[COMMITTEE PRINT]

# THE REVENUE ACT OF 1962

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

AS REPORTED BY THE HOUSE COMMITTEE ON WAYS AND MEANS

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

## 1. INVESTMENT TAX CREDIT (SEC. 2)

### (a) *General*

The most important section of the bill provides that a business can subtract from its tax liability 8 percent of its new investment in tangible business assets other than buildings. This tax credit is an outright subtraction from the tax and is in addition to the full allowable depreciation of the cost of the asset.

The amount of the credit that can be taken in any year is limited by the amount of tax. The limitation involves the figure of $100,000 of tax liability. For a taxpayer whose tax (before the credit) is not over $100,000, the credit can offset his tax dollar for dollar. Where the tax is larger than $100,000, the credit is limited to $100,000 plus 50 percent of the part of the tax over $100,000. Any dollar amount of credit which is not usable (because of this limitation based on the tax) may be carried over and used against tax of the following 5 years.

The credit is available for investments in tangible personal property and certain real property used in business so long as it is not a building or a structural component of a building. The credit will apply to assets such as blast furnaces, outdoor machinery, etc., which under State law might be classified as real estate.

### (b) *Short-lived assets*

The investment credit is not available for property which when acquired has an expected useful life (for depreciation) of less than 4 years. Where the expected useful life is between 4 and 6 years, one-third of the normal 8 percent credit is allowed; where the life is between 6 and 8 years, two-thirds of the normal credit; where it is 8 years and over, 8 percent is available. Without the above limitations, short-lived property would otherwise get an advantage over long-lived property because a new credit would be available on the short-lived property each time that it was replaced.

### (c) *Limitations and exclusions*

Property used in regulated public utilities, other than transportation, generally will be entitled to one-half of the normal credit (e.g., 4 percent for 8 years and over). No credit will be allowed with respect to property located outside of the United States. The credit is not allowed for equipment used in residential housing but it will be available for equipment used in hotels and motels.

A limited credit is available with respect to the purchase of used property up to $50,000 of purchases a year.

Where new property is acquired by a firm in the business of leasing property, it may permit the lessee of the property to take the investment credit to which the owner of the property would be otherwise entitled.

The bill provides that if property on which the taxpayer originally obtained the credit is sold within 8 years of the time of acquisition, the taxpayer will be required to recompute the credit to which he was originally entitled, basing it now on the actual period for which he held the property. If the property is disposed of within 4 years, for example, the taxpayer, in accordance with the general rule, would not be entitled to any credit. This readjustment rule also applies where the property is shifted to an ineligible status (e.g., outside the United States).

*(d) Effective date*

The investment credit will apply with respect to property acquired after December 31, 1961. In the case of property constructed or reconstructed by the taxpayer, the credit will only apply to so much of the property as was built after that date.

### 2. Legislative Expenses (Sec. 3)

This section provides a deduction for the costs (including dues to organizations) directly related to appearances before and communications with a legislative body or a committee thereof or individual members thereof, provided they are otherwise ordinary and necessary business expenses. This applies to the U.S. Congress and the State legislatures as well as county and city boards and councils. The provision will not relate to advertising or other expenses relating to political campaigns for candidates or expenses to influence public opinion on legislative issues or to influence voting on things like referendums.

### 3. Entertainment Expenses (Sec. 4)

In the area of travel and entertainment expenses, a major change from present law deals with the proof required of the taxpayer in establishing his deduction. Under present law, by reason of the application of the Cohan rule, the taxpayer may obtain a deduction merely on the presentation of evidence that indicates that it was likely that he spent some amount of money on these items. Under the bill, the taxpayer is not permitted to have deductions for travel, entertainment, or gift expenses unless he substantiates by adequate records or other sufficient evidence the amount of the deduction and the circumstances surrounding the incurrence of the expense.

In addition, it is provided that where an activity is of a type "generally considered to constitute entertainment, amusement, or recreation" the expenses thereof will be disallowed except to the extent that the taxpayer establishes that "the expense was directly related to the active conduct of a trade or business" and it is only deductible to the extent that it is so related. These new tests are in addition to the requirement under present law that the expense must be "ordinary and necessary" to the conduct of a trade or business.

Under present law, the costs of a facility, such as a yacht, are deductible to the extent used for business entertainment. The bill provides that deductions will be allowed for facilities only where they are used for business entertainment more than half the time and then only to the extent of the business use. The expense of a particular use, to be deductible, must also be directly related to the business.

The bill also provides that certain items in this area will not have to be proven to be directly related to the business. These exceptions include business meals under conditions conducive to discussion, entertainment, etc., provided to employees, expenses of certain meetings, items made available to the public, and items treated as compensation of employees. Thus the cost of taking customers to dinners in restaurants to promote good will will continue to be deductible if it is an ordinary and necessary business expense.

The bill also provides that no deduction will be allowed with respect to business gifts to the extent that the gift exceeds in value $25 per recipient per year.

The present law provides a deduction as a business travel expense for the entire amount expended for meals and lodging. The bill amends this to provide a "reasonable allowance" as a deduction for amounts expended for meals and lodging.

These new rules on entertainment and gifts are effective after June 30, 1962.

## 4. Mutual Thrift Institutions

The bill considerably changes the present law tax treatment of mutual savings banks and savings and loan associations effective for incomes in 1963. Under present law, these institutions are permitted to take a deduction for an addition to bad debt reserves in an amount equal to their entire income so long as the aggregate reserve does not exceed 12 percent of deposits. The present law provision has resulted in most institutions having no tax liability.

Under the bill, the thrift organizations will have the opportunitity to take a deduction for amounts set aside in a loss reserve on real property loans based on either of two alternatives. The alternative that will be more frequently used will be a deduction of 60 percent of the taxable income of the institution computed without regard to any loss deduction. Alternatively, the institution may take a deduction for an amount set aside in a loss reserve necessary to bring the reserve at the end of the year up to 3 percent of loans on improved real estate (or whatever amount their experience indicates is necessary for an adequate reserve). Under this second alternative, losses on other than real property loans may be reserved under the general provisions applicable to other taxpayers.

This provision will be available to both mutual institutions and to savings and loan associations with outstanding stock. In the case of a stock company, however, distributions to shareholders will serve to cut down the reserve deduction.

The bill provides several technical amendments in the savings and loan area. A special rule is provided for treating losses arising in connection with the foreclosure of mortgages in a way that is realistic from the standpoint of banks. The bill also amends the definition of savings and loan associations.

## 5. Mutual Fire and Casualty Insurance Companies (Sec. 10)

The bill provides that mutual fire and casualty insurance companies will, effective for incomes in 1963, be subject to tax in a way similar to stock fire and casualty insurance companies with certain modifications. This change would have the effect of requiring the mutual companies to include in their tax base the gain from operations, that is, the excess of insurance premiums over operating expenses and insurance losses paid. (At the present time, these companies are taxable on their investment income only, with an alternative tax of 1 percent, if higher, on gross receipts (premiums and investment income). The bill removes completely the 1-percent alternative.)

The major modification with respect to mutual insurance companies is that a portion of the gain from operations which is made subject to tax in this bill may be deducted from income currently and put into a deferred income account. The amount that is added to the account will be one-fourth of the underwriting gain plus 1 percent of incurred losses (claims payable). After an amount is added to the deferred income account, it will be available to meet underwriting losses. If the amount set aside in a taxable year in the deferred income account is not used to meet these losses during the following 5 years, there will be added back into taxable income in the sixth year the amount remaining from the 1 percent of incurred loss formula and one-half of the amount remaining out of the one-fourth of underwriting gain for mula. An additional deferral is provided for companies with concentrated risks in windstorm, etc., coverage.

The bill provides that the mutual company will get a deduction for dividends paid to policyholders. In all cases, an underwriting loss which the company would show without regard to the deduction for policy dividends will be subtracted directly from investment income. Other underwriting losses would be charged against amounts in the deferred income account and would be subtracted from investment income only when the deferred income account was exhausted. Certain additional relief is provided for small companies (whose gross receipts are below $900,000).

The bill contains a special rule relating to the factory mutuals. Generally these are to be treated in the same manner as stock companies. It is provided, however, that the amounts out of the premium deposit which the company would be obligated to return to the policyholder if the insurance contract were terminated at the end of the year will not be included in earned premiums. (These amounts must be subtracted from the cost of insurance for the business policyholder.) Furthermore, the factory mutual company must add to their gross income 2 percent of the earned premiums computed in the foregoing manner.

The reciprocal insurance companies will be permitted to treat as policy dividends amounts which they would be obligated to return to the policyholder if the insurance contract were terminated at the end of the year. In addition, it is provided that for certain purposes the reciprocal might compute its own tax by including in its taxable income the taxable income of the corporate attorney-in-fact attributable to relations with the reciprocal. In this case the reciprocal can take a credit for the tax paid by the corporate attorney-in-fact. This would, for example, result in a refund of tax to the reciprocal where the reciprocal had net losses and had no income against which to charge them.

## 6. Gain From Dispositions of Certain Depreciable Property (Sec. 14)

This section provides that if depreciable property, other than buildings, is disposed of, then there will be included in ordinary taxable income in the year of disposition any gain on the disposition of the property to the extent that it represents depreciation taken after December 31, 1961.

Under present law, property may be depreciated (deductions taken against ordinary income) and, then, when it is disposed of, the current value of the property may be considerably in excess of the basis (the original basis reduced by depreciation taken), thus converting deductions from ordinary income into capital gains. The bill takes the approach of recognizing that in such a case the depreciation actually allowed on the property as a deduction from ordinary income has been excessive and should be restored to ordinary taxable income. The rule applies not only to sales or exchanges of the depreciable property but it applies also to depreciable property disposed of in a number of situations where under present law there would be no recognition of gain or loss. This provision will not apply to buildings or to any property which is a structural component of a building.

## 7. Tax Treatment of Cooperatives (Sec. 17)

The bill deals with the problem, in the taxation of cooperatives, arising from certain court decisions under the Revenue Act of 1951 whereby some portion of the income of cooperatives has been able to avoid tax.

Under the bill, it is provided that a cooperative will be permitted to take a deduction for cash dividends or dividends paid in the form of written notices of allocation (so-called scrip). A written notice of allocation will be deductible only if it is either (1) payable in cash within 90 days at the option of the patron, or (2) the patron has consented to include the amount of this written allocation in his own income. This consent can take either of two forms. First, it may be a written consent which may be given once by a patron and remain in effect unless it is revoked. Second, the patron who is a member of the cooperative may consent to this inclusion by the co-op adopting a bylaw requiring all patron members to pay tax on these written notices of allocation.

Both the cash dividends (other than those of consumer cooperatives) and the noncash patronage dividends will be subject to withholding at a rate of 20 percent under the same general provisions as withholding for interest and dividends described below. The patron would take credit on his tax return for the amount withheld.

Certain technical provisions of the law presently applicable only to farm cooperatives are extended to nonfarm cooperatives. These include the ability to take deductions for noncash patronage dividends and to take into account for a taxable year dividends allocated within 8½ months after the end of the year and to file their returns under certain circumstances up to 8½ months after the end of the year. The new provisions do not apply to REA cooperatives.

## 8. Withholding on Dividends, Interest and Patronage Refunds of Cooperatives (Sec. 19)

The bill provides that a payor of dividends, interest, and patronage refunds (of marketing or producer cooperatives) will be required to withhold tax at a rate of 20 percent. There is no requirement that the payor notify the recipient of the amount withheld. It will be made clear on the tax return that for every 80 cents that an individual receives as dividends, interest or patronage refunds, he may calculate the amount that has been withheld by taking one-fourth of this (20 cents). He will report his gross income as $1 by adding the amount that he receives plus the amount that has been withheld, and he will take credit in his tax computation for the amount that has been withheld.

The bill contains several provisions cutting down on overwithholding:

(1) *Exemption certificates.*—All individuals who expect that they will have no tax liability for the year will be able to file an exemption certificate and avoid the withholding on bank interest, series E-bond interest, and dividend income. Individuals under 18 may file exemption certificates whether or not they expect tax liability.

(2) *Quarterly refunds.*—Married couples with less than $10,000 of income and single persons with less than $5,000 receiving dividend or interest income, if they expect to have less tax liability for the year than the amount withheld, as well as tax-exempt organizations, may file quarterly claims for refund. It is anticipated that this refund procedure will be operated in such a way that the refunds may be paid promptly. The claim for refund may be filed at any time during a quarter, rather than waiting until its close.

(3) *Offsets.*—It is provided that corporations and tax-exempt organizations may take credit for amounts withheld from them against any liabilities that they have as withholding agents of income and social security taxes. For example, if an organization has had withheld from it $200 on dividends that it receives, then when it deducts withholding from dividends, or in certain cases wages, that it pays, it is permitted to offset $200 against the amount which it holds as a withholding agent and otherwise would pay over to the Treasury. Where the offset provision is not adequate with respect to withholding on a tax-exempt organization, the quarterly refund provision is still available.

The bill provides that amounts withheld may be retained by the withholding agent until 1 month after the end of the quarter in which the dividends or interest are paid.

The withholding provisions will be effective January 1, 1963.

## Foreign Provisions

The provisions dealing with foreign income are as follows:

*F-1. Foreign earned income and pensions of individuals (sec. 12)*

Under present law a U.S. citizen is permitted certain exclusions from taxable income for income that he earns while abroad. This exclusion is unlimited if he establishes that he is a bona fide resident of a foreign country; and it is limited to $20,000 a year if he is not a bona fide resident of the foreign country but remains abroad for 17 out of 18 consecutive months.

The bill imposes a ceiling on bona fide residents. It provides that for the first 3 years during which an individual is a bona fide resident in a foreign country the annual exclusion of foreign earned income will be limited to $20,000. If this individual stays beyond 3 years, his annual exclusion from then on will be to $35,000.

Under present law if an individual employed abroad is under a pension or annuity plan established by the employer, any contributions made to this pension or annuity plan by the employer while the individual is abroad are treated as tax-exempt income even though received by the annuitant when he is in the United States. The bill provides that any amount contributed by the employer to the pension plan will be taxable to the individual upon retirement wherever he may then live. But, this rule will not be applied to amounts contributed by the employer with respect to periods prior to December 31, 1962.

*F-2. Estate tax on foreign real property (sec. 18)*

Present law excludes from the gross estate of a U.S. citizen or resident the amount of real estate located outside of the United States. The bill removes this exclusion as of the date of enactment for newly purchased real estate. In the case of real estate held by the decedent on February 1, 1962, the real estate may still be excluded from the gross estate if he dies before July 1, 1963.

*F-3. Distributions by foreign trusts (sec. 9)*

Under present law some tax advantage may be obtained where a U.S. grantor establishes a trust outside of the United States. The foreign source income received by this trust may be accumulated without any U.S. tax liability and in a later year paid over to a U.S. beneficiary. This accumulated income, paid out in a later year, under present law is treated as a distribution of the corpus of the trust and does not involve further U.S. income tax.

The bill provides that after the date of its enactment, if a foreign trust established by a U.S. grantor makes any distribution of prior accumulated income, any U.S. beneficiary who receives this accumulated income will be required to include it in his own income and to take credit for any taxes that the trust has already paid. The bill contains alternative formulas for spreading the income back over prior years so as to prevent the imposition of excessive surtax rates due to the bunching of income in a year in which the accumulation is received by the U.S. beneficiary.

*F-4. The gross-up of foreign dividends (sec. 11)*

Under present law a corporation which owns at least 10 percent of the stock of a foreign corporation may obtain a foreign tax credit with respect to taxes paid by the foreign corporation at the time that it receives dividends from the foreign corporation. This tax credit is also available with respect to dividends received through the first foreign corporation from any 50 percent subsidiaries which it owns.

The allowance of foreign tax credit to the domestic corporation in such cases, together with the exclusion of the foreign taxes paid, results in an overallowance for these foreign taxes. The bill eliminates this overallowance through a technique referred to as the gross-up. Wherever a U.S. corporation receives a dividend from a foreign subsidiary (where it would be entitled to a foreign tax credit under present law) it will receive credit for foreign taxes paid attributable to the dividend only if it includes in its income the amount of the foreign tax for which it receives credit. (This corresponds to the treatment of individuals who take credit on their income tax return for the amount that has been withheld by the employer and report as income the gross wages before withholding.)

This provision will apply with respect to all dividends from foreign corporations received after December 31, 1964. It will apply to dividends from foreign corporations received during 1964 to the extent that these are paid out of current earnings and profits.

*F-5. Allocation of sales income between a U.S. corporation and a foreign subsidiary (sec. 6)*

Under present law, a U.S. corporation selling products abroad through a foreign sales subsidiary may obtain considerable tax advantage by charging a low price to the foreign sales subsidiary so as to show very little profit on the U.S. manufacturing operation and thus incur very little liability for U.S. tax. When the foreign sales subsidiary sells the product at a substantially higher price, the total profit might be reflected in the income of the sales subsidiary where it might be subject to a very low rate of tax. This is also possible, in reverse, by paying a high price for things bought from the foreign subsidiary. The provision in existing law to deal with this distortion of income (sec. 482) gives the Secretary of the Treasury authority to adjust the sales price on the transaction between the parent and the subsidiary, but this has proven to be extremely difficult to administer.

The bill provides that, in lieu of adjusting the sales price between the parent and the subsidiary, where there are no arm's-length transactions to establish a price, the Secretary of the Treasury may reallocate taxable income between the subsidiary and the parent to the extent that this income arose from sales or purchases of property at other than established arm's-length prices. This reallocation of taxable income may be on the basis of a formula that would involve, on the one hand, the assets, payroll, and selling expenses located in the foreign country and, on the other hand, the assets, payroll, and expenses located in the United States. All the profit may be subjected to the U.S. tax if the foreign subsidiary is little more than a "paper" corporation.

*F–6. Controlled foreign corporations (sec. 13)*

This section deals with a number of problems existing under present law which have the effect of permitting U.S. investors to conduct certain operations through a foreign corporation.

A foreign corporation is defined as a controlled foreign corporation if at least 50 percent of its stock is owned, directly or indirectly, by American interests. The bill provides that a U.S. person who owns, directly or indirectly, 10 percent of the stock will be taxable on certain income of this controlled foreign corporation whether or not it is distributed as a dividend. This U.S. person will be taxable on the portion of this income which is attributable to the shares that he held directly or to the shares that he holds through foreign persons (corporations, trusts, etc.).

The amounts on which the U.S. person is taxed may be classified as: (1) Subpart F income, and (2) profits considered as being distributed.

Subpart F income is, in general, those types of income which are taxed to the U.S. shareholder on the ground that the income is of a type that could as well have been received directly by the American owner. This includes:

(1) income from insuring U.S. risks,

(2) income earned on the basis of ownership of patents, copyrights and exclusive processes developed in the United States and transferred to the foreign subsidiary,

(3) certain interest, dividends, rents, royalties and profits on sales of property for use outside of the foreign country of organization (where the property is sold to, or was acquired from a related corporation). Income in this category (3) may be kept out of the tax base by being reinvested in a business in a less developed country.

The amount treated as having been distributed is the profit accumulated after 1962 to the extent that it is invested in certain prohibited types of property which include:

(1) assets which are over and above amounts necessary for the operation of the business,

(2) assets used in a "new" trade or business in a developed country, i.e., one which the company has not been engaged in for 5 years (or on December 31, 1962),

(3) most assets situated in the United States.

These income inclusion provisions are drafted to avoid having the same income taxed under more than one provision. It is also provided that income which is taxed to a U.S. person under these provisions will not be subsequently taxable to the same person if it is paid to him as a dividend. Appropriate provisions are included for the adjustment of basis in stock and for the appropriate foreign tax credit.

*F–7. Gain from certain sales of stock (sec. 16)*

The bill provides that on the redemption or liquidation of the stock of a controlled foreign corporation any gain will be taxed to the American shareholders as ordinary income to the extent of their share of the earnings and profits. This provision applies only with respect to shareholders having an interest of 10 percent or more. Similarly on sale by such a shareholder of his stock, gain will be taxed as ordinary income to the extent of the earnings of one controlled corporation during his holding period. This change is related to the preceding section limiting the advantages of tax deferral through the use of foreign corporations. This will have effect with respect to income where there is allowed some deferral of tax on ordinary income and it will prevent this income from later being realized by the American investor at capital gains rates rather than ordinary income rates.

*F-8. Foreign investment companies (sec. 15)*

Under present law, a pure investment company organized in certain foreign countries, particularly Canada, has considerable advantage tax-wise over regulated investment companies organized under the laws of the United States and subject to U.S. taxes. The principal advantage of these foreign investment companies is that they may accumulate income with little or no tax at the corporate level, and this income might later be realized by the investor through the sale of his stock and, then, be taxable only at capital gains rates. (It might never be subject to income tax if the basis of the stock is increased because of transfer by death.)

Under the bill, it is provided that when an investor sells his stock in a foreign investment company (which is either registered in the United States or principally owned in the United States) the portion of his gain attributable to retained earnings of the investment company after 1962 will be taxable as ordinary income. A technique is provided in the bill for a registered foreign investment company to elect tax treatment substantially identical with the tax treatment of a U.S. regulated investment company, thereby providing current tax on the dividends and "pass through" treatment for the capital gains on a current basis.

It is provided that the effect of this provision cannot be avoided by the step-up basis of property resulting from transfer at death.

*F-9. Property distributions from foreign corporations (sec. 5)*

Under present law, where property other than money is distributed by a corporation and received by a second corporation which is a stockholder, the amount of the distribution to be taken into account by the recipient (e.g., as a dividend) is the lower of the fair market value of the property or the adjusted basis of the property in the hands of the distributing corporation. The bill modifies this rule by requiring that distributions from foreign corporations be taken into account at fair market value. This will prevent American parent corporations from realizing on the profits of a foreign subsidiary, at a minimum U.S. tax liability, through having the subsidiary distribute appreciated property.

*F-10. Distributions of foreign personal holding company income (sec. 7)*

The bill changes the provisions in present law dealing with foreign personal holding companies. At present, the income of these companies is taxed to certain U.S. shareholders only if 60 (or in certain circumstances 50) percent of the income is from foreign personal holding company income sources. Under the bill, the foreign personal holding company income will be taxed proportionately to the shareholders if it represents 20 percent or more of its income. Where the foreign personal holding company income represents 80 percent of the total income, then all of the income of the company will be taxed to the shareholder.

*F-11. Information on foreign entities (sec. 20)*

The bill extends the provisions of existing law that permit the Secretary of the Treasury to obtain information with respect to certain foreign corporations owned by Americans. This extension of the information provision is necessary for the enforcement of the provisions dealing with controlled foreign corporations.

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