of 40 points. The only effect of the insurance was to protect him (for a premium) against the loss of the potential profit he had at the time he bought the put (as well as against the loss of part or all of the cost of the stock). If he makes the sale of the stock at a time when he has held it for more than 6 months, the profit of 40 points should be taxed as a long-term capital gain, and the fact that he insured himself against loss of 10 points of this profit should not be an excuse for taxing the gain as a short-term capital gain.

3. *The fact that a taxpayer has insured himself against loss of an unrealized profit on property held for not more than 6 months should not cost him the right to treat as long-term gain the profit he realizes after holding the property for more than 6 months.*

The general rule of income-tax law is that the entering into an executory contract for the sale of property at a future date does not terminate the holding period of the property. Thus, a taxpayer can enter into a contract for the sale (at a profit) of real estate which he has held for 5 months and a day, title to close in 30 days, without losing the right to have his profit taxed as long-term capital gain. The only exception to this general rule is in the case of a short sale of property of the kind covered by section 1233 (i. e., stocks and bonds). Why should one type of contract cause a loss of holding period and the other type not cause such loss? The answer to this question is that, in the ordinary type of executory contract for sale, the contract is not the kind of property right which can be disposed of separately. The contract will be satisfied by the delivery of property which is the subject matter of the contract. In the case of the contract for the sale of real estate, the real estate will be sold and there will be a single profit on the transaction. But, in the case of a short sale of stock, the short seller has not identified any of the stock which he holds as being intended to be used to close the short sale. Until the addition of section 117 (l) of the 1939 code, he was free, if the market price of the stock rose after the making of the short sale, to close the short sale with newly purchased stock for a short-term loss and to sell out his long position at a price in excess of the price at which the short sale was made for a long-term gain. One has only to read the committee reports on H. R. 6143, the Treasury Department statements of February 1950, and the commitee reports on the Revenue Act of 1950 to realize that Congress singled out short sales of stocks and bonds for special treatment primarily because of the possible use of short sales to create long-term gains and short-term losses. The loss of holding period was one of the sanctions used to close the loophole. We doubt very much whether, if there had not been the loophole, Congress would have treated a short sale as terminating the holding period of the long position.

Even if we were to assume that Congress would have provided that a short sale was to terminate the holding period even if no long-term-short-term problem had been involved, we can envision its analyzing different types of transactions as follows:

(a) Completed sale should terminate the holding period. Buyer has paid the consideration; title has passed to him and he has started his holding period.

(b) Short sale should terminate the holding period. Buyer has paid the consideration, has received delivery, and has started his holding period. No gain or loss should be recognized to the short seller because he has not delivered his own stock and because he has been required to deposit with the lender the proceeds of the short sale.

(c) Executory contract for sale at future date should not terminate the holding period. The buyer has not received delivery, has not paid the purchase price, and has not started his holding period.

In the light of such analysis, what should be the answer to the question? Should the acquisition of a put which insures against loss of an unrealized profit on stock held for not more than 6 months cause a loss of holding period? We think, without any doubt whatsoever, that the answer should be "No." The writer of a put has not even contracted to buy the stock. He has merely contracted to accept delivery of the stock and pay for it if the buyer of a put elects to exercise it. He has not paid any part of the purchase price; in fact, he may never buy the stock. The buyer of the put has not received any part of the proceeds of any sale, since no sale has taken place.

4. *The requirements in the present subsection (c) of section 1233 which we recommend be included in the new subsection (c) that, if the put is not permitted to expire it be exercised by sale of the related stock, is sufficient protection against the use of a put to avoid tax liability.*

The only situation in which a put may be used to avoid tax liability is where the market price of a stock declines after the acquisition of a put. To illustrate: Taxpayer buys stock at 50 and acquires a put at 50. The price of the stock declines to 30. Therefore, the put becomes a valuable contract since it represents the right to sell at 50 stock which can be bought at 30. Taxpayer can sell the put after holding it for more than 6 months for slightly less than the 20-point profit which represents realizing a long-term gain. He can also sell the stock when he has held it for not more than 6 months for a short-term loss of 20 points. Congress was aware of this loophole when it provided in subsection (c) that the acquisition of certain puts would not be deemed to be short sales. It closed the loophole by providing that, in order for the acquisition of the put not to be considered as a short sale, the put, if not permitted to expire unexercised, must be exercised by the sale of the related stock. Thus, if it becomes valuable and is sold, the requirements of subsection (c) would not have been met. Consequently, the acquisition of the put will be considered as a short sale, with the result that the gain on the sale of a put (i. e., the equivalent of the closing of a short sale) will be short term.

What we are recommending is that the special rules of subsection (c) which now apply only to puts acquired on the same day the related stock is acquired, be extended to all puts. Consequently, restriction on the use that may be made of the put would be made to apply to all puts. With this protective provision there is no situation of which we know in which a put can be used to create a long-term gain and short-term loss.

5. *The proposed amendment would not result in any loss of revenue and would, in fact, increase the revenue.*

In considering the effect upon the revenue of any provision dealing with capital gains and losses, Congress must take into consideration the following:

(*a*) The rates of tax applicable to long-term capital gains which are lower than those applicable to short-term capital gains.

(*b*) The discrepancy between the two sets of rates is so high that taxpayers will not ordinarily realize a gain as a short-term capital gain.

(*c*) Since the taxpayer is not compelled to realize as a short-term gain the unrealized appreciation on his securities, he can afford to take, and will take, substantial market risks in holding the securities for the additional period of time required to qualify the gain as long-term. To illustrate: Taxpayer purchases a stock and in less than 6 months it appreciates 20 ponts. Taxpayer's income is such that he is in the 80-percent bracket. If he sells the stock for a short-term gain of 20 points, his tax will be 16 points and his net, after tax, will be only 4 points. If he holds the stock for the balance of the "more than 6 months" holding period, he will be just as well off if the appreciation shrinks during the holding period from 20 points to 5⅓ points. A long term gain of 5⅓ points less 1⅓ points tax will also leave him with 4 points net after tax. But if the price of the stock does not decline and he realizes 20 points of long-term gain, his net after tax will be 16 points. For these odds, the taxpayer will not take his gain as a short-term gain. He will run the risk that the decline in price may be greater than from 20 to 5⅓ points and that he may end up with less than if he had taken his gain as a short-term gain.

Prior to the addition of section 117 (1) of the Internal Revenue Code of 1939, a taxpayer with an unrealized short-term appreciation would protect the appreciation by buying a put. But since 1950 he is not free to do this inasmuch as the acquisition of the put would have resulted in a loss of the holding period of the stock.

What would happen if the law were to be changed so as to permit a taxpayer to buy a put to protect an unrealized profit without losing his holding period? Let us take three situations. In each of them the taxpayer has bought stock at 50, the stock has increased in value to 70 within 6 months and the taxpayer has bought at a cost of 3 points a put to sell the stock at 70 running to a date more than 6 months after his purchase of the stock.

Situation 1.—At the date of the expiration of the put the price of the stock is 95 and the taxpayer sells his stock at 95, permitting the put to expire unexercised. He will have a long-term capital gain of 45 points. The 3 points paid for the put will be a short-term capital loss, since the put had a life of less than 6 months. For the purpose of this illustration we will assume that the taxpayer has no other short-term capital gains. Consequently, the 3-point loss will be offset against the 45-point gain, leaving the taxpayer with a net long-term capital gain of 42 points on which he will pay a tax of 10½ points.

Under the present law the taxpayer would not have bought the put. He would have held his stock for the "more than 6 months" period, sold it at 95 for a long-term gain of 45 points on which he would pay 11.25 points in tax.

Situation 2.—On the date of the expiration of the put the market price of the stock is 70. Taxpayer exercises the put and sells the stock to the writer at 70. He is required to add the cost of the put to the cost of the stock sold, increasing the cost to 63. Consequently, he has a long-term gain of 17 points on which he pays a tax of 4¼ points.

Under the present law the taxpayer would not have bought the put. He would have held the stock for the 6 months and then sold it at 70 for a long-term gain of 20 points on which he would pay a tax of 5 points.

Situation 3.—On the date of the expiration of the put the stock is selling at 50. Taxpayer exercises his option and sells the stock to the writer at 70. He adds the 3 points paid for the put to the cost of his stock and has a long-term capital gain of 17 points on which he pays a tax of 4¼ points.

Under the present law, the taxpayer would not buy the put. He would sell his stock at 50 without gain or loss and would pay no tax.

Thus we see that if the price of the stock rises, or does not fall, between the date of the purchase of the put and its expiration, he will pay substantially the same tax that he would have paid had he not acquired the put. But, if the price of the stock falls in this period, the put will permit him to realize and *pay tax on*, a profit which, except for the put he could not realize. Therefore, if the law were to be changed so as to permit a taxpayer to buy a put without losing the holding period of the related stock, the Government would collect more tax than it now does. In 1957 the Government lost substantial amounts of revenue by reason of the present provision. In that year prices of stock rose in the first half of the year and dropped sharply in the second half of the year. Many taxpayers, in order to realize long-term capital gains, held stocks with substantial unrealized profits only to see their profits wiped out by a fall in price in the second half of the year. Result, the *Government collected no tax* because the profits had disappeared before they could be realized as long-term gain.

In the year 1957 (it was also true in many a prior year and will probably be true in many a future year) there was a general rise in stock prices in the early part of the year followed by a general decline in stock prices in the latter part of the year. To illustrate the effect on the revenue of the present provisions of section 1233 of the code as to the income-tax consequences of the acquisition of puts let us take the following situation: On April 15, 1957, a taxpayer purchased 100 shares Lukens Steel at 79⅛. On June 30, 1957, the market price of the stock was 119¾. At that time he would have liked to insure himself against loss of the then unrealized appreciation of 40⅝ points ($4,062.50) by purchasing a 4 months put (i. e., 1 expiring October 30, 1957, at which time his stock would be held for more than 6 months) on 100 Lukens Steel at the market. He could have bought such a put for $700, but the penalty for acquiring such a put would have been the loss of the holding period of the stock. Consequently, he did not buy the put. On September 30, 1957, which was still before the required "more than 6 months" holding period, the market price of Lukens Steel had fallen to 85½. The taxpayer still did not take his profit as a short-term gain. Eventually he sold his stock, through a stop-loss order, at his cost of 79⅛. He had no profit and he paid no tax. Had he been free to acquire the put without penalty he would have done so. He would have exercised the put before it expired on October 30, 1957, by selling at 119¾ the stock he purchased at 79⅛. He would have reported a long-term capital gain of $3,362.50 ($4,062.50 minus $700) and paid a tax of $840.63.

We do not present our recommendation for a change in the income-tax treatment of puts as a revenue-producing measure. But we do state that the change recommended will not cause any loss of revenue and will, under certain circumstances, result in increased revenue.

CONCLUSION

The present provisions of section 1233 of the Internal Revenue Code of 1954 as to the income-tax consequences of the acquisition of puts unnecessarily penalize taxpayers who seek to avail themselves of a long-established method of insuring against loss caused by adverse fluctuations in the prices of stock. If these penalties were to be eliminated, taxpayers who acquire puts would not be given any tax advantages over other taxpayers and there would be no loss of revenue. We strongly urge that the changes in section 1233 recommended in this statement be enacted into law.

(Whereupon, at 1:30 p. m., the committee adjourned subject to the call of the Chair.)

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