1074

THE INTERNAL REVENUE CODE OF 1954

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-THIRD CONGRESS

SECOND SESSION

ON

H. R. 8300

AN ACT TO REVISE THE INTERNAL REVENUE LAWS OF THE UNITED STATES

PART 3

APRIL 16, 19, 20, AND 21, 1954

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THE INTERNAL REVENUE CODE OF 1954

FRIDAY, APRIL 16, 1954

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

The committee met, pursuant to recess, in room 312, Senate Office Building, at 10:10 a. m., Senator Eugene D. Millikin (chairman) presiding.

Present: Senator Millikin, Flanders, Carlson, Frear, and Long.

The CHAIRMAN. Mr. Herrmann, will you identify yourself for the record, please?

STATEMENT OF DAVID W. HERRMANN, PRESIDENT, NATIONAL ASSOCIATION OF SHOE CHAIN STORES, ACCOMPANIED BY EDWARD ATKINS, EXECUTIVE VICE PRESIDENT

Mr. HERRMANN. Mr. Chairman, Senators of the committee, my name is David W. Herrmann. I am vice president of the Melville Shoe Corp. of New York, which operates 794 stores throughout the United States and 12 factories in New Hampshire and Massachusetts.

The CHAIRMAN. How many stores?

Mr. HERRMANN. 794.

The CHAIRMAN. You make your shoes where?

Mr. HERRMANN. Primarily in factories located in New Hampshire and Massachusetts. New England.

I am president of the National Association of Shoe Chain Stores, and am appearing in behalf of that association, and the American Retail Federation, representing their position on section 359 and related sections of the Internal Revenue Code of 1954, designated as H. R. 8300.

Descriptions of both of the aforementioned retail groups and their memberships are appended to this statement.

Those responsible for H. R. 8300 are to be complimented on the magnitude of the task they assumed, and the general results of this gigantic effort, in effecting a major revision of the existing code.

H. R. 8300 is to be more commended than criticized, but it is inevitable that in drafting volumes of tax legislation, a number of flagrant inequities will appear.

Although sections 351 to 373, under the title of "Corporation Organizations, Acquisitions, and Separations," contain a number of clarifications helpful to taxpayers, our opposition is directed to the provisions of section 359 and related sections, dealing with mergers, consolidations, and corporate acquisitions. I will hereafter use these terms interchangeably.

As a result of these provisions, relatively large corporations can no longer acquire the assets, or the stock, of relatively smaller corporations in a tax-free statutory merger or consolidation. Two publicly held corporations may merge or consolidate in a tax-free transaction. However, even in this instance, many corporations whose securities are traded on the major stock exchanges would not fall within the definition of a "publicly held corporation," which states:

A corporation will be deemed to be publicly held unless 10 or fewer shareholders own more than 50 percent either of the total combined voting power or of the total value of all classes of stock of the corporation.

A publicly held corporation could not consolidate tax-free with a closely held corporation unless the stockholders of the transferor corporation received at least 20 percent of the participating stock—after consolidation—of the acquiring corporation.

This imposes an almost impossible, if not purely academic, requirement which virtually outlaws consolidations or mergers between publicly held corporations and closely held corporations.

The CHAIRMAN. Give me some idea of the stock structure of your association. Who owns your stock?

Mr. HERRMANN. The association is made up primarily of chain-store organizations, operating in the shoe business.

The CHAIRMAN. Is it a true association, or do you have stock?

Mr. HERRMANN. It is a true trade association.

The CHAIRMAN. Very well, go ahead.

Mr. HERRMANN. It is incorporated and tax-exempt under the code, sir.

I am not an attorney, but as a businessman, will address myself primarily to the equities and economics involved in those provisions of section 359 relating to consolidations and mergers.

Most statutory consolidations or mergers take the form of acquisition by a corporation of the stock, or assets, of another in exchange for part of its voting stock.

Under the provisions of section 359, few mergers, involving closely held or privately owned corporations, would ever have been effected. In only exceptional and isolated instances would the greatest portion of these mergers have qualified for tax-free status. The tax impact would have precluded most of them.

In a majority of instances, a closely held corporation is consolidated or merged with a publicly held corporation. It is this typical transaction most adversely affected by the restrictions imposed in section 359.

Consolidations or mergers are undertaken for a number of reasons recognized by law, and recognized as sound, economically. Considerations accruing to the advantage of the stockholders of a closely held corporation include the following:

1. Additional financial resources.
2. Acquiring capital for business needs and expansion.
3. Increased efficiency through an exchange of personnel, methods, and research, which a small corporation might not be able to afford.
4. Acquisition of more readily marketable stock.
5. Continuity of the business in the event one or more key executives die, and heirs are incompetent to run the business.
6. Insuring the ability to meet estate taxes, without sacrificing the business through forced sale.

Advantages to the acquiring corporation include:

1. Diversification.
2. Acquisition of capable management.
3. Expansion which might otherwise require many years to effect.
4. Economies resulting from combined operations, resulting in increased net profits.
5. The elimination of losses usually incurred in launching a new enterprise.

All of these considerations are vital to the business involved, and generally result in higher taxable corporate income for the Government.

In the report of the Committee on Ways and Means, the sole justification for section 359 is contained in the following statement:

> Publicly held corporations usually have a corporate existence separate from that of their shareholders and, as a rule, do not merge or consolidate with a view to the tax advantages which may result therefrom at the shareholder level. There is ample evidence, however, that closely held corporations may undertake these transactions solely in the hope of distributing earnings to shareholders at capital gains rates.

It appears from the aforementioned statement, that Government is requesting legislation to kill dozens, maybe hundreds, of legitimate transactions, when it already possesses more direct means to deal with the situation which section 359 attempts to reach by indirection.

Section 102 may be invoked in cases of unnecessary accumulation of surplus, which may be taxed as provided in the act. If surplus is necessary in the conduct of a business, it will not be paid out, in any event, and no tax will arise at the stockholder level.

The CHAIRMAN. Give us an example of your operations.

Mr. HERRMANN. The operation of the corporation that I——

The CHAIRMAN (interposing). Your National Association of Shoe Chain Stores.

Mr. HERRMANN. Our National Association of Shoe Chain Stores represents practically all of the accredited shoe chains in the United States. We endeavor to implement a program of research for the benefit of the association members. We endeavor to interpret legislation for the benefit of the association's members. We run a style show each year for the purpose of creating general style uniformity in the industry, and giving the association's members the benefit of research by expert stylists who are hired to do a job which some members could not afford to pay for.

The CHAIRMAN. What is the financial relationship between your association and the Foot Comfort Shoe Store of Keokuk, Iowa?

Mr. HERRMANN. The financial relationship of the association to the average shoe store is on a basis of dues, very low dues, which are predicated on covering the expenses of the association. It is a nonprofit association, and it is an association that is run entirely for the benefit of its membership.

The CHAIRMAN. Do you direct their operations?

Mr. HERRMANN. We have an executive secretary, Mr. Edward Atkins, who actively directs the operation. We elect new officers, every 2 years, who are representatives of the association's member companies.

The CHAIRMAN. What is the obligation of the shoe store toward the association?

Mr. HERRMANN. The obligation of a shoe store toward the association is voluntary. The stores, or the chains, pay dues up to approximately $2,000 for the larger chains, based on the size of the company and starting with $100, which is a nominal membership.

The CHAIRMAN. You don't own any of the stock? Do you have any ownership interests, stock or otherwise, in any of the companies that you serve?

Mr. ATKINS. Mr. Senator, may I interrupt?

The CHAIRMAN. Yes.

Mr. ATKINS. I am Edward Atkins, executive vice president of the association. I think I sense the direction of your question. May I say this: No officers of the association, neither paid or unpaid, own stock in other members of the association, except the companies which they happen to be affiliated with. The association, itself, controls no stock in any member company. Is that your question?

The CHAIRMAN. I believe so. I am still somewhat confused.

Mr. ATKINS. We are just a typical trade association like several thousand others. The association, itself, has no financial control over any of its members.

The CHAIRMAN. Proceed, please.

Mr. HERRMANN. Thank you.

Up to the present time, it has been regarded economically and legally sound to put one's estate in good order, to create maximum liquidity, so that the heirs and, incidentally, the Government's interest in estate taxes, are adequately protected.

If section 350 becomes law, two lamentable results are inevitable. A business, which might otherwise be merged with another, will not be, because of the tremendous tax impact on stockholders. It will face the possibility of sale subsequent to the death of one or more key stockholders, in order to meet estate taxes. It may be sacrificed under pressure, a lower estate valuation will result, and the Government will incur a loss in revenue.

Or, the business may be merged with a publicly held corporation; the profit to the stockholders of the transferor corporation will be taxed at capital gains rates based on the market value of the stock exchanged, and more often than not, a large block of the stock received will be sold within the fiscal year to satisfy the tax liability accruing. This might easily depress the market, affecting thousands of innocent stockholders. As a result, stockholders of many companies, aware of these consequences, will become reluctant to approve mergers, regardless of corporate advantage.

In the case of highly desirable acquisitions, purchase prices would have to be stepped up to meet the tax liability resulting from the exchange. It is quite conceivable that in the cases of many closely held corporations whose stocks carry a characteristically low base, the purchase price would have to be advanced as much as 33 percent. This would tend to make many worthwhile mergers impossible to complete.

Many closely held corporations, especially the type most likely to be involved in mergers, are relatively large, with their shares actively traded on the exchanges, or over the counter, and with their stock widely distributed and held by thousands of stockholders, and I am at this point citing an example with which I am very familiar.

The following example is by no means unusual in the case histories of consolidations or mergers. Corporation X, a closely held corporation, according to the definition in section 359, was merged, in 1952, with corporation Y, a publicly held corporation, in a statutory consolidation.

Corporation X had approximately 475,000 common and preferred shares outstanding, a net worth over $7 million, and a list of about 2,000 stockholders. Corporation Y had 2,400,000 common shares outstanding, a net worth of $23 million, and over 15,000 stockholders.

There were a number of advantages for both organizations inherent in the merger: Diversification, a new medium of expansion, and the ecquisition of management with a fine record of achievement, evidently motivated the larger corporation. Increased efficiency, the backing of larger resources for an expansion program, and greater marketability for the stock evidently motivated the smaller corporation.

If section 359 were then law, the merger would not have occurred. Stockholders of the smaller corporation would not have assumed the tax burden. Stockholders of the larger corporation would have been reluctant to create a situation whereby large blocks of stock would have to be thrown on the market to meet the tax obligation. Thousands of stockholders would have been penalized.

The real loser, however, would have been the United States Government.

The annual dividends on the common shares of stock of the X corporation have been increased from $1.45 per share annually to $1.80 per shade. The value of the common shares of the X corporation has risen from $17 to $29, with an obvious comparable increase in potential estate taxes.

There is no greater justification for taxing stockholders because they changed certificates pursuant to a statutory consolidation, or merger, under section 112 (g) than there is to tax a stock dividend. No real profit can accrue in either instance until the stock is sold.

The stated purpose of section 359 is to prevent the distribution of earnings at capital gains rates. But despite this statement in the report, the section then proceeds to impose a tax on the exchange at those very capital gains rates, not only on accumulated earnings, but on the entire amount of stock received in the exchange, to the extent that the value of such stock represents an accretion in value over its original base.

Actually, this section imposes a tax on capital. The surplus, and even that part of the capital stock which might have resulted from a transfer of surplus to capital, was taxed at normal and surtax rates in the years in which the earnings occurred. It is now in danger of being doubly taxed at capital gains rates before a share of stock is sold, or a dollar of real or liquidated profit is realized.

The proposed section is invidious in its implications. It differentiates between small business and big business. It forbids, or penalizes, the stockholders of a closely held corporation from realizing greater marketability for their stock holdings through consolidation, or merger, and in the same section, gives a green light to publicly held corporations.

We should not labor under any illusion about publicly held corporations. They merge for the same justifiable business reasons; but

there are few mergers wherein the stock of both corporations enjoy equal marketability. Certainly, the stockholders of the publicly held corporation, whose shares are less active, less marketable, and would tend to depress the quotation on any sizable offering, should not be accused of attempting to distribute surplus at capital gains rates through the device of the merger. There is no more justification for impugning the motives of a closely held corporation.

Section 359, in essence, singles out stockholders of closely held corporation, and states: You can't make your stock more marketable through consolidation, unless you pay the full tax on the corporate surplus and any capital accretion before you died. On evaluation, the Government might discover this to be an expensive philosophy. Stocks of closely held corporations, with debatable market values, are always difficult to appraise. They are often the subject of controversy, compromise, or litigation, for the levying of an estate tax. Stocks of a publicly held corporation have a specific market value, which minimizes the problem inherent in appraisals and subsequent collection of tax.

The provisions of section 359, and related sections, insofar as they apply to consolidations and mergers, are unjustifiably punitive. They are more regulatory than revenue producing, and will stifle normal business practices which have built some of our greatest industries.

An even greater inequity exists in the case of a contemplated merger between 2 closely held corporations wherein the stockholders of 1 corporation would not receive in exchange at least 20 percent of the stock—after consolidation—of the acquiring corporation. The stockholders of the transferor corporation would be confronted with a capital-gains tax on all of the stock received in exchange, without the availability of a ready market to liquidate sufficient stock to meet their tax liability.

To illustrate the vital interest of the retail industry, the following statistics are important:

According to information of the Securities and Exchange Commission, there are 250 retail companies listed on the exchanges, and I might add at this point, Mr. Chairman, that applies to corporations, rather than companies. A number of these might not meet the definition of "publicly owned." The latest available compilation of the Internal Revenue Division indicates 112,000 retail companies filed returns in 1948. Section 359 may appropriately be construed as legislation inimical to the interest of over 111,000 retail companies. These so-called small business establishments constitute the major portion of the retail industry.

I have been informed that witnesses who appeared before the Senate Finance Committee have advocated postponing the effective date of section 359, which is specified as March 1, 1954. This suggestion has evidently beeen offered in the spirit of compromise. I could not, in due conscience, oppose a postponement. Undoubtedly, a number of mergers and consolidations were in process as of March 1. We all know, that as a result of SEC regulations, such transactions require considerable time for consummation. Any type of retroactivity would involve tremendous losses and undue hardship to the parties involved, who had good reason and justification to rely on the statutory provisions of section 112 (g) in the Revenue Code, as it existed prior to March 1, 1954.

However, the provisions of section 359 are inequitable, oppressive, uneconomic, and unsound as a revenue-producting device. They are either right or wrong, and should be completely stricken from the code. There should be no compromise with poorly conceived legislation.

I sincerely doubt if legislators responsible for the inclusion of this section had sufficient time to evaluate its effects properly. I think, eventually, it will be realized that the results of these provisions, in no way, carry out their intentions, or represent the solution they hope to achieve. Although it represents a perfectly obvious conclusion, at this point, I would like to state that the substance of the present provisions of section 112 dealing with mergers and consolidations should be renewed and retained in the code.

Mr. Chairman, we have requested time to express our opposition to section 6016, relating to the declaration of estimated income tax by corporations. We believe that this section directly effects an increase in corporate taxes at a time when reductions were anticipated and, incidentally, deferred. However, in the interest of time, and to avoid duplication, the views of the National Association of Shoe Chain Stores will be presented by the American Retail Federation, scheduled to appear before this committee at a later date.

Senator LONG. Might I just ask you to give me an illustration of what you have in mind when you tell me how these consolidations would be affected under the law as it stands, and how it would be if section 359 becomes law? I would just like for you to illustrate the difference so I can get it straight in my mind.

Mr. HERRMANN. Well, reverting to the example contained in this presentation, preferred stock was exchanged for preferred stock; common stock was exchanged for common stock. The stockholders received stock in identically the same proportions as they held stock prior to the consolidation in the transferor corporation, and none of that stock which was received in accordance with the plan of statutory tax-free consolidation was taxable to the stockholders.

Senator LONG. Was that a corporate reorganization or a merger?

Mr. HERRMANN. That was a merger. The transferor corporation was subsequently liquidated and became part and parcel of the acquiring corporation.

The total of 450,000 shares of common stock, which was the capitalization of the transferor corporation before the merger, and 25,000 shares of preferred stock, would not have constituted the 25 percent requirement before consolidation, or 20 percent subsequent to consolidation of the 2,400,000 shares outstanding in the acquiring corporation.

Consequently, stockholders would have been confronted, in that particular situation, with the necessity of rejecting the merger. That merger never would have been concluded because it would have been folly to file an application or a plan of statutory consolidation, there, in view of the fact that all of the stock received by the stockholders of the transferor corporation would have been subject to a capital gains tax.

Senator LONG. Now, if I understand you correctly, as it stands today, that transaction is a tax-free transaction; there is no profit or gain on it; it is a simple consolidation or merger of two corporations, is that right?

Mr. HERRMANN. That is exactly right, sir.

Senator LONG. If certain stockholders own more than 25 percent of the stock in the corporation, then under section 359 that would no longer be a tax-free transaction. Am I correct in assuming that?

Mr. HERRMANN. Well, it would qualify for a tax-free transaction if all of the stockholders of the transferor corporation owned 25 percent of the stock of the acquiring corporation before consolidation, which, through the process of mathematics, becomes 20 percent of the stock of the corporation after consolidation.

Now, in this particular situation that I am referring to, the tax impact would have been so great because this corporation would not qualify for tax-free consolidation, that the consolidation never would have taken place. The tax liability that situation would have been somewhere around $4 million to $4.5 million, in view of the fact that the transferor corporation, even though it was a large corporation with a surplus and capital of over $7 million, actually was started from a very small business.

The major stockholders had a very low base. The capitalization was increased, from time to time, as a result of transferring surplus to capital.

Now, even though the surplus of the corporation represented a minor portion of the capitalization, practically the entire amount, or the entire value of the stock received in exchange, represented a capital gain to the majority stockholders, because of their low base.

The CHAIRMAN. Thank you very much, indeed.

Mr. HERRMANN. I wish to thank you for the privilege of appearing before this committee.

The CHAIRMAN. We have been glad to have you here.

(The appendix to Mr. Herrmann's statement follows:)

APPENDIX

The National Association of Shoe Chain Stores is a group of 47 companies operating approximately 6,000 retail shoe stores and departments in 48 States. Their annual volume of business is in excess of $600 million.

The association headquarters are at 51 East 42d Street, New York, N. Y.

A list of the membership is as follows:

A. S. Beck Shoe Corp., New York, N. Y.
The Berland Shoe Stores, Inc., St. Louis, Mo.
Block's Shoe Stores, Seattle, Wash.
Books Shoe Co., Pittsburgh, Pa.
Brasley-Cole Shoe Co., Ltd., Los Angeles, Calif.
Butler's, Inc., Atlanta, Ga.
The Dan Cohen Co., Cincinnati, Ohio
Dial Shoe Co., Inc., Philadelphia, Pa.
Edison Brothers Stores, Inc., St. Louis, Mo.
Endicott Johnson Corp., Endicott, N. Y.
Entroth Shoe Co., Toledo, Ohio
Epko Shoes, Inc., Toledo, Ohio
Eppenberger Shoe Co., St. Louis, Mo.
Fashion-Thimble Shoe Co., Inc., St. Louis, Mo.
Robert Feilich Shoe Co., Inc., St. Louis, Mo.
The Felsway Shoe Corp., New York, N. Y.
Gallenkamp Stores Co., Los Angeles, Calif.
General Retail Corp., Nashville, Tenn.
Karl's Shoe Stores, Ltd., Los Angeles, Calif.
Keystone Shoe Stores, Inc., Pittsburgh, Pa.
G. R. Kinney Co., Inc., New York, N. Y.
Kitty Kelly Shoe Corp., New York, N. Y.

The Krohngold Shoe Co., Cleveland, Ohio
Lee's Shoe Stores, Inc., St. Louis, Mo.
Liberty Shoe Stores, Inc., Buffalo, N. Y.
Maling Bros, Inc., Chicago, Ill.
Marilyn Shoe Corp., Augusta, Ga.
Melville Shoe Corp., New York, N. Y.
Miles Shoes, New York, N. Y.
Miller-Jones Co., Columbus, Ohio
Morse Shoe Stores, Boston, Mass.
Morton's Shoe Stores, Boston, Mass.
National Shoe Co., Ltd., Los Angeles, Calif.
National Shoes, Inc., Bronx, N. Y.
The Nobil Shoe Co., Akron, Ohio
The Louis Ostrov Shoe Co., Akron, Ohio
Roe Bros. Stores, Inc., Beverly Hills, Calif.
Sears, Roebuck & Co., Chicago, Ill.
Shoe Corporation of America, Columbus, Ohio
The D. M. Siff Shoe Co., Akron, Ohio
I. Simon Co., Inc., New York, N. Y.
Spencer Shoe Corp., Boston, Mass.
Thrift Shoe Stores, Wilkes-Barre, Pa.
Tradehome Shoe Stores, Inc., St. Paul, Minn.
Triangle Shoe Co., Inc., Wilkes-Barre, Pa.
Uncle Sam's Shoe Stores, Paterson, N. J.
Wilkerson Shoe Co., St. Louis, Mo.

The American Retail Federation is a federation of 26 national retail trade associations and 34 State retail associations representing approximately 700,000 retail stores. Headquarters are at 1025 Eye Street NW., Washington, D. C.

Members of the American Retail Federation follow:

American National Retail Jewelers Association
American Retail Coal Association
Arizona Federation of Retail Associations
Association of Credit Apparel Stores, Inc.
Associated Retailers of Indiana
Associated Retailers of Iowa, Inc.
Associated Retailers of Washington
California Retailers Association
Colorado Retailers Association
Council of Texas Retailers' Associations
Delaware Retailers' Council
Florida State Retailers Association
Georgia Mercantile Association
Idaho Council of Retailers
Illinois Federation of Retail Associations
Institute of Distribution, Inc.
Kentucky Merchants Association, Inc.
Limited Price Variety Stores Association, Inc.
Louisiana Retailers Association
Mail Order Association of America
Maine Merchants Association, Inc.
Maryland Council of Retail Merchants, Inc.
Massachusetts Council of Retail Merchants
Michigan Retailers Association
Minnesota Retail Federation, Inc.
Missouri Retailers Association
National Appliance and Radio-Tv Dealers Association
National Association of Chain Drug Stores
National Association of Food Chains
National Association of Music Merchants, Inc.
National Association of Retail Clothing and Furniture
National Association of Retail Grocers
National Association of Shoe Chain Stores
National Foundation for Consumer Credit, Inc.
National Industrial Stores Association
National Jewelers Association
National Luggage Dealers Association
National Retail Dry Goods Association

National Retail Farm Equipment Association
National Retail Furniture Association
National Retail Hardware Association
National Shoe Retailers Association
National Sporting Goods Association
National Stationery and Office Equipment Association
National Tea and Coffee Merchants Association
Nevada Retail Merchants Association
New York State Council of Retail Merchants
North Carolina Merchants Association, Inc.
Ohio State Council of Retail Merchants
Oklahoma Retail Merchants Association
Oregon State Retailers' Council
Pennsylvania Retailers' Association, Inc.
Retail Merchants Association of New Jersey
Retail Merchants Association of South Dakota
Retail Merchants Association of Tennessee
Retail Paint and Wallpaper Distributors of America, Inc.
Rhode Island Retail Association
Utah Council of Retailers
Virginia Retail Merchants Association, Inc.
West Virginia Retailers Association, Inc.

Mr. Kable, be seated and identify yourself to the reporter, please.

STATEMENT OF CHARLES W. KABLE, JR., CHAIRMAN, TAX COMMITTEE, AMERICAN COTTON MANUFACTURERS INSTITUTE

Mr. KABLE. My name is Charles W. Kable, Jr., of 240 Church Street, New York City. I am associated in business with Durring, Millikin & Co. We are commission merchants selling textile products of all types. I am also chairman of the tax committee of the American Cotton Manufacturers Institute, with principal offices in Charlotte, N. C.

I appear before your committee on behalf of the institute. The institute also is a voluntary association, a nonprofit group, and includes in its membership about 85 percent of the total manufacturing capacity of the cotton end of the textile industry.

This industry employs about 500,000 workers and it is essentially an industry of small enterprises, no one of which constitutes more than 4 percent of the total. Since the average cotton textile manufacturer operates on the basis of a minor fraction of 1 percent of the industry's total business, his resources are necessarily limited.

The CHAIRMAN. What is the total business of the industry?

Mr. KABLE. I would have to give you a guess on that.

The CHAIRMAN. Give me an estimate.

Mr. KABLE. It would be $6 billion to $7 billion.

When Chairman Reed and the House Ways and Means Committee first undertook the complete revision of the Internal Revenue Code which had, over the years, evolved into a patchwork of unworkable legislation and a myriad of confusing and contradictory regulations, most observers felt that an impossible task had been undertaken. Nevertheless, H. R. 8300, completed within an incredibly short period of time, for the most part represents a vast improvement over the present Internal Revenue Code.

The CHAIRMAN. I might say that the House Ways and Means Committee worked on this for over a year.

Mr. KABLE. I know, sir.

The CHAIRMAN. And their efforts followed questionnaires which were widely spread througout the country, so it isn't a case of "Let's sit down, boys, and write a new revised tax bill, overnight." There was a lot of work put into this bill, whether you like it or not.

Mr. KABLE. I understand that.

In an undertaking of this magnitude, it is only natural that all considerations could not have been taken into account. Suggestions for improvement of certain sections of subchapter C of chapter 1 of H. R. 8300, relating to corporations, are, therefore, offered for your consideration.

The first section of subchapter C to which I shall refer is 309. For the past 10 years, under applicable case law and rulings of the Internal Revenue Service, stockholders were permitted to receive a preferred stock dividend on common tax free, in cases where there was no prior outstanding preferred stock. Subsequently, when such preferred stock was redeemed or sold, litigation ensued as to the question of whether such sale or redemption constituted capital gain or a dividend.

That is the reason for the enactment of section 309, undoubtedly. Section 309 now proposes an 85-percent transfer tax on such corporation when and if it redeems such preferred stock within 10 years of issuance, or January 1, 1954, whichever is later, with certain exceptions. There are certain exceptions, as stated in the section.

If these provisions of section 309 are permitted to remain in the bill they will paralyze many legitimate business functions. It appears that they will also nullify the intended outcome of many transactions originated prior to January 1, 1954, under the present code, and approved by the Treasury Department. The problems of small business, operating on the basis of limited capital and limited credit, at times require rapid changes in corporate structure, which are not predictable at the time earlier transactions are made.

Our reaction to section 309 is threefold. First, there should be no tax imposed on the corporation. Such a tax is intended to penalize the majority stockholder whose stock is redeemed, and it would also severely punish the minority man who has a few shares, and is really not involved in the transaction.

Secondly, from the standpoint of our experience as businessmen, it would appear that a 5-year maximum period of prohibition as to redemption of preferred stock under these conditions would be more than ample.

Finally, the arbitrary provision that the period of prohibition start on January 1, 1954, rather than the date of the issuance of the preferred stock dividend itself, should certainly not be accepted by the Senate.

Corporations who issued nontaxable preferred stock dividends on common prior to January 1, 1954, and in some cases as much as 30 or ever 40 years ago, should not be trapped in this fashion, particularly if business considerations indicate the desirability of retiring preferred stock within the next few years. I am referring to the possible desirability of retiring stock because of the present easy money, and if there was continuance of it, you could probably borrow at 3 percent when your preferred stock might have a 5½ percent rate.

Even without tax considerations, that would be good business. In 1951, when section 112 (b) (11) dealing with the spin-off situation was before the Senate, Senator Humphrey of Minnesota discussed

the problem of tax avoidance and the possibility that turning ordinary income into capital gain might be done through the disposal of stock or assets. At that time, he proposed a 3-year holding period to protect the Government from tax avoidance.

Senator George opposed the 3-year period on the ground that here, again, it might unduly interfere with general business practice. I quote in part from Senator George's statement at that time, in the Congressional Record, volume 97, No. 181, September 27, 1951, pages 12459 through 12462. Mr. George stated:

That is true; but why put in a time element, which would make the section unworkable? In these uncertain times, we cannot foresee how long we can carry on a business, or when we may have to sell the stock. I believe that the Senator's amendment is wholly unnecessary.

It is a matter of record that Senator George's reasoning prevailed in the Senate at that time.

The loophole as represented by the recent Chamberlin case, which section 309 intends to close, still exists. In that case, the stockholder who received a nontaxable preferred stock dividend sold it the next day to an insurance company and was allowed to pay tax at capital gains rates. That is what the court held.

The House bill deals only with redemption of preferred stock dividends and not with their sale. A dividend tax should be levied on the gain derived by the recipient of preferred stock, whether he redeems or sells the stock within 5 years from the date of its issue. Thereafter, any gain derived by him should be taxed as a capital gain, and that is the way we view it. And I think that would plug the loophole, Mr. Chairman.

We suggest a 5-year period, as being unreasonable—6 months is considered a proper holding period for ordinary capital gains. A transfer tax upon the corporation is unjustified and the retroactive feature with respect to the holding period contained in the present House bill, to our way of thinking, is completely unwarranted.

Our next suggestion refers to section 359. In general, it amends section 112 (b) (1) (b) of the present code, which has already been covered by Mr. Herrmann, whereby it has always been possible for a corporation to exchange voting stock for at least 80 percent of the stock or assets of another corporation in tax-free reorganization. This is something that has been in the code for a long time, and has been found to be thoroughly workable.

Time didn't permit me personally to make the necessary researches. I don't know when 112 emerged into the code, but I would like to have reviewed the reason-why philosophy that underlay the section 112 grouping, at that time. However, I was in Mr. Gemmill's office a few days ago, and he gave me to understand that the technical advisers of the committee recognize the need for basic changes in this section of the statute and, therefore, I won't discuss them. It is requested, however, that my written statement be made a part of the record. I have something on it here, but I don't think I need burden you with the length of that.

The CHAIRMAN. It will appear in the record.

Mr. KABLE. Subsection (a) of section 359 contains a definition of a publicly held corporation by defining a closely held corporation

as one having 10 or fewer stockholders, owning more than 50 percent of the combined voting power of all classes of stock. Here, again, there appears in proposed tax legislation specific discriminations against small business.

Under present law, no gain or loss is recognized to a large or small corporation which consolidates a merger, under State law, into another corporation. As Mr. Herrmann has already pointed out, this principle is retained only for statutory mergers and consolidations now in H. R. 8300, for the publicly held corporation.

It appears that in drafting this provision, the House Ways and Means Committee lost sight of its own objectives, which appear to be set forth on page 2 of the committee report accompanying H. R. 8300 where it is stated:

> The bill contains many provisions which are important to the growth and survival of small business.

The enactment into law of sections 300 and 359, as well as such other sections of subchapter C, H. R. 8300, which depend upon the definition of "publicly held corporations" will seriously impair the competitive position of the small American businessman, seriously impair the marketability of the equity stock in his company, which will reflect in due time in the reduced death taxes collected by the Government because the stock isn't worth as much, and, over a period of time, greatly increase the incidence of failure of small businesses where a timely reorganization is not effected because it cannot be effected, as pointed out by Mr. Herrmann, due to the restrictions imposed by subchapter C.

A man who is the head of one of the small mills in South Carolina may just have a wife and minor children when he dies. It would be a very serious matter for that man, if he weren't able to capitalize on the results of a life work, by merging with a much larger unit. Why shouldn't the owner of an open hearth furnace employing half a dozen people be willing and anxious to merge with a much larger corporation and take his holdings out in something that is liquid, about which there will be no argument whatever at the time of his death, as to valuation? When such a transaction is completed, the small-business man has readily marketable securities, received in exchange for his closely held stock—no cash.

We, therefore, recommend that the definition of publicly held corporations set forth in section 359 (a) be stricken from the bill, as well as the tax concept reflected in sections 354, 382, and many others in H. R. 8300 that rely on this concept.

I appreciate very much the opportunity you have given me to speak.

The CHAIRMAN. Thank you very much.

Mr. WALTER J. MYERS. I will ask the remaining witnesses to please, while you are waiting, review your remarks. We will have to shorten the length of them. We have spent almost an hour with two witnesses. That is not too long from the standpoint of our desire, but it is too long for the time limit within which we have to operate.

If you can just give us a summary of your paper, the paper will be digested by the staff and nothing will be lost, and a lot will be gained.

(Mr. Kable's prepared statement follows:)

STATEMENT OF CHARLES W. KABLE, JR., CHAIRMAN OF THE TAX COMMITTEE, AMERICAN COTTON MANUFACTURERS INSTITUTE

Mr. Chairman, my name is Charles W. Kable, Jr., of 240 Church Street, New York City. I am chairman of the tax committee of the American Cotton Manufacturers Institute, and appear before your committee on behalf of the institute.

The institute, a trade association, includes in its membership about 85 percent of the total manufacturing capacity of the cotton-textile industry. Our industry employs about 500,000 workers, and is essentially an industry of small enterprises, no one of which constitutes more than 4 percent of the total. Since the average cotton textile manufacturer operates on the basis of a minor fraction of 1 percent of the industry's total business, his resources are necessarily limited.

When Chairman Reed and the House and Ways and Means Committee first undertook the complete revision of the Internal Revenue Code, which had, over the years, evolved into a patchwork of unworkable legislation and a myriad of confusing and contradictory regulations, most observers felt that an impossible task had been undertaken. Nevertheless, H. R. 8300, completed within an incredibly short period of time, for the most part represents a vast improvement over the present Internal Revenue Code.

In an undertaking of this magnitude, it is only natural that all considerations could not have been taken into account. Suggestions for improvement of certain sections of subchapter C of chapter 1 of H. R. 8300 relating to corporations are, therefore, offered for you consideration.

The first section of subchapter C to which I shall refer is 309. For the past 10 years, under applicable case law and rulings of the Internal Revenue Service, stockholders were permitted to receive a preferred stock dividend on common tax free, in cases where there was no prior outstanding preferred stock. Subsequently, when such preferred stock was redeemed or sold, litigation ensued as to the question of whether such sale or redemption constituted capital gain or a dividend.

Section 309 now proposes an 85 percent transfer tax on such corporation when and if it redeems such preferred stock within 10 years of issuance, or January 1, 1954, whichever is later with certain exceptions.

If these provisions of section 309 are permitted to remain in the bill, they will paralyze many legitimate business functions. It appears that they will also nullify the intended outcome of many transactions originated prior to January 1, 1954, under the present code, and approved by the Treasury Department. The problems of small business, operating on the basis of limited capital and limited credit, at times require rapid changes in corporate structure, which are not predictable at the time earlier transactions are made.

Our reaction to section 309 is threefold. First, there should be no tax imposed on the corporation. Such a tax, intended to penalize the majority stockholder, whose stock is redeemed, would also severely punish the minority stockholder, who is not involved in the transaction. Secondly, from the standpoint of our experience as businessmen, it would appear that a 5-year maximum period of prohibition as to redemption of preferred stock under these conditions would be more than ample. Finally, the arbitrary provision that the period of prohibition start on January 1, 1954, rather than with the date of the issuance of the preferred stock dividend should certainly not be accepted by the Senate. Corporations who issued nontaxable preferred-stock dividends on common prior to January 1, 1954, and in some cases as much as 30 or even 40 years ago, should not be trapped in this fashion, particularly if business considerations indicate the desirability of retiring preferred stock within the next few years.

In 1951, when section 112 (b) (11) dealing with the spin-off situation was before the Senate, Senator Humphrey, of Minnesota, discussed the problem of tax avoidance and the possibility of turning ordinary income into capital gain through the disposal of stock or assets. At that time, he proposed a 3-year holding period to protect the Government from tax avoidance. Senator George opposed the 3-year period, on the ground that it would unduly interfere with general business practices. I quote in part from Senator George's statement at that time in the Congressional Record, volume 97, No. 181, September 27, 1951, pages 12459 through 12462. Mr. George stated:

"That is true; but why put in a time element, which would make the section unworkable? In these uncertain times we cannot foresee how long we can

carry on a business, or when we may have to sell the stock. I believe that the Senator's amendment is wholly unnecessary."

It is a matter of record that Senator George's reasoning prevailed in the Senate at that time.

The loophole as represented by the recent Chamberlin[1] case, which section 309 intends to close, still exists. In that case the stockholder who received the nontaxable preferred stock dividend sold it the next day to an insurance company and was allowed to pay tax at capital gain rates. The House bill deals only with redemption of preferred stock dividends and not with their sale. A dividend tax should be levied on the gain derived by the recipient of the preferred stock whether he redeems or sells the stock within 5 years from the date of its issue. Thereafter any gain derived by him should be taxed as a capital gain.

We suggest a 5-year period as being reasonable—6 months is considered a proper holding period for ordinary capital gains. A transfer tax upon the corporation is completely unjustified, and the retroactive feature with respect to the holding period contained in the present House bill is completely unwarranted.

Our next suggestion refers to section 359 of H. R. 8300. In general, it amends section 112 (g) (1) (b) of the present code, whereby it has always been possible for a corporation to exchange voting stock for at least 80 percent of the stock or assets of another corporation in tax free reorganization. Subsections (b) and (c) of section 359 require that immediately after such transaction, shareholders of the corporation whose stock is acquired may not own less than 25 percent nor more than 400 percent of the stock of the issuing corporation held by its stockholders immediately prior thereto. This new requirement appears to raise an unwarranted obstacle to the merger or consolidation of a very small with a very large corporation. Here again it must be emphasized that the small business and the closely held corporation would be the sufferers. Small businessmen must constantly face questions as to whether their businesses can survive their death. Problems of estate liquidity, managerial succession, and stability of the income of the survivors of the head of the business often force decisions to merge small businesses with large ones. Due to the unpredictability of business, and living as well, in many instances the small businessman must make such decisions overnight. These rules may have been proposed by the Ways and Means Committee because they considered that very small corporations were actually making sales and not effecting mergers with large corporations. However, after such reorganizations occur, the owners of the small corporations who sell out their interests for stock in the larger corporations usually dispose of their listed securities in whole or in part, and pay capital gains taxes. Such small businesses are usually not controlled by young men, and even if no portion of the listed securities were sold, the death taxes on the market value of such securities would inexorably bring appropriate revenues to the Government within a relatively short period of time. The impairment to the financial mobility of the small businessmen of the Nation is too great a price to pay for this type of legislation.

Subsection (a) of section 359 contains the definition of a publicly held corporation by defining a closely held corporation as one having 10 or fewer stockholders owning more than 50 percent of the combined voting power of all classes of stock. Here again, there appears for the first time in proposed tax legislation, specific discrimination against small business. Under present law, no gain or loss is recognized to a large or small corporation which consolidates or merges under State law into another corporation. Under H. R. 8300, this principle is retained only for statutory mergers and consolidations of publicly held corporations. Closely held corporations may not reorganize by merger or consolidation without recognition of gain or loss. Even in cases where there are a group of publicly held corporations involved in a reorganization transaction, if one closely held corporation is involved, it appears that the transaction would give rise to taxable gain or loss.

In the rush of drafting an 875 page tax bill, it appears that the House Ways and Means Committee here lost sight of its own objectives as set forth on page 2 of the committee report accompanying H. R. 8300, where it is stated "The bill contains many provisions which are important to the growth and survival of small business."

The impact of the enactment into law of sections 309 and 359, as well as such other sections of subchapter C of H. R. 8300 which depend upon the definition of

[1] 207 Fed. (2d) 462 (C. C. A. 6th, Oct. 14, 1953).

"publicly held corporation" will seriously impair the competitive position of the small American businessman, seriously impair the marketability of the equity stock in his company, and over a period of time, greatly increase the incidence of failure in small business corporations, where timely reorganization steps are not taken because of restrictions imposed by subchapter C. It is therefore recommended that the definition of "publicly held corporation" set forth in section 359 (a) be stricken from the bill, as well as the tax concept thereof reflected in section 354, 382, and others in H. R. 8300.

STATEMENT OF J. WALTER MYERS, JR., EXECUTIVE SECRETARY, FOREST FARMERS ASSOCIATION OF ATLANTA, GA.

Mr. MYERS. My name is J. Walter Myers, Jr., and I am executive secretary of the Forest Farmers Association of Atlanta, Ga., which is an association of timberland owners in 15 Southern States. Our people are primarily the people who actually own the land. Our 1,300 members in 15 States own 20 million acres of timberland, and we are interested primarily in the revisions to the Internal Revenue Code as embodied in H. R. 8300, as they will affect timberland owners and their properties.

The forests of the United States are one of our most important natural resources and play a vital part in our economy. There has been a lot of money spent in developing these resources, and there has developed a great interest in better forestry practices in recent years.

However, there is still a tremendous development job to be done, and the importance of this development job is emphasized by the fact that there are still 10 to 15 million acres of cutover forestlands in the South, alone, which must be planted.

While I speak for the South, the same situation generally prevails over the Nation. I was checking yesterday with the United States Forest Service to be certain of my figures. While naturally it is impossible to pinpoint it down to the precise number of acres, because there are constant changes, and surveys are not able to keep up with the situation, except as on an estimated basis, there are about 75 million acres over the United States that need replanting, even yet.

Much is being done to foster the rebuilding of these forests, and we are planting millions of trees every year. Last year we planted more trees in the South than had ever been planted before in that area—450 million of them; 450 million trees, however, will only plant about 450,000 acres, so with an acreage of 10 to 15 million, needing planting in the South, it becomes rather obvious that it will take us about 85 years just to complete the development job.

Senator LONG. My understanding in Louisiana, at the rate we have been going—and we have been making considerable effort—it would take over 60 years to replant the cutover land.

Mr. MYERS. That is right, Senator Long. I am a native of Louisiana myself, and a graduate of the LSU forestry school, and I am familiar with the fact that Louisiana unfortunately has more cutover land than certain other States.

I think we have in Louisiana one of the most progressive State forestry commissions, but the job there is larger, because originally they had very rich forests, and they were harvested quite heavily.

Senator LONG. In some of those cutover areas, the old-age pension is the biggest payroll in the entire area.

Mr. MYERS. That is a point we would like to present for the committee's consideration, the fact that there are lands like that where capital needs to be interested in putting those lands back into use.

The CHAIRMAN. What do you want to see in the act? What are you after? What do you want us to do?

Mr. MYERS. We would like an amendment to the present code, or an addition, you might say, a new section which might possibly be numbered 617, to subchapter 1, part I, to follow exploration and development expenditures—those two items are now shown as sections 615 and 616, respectively. We suggest this new section read as follows:

> Expenditures for forest development and protection. A taxpayer owning, leasing, subleasing, or operating forest tracts which are properly managed for sustained wood production, and who makes expenditures primarily for forest protection, conservation, or improvement, or for forestation or reforestation, at his option, may treat any such expenditures paid or accrued in the taxable year, either (1) as a capital charge to be recovered through depreciation or depletion, as the case may be, or (2) as a deductible expense in such year. Proper forest management is the application of suitable and economically sound forestry principles relating to protection, utilization, and reproduction of forest tracts. This subparagraph shall be effective for taxable years commencing after December 31, 1953.

The CHAIRMAN. Have you discussed the matter with our Joint Committee on Internal Revenue Taxation?

Mr. MYERS. Beg your pardon?

The CHAIRMAN. Have you discussed this matter with our staff, the Joint Committee on Internal Revenue Taxation?

Mr. MYERS. No; but it has been discussed with various attorneys and other interested parties.

The CHAIRMAN. Let me suggest that you talk to Mr. Stam, Joint Committee on Internal Revenue Taxation, 1011 House Office Building. See that gentleman sitting against the blind, there? You get in contact with him and he will make a date. He is head of our technical staff which advises us on such matters, and it would be a good idea if they had a detailed notion on this, if they haven't already. They will give you a good hearing, and I hope you will see them.

Mr. MYERS. Rather than go into the ramifications of this now, possibly I could discuss it with him.

The CHAIRMAN. Yes.

Mr. MYERS. There is one other change we would suggest for the committee's consideration. Section 272, of H. R. 8300, in our opinion, should be changed to restrict the expenses to be applied against capital gains to such expenses directly attributable to the quantity measurement and to the making of contracts for the disposition of timber.

The CHAIRMAN. When you see Mr. Stam, you tell him about that, too, will you?

Mr. MYERS. Yes, sir.

The CHAIRMAN. Thank you very much for coming.

Senator LONG. I would like to see something of that sort put in the law, Mr. Myers.

The only thing that concerns me about it is, I believe as proposed that could be a completely open-end proposition. In other words, the man who owed the Government a million dollars in taxes—if I understand it the way you explained it—might invest the whole million

dollars in reforestation, and thereby avoid the tax on it. If it were not a completely open-end proposition, I would be interested in supporting that.

Mr. MYERS. There is a tremendous amount of capital that needs to be interested, and this is one possible way to do it. He might avoid taxes for a short time, but when that timber was cut, there would be a substantial amount of newly developed taxable income—it is similar to an oil exploration situation, where you want to develop areas which are not bringing in any return, now.

As a matter of fact, a lot of these areas are, or have been until recently, tax-delinquent lands. They are not only not producing anything, they are actually a drain on the State. The State is often not collecting anything from them. Seventy-five million acres—well, that is roughly the size of the entire States of Mississippi and Louisiana. So you can see how large the problem is.

The CHAIRMAN. Thank you very much for coming, and have a good talk with Mr. Stam.

Mr. MYERS. Thank you, sir.

(The prepared statement of Mr. Myers follows:)

STATEMENT OF J. WALTER MYERS, JR., EXECUTIVE SECRETARY, FOREST FARMERS ASSOCIATION, ATLANTA, GA.

My name is J. Walter Myers, Jr. I am executive secretary of the Forest Farmers Association of Atlanta, Ga.

The Forest Farmers Association is an organization of timberland owners in 15 Southern States. Our 1,300 members own approximately 20 million acres of forest land in this area. Hence, our considerable interest in certain proposed changes to the Internal Revenue Code as embodied in H. R. 8300 and the possible effect of these revisions when applied to timberlands owned by our members and similar properties, not only in the South but over the Nation.

The forests of the United States represent one of our most important natural resources. These forests supply the basic raw material to the lumber, naval stores, plup and paper, and other wood-using industries which constitute a large part of our economy. The products of our forests are vital to the economy and security of our Nation. The future growth of our forests will depend upon the manner in which the forest farmers improve their methods of producing and reproducing trees and protecting them from forest fires, insects, and disease.

Timber owners and public agencies are spending substantial sums of money in the Southeastern States to promote and increase the growth of this natural resource. In cooperation with the Federal and State Governments, experimental tree farms and research stations have been established to utilize scientific knowledge and develop factual data in the growing and utilization of wood. The owners are building firebreaks and other fire-control facilities to reduce damage to their timber from fires. They have fostered educational programs to stimulate interest in protecting our forests and in the opportunities of timber production.

If our timberland owners are encouraged to continue their development work by a favorable tax program, it has been estimated that over a reasonably short period of years, the annual growth of our timber might well be doubled. Past increase in the use of forest products and authoritative predictions of future needs indicate that this will be required. The provisions of our tax laws, particularly those relating to the treatment of forest expense, will encourage or discourage such improvements in forest management development and protection.

The importance of this development job is emphasized by the fact that there are still some 10 to 15 million acres of cutover forest land in the South, alone, which must be planted before they can go back into full production.

Much is being done to foster the rebuilding of these forest areas, but even if we continue at our present rate it will take an estimated 35 years to complete the program, so tremendous is the job.

Therefore, it becomes clearly apparent that every encouragement to the rebuilding of these forests is of vital necessity and will continue to be for quite a number of years to come.

At the present time, some advantages are accorded for the development of natural resources, of which timber is one of the more important. It has been found that such treatment is in the public interest because the exploration, discovery, development, and growth of our natural resources are thus encouraged and enhance the national wealth.

Building up and maintaining our forest resources at a high level requires substantial and continuing financial investments. Even so, a considerable interval of time must elapse between the investment and the return on that investment. Meanwhile, the forest is subject to the hazards of fire, insects, disease, and storms, which may completely wipe out the owner's investment and operating costs at any time prior to the realization of any income. Equitable tax treatment to the forest owner is therefore essential to continued good forest management.

Under the present income-tax law, expenses incurred relating to the cutting and disposal of timber are deductible against ordinary income. Under H. R. 8300 (secs. 272 and 631) the deduction of these expenses may only be applied against capital-gain income.

For the reasons previously stated, the owners of forest properties who make expenditures primarily for forest protection, conservation, or improvement, or for reforestation, urgently need as much tax incentive as possible.

Accordingly, it is suggested that the proposed Internal Revenue Code be amended by adding a new section 617 to subchapter I, part 1, to follow exploration and development expenditures, which are shown as sections 615 and 616, respectively. We suggest this new section read as follows:

"EXPENDITURES FOR FOREST DEVELOPMENT AND PROTECTION.—A taxpayer, owning, leasing, subleasing, or operating forest tracts which are properly managed for sustained wood production, and who makes expenditures primarily for forest protection, conservation, or improvement, or for forestation or reforestation, at his option, may treat any such expenditures paid or accrued in the taxable year, either (1) as a capital charge to be recovered through depreciation or depletion, as the case may be, or (2) as a deductible expense in such year. Proper forest management is the application of suitable and economically sound forestry principles relating to protection, utilization, and reproduction of forest tracts. This subparagraph shall be effective for taxable years commencing after December 31, 1953."

Furthermore, section 272 of H. R. 8300, in our opinion, should be changed to restrict the expenses to be applied against capital gains to such expenses directly attributable to the quantity measurement and to the making of contracts for the disposition of the timber.

The CHAIRMAN. Mr. Schillin.

STATEMENT OF JAMES G. SCHILLIN, CANAL BANK & TRUST CO., NEW ORLEANS, LA.

Mr. SCHILLIN. My name is James G. Schillin. I am an attorney, of New Orleans, La., and I am here on behalf of the Canal Bank & Trust Co., in liquidation, which is one of the old State banks which went into statutory liquidation at the time of the bank holiday back in 1933.

We are concerned about the possible effect of the effective date that the House bill has fixed as to corporate liquidations and reorganizations.

The House bill provides that distributions made pursuant to a plan of complete or partial liquidation, adopted after March 1, 1954, shall be covered by the new bill. Now our situation is a peculiar one in this respect. We were in no sense a voluntary liquidation. In other words, we didn't go into liquidation for the purpose of taking advantage of any of the liquidation provisions of the law.

As I have said, we were forced into liquidation in 1933. From 1933 until 1948, over a period of 15 years, the State bank commissioner liquidated our bank and we were able to pay off all of the depositors in

full. Besides we paid a substantial amount of interest on these deferred payments on deposits.

In 1948 when we had accomplished what we thought was this very satisfactory result, the State bank commissioner delivered, under our local statute, the assets of our bank to the shareholders, and from there on, the shareholders took charge of the liquidation.

The Supreme Court of Louisiana, in 1949, appointed three receivers to complete the liquidation.

These receivers over a period of 2 or 3 years commencing in 1951, were up here negotiating with the Internal Revenue Bureau, looking to the obtention of a ruling which would permit us to liquidate as far as we could and then to enter into a plan of reorganization. We were negotiating, as I have said, for probably 2 or 3 years.

Finally, in November 1953, we filed with the Bureau, our final application.

The Bureau, on January 6, 1954, approved our application and issued this ruling. We immediately went into the local receivership court—I say "immediately." We got our ruling down in New Orleans on January 8, or January 9, and on January 11, 1954, we were in the receivership court with our plan of liquidation and reorganization. Under the local practice in Louisiana, the court issued its notice of publication and gave all of the shareholders until February 15, which was approximately 30 days—the court fixed that period as the period during which any shareholder might object to this plan. Not a single shareholder, or any other party interested in it, objected. On February 15, 1954, we had a hearing before the court, the matter was submitted to the judge. Unfortunately, the judge did not enter his decree approving and ratifying our plan, which was not approved by the Government, by the Treasury, until March 5, 1954, which as you will see, Mr. Chairman, was 5 days after the effective date of this bill, which is March 1, 1954.

Now, I have discussed this matter with members of the staff and I believe they are in sympathy with our position.

The CHAIRMAN. Have there been many complaints along that general line?

Mr. SCHILLIN. Yes, Mr. Chairman.

The CHAIRMAN. As I understand, the staff is giving considerable attention to that.

Mr. SCHILLIN. The statement of Congressman Reed is to the effect that it was not intended that the new bill would prevent the consummation of plans which had been adopted by the shareholders prior to March 9, 1954.

Now, if the bill as finally adopted provides an effective date of March 9, 1954, then we are taken care of. But, of course, the bill must literally make that change, itself, it would seem to us, Mr. Chairman.

If the bill doesn't do that, then we have proposed an amendment to the effective-date provision of the new bill which provides that if in any receivership or liquidation or similar proceeding a plan has been submitted to the court prior to March 1, that it will be considered as having been adopted prior to March 1, although it may not have been actually signed by the judge until after March 1. We don't think that Congress or the Treasury intended to affect adversely, certainly not our particular plan which we have been working on over a period of

years, and which we finally got through on January 6, and unfortunately the judge omitted—of course, none of us knew until March 9 what the new bill provided.

The CHAIRMAN. You have no control over that. You cannot tell a judge when he must put in his decree.

Mr. SCHILLIN. That is correct, sir.

The CHAIRMAN. I might say right off the bat, and without complete committal, and until I hear what the staff has to say, it seems to me you have a good case.

Mr. SCHILLIN. Thank you, sir.

Senator LONG. As I understand it you have around 3,000 stockholders, don't you?

Mr. SCHILLIN. I am glad Senator Long mentioned that. We have around 3,000 shareholders and all the shareholders have been acting on reliance of the fact that this plan was going into effect.

As a matter of fact, in the over-the-counter market down in New Orleans, the stock in the new corporation is actively being traded in, in reliance on what we thought would be our plan.

Senator LONG. You have been working for 3 years on this reorganization, and now this bill comes out which will change the whole picture.

Mr. SCHILLIN. It will change the whole picture.

Senator LONG. And there will be a very injurious effect to your people.

Mr. SCHILLIN. We have gone to a great deal of time and effort and expense to have this plan evolved; it is the result of many years of effort on the part of the receivers and their attorneys, Mr. Chairman, and we don't think you intend to penalize us by saying that because the judge didn't sign his decree 5 days after March 1, that we don't come under the present law.

The CHAIRMAN. As I say, there have been a number of complaints on variations of your situation and we are very well acquainted with them. I believe there is a general sympathetic feeling toward doing something about it, although I cannot say what the committee will finally decide.

You have submitted your case to the staff, have you?

Mr. SCHILLIN. We have seen the staff several times.

The CHAIRMAN. I think you have done everything you can do.

Senator LONG. I want to compliment you for your diligence in this matter, Mr. Schillin. As one who practiced law, myself, I think there would be an inclination on the part of a lot of attorneys to check the law and if the law was favorable to think that they were safe, but you were very diligent to see that retroactively it might affect all your shareholders and you have explained it to Congress.

Mr. SCHILLIN. Mr. Chairman, we got this ruling on January 9 and we worked feverishly to get it in court on January 11, and we did everything we could humanly do to get our plan into effect.

I would like to ask permission to file in the record a petition which has been sworn to by the receivers, and a brief appendix, giving a synopsis of the things that we did.

The CHAIRMAN. It will be put in the record.

(The document referred to follows:)

CANAL BANK & TRUST CO., IN LIQUIDATION,
New Orleans, La., April 9, 1954.

To the chairman and members of the Senate Committee on Finance:

Canal Bank & Trust Co., in liquidation, New Orleans, La., has proposed an amendment to section 391 of the revenue revision bill (H. R. 8300), in order to make certain that Canal Bank's plan of partial liquidation and reorganization, which was approved by the Internal Revenue Bureau on January 6, 1954, in a favorable tax ruling, and which was submitted to the local court on January 11, 1954—long before March 1, 1954, the effective date of the new revenue bill, although the judgment of the court was not rendered and signed March 5, 1954.

At the outset we emphasize that Canal Bank receivership has never, in any sense, been a voluntary liquidation or receivership. The bank, along with many others, was placed in liquidation in 1933 and has been under court supervision ever since. It has over 2,000 stockholders, most of whom are located in and around Louisiana. The bank was ultimately able to pay off its creditors in full, and, for the past several years, the receivers have been working actively toward liquidating and winding up the bank's affairs. After detailed study of the many difficult problems involved, and innumerable conferences with the Internal Revenue Service and others, the receivers determined that the bank's affairs could be best terminated by a plan involving a partial liquidation and reorganization.

On November 26, 1953,[1] this plan in its final form was submitted to the Commissioner of Internal Revenue for an advance ruling. On January 6, 1954, a ruling favorable in all respects was issued by the Internal Revenue Service. On January 11, 1954, the receivers filed a petition in the local court with respect to said course of procedure, and the necessary notices were thereupon published in the New Orleans newspapers. On February 15, 1954, the court held open hearing at which no objections of any kind were interposed by any shareholder or other person. On March 5, 1954, the court's final order was signed, approving and accepting in every respect the receiver's petition insofar as the tax ruling was concerned.

The proposed revenue bill, if enacted in its present form, would apply to distributions under a plan of complete or partial liquidation unless the plan was adopted prior to March 1, 1954 (sec. 391 (a) (1)), and might adversely affect the tax consequences of the bank's plan which, as indicated, the Internal Revenue Service has already approved under presently existing law. Although Canal Bank's plan was adopted, in the real sense of the word, long before March 1, 1954, and in fact possibly as early as May 30, 1950, the technical objection might be raised that the plan was not adopted within the meaning of the new law until the signing of the court's order on March 5, 1954.

We understand that March 1 was inserted in the revenue bill as the cutoff date because committee press releases were issued on that date, and we take it that neither the Treasury nor the Congress intend, or want, to disturb the tax consequences, under presently existing law, of plans of liquidation adopted prior to the time that a taxpayer could have had public knowledge of the provisions of the proposed revenue bill. The undersigned had no knowledge of the contents of the revenue revision bill of 1954 until March 9, 1954.

It is apparent from section 336 (c), page 81, of the new bill that a plan under that section is to be considered adopted when a resolution is adopted by the shareholders or a board of directors. We feel that some language should be used to make it certain that under section 391 (a) (2) a plan should be considered as adopted when receivers, liquidators, or other representatives of a corporation or its shareholders have made application to the Internal Revenue Bureau, and obtained a favorable ruling long before March 1, 1954, although the court may not have approved the plan, as in our case, until March 5, 1954.

The plan approved by the local court on March 5, 1954, is the result of many years of study and effort on the part of the receivers and its attorneys, and was accomplished at considerable expense, and the receivers are under court order to complete the program described above. Long before March 1, 1954, the shareholders had full knowledge through newspaper and other publicity of the plan and have acted in reliance upon its consummation.

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[1] The form of the proposed amendment and synopsis of the bank's activities in formulating and presenting its plan is contained in annexed appendix.

We trust that the Congress will appreciate the fairness and equity of our position by enacting the proposed amendment into law.

Very respectfully yours,

J. EDGAR MONROE,
GEORGE E. BURGESS,
JOHN F. FINKE,
Receivers, Canal Bank & Trust Co., in liquidation.
JAMES G. SCHILLIN,
Attorney.

AFFIDAVIT

STATE OF LOUISIANA,
Parish of Orleans,
City of New Orleans, ss:

Before me, the undersigned authority, personally came and appeared J. Edgar Monroe, George E. Burgess, and John F. Finke, receivers, Canal Bank & Trust Co., in liquidation, each of whom being duly sworn, deposes and says:

That he has read the foregoing petition; that all the allegations and statements contained therein are true and correct.

J. EDGAR MONROE,
GEORGE E. BURGESS,
JOHN F. FINKE,
Receivers, Canal Bank & Trust Co., in liquidation.

Sworn to and subscribed before me, this 9th day of April 1954.

MICHAEL M. IRWIN,
Notary Public.

APPENDIX

AMENDMENT PROPOSED BY CANAL BANK & TRUST CO., IN LIQUIDATION, NEW ORLEANS, LA., TO SECTION 391 OF INTERNAL REVENUE CODE OF 1954 (H. R. 8300, UNION CALENDAR NO. 408)

Amend section 391. Effective date of subchapter C, by adding subsection (c), so that said section 391, as amended, shall read in its entirety as follows:

"SEC. 391. EFFECTIVE DATE OF SUBCHAPTER C.

"(a) This subchapter shall be effective with respect to distributions or transfers occurring after March 1, 1954, except that—

"(1) Part II of this subchapter shall be effective only with respect to distribution made in pursuance of a plan of partial or complete liquidation adopted after March 1, 1954; and

"(2) The tax imposed by section 309 shall be applicable only with respect to amounts distributed after the date of enactment of this Act.

"(b) CERTAIN NET OPERATING LOSS CARRYOVERS. For purposes of applying the special limitation on net operating loss carryovers in section 382, the beginning of the taxable years specified in subsections (a) (1) and (b) (1) and (2) of such section shall be considered to be the beginning of such taxable years or March 1, 1954, whichever occurs later.

"(c) PLAN. For the purpose of subsection (a) (1) a plan shall be considered as having been adopted prior to March 1, 1954, if, in any receivership, liquidation, or similar proceeding, pending in any court of competent jurisdiction, the plan is submitted by the shareholders or their legal representative to the court for approval prior to March 1, 1954, although the decree approving said plan is not rendered until after that date."

Between May 30, 1933, and May 1, 1948, Canal Bank & Trust Co. was in process of statutory liquidation by the State banking commissioner of Louisiana. At a stockholders' meeting on May 1, 1948 (recessed to May 10, 1948), the assets of the bank were delivered by the State bank commissioner to the bank's shareholders. Some stockholder litigation ensued, and finally, on November 7, 1949, the Supreme Court of Louisiana appointed the undersigned as receivers for the bank.

Under date of May 31, 1950, on the petition of the receivers, the State court signed a judgment ordering a complete liquidation of all of the assets of this bank. On March 26, 1951, the receivers applied to the Commissioner of Internal Revenue, and on May 14, 1951, the Commissioner issued his ruling approving for tax purposes a partial liquidation and tax-free reorganization of the bank. On October 31, 1951, a supplemental application to amend the ruling of May 14, 1951, was filed, which supplemental application was withdrawn on January 14, 1952.

After further consultation with the local court, the receivers, on April 14, 1952, filed a new application for a new ruling, which contemplated creation of an oil trust and another plan of reorganization; on September 4, 1952, a supplemental application for ruling was filed with the Commissioner materially modifying the plan previously proposed on April 14, 1952.

After many conferences with the Bureau a favorable ruling was issued under date of April 30, 1953, approving the creation of Canal Bank Trust and holding that it would not be taxable as a corporation or as an association.

On November 23, 1953, the undersigned receivers presented their final application for a ruling on their plan which called for the creation of an oil trust to be known as Canal Bank Trust, a plan of partial liquidation and tax-free reorganization, which plan was approved by the Commissioner of Internal Revenue under date of January 6, 1954.

A copy of this favorable ruling having been received by the receivers in New Orleans, La., on or about January 8, 1954, the undersigned receivers, through their attorney, immediately and without any delay whatsoever worked feverishly on a petition to the local court, which petition was filed on January 11, 1954, 2 days after the receipt of the favorable ruling from the Commissioner.

The civil district court for the parish of Orleans, State of Louisiana, New Orleans, La., the local court having jurisdiction over this receivership, fixed February 15, 1954, as the day upon which the hearing would be had and evidence taken on the petition of the receivers recommending wholeheartedly the adoption of this plan.

The court allowed a delay from the filing of the petition on January 6, 1954, until February 15, 1954, within which any shareholder or other interested person might file oppositions to the plan. No opposition having been filed by any shareholder or other person, the plan was submitted to the court on February 15, 1954 (which was, of course, before the effective date affixed by sec. 301 (a) (1) of the revenue revision bill (H. R. 8300)).

A certified copy of the judgment of the local court dated March 5, 1954, is annexed to the original petition being filed with the Senate Committee on Finance.

J. EDGAR MONROE,
GEORGE E. BURGESS,
JOHN F. FINKE,
Receivers, Canal Bank & Trust Co., in Liquidation.
JAMES G. SCHILLIN,
Attorney.

EXTRACT OF JUDGMENT

Civil District Court, Division "E" (Docket 5)

No. 283-532

Ruby L. Dowling v. Canal Bank & Trust Co., et al., in re liquidation Canal Bank & Trust Co.

JUDGMENT

This matter came on for hearing on the petition of the Receivers filed on January 11, 1954, their supplemental petition filed on February 1, 1954, and the rule embodied in said supplemental petition on February 1, 1954.

Present: James G. Schillin, Fishman, Reuter, Rosenson & D'Aquin, Warren M. Simon, Attorneys for Receivers.

When, after hearing the pleadings, evidence, and argument of counsel, and considering the certificates of the Clerk that the petitions and applications of the Receivers have been placed upon the Receivership Order Book and duly published, for the time and in the manner prescribed by law, and considering further that no oppositions have been filed to said petitions and applications, the Court, for the reasons assigned, being of the opinion that the law and the evidence are in favor of making absolute the rule filed on February 1, 1954, and is in favor of granting the relief prayed for by the Receivers to the extent hereinafter stated: for the reasons this day handed down:

(1) IT IS ORDERED, ADJUDGED, AND DECREED that petitioners be and they are hereby authorized, empowered and directed, pursuant to the plan of complete liquidation heretofore inaugurated, to distribute on or after May 8, 1954, to

each stockholder of Canal Bank & Trust Company, in Liquidation, owning stock as of record date hereby fixed as April 20, 1954, who holds a Definitive Receipt of The National Bank of Commerce in New Orleans (based on a deposit on or prior to said record date of the stock represented thereby with said The National Bank of Commerce in New Orleans) on the form heretofore authorized by this Court by its order dated January 24, 1950, for stock in Canal Bank & Trust Company, in Liquidation, or to his or her assigns, or to such other owners of stock of Canal Bank & Trust Company, in Liquidation, as of said record date, as may make adequate proof of their respective ownerships of stock on said record date, for each share of stock in Canal Bank & Trust Company, in Liquidation, so owned and so shown to be owned (a) the sum of $2.00 in cash, and (b) one share in Canal Bank Trust, hereinafter referred to, the distribution of said cash and Trust shares to be the fifth distribution pursuant to the plan of complete liquidation.

(2) IT IS FURTHER ORDERED, ADJUDGED, AND DECREED that petitioners be and they are hereby authorized, empowered, and directed to enter into a contract with The National Bank of Commerce in New Orleans, which contract will provide (a) that petitioners shall deposit with the said Bank the sum of $808,700.00 in cash, to be held in trust by said Bank in an account styled "Canal Bank & Trust Company, in Liquidation, J. Edgar Monroe, George E. Burgess and John F. Finke, Receivers, The National Bank of Commerce in New Orleans, Trustee, Stockholders Distribution No. 5", which deposit shall be fully secured as a Trust Deposit, (b) that in case of any dispute concerning said security, same shall be settled by the Civil District Court for the Parish of Orleans, (c) that from said deposit, The National Bank of Commerce in New Orleans shall, on or after May 3, 1954, pay to persons proving to be stockholders of record of Canal Bank & Trust Company, in Liquidation, as of April 20, 1954, the sum of $2.00 per share, without interest, for each share of stock in Canal Bank & Trust Company held by said stockholder, respectively, upon compliance with the terms and conditions substantially set forth in the contracts previously authorized by judgments of this Court, and (d) that the compensation of The National Bank of Commerce in New Orleans for services in handling the cash distribution aforesaid shall be $0.35 for each check issued, and $0.15 for each Definitive Certificate stamped showing the aforesaid fifth distribution, said Bank to be reimbursed for all costs expended or incurred in the purchase of supplies, stationery and postage.

(3) IT IS FURTHER ORDERED, ADJUDGED, AND DECREED that petitioners be and they are hereby authorized, empowered, and directed to transfer, in accordance with the aforesaid contract to the said The National Bank of Commerce in New Orleans, as Trustee, the sum of $808,700.00 in cash, and to take, or cause to be taken by The National Bank of Commerce in New Orleans, or otherwise, all the action, and to do all of the things contemplated and provided for by said contract; that petitioners are further authorized, empowered and directed to do and perform, or to cause to be done and performed, any and all things, and to take, or cause to be taken, any and all steps, and to sign, execute, acknowledge and deliver, or cause to be signed, executed, acknowledged and delivered, any and all documents, stock certificates, receipts and other papers necessary or appropriate, to completely carry out this judgment, and to make to the stockholders entitled thereto the distribution above referred to.

(4) IT IS FURTHER ORDERED, ADJUDGED AND DECREED that petitioners be and they are hereby authorized, empowered, and directed, pursuant to and in accordance with the plan of complete liquidation heretofore inaugurated, to transfer, assign, and convey, in kind, to a Trust with The National Bank of Commerce in New Orleans, as corporate Trustee, and Francis C. Doyle, as individual Trustee, said Trust to be established and operated in accordance with the terms and conditions of the Trust Indenture identified as "Exhibit 1," annexed to and made part of this judgment, those nineteen certain royalty interests belonging to this receivership estate, described as follows, to wit:

1. 1/8th royalties on oil and gas; $1.00 per long ton on sulphur; 1/10th on other minerals out of and from that certain mineral lease from Canal Bank & Trust Company, in Liquidation, Lessor, to Humble Oil & Refining Company, Lessee, dated April 5, 1937, covering 200 acres (owned in fee), more or less, in St. Mary Parish, Louisiana, recorded in Book 5-J, under Entry No. 61810.

2. 1/8th royalties on oil and gas; $1.00 net per long ton on sulphur; 1/10th on other minerals out of and from that certain lease from Canal Bank & Trust Company, in Liquidation, Lessor, to O. B. Pennington, Lessee, dated July 31, 1940, covering 665 acres (owned in fee), more or less, in St. James Parish, Louis-

iana, recorded in Book 76, folio 398 of the Conveyance Records of said Parish, as modified by agreement between Lessor and Humble Oil & Refining Company, assignee, dated February 10, 1944, recorded in Book 80, folio 451, and amendment between the same parties dated February 26, 1945, recorded in Book 82, folio 493, and as modified by release of 505 acres, more or less, between the aforesaid parties, dated December 20, 1946 and recorded in Book 85, folio 222 of the Conveyance Records of St. James Parish.

3. 1/8th royalties on oil and gas and other minerals, except sulphur; $1.00 net per long ton on sulphur plus payment up to $50,000.00 out of an additional 1/48th on oil, distillate and gas out of and from that certain mineral lease by Canal Bank & Trust Company, in Liquidation, Lessor, to Humble Oil & Refining Company, Lessee, dated July 27, 1945, and covering 400 acres (owned in fee), more or less, in St. James Parish, Louisiana, and recorded in Book 83, folio 178 of the Conveyance Records of said Parish.

4. ⅛th royalties on oil from wells producing less than 500 barrels per day and ⅙th royalties on wells producing 500 barrels or more per day; ⅛th on gas; royalty on sulphur and other minerals in an amount equivalent to the highest royalty being paid in the Gulf Coast fields of Louisiana and/or Texas, for sulphur and/or other minerals, as the case may be, at the time of the discovery of sulphur or other minerals, as the case may be, provided that same shall, in no event, exceed 20% on such sulphur and/or other minerals, or the value thereof, and in the case of sulphur, shall in no event be less than $1.00 per ton, said royalty interests arising out of and from that certain mineral lease from Mulvey Irrigation Company, Lessor, to Pure Oil Company, Lessee, dated January 9, 1930, covering an undivided ½ interest in 866.57 acres, more or less, in Vermilion Parish, Louisiana, recorded in Book 98, folio 391 of the Conveyance Records of said Parish, as modified by release of 326.37 acres, more or less, dated January 22, 1938, recorded in Book 137, folio 621 of the Conveyance Records of said Parish.

5. ⅛th royalties on oil and gas or other minerals, except sulphur; $1.00 net per long ton on sulphur, out of and from that certain mineral lease from Mulvey Irrigation Company, Lessor, to C. S. Powers, Lessee, dated July 20, 1939, covering an undivided ½ interest in 326.37 acres, more or less, in Vermilion Parish, Louisiana, recorded in Vol. 142, folio 251 of the Conveyance Records of said Parish, as modified by release of 216.87 acres, more or less, dated October 23, 1947.

6. ⅙th royalties on oil, gas and other minerals, except sulphur; $1.00 net per long ton on sulphur out of and from that certain mineral lease from Canal Bank & Trust Company, in Liquidation, et als., Lessors, to Sun Oil Company, Lessee, dated May 11, 1950, covering an undivided ½ interest in 216.87 acres, more or less, in Vermilion Parish, Louisiana, recorded in Book 216, folio 337 of the Conveyance Records of said Parish, as amended by instrument dated July 16, 1952, recorded under act #111,911 and C. O. B. 237, folio 569 of the Conveyance Records of said Parish, together with the pooling agreement dated October 5, 1952 recorded under original act #112,252 and C. O. B. 241, folio 213 of the Conveyance Records of said Parish.

7. ⅙th royalties on oil, gas and other minerals, except sulphur; $1.00 net per long ton on sulphur out of and from that certain mineral lease from Canal Bank & Trust Company, in Liquidation, Lessor, to Superior Oil Company, Lessee dated March 6, 1950 covering and effecting an undivided interest of .009375 in 1280 acres, more or less, in Terrebonne Parish, Louisiana, recorded in Book 173, under Entry No. 88912 of the Conveyance Records of said Parish.

8. ⅙th royalties on oil, gas and other minerals, except sulphur; $1.00 net per long ton on sulphur out of and from that certain mineral lease from Canal Bank & Trust Company, in Liquidation, Lessor, to the Superior Oil Company, Lessee, dated March 6, 1950, covering an undivided interest of .009375 in 2880 acres, more or less, in Terrebonne Parish, Louisiana, recorded in Book 173, under Entry #88911 of the Conveyance records of said Parish, as modified by act of release dated January 10, 1951, of 1280 acres, more or less.

9. ⅙th royalties on oil, gas and other minerals, except sulphur; $2.00 net per long ton on sulphur, out of and from that certain mineral lease from Canal Bank & Trust Company, in Liquidation, Lessor, to Kermit Wurzlow, Lessee, dated November 20, 1951, covering an undivided .009375 interest in 800 acres, more or less, located in Terrebonne Parish, Louisiana, recorded in Book 187, under Entry No. 109,517 of the Conveyance Records of said Parish.

10. ⅙th royalties on oil, gas and other minerals, except sulphur; $2.00 net per long ton on sulphur out of and from that certain mineral lease from Canal

Bank & Trust Company, in Liquidation, Lessor, to Union Oil Company of California, Lessee, dated May 9, 1951, covering an undivided .000375 interest in 1258 acres, more or less, located in Terrebonne Parish, Louisiana, recorded in Book 180, under Entry No. 99,809 of the Conveyance Records of said Parish.

11. 1/8th royalties on oil, gas and other minerals, except sulphur; $2.00 net per long ton on sulphur, out of and from that certain mineral lease from Canal Bank & Trust Company, in Liquidation, Lessor, to the California Company, Lessee, dated August 20, 1951, covering an undivided 1/2 interest in 1731 acres, more or less, located in St. Martin Parish, Louisiana, recorded in Book 217, folio 305 of the Conveyance Records of said Parish, less 1698 acres released by act of partial release dated August 13, 1953, recorded under Entry No. 80,253 of the Conveyance Records of said Parish.

12. 1/8th royalties on oil, gas and other minerals, except sulphur; $1.00 per long ton on sulphur, out of and from that certain mineral lease from Canal Bank & Trust Company, in Liquidation, Lessor, to the California Company, Lessee, dated March 27, 1950, covering an undivided 1/2 interest in 177 acres, more or less, in St. Martin Parish, Louisiana, recorded in Book 210, folio 258 of the Conveyance Records of said Parish.

13. 1/8th royalties on oil, gas and other minerals, except sulphur; $1.00 net per long ton on sulphur, out of and from that certain mineral lease from Canal Bank & Trust Company, in Liquidation, Lessor, to A. B. House, Lessee, dated February 27, 1950, covering an undivided 51% of an undivided 1/2 interest in 1727 acres, more or less, located in Lafourche Parish, Louisiana, recorded in Book 151, folio 284, under Entry No. 95,309 of the Conveyance Records of said Parish.

14. 1/8th royalties on oil, gas and other minerals, except sulphur; $3.00 net per long ton on sulphur out of and from that certain mineral lease from Canal Bank & Trust Company, in Liquidation, Lessor, to M. P. O'Meara and James F. O'Meara, Lessees, dated May 22, 1952, covering an undivided 1/4th interest in 500 acres, more or less, located in Calcasieu Parish, Louisiana, recorded under Entry No. 539,001, Book 523, folio 585, et seq, of the Conveyance Records of said Parish.

15. 1/8th royalties on oil, gas and other minerals, except sulphur; $1.00 net per long ton on sulphur, plus payment up to $150,000.00 out of 1/128th on oil, gas and distillates, out of and from that certain mineral lease from Canal Bank & Trust Company, in Liquidation, Lessor, to the California Company, Lessee, dated March 22, 1950, covering 5,500 acres, more or less, located in Jefferson Parish, Louisiana, recorded in Book 7, folio 286 of the Conveyance Records of said Parish.

16. 1/8th royalties on oil and gas; $1.00 net per long ton on sulphur; 1/10th on other minerals, out of and from that certain mineral lease from Poitevent & Favre Lumber Company, Lessor, to Earle H. Short, Lessee, dated April 5, 1950 as of March 8, 1950, covering 42,188.20 acres, more or less, in St. Tammany Parish, Louisiana, recorded in Book 194, folio 75 of the Conveyance Records of said Parish. Under which lease Canal Bank & Trust Company, in Liquidation acquired a 500/4000ths undivided interest in said lease under instrument recorded in Book 132, Entry 4, Page 4 of the Conveyance Records of said Parish.

17. 1/8th royalties on oil and gas; $1.00 net per long ton on sulphur; 1/10th on other minerals; out of and from that certain mineral lease from Poitevent & Favre Lumber Company, Lessor, to Earle H. Short, Lessee, dated April 5, 1950, as of March 8, 1950, covering 18,177.85 acres, more or less, in St. Tammany Parish, Louisiana, recorded in Book 194, folio 88 of the Conveyance Records of said Parish. Under which lease Canal Bank & Trust Company, in Liquidation acquired a 500/4000ths undivided interest in said lease under instrument recorded in Book 132, Entry 4, Page 4 of the Conveyance Records of said Parish.

18. 1/8th royalties on oil, gas and other minerals, except sulphur; $3.00 net per long ton on sulphur; out of and from that certain mineral lease from Canal Bank & Trust Company, in Liquidation, Lessor, to John J. Cosner, Lessee, dated October 26, 1953, covering 850 acres, more or less, in St. James Parish, Louisiana, recorded in Book 95, under Entry No. 10,870 of the Conveyance Records of said Parish.

19. 1/8th royalties on oil, gas and other minerals, except sulphur; $2.00 net per long ton on sulphur; out of and from that certain mineral lease from Canal Bank & Trust Company, in Liquidation, Lessor, to Union Oil Company of California, dated January 30, 1953, covering an undivided .000375 interest in 1357.37 acres, more or less, located in Terrebonne Parish, Louisiana, recorded in Book 196, under Entry No. 118,958 of the Conveyance Records of said Parish.

To all of which oil, gas and mineral leases, pooling agreements, assignments and transfers reference is hereby made for all purposes as though incorporated herein in extenso.

In consideration of the issuance to petitioners of a certificate of beneficial interest representing 404,350 shares in said Trust, and that petitioners thereupon transfer said certificate of beneficial interest in the Trust to The National Bank of Commerce in New Orleans, under the plan of complete liquidation heretofore inaugurated, the said The National Bank of Commerce in New Orleans to distribute the 404,350 shares in said Trust, represented by said certificate of beneficial interest, pro rata to Canal Bank shareholders under and by virtue of appropriate contracts and arrangements substantially similar to the contract above provided with reference to the cash distribution; that said arrangements will provide for proper compensation to The National Bank of Commerce in New Orleans for services rendered.

(5) IT IS FURTHER ORDERED, ADJUDGED AND DECREED that, before any step is initiated to transfer this Liquidation's residual assets to the new corporation and otherwise accomplish a tax-free reorganization, which is hereinafter provided for, petitioners are authorized, empowered and directed to cancel, or cause to be cancelled, 80 percent in number of each shareholder's shares in order that 80 percent in number of each shareholder's shares may be completely cancelled and retired, so that there shall remain only 80,870 shares of Canal Bank & Trust Company, in Liquidation; that, in order to effectuate such a result, each shareholder, at the time he receives the liquidating distribution heretofore provided for, shall present the Definitive Receipt held by him, which was issued under the stock plan previously adopted by the Court, to The National Bank of Commerce in New Orleans at the time said shareholder receives the distribution in liquidation, previously provided for herein, and that, at such time, said The National Bank of Commerce in New Orleans shall issue to said shareholder a new Definitive Receipt for two-tenths of the number of shares in Canal Bank & Trust Company, in Liquidation, which said shareholder had theretofore held; that appropriate provision may be made for the issuance of scrip certificates to take care of fractional shares; that as to those shareholders who have not deposited with The National Bank of Commerce in New Orleans their certificates of stock in accordance with the stock plan heretofore inaugurated, it is now ordered, adjudged and decreed that 80 percent in number of said undeposited shares are hereby declared to be completely cancelled and retired to the same extent and for the same purpose as is heretofore provided in the case of shares which have been deposited in accordance with the stock plan.

(6) IT IS FURTHER ORDERED, ADJUDGED AND DECREED that, petitioners be and they are hereby authorized, empowered and directed to do and perform all things appropriate and necessary to effectually cancel, or cause to be cancelled, 80 percent in number of each shareholder's shares in order that 80 percent of Canal Bank shares shall be cancelled and retired.

(7) IT IS FURTHER ORDERED, ADJUDGED AND DECREED that, petitioners are authorized, empowered and directed, following the consummation of the above partial liquidation, to adopt and consummate a plan of reorganization, and to effectuate said plan of reorganization, they are authorized, empowered and directed:

(a) To form, or cause to be formed, a new corporation called "Canal Assets, Inc.," organized under the General Business Corporation Laws of the State of Louisiana, and having an authorized capital stock of 80,870 shares of common stock of the par value of $1.00 per share, a copy of the Articles of Incorporation to be executed by petitioners being annexed hereto and made part of this judgment, and marked "Exhibit 2";

(b) To transfer and convey to said Canal Assets, Inc., all of the assets of every kind, character, and description owned by this Liquidation as of the date of the transfer and conveyance thereof, which said corporation will assume the liabilities of this Liquidation of every kind, character, and description; the real property to be transferred to Canal Assets, Inc., is more fully described hereinafter in this judgment;

(c) To cause Canal Assets, Inc. to issue, in consideration therefor, all of its authorized capital stock of 80,870 shares to petitioners, and petitioners thereupon shall distribute said 80,870 shares of capital stock of Canal Assets, Inc. to Canal Bank shareholders in proportion to their relative interest in Canal Bank & Trust Company, in Liquidation;

(d) To cause the remaining 80,870 Canal Bank shares to be cancelled, to completely dissolve said corporation, and surrender its charter.

(8) IT IS FURTHER ORDERED, ADJUDGED AND DECREED that, petitioners mail notice of this judgment to all Canal Bank shareholders with the direction that Definitive Receipts issued to represent shares deposited be presented to The National Bank of Commerce in New Orleans, as Agent for petitioners; that, for all purposes and in all events, 80 percent in number of each shareholder's shares, and hence 80 percent in number of all of Canal Bank shares shall stand completely cancelled, said cancellation to be effective seventy-five days following the date this judgment is rendered; that petitioners are directed to deposit with The National Bank of Commerce in New Orleans, under an appropriate contract and arrangement, documentary evidence of the rights, benefits, and privileges which inure hereunder to the shareholders of Canal Bank & Trust Company, in Liquidation, who have not deposited their stock, distributions heretofore made and those made in this judgment to remain with the said The National Bank of Commerce in New Orleans, for the account and benefit of all undeposited shares, until the further orders of this Court.

(9) IT IS FURTHER ORDERED, ADJUDGED AND DECREED that, the final fees and compensation to be paid to the Receivers and their attorneys be fixed before the Receivers are discharged, their bonds cancelled, and the Receivership finally terminated.

(Description of real property omitted.)

JUDGMENT READ, RENDERED AND SIGNED in open Court this 5th day of March 1954.

FRANK J. STICH, *Judge*.

A true copy.

[SEAL] E. L. MCCARTHY,

Deputy Clerk, Civil District Court, Parish of Orleans, State of Louisiana.

Senator LONG. Will there be taxes due under this reorganization plan as you proposed?

Mr. SCHILLIN. Yes, sir; there would be taxes due.

Senator LONG. They will be due at the capital gains rate.

Mr. SCHILLIN. Yes, they will be due at the capital gains rate.

The CHAIRMAN. Mr. Haussermann, will you identify yourself to the reporter, please.

Mr. HAUSSERMANN. My name is Oscar W. Haussermann; my address is 15 State Street, Boston, Mass. I am a director, the secretary, and counsel of American Research & Development Corp., a Massachusetts corporation with its principal offices in Boston. American Research has presented to this committee, along with a draft of its proposed amendments to the new code, a written statement dated April 14, 1954, and an April 16, 1954, addendum to the first written statement.

STATEMENT OF OSCAR W. HAUSSERMANN, AMERICAN RESEARCH & DEVELOPMENT CORP., BOSTON, MASS.

Our amendment involves subchapter M of the proposed new code. Subchapter M deals with regulated investment companies. It says that if an investment company desires to obtain the tax benefits of subchapter M, it must elect to become a regulated investment company. To become a regulated investment company, two sets of conditions or requirements must be met, one relating to income and the other to assets. Our proposed amendments have nothing to do with the income requirement, but solely with the assets requirement.

Senator FLANDERS. Excuse me, Mr. Haussermann. I wonder if you might just indicate very briefly the nature of this particular corporation, because that is pertinent, I think.

Mr. HAUSSERMANN. Our corporation comes within the purview of the definition in the new code and in the old code of a development investment company, which is defined as an investment company which

is principally engaged in the furnishing of capital to other corporations, which in turn are principally engaged in the development or exploitaton of inventions, technological improvements, new processes, or products not previously generally available.

The CHAIRMAN. Senator Flanders is particularly interested in this.

Mr. HAUSSERMANN. He is one of the founders of American Research & Development Corp., and he was its first president. The corporation will always be indebted to him for starting us out on the right track.

The asset requirement is to the effect that every investment company which desires to become a regulated investment company must show that 50 percent or more of the value of its assets is represented (1) by cash, receivables, government securities, and securities of other regulated investment companies, and (2) by securities, with respect to any one issuer, which represent not more than 5 percent of the value of the total assets of the investment company and not more than 10 percent of the voting securities of the issuer.

Now, these requirements apply to ordinary investment companies, and they also apply to American Research's type of investment company, with one exception. That exception is that in computing 50 percent or more of the total value of its assets, an investment company such as American Research may include securities of any one issuer, even though they represent more than 10 percent of the voting securities of that issuer, provided they don't represent more than 5 percent of the total value of the investment company's assets.

Our proposed amendment is to change that 5 percent to 10 percent. Our reason for our proposal issues from our experience since we started business late in 1946.

In at least half a dozen cases we have advanced money to new projects and the securities which we received for such advances cost us in each case much less than 5 percent of the value of our total assets. By assisting the new projects through the furnishing of managerial and financial advice, giving it financial help in a time of need, and furnishing, from our own personnel, persons for its board of directors, we have contributed materially to the appreciation of the value of the securities held by us in the new project to an amount considerably in excess of 5 percent of the total value of all our assets.

For example, we made an early investment in Tracerlab, Inc. The cost of our investment stands us at $236,000. By staying with that concern from its early days to the present time, and assisting it in the solution of many problems, we have seen the value of our investment grow until it is now about $727,000 as against a cost to us of $236,000.

Another example is Ionics, Inc. Our investment in that enterprise cost us $400,000 and now has a value of almost $900,000.

Another example is High Voltage Engineering Corp. The cost of our investment in this enterprise is $200,000 and its present value is $600,000.

There are other examples of our buying into new enterprises at a cost amounting to less than 5 percent of the value of our total assets and working with these enterprises and contributing to their rise in value until our investment in each has grown in value to an amount greater than 5 percent of the value of our total assets. With these examples in mind, I should like to point out that the more successful

we are in helping to develop a new enterprise, the harder it is for us to qualify as a regulated investment company. We feel that this result was not intended by the code and that raising this 5 percent limitation to 10 percent would be consistent with the aim and spirit of section 851 and would be fair and helpful to development investment companies.

I might point out that the reason American Research hasn't asked for a change hitherto is because we weren't selling our appreciated investments and we weren't asking our projects to pay us great dividends. Hence, although we operated at a profit in the past 2 years, our net income in 1952 was small and in 1953 was small. However, it is much larger for the first quarter of 1954. It looks, therefore, that we are now approaching a time when we may be ready to distribute earnings and, therefore, ready to become a regulated investment company and to serve as a conduit through which our earnings may be passed on to our stockholders as dividends.

Our other proposed amendment is simply this——

The CHAIRMAN. Will you pause just a moment, please.

Has the staff considered that problem?

Mr. SMITH. Yes, sir; a group was in the other day, Senator, on that matter.

The CHAIRMAN. Have you been in touch with the staff?

Mr. HAUSSERMANN. No; but I shall.

The CHAIRMAN. Get in touch with Mr. Stam, 1011 New House Office Building. They are studying all the technical features of this. I think you will find them sympathetic and they will try to work something out.

Mr. HAUSSERMANN. I shall go there. Thank you, sir.

Now, as to our other proposed amendment. The present language of section 851 of the proposed new code and of section 361 of the existing code defines a development investment company as one "principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available."

We would like to change the word "principally" where it is used the second time in section 851 (e) (1) and in the two places where it is used in section 851 (e) (3) to "substantially."

The CHAIRMAN. You would like to do what?

Mr. HAUSSERMANN. We would like to change the word "principally" to "substantially" in the places indicated so that a development investment company would be defined as an investment company "principally engaged in the furnishing of capital to other corporations which are substantially engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available."

Changing "principally" to "substantially" in the places indicated would encourage a development investment company to furnish funds for a new enterprise launched by an old company prior to the time when the old company could be said to be "principally" engaged in the new enterprise; and would obviate the present practical difficulties inherent in determining annually whether each corporation to which a development investment company has furnished capital, though

clearly "substantially" engaged in new things, is "principally" engaged in new things.

Bear in mind that the changing of the word "principally" to "substantially" in the places requested doesn't mean that we could arbitrarily say, "Any corporation in which we have invested funds is 'substantially' engaged in new enterprises." The SEC would be the final judge as to this. As you know, in order for us to become a regulated investment company, we would have to get each year a certificate from the SEC, addressed to the Secretary of the Treasury, to the effect that the SEC deemed us to be principally engaged in furnishing capital to other corporations which are "substantially" engaged in new enterprises.

The CHAIRMAN. Thank you very much.

(The prepared statement of Mr. Haussermann follows:)

STATEMENT OF AMERICAN RESEARCH AND DEVELOPMENT CORP. (HEREINBELOW REFERRED TO AS AMERICAN RESEARCH)

The amendments sought by American Research are annexed hereto. They pertain to section 851 of the proposed new revenue law (H. R. 8300) and old section 361 of the existing Internal Revenue Code.

New section 851 and old section 361 (which are now substantially the same) each contains a subdivision relating solely to that type of investment company which is a "development company," that is to say, a company "principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available." (The term "development company" as used hereinbelow refers to the above type of investment company.)

As now written these sections, among other things, first specify the conditions as to assets which an investment company, other than a development company, must meet in order to become a regulated investment company and then specify the conditions as to assets which a development company must meet in order to become a regulated investment company. The two sets of conditions as to assets are the same, except as below indicated.

Under new section 851 (b) as now written, for an investment company, other than a development company, to quality as a regulated investment company the following conditions as to its assets must be met:

"(4) At the close of each quarter of the taxable year—

"(A) at least 50 percent of the value of its total assets is represented by—

"(i) cash and cash items (including receivables), Government securities, and securities of other regulated investment companies, and

"(ii) other securities for purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and, except and to the extent provided in subsection (e), to not more than 10 percent of the outstanding voting securities of such issuer, and"

Under new section 851 (e) as now written, an investment company which is a development company and which desires to qualify as a regulated investment company must meet all the above requirements, with the exception that, in computing 50 percent or more of the value of its assets, securities of an issuer representing more than 10 percent of the voting securities of such issuer may be included, provided the securities of such issuer do not represent more than 5 percent of the total value of the development company's assets. The effect of the attached amendments proposed by American Research would be to raise the last-mentioned figure of 5 percent to 10 percent.

REASONS FOR ATTACHED AMENDMENTS

Development companies by advancing capital to and assisting in the development of new enterprises contribute to the increase of new business and to the increase of employment in new fields and are thus helpful to our national economy and our industrial progress. Legislation that facilitates a successful development company's qualifying as a regulated investment company is legis-

lation in the national interest; legislation that virtually prevents a successful development company's qualifying as a regulated investment company is not in the public interest.

The existing provisions of new section 851 (b) (4) and section 851 (e), if not revised as proposed by American Research, would justify the charge (as do the existing provisions of old sec. 361 (c)) that the more successful a development company is in developing new enterprises and increasing the value of its investments in such new enterprises the harder it is for such a development company to qualify as a regulated investment company.

American Research is a case in point. With respect to some half dozen or more new enterprises, American Research (*a*) has bought securities of the new enterprise at a cost amounting to less than 5 percent of American Research's total assets and (*b*) has directly caused a material increase in the value of its holdings in such new enterprise to an amount greater than 5 percent of the value of its total assets by contributing to the new enterprise managerial and financial advice and timely financial aid and by furnishing one or more experienced directors (taken from its own personnel) for the board of such new enterprise.

The very success of American Research in thus developing new enterprises and increasing the value of its investments in some of these new enterprises far above original cost has made it increasingly harder for American Research to qualify as a regulated investment company under the existing provisions of old section 361 and new section 851.

It is submitted that the attached amendments or revisions would be equitable and helpful from the standpoint of a development company such as American Research and would be in the public interest.

Respectfully submitted.

GEORGES F. DORIOT,
President.
OSCAR W. HAUSSERMANN,
Secretary, Director, and Counsel.

APRIL 16, 1954, ADDENDUM TO APRIL 14, 1954, STATEMENT FILED WITH SENATE FINANCE COMMITTEE

In addition to the amendments to section 851 (e) of H. R. 8300 proposed by American Research and Development Corp. (herein called American Research) in its April 14, 1954 statement already submitted to the Senate Finance Committee, American Research respectfully submits one further amendment to section 851 (e). This further amendment and the amendments to section 851 already submitted by American Research are all embodied in exhibit A annexed hereto.

The additional amendment herein proposed consists of changing the word "principally" found in the sixth line of section 851 (e) (1) to "substantially" and of changing the word "principally" in the two places in which it is used in section 851 (e) (3) to "substantially."

Substituting the word "substantially" for the word "principally" in the places above indicated would obviate the practical difficulties inherent in determining annually as of the end of each quarter whether each and every corporation to which a development investment company has furnished capital and whose securities are then in its portfolio is engaged to the extent of 51 percent or more in the "development or exploitation of inventions, technological improvements, new processes, or products." To determine whether a corporation is "substantially" so engaged is not a difficult matter whereas to determine whether it is "principally" so engaged involves a mathematical problem for which there is no recognized formula.

In this connection it might be pointed out that the question whether an enterprise is "substantially" engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available would have to be officially considered and passed upon by the Securities and Exchange Commission and would not be left to the arbitrary determination of the investment company itself.

In the nature of things, a new enterprise launched by an existing corporation engaged in other activities may need capital advances from a development investment company at an early stage of the new enterprise—at a stage when the activities devoted to the development or exploitation of its new enterprise constitute less than 51 percent of the total business in which it is then engaged. Virtually to prevent a development investment company from furnishing funds

to help such a new enterprise at a critical time of need, solely because the new enterprise does not at the time represent 51 percent or more of the needy corporation's activities, runs counter to the aim and spirit of section 851 (e). The encouragement of investment companies furnishing capital to development enterprises, which section 851 (e) aims to give in the interest of the national economy and of industrial progress, would actually be furthered, rather than retarded, by permitting an investment company to invest its funds in concerns which are substantially engaged in new enterprises even though doubt may attach to the question whether they are principally so engaged at any given time.

Respectfully submitted.

AMERICAN RESEARCH AND DEVELOPMENT CORP.,
By OSCAR W. HAUSSERMANN,
Secretary, Director and Counsel.

EXHIBIT A

REVISIONS OF SECTION 851 OF THE PROPOSED NEW REVENUE LAW (H. R. 8300) PROPOSED BY AMERICAN RESEARCH AND DEVELOPMENT CORP.

American Research and Development Corp. proposes that the provisions of subdivision (ii) of paragraph (4) of subsection (b) of section 851 of the proposed new revenue law (H. R. 8300) be revised to read as follows (the revision consisting of the transposition of the exception clause italicized below):

"(ii) other securities for purposes of this calculation limited, *except and to the extent provided in subsection (e)*, in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer, and".

American Research and Development Corp. proposes that the provisions of subsection (e) of said section 851 be revised to read as follows (the revisions being italicized hereinbelow):

"(e) INVESTMENT COMPANIES FURNISHING CAPITAL TO DEVELOPMENT CORPORATIONS.

"(1) GENERAL RULE. If the Securities and Exchange Commission determines, in accordance with regulations issued by it, and certifies to the Secretary or his delegate not less than 60 days prior to the close of the taxable year of a registered management *investment* company, that such investment company is principally engaged in the furnishing of capital to other corporations which are *substantially* engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, such investment company may, in the computation of 50 percent of the value of its assets under subparagraph (A) of subsection (b) (4) for any quarter of such taxable year, include the value of any securities of an issuer *in an amount not greater in value than 10 percent of the value of the total assets of the taxpayer*, notwithstanding the fact that such investment company holds more than 10 percent of the outstanding voting securities of such issuer, but only if the investment company has not continuously held any security of such issuer (or of any predecessor company of such issuer as determined under regulations prescribed by the Secretary or his delegate) for 10 or more years preceding such quarter of such taxable year.

"(2) LIMITATION. The provisions of this subsection shall not apply at the close of any quarter of a taxable year to an investment company if at the close of such quarter more than 25 percent of the value of its total assets is represented by securities of issuers with respect to each of which the investment company holds more than 10 percent of the outstanding voting securities of such issuer and in respect of each of which or any predecessor thereof the investment company has continuously held any security for 10 or more years preceding such quarter unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.

"(3) DETERMINATION OF STATUS. For purposes of this subsection, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be *substantially* engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or

its predecessor was *substantially* so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years prior to such date it has acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or predecessor thereof. For purposes of the certification under this subsection, the Securities and Exchange Commission shall have authority to issue such rules, regulations and orders, and to conduct such investigations and hearings, either public or private, as it may deem appropriate.

"(4) DEFINITIONS. The term used in this subsection shall have the same meaning as in subsections (b) (4) and (c) of this section."

The CHAIRMAN. Mr. McDaniel, please.

STATEMENT OF GLEN McDANIEL, PRESIDENT, RADIO-ELECTRONICS-TELEVISION MANUFACTURERS ASSOCIATION

Mr. McDANIEL. I am Glen McDaniel. I am president of the Radio-Electronics-Television Manufacturers Association, an organization of 380 companies, which is celebrating its 30th anniversary today. We were incorporated on April 16, 1924. This isn't the way I would have chosen to have a birthday celebration, Senator, coming down here to testify on a revenue bill.

The CHAIRMAN. It is a holiday and a good day for a good deed.

Mr. McDANIEL. I was here a month ago and testified on H. R. 8224, the excise tax bill. Today, I want to talk very briefly—I have quite a short statement——

The CHAIRMAN. Tell me just a little about your corporation. What exactly do you do—what are your activities?

Mr. McDANIEL. I am talking, Senator, for the radio-electronics-television manufacturing industry. The association is a nonprofit organization and I am talking for the interests of its various companies, particularly from the excise-tax point of view.

H. R. 8300 recodifies ctrtain provisions of the excise tax on television and radio receiving sets and I wanted to talk about those.

Senator FREAR. Are these companies in an association and is the association a corporation?

Mr. McDANIEL. It is a nonprofit corporation; yes, sir.

Senator FREAR. Where is it incorporated?

Mr. McDANIEL. In Illinois.

Senator FREAR. Well, I can't say too much for it, then, I guess.

Mr. McDANIEL. The incorporation in Illinois was because of a historical accident, Senator Frear.

I wanted to make clear where we stand on excise taxes, because the industry is very disturbed about it. We are the only consumer-goods industry which does not benefit from an excise tax reduction, either this year or next year, under the Revenue Reduction Act of 1954 that has just passed. I want to take 1 minute to have the record show our view.

We think that television is an instrument of public enlightenment and it ought not to have a selective excise tax any more than newspapers ought to have one. We think Congress recognized this fact by refraining from levying the tax on television until the Korean war broke out in 1950. Even then, the committee report said that one of the reasons—I am talking about the Finance Committee report—said that one of the reasons the excise tax was levied on television was to equalize competition with the movies. Now, Congress has prac-

tically removed the tax from the movies but it hasn't done anything to equalize competition this time with television.

The CHAIRMAN. Well, you have almost put them out of business. They haven't put you out of business.

Mr. McDANIEL. But this committee said in 1950 that it was unfair competition to tax one and not the other of these closely competitive forms of entertainment. Now, that is just what Congress has done in the last month.

At the same time, Congress voted a reduction of 10 percent to 5 percent on refrigerators and other household appliances and left television and radio sticking out very conspicuously as the one type of household product that didn't get a reduction. Our products are the only consumer durables left that are taxed at 10 percent.

Senator LONG. Do you know what it would cost to remove the tax on television?

Mr. McDANIEL. $150 million.

Senator LONG. Television and radio.

Mr. McDANIEL. Television and radio, yes.

Senator FREAR. The excise tax.

Mr. McDANIEL. The manufacturers' excise tax. To remove it would cost $150 million a year.

Senator LONG. On radio and television.

Mr. McDANIEL. To remove it entirely, and we think that is what should be done.

The CHAIRMAN. I doubt very much that this committee in connection with this bill would fool with excise-tax rates. If you have any administrative problems, that would be something else again.

Mr. McDANIEL. I will proceed with those. We want to go on record as opposed to the accelerated corpo on-tax payments in sections 6016, 6152, and 6154. We oppose this because we regard it as a tax increase of roughly 10 percent over 5 years, and in our particular industry we think it will create very difficult problems, particularly for the smaller companies. That is because in marketing television and radio sets you have in the last 3 months of the year your big market. You prepare all year for that market. If you guess wrong you can get into difficulties. If you have paid to the Government your taxes before you start, then it greatly increases the hardship that smaller companies find themselves in, if the desires and the whims of the purchasing public go the wrong way.

We think it would be a lot sounder and a lot more in keeping with the administration's professed desire to encourage investment and to encourage the working of the free enterprise system, to leave the tax collections the way they are.

Now, I will go to the structure of this radio-television excise tax.

The House, in recodifying the excise-tax provisions—I am not talking about rates, now, Senator, I am talking about the provisions of the bill.

Senator FLANDERS. You will excuse me just a moment?

Mr. McDANIEL. Yes.

Senator FLANDERS. With regard to this new pay-as-you-go plan which at the end of X years, at the cost of 5 percent a year, brings the corporation into a current tax payment position, I might just say, Mr. Chairman, that I have meditated on the possibility or the desirability of doing away with the forward estimate and paying each

quarter, on the estimated profits of that quarter, instead of trying to guess in March what things are going to be like in December.

I don't know whether there is any possibility of that, or any desirability of it, but I would like at least to raise the question.

The CHAIRMAN. In other words, you are raising the question, "Will you love me in December as you did in May?"

Senator FLANDERS. That is what was in my mind but I didn't mention it because I knew you would.

Mr. McDANIEL. Your proposal would be more accelerative than the present plan.

Senator FLANDERS. There would have to be acceleration in it but I haven't figured out whether it would require more or less. I wouldn't want you to pay more than 5 percent anyway but it strikes me as a bit more equitable to pay it as you get it than to pay as you hope to get it.

Mr. McDANIEL. Well, we think that the bill as now written puts corporations in a guessing game about revenue which would present some very unworkable features, just the way the old declared-value excess profits tax did. Congress finally repealed that as being unworkable, because a taxpayer was guessing on the declared value which was based upon his guess of revenue, and it was just not workable. In our industry you cannot guess your income even in September, because it depends on events occurring in the last 3 months of the year. I am sure there are other industries that have seasonable factors of that kind which cause the same sort of difficulties.

Senator FREAR. How do you compare that to an individual's guess? Do you think it is fair for an individual to estimate his income?

Mr. McDANIEL. I assume that the gerat bulk of the people can estimate very well what they are going to make. Most people receive a fixed wage or salary but no corporation has that much certainty of income, unless it is perhaps some kind of public utility.

Senator FREAR. I suspect you are right but there are probably as many individuals who would be in the same classification that you are talking about as there are corporations.

Mr. McDANIEL. Are there not special provisions for them, such as the farmers and others?

Senator FREAR. I didn't know the farmer got anything very special attributed to him, but it might be.

Mr. McDANIEL. Now, on the recodifying of the excise tax provisions, the House took a needed step in reasserting the original intention of Congress that our excise tax should apply only to so-called entertainment types of articles. That is the home set, the home radio set, the home television set, and not the marine and mobile equipment or the complicated police systems of communications that have developed since the time the tax was first enacted.

However, the trouble is that the House didn't go far enough.

On page 433 of the bill, the radio-television tax is codified under a new subchapter, C, of chapter 32, entitled, "Entertainment Equipment," but the bill carries over into section 4143, an exemption for sales to the United States of so-called communication, detection, and navigation receivers. This exemption was added to the Internal Revenue Code by section 482 of the Revenue Act of 1951, at a time when the Internal Revenue Service was improperly seeking to impose the tax on nonentertainment equipment sold to the United States.

There is no need for section 4143 of the new code, provided it is made absolutely clear that the tax imposed by section 4141 applies only to entertainment equipment as indicated by the title of subchapter C. Our recommendation is therefore that the position of the House be strengthened by the deletion of section 4143 and the addition of a clarifying amendment to section 4141, which makes it clear that the tax does what the heading of the chapter says it does, and a suggested form of amendment is attached to my statement.

Senator FLANDERS (presiding). This section 4143, on the basis of what you have just said, seems to be unnecessary, but is there any positive calm that flows from it?

Mr. McDANIEL. In the sense, Senator, that it casts an implication that a non-home-entertainment type of receiver, that is not sold to the United States, is still taxable. Such as one sold to a shipping line or a complicated transmitting and receiving apparatus in which the Revenue Service tries to select out the receiver components. This results in a terrible headache which we think costs the Government more money to administer than the revenue derived from it.

We think it was a very badly framed amendment and it was enacted at a time when the Revenue Service said, "We will relieve inequities and make clarifications, providing they don't cost any revenue," since it was certain that taking money out of one of the Government's pockets and putting it in another didn't cost the Government any revenue, so it was passed in that form.

Senator FLANDERS. I would like to have the staff inform the committee if there was any positive reason for putting that in.

Mr. SMITH. In 1951, the committee adopted this provision which exempted purchases by the Government. I think there might be a loophole there if we did take it out as the witness suggests.

Mr. McDANIEL. It isn't a loophole; it is a question of coverage. We think there was never any intention to impose the tax on these portions of complicated equipment that are not home receivers. The title of subchapter C as it now appears in 8300 indicates as much. It is the entertainment type article that it was intended to tax.

Mr. SMITH. The way the present law is drafted I am not so sure.

Mr. McDANIEL. There are a few articles which have receiving components in them or are in part receiving sets which in turn are parts of technical communications apparatus. These should be removed from the tax.

Senator FLANDERS. What you are asking, in effect, is to indicate that the exemptions apply to everything that is not entertainment equipment, whether or not it is sold to the United States Government.

Mr. McDANIEL. That is correct.

Senator FLANDERS. And in your point of view it is too narrow and you would like the broader exemption?

Mr. McDANIEL. Yes.

Mr. SMITH. Mr. Chairman, I might say that the committee in going over this in 1951 intended it to be as narrow as it is.

Senator FLANDERS. At that time, however, you weren't exempting other nonentertainment apparatus. Now you are.

I think that is the basis of Mr. McDaniel's suggestion. It has changed since 1951.

Mr. McDANIEL. We can present more facts to the staff about it. The revenue loss in what we are talking about is, we think, smaller

than the cost of administration. The cost of administration to the companies is tremendous. There are never-ending layers of complexities as to what constitutes a receiver or something that is suitable for use in a receiver—when you are trying to apply a tax, that was enacted to apply only to home-type sets, to a very different article.

Senator FLANDERS. You will take that up with the staff and the staff will listen sympathetically but without any statements in advance as to what it is going to do.

Senator LONG. Mr. McDaniel, I will offer you a little encouragement in your proposal to take the excise tax off television sets. I have been thinking about offering an amendment to remove that excise tax. I did not vote for it on the floor before because I didn't want the previous bill to be one that lost the Government more revenue than it raised it. Inasmuch as there is going to be a tax-reduction bill anyway, I have been thinking about offering this proposal, along with some other excise tax reductions.

You will find some support for your position by Prof. Sumner Slichter, who is regarded as one of the best economists in the country. He wrote an article that appeared in the magazine section of the New York Times last week, in the Sunday edition. He urged that this would be just about the type of antirecession device that we would need to encourage more production.

Do you think it would mean additional employment of any considerable degree if this excise tax were removed from television sets?

Mr. McDANIEL. We think it would mean additional employment for this reason: Our greatest manufacturing center happens to be Chicago. The union which has the organization of the employees there has suffered a 35 percent drop—that is reported in a survey of the plants—in employment in January and February of this year, that is to a point equal to 65 percent of employment when compared to a year ago.

Of course, our industry is showing pronounced recessionary tendencies.

Senator LONG. Do you mean you are 65 percent down in employment?

Mr. McDANIEL. No, Senator, down to a point equal to 65 percent of a year ago.

Senator LONG. Only employing one-third the number of people you were employing this time a year ago?

Mr. McDANIEL. No; only employing two-thirds the number in that large center.

Now, I presented many charts and other information here a month ago on that and we can bring those up to date. Our inventories are swollen. They were up 35 percent at year-end, as compared with the previous period, and our production was off 35 or 40 percent over the previous year.

Senator LONG. What is your prospect of marketing color television in large measure?

Mr. McDANIEL. We have created a production which costs a thousand or $1,200, and we are concerned because we are afraid the public won't buy it—certainly they haven't bought it so far because it costs too much, and we are afraid that they won5t buy the black and white either because they want to wait for color, and we are afraid of a stalemate.

Senator LONG. You have built up a huge demand for your product and slowed down the demand for the one you have on the market.

Mr. MCDANIEL. We are facing a technological revolution which I am afraid is going to do the industry a great deal of damage and result in the loss of a lot of employment. Now, it depends on the public whim, again, but we need in the worst way to get the prices of these sets down, both color and black and white. That is the reason we need the tax off in order to combat these stalemate possibilities. We have had quite a number of layoffs in the industry.

Senator LONG. I just received word from New Orleans that there are more television sets in New Orleans than there are telephones.

Mr. MCDANIEL. We understand in West Germany there are more now than there are bathtubs.

Senator FREAR. Mr. McDaniel, you don't attribute this increase in unemployment entirely to people's thinking that color television will come on? I mean the sales of black-and-white television sets stopped anticipating lower priced color television sets?

Mr. MCDANIEL. Well, it isn't quite that simple, Senator Frear. What has happened is that we had a swollen inventory situation at the time the FCC authorized the new color system. We then had what I think was a bit of concern on the part of the industry executives, because of the situation they were facing. We then had distress sales from inventory, coming at the same time as a sharp drop in production. Manufacturers have tried to eliminate their inventory and they have done it at price-cutting figures which mean no profit to them. We, therefore, have a situation very different from last year, which was a profitable year. Our figures now from our various companies, on the results of 1953, are profitable, but the results of 1954 are going to be very different, because of these difficulties.

How soon this is going to pick up, I don't know, but there is a scramble now to make cheap sets of $130, $140, to cut the price, to get the price down.

The sets that sell above $130 or $150, for example, are not moving and you have a scramble to get the price down so you can sell them. In other words, you have to offer more inducement, pricewise, to sell your black and white, while the color threat overhangs the market.

I don't frankly know whether it is going to work into a serious stalemate or not. I think we will know by next fall. However, we need the tax off in the worst way to make sure it doesn't happen.

Senator LONG. What you are producing in the way of color television costs around $1,000?

Mr. MCDANIEL. It sells for around $1,000. Some sets are $1,200, the color television sets. That is for a 12-inch tube.

Senator FREAR. You have already stopped manufacturing the 12-inch tube?

Mr. MCDANIEL. Yes; in black and white. The public wants a bigger picture than that.

Senator FREAR. Isn't that true in color television?

Mr. MCDANIEL. We haven't yet put on the market a bigger tube than a 12½-inch horizontal picture. That is because of the tremendous cost and technological problems involved in making a bigger tube.

It is felt by many in the industry that we will never be able to market color television successfully until we have a picture tube of around 20 inches for a price much less than we are able to sell a 12-inch tube for now. With all of the appeal that color has to the public—and it is a wonderful thing—it is going to be a great thing when we can finally overcome these difficulties—but if we can't keep our black-and-white sales going, meanwhile, we are not going to overcome them. We are going to have a very difficult situation.

Senator FREAR. Mr. McDaniel, do you find that where color television is now put on the air where it can be received by black-and-white sets, that it improves the receiving of the black-and-white set? Doesn't it make the picture sharper in black and white even though it is televised in color?

Mr. McDANIEL. There have been a great many comments to that effect. The principal reason for it is, however, that when color is put on the air the engineers are swarming over the apparatus to make sure that everything is in perfect tune, you see, because of the close tolerances and the difficulty of color transmission, and therefore it does give a better-looking picture.

Senator FREAR. You don't think, then, that that is going to help in the sale of black-and-white sets?

Mr. McDANIEL. I honestly don't think it is something that you can use as a merchandising factor, because it isn't always true.

Senator FREAR. Thank you.

Mr. McDANIEL. We collaborated in a booklet with the National Better Business Bureau on that subject and that is the position we took there. We don't think it would be honest to represent it as a better picture, because it may not be, depending upon the transmitter.

The rest of my statement is on excise tax administrative problems, Senator. I know you are pressed for time and I will just file the statement and, if we may, we would like to take those up with the staff.

The CHAIRMAN. Feel free to do that. We will be very glad to have you do that.

Mr. McDANIEL. I greatly appreciate your statement about your intentions, Senator Long, and I would like to call on you later and give you some of our figures on that. I think you would be interested.

Thank you very much.

(The prepared statement of Mr. McDaniel follows:)

STATEMENT OF GLEN McDANIEL, PRESIDENT, RADIO-ELECTRONICS-TELEVISION MANUFACTURERS ASSOCIATION, ON H. R. 8300

My name is Glen McDaniel. I am president of the Radio-Electronics-Television Manufacturers Association, which consists of 380 manufacturing companies. A month ago I appeared here on H. R. 8224 and asked for a reduction in the excise tax on radio and television sets. Today I will address myself to certain of the provisions of H. R. 8300 as they affect this industry.

Before doing so, however, I want the record of this hearing to show that the members of our industry are greatly disturbed, and rightly so, about the position in which the passage of the Excise Tax Reduction Act of 1954 leaves them. Ours is the only consumer products industry not receiving immediate or prospective tax reductions under this act. We strongly urge that this injustice be corrected at the earliest possible time.

I would like to take 1 minute now to make our views clear. Television is an instrument of public enlightenment and news dissemination, and an excise tax on it is as contrary to wise public policy as a tax on newspapers would be. Congress recognized this fact by refraining from levying a tax on television until the Korean war broke out. Even then, the report of this committee indicated

that the tax was imposed partly to equalize entertainment competition with the movies. Now Congress has in practical effect removed the tax from movies but has done nothing this time to equalize competition. Congress also reduced the tax on refrigerators and other home appliances from 10 to 5 percent, to stimulate employment and combat recessionary tendencies, but voted down a similar amendment on radio and television where the danger signs—reduced production, layoffs, and swollen inventories—are more pronounced. This selective excise tax on television and radio should be entirely removed.

I will now turn to the provisions of H. R. 8300.

THE ACCELERATION OF CORPORATE TAXPAYMENTS

Sections 6016, 6152, and 6154 of the bill provide for the acceleration of corporate income tax liability through a new declaration of estimated income tax procedure. The new system purports to put corporations on a "pay as you go" basis without any "forgiveness" feature such as was used when individuals were placed on such a basis. It amounts to a substantial increase in the corporate tax rates over the next 5 years and will correspondingly reduce corporate working capital. The inordinate difficulties of estimating a corporation's profits from 3 to 6 months before the end of its fiscal year are reminiscent of the problems presented by the thoroughly discredited declared-value excess-profits tax which Congress saw fit to repeal as unworkable. This plan is in direct conflict with the avowed purpose of the bill to stimulate business investment and expansion. This new requirement will place a particularly onerous burden on the small companies which comprise 72 percent of our industry. These companies are finding that more and more money is being tied up in the complicated equipment and additional working capital required to keep abreast of the rapid developments in the industry, such as color television. This current taxpayment plan for corporations should not be adopted at this time.

THE STRUCTURE OF THE RADIO-TELEVISION EXCISE TAX

In recodifying the radio-television excise tax provisions, the House took a much-needed step in reasserting the original intention of Congress that the tax applies only to so-called entertainment type sets and not to complicated pieces of electronic equipment which have developed since the tax was first enacted in 1932. Certain minor changes in these provisions should be made in order to make the House action completely effective.

On page 488 of H. R. 8300, the radio-television tax is codified under a new subchapter C of chapter 32, entitled "Entertainment Equipment." The House bill, however, carries over into section 4143 an exemption for sales to the United States of so-called communication, detection, and navigation receivers. This exemption was added to the Internal Revenue Code of 1939 by section 482 of the Revenue Act of 1951 at a time when the Internal Revenue Service was improperly seeking to impose the tax on nonentertainment type equipment sold to the United States. There is no need for section 4143 of the new code, provided it is made absolutely clear that the tax imposed by section 4141 applies only to entertainment equipment as indicated by the title to subchapter C. We recommend, therefore, that the position of the House be strengthened by the deletion of section 4143 and the addition of a clarifying amendment to section 4141 which makes it clear that the tax applies only to entertainment type equipment. A suggested form of such an amendment is attached.

IMPROVEMENT OF EXCISE TAX ADMINISTRATIVE PROVISIONS

A group of experts of which Mr. Maurice G. Paul, of Philco Corp., was chairman, made a thorough study of the present excise-tax provisions and submitted to the Ways and Means Committee at its hearings last summer, extensive recommendations of necessary administrative changes in the excise-tax law. Prior to that, the Ways and Means Committee and the Treasury had declined to include any such changes in the Technical Changes Act of 1953 on the ground that they were proper matter for the anticipated revenue revision bill. The President, in his tax message this year, recommended that steps be taken to simplify "the administrative provisions of the excise taxes," which recommendation is not implemented by any of the changes to be made by H. R. 8300. We were then informed that there would be no excise tax administrative changes accomplished by H. R. 8300 because of the forthcoming Excise Tax Reduction Act of 1954. When, however, the House committee was considering H. R. 8224, it refused to

include any such changes because there was not enough time to adequately consider such proposals. This seemed to effectively kill the possibility of any House consideration of these problems. Thus the need for Senate consideration of these administrative matters is now urgent.

During the hearings on general revenue revision before the House Ways and Means Committee last summer, we pointed out that many of the costly and troublesome administrative problems under the radio-television excise tax could be eliminated if the tax was not applied to radio and television components other than tubes. We submitted data to the staff of the joint committee which showed that such a change in the statute would involve a loss of revenue of less than 1 percent of the collections of this tax and that the savings in administrative costs would largely offset such loss. The House failed to take action on this matter and we urgently request that your committee give consideration to it at this time. We will not duplicate here the testimony we gave before the House committee and the data we submitted to the joint committee staff.

We are submitting a list of other changes in the administrative provisions under these manufacturers' excise taxes which should receive attention in this first general revenue revision of the internal revenue laws in many years. Time does not permit a detailed explanation of these items. Although the House committee did not act upon the excise tax administrative provisions generally, it did make an inadvertent error in the course of recodifying the credit and refund provisions which should be specifically called to your attention. Section 3443 (d) of the old code prohibited refunds to manufacturers (other than those resulting from price readjustments on the use of tax paid articles for further manufacture of taxable articles) unless the manufacturer could establish that the tax had not been passed on to the vendee or that he has repaid the amount of the tax or obtained the consent of the ultimate purchaser to the allowance of the refund. H. R. 8300 inadvertently extends the principle of section 3443 (d) to the refunds relating to price adjustments and to the situation where tax paid articles are used in the further manufacture of other articles. This is done in section 6416 and will create many additional problems for manufacturers which I am sure your committee would like to avoid. The group of experts headed by Mr. Paul recommended to the Ways and Means Committee that the principle of section 3443 (d) be eliminated from the new code. In any event, the principle should be limited to its present scope under the 1939 code.

I have with me today Mr. Cleveland Hedrick, special tax counsel to our association, Mr. A. M. Freeman, of Radio Corporation of America, and Mr. Maurice G. Paul, of Philco Corp., who are familiar with the technical phases of these administrative problems and who will be available to consult with the staff of your committee in drafting the necessary changes in H. R. 8300 to improve the administration of the excise tax with regard to the radio and television industry.

AMENDMENT TO H. R. 8300, CHAPTERS 32 AND 65, TO REMOVE THE EXEMPTION FROM THE MANUFACTURERS' EXCISE TAX OF COMMUNICATION, DETECTION, AND NAVIGATION RECEIVERS WHEN SOLD TO THE UNITED STATES

1. Chapter 32 of the Internal Revenue Code is hereby amended:

(a) In subchapter C, by deleting section 4143 (relating to exemptions for sales to the United States of communication, detection, and navigation receivers).

(b) In subchapter F, by deleting section 4218 (b) (relating to the use by the manufacturer, producer, or importer of radio and television parts in the manufacture of receivers for sale to the United States).

2. Chapter 65, subchapter B, section 6416 (relating to the credit or refund of certain taxes on sales and services) is hereby amended by deleting subsections (b) (2) (H) and (b) (3) (B).

NEEDED CHANGES IN ADMINISTRATIVE PROVISIONS OF MANUFACTURERS' EXCISE TAXES

This is a list in summary form of the changes needed to improve the administration of manufacturers' excise taxes.

1. While excise taxes are imposed on "manufacturers," this term is not defined in the code. This omission should be corrected to avoid serious compliance problems.

2. Present licensing provisions of the Treasury regulations should be incorporated in the code and expanded to permit licensing of all manufacturers, dealers, and exporters and thereby authorize them to make tax-free purchases

or sales or to file claims for refund or credit. The law should also specify that the furnishing of the purchaser's registration number to the vendor, either on individual purchase orders or in a continuing document applicable to all future purchase orders until withdrawn in writing, will constitute sufficient validation of all tax-free sales. This will permit elimination of the present cumbersome monthly exempton certificate procedure.

3. The refund and credit provisions should be expanded to make clear that any licensed manufacturer, dealer, or exporter may recover the tax paid where ultimately a tax-free sale or use has occurred.

4. The law should provide clear-cut definitions of the articles intended to be taxed. Examples of deficiencies in this respect are "self-contained air conditioners" and "radio receiving sets," and "parts and accessories for automobiles."

5. A credit and refund provision should be added to authorize clearly a credit or refund to a manufacturer or licensed vendee where the tax-paid article has been used in further manufacture of another article sold in a tax-exempt transaction (i. e., sale to state or for export).

6. The law should be clarified so that the return and payment of tax shall be deemed to apply against all taxable sales made during the period covered by the return. The Service and courts now construe the law to treat each individual sale as a separate transaction. Under this theory, an overpayment of tax on one sale may not be used as an offset against an underpayment of tax on another sale unless the manufacturer can prove that the overpayment was not passed on to the ultimate purchaser. The logical extension of this theory would nullify the statute of limitations on the ground that if no tax had been paid on a given transaction, then no return had been made to start the running of the statutory period.

7. The law should make clear that articles are not subject to tax when manufactured or bought by the manufacturer of a taxable end-product and used by him in connection with an exchange for a taxable article under his warranty program.

8. The law should provide for the use of "licensed wholesale branches" patterned after the Canadian practice in order to eliminate the use of subsidiaries as sales outlets.

9. Under certain conditions, a manufacturer can recover an overpayment of tax only by making a refund to the "ultimate purchaser." As now defined in regulations, "ultimate purchaser" excludes distributors and dealers holding tax-paid articles for sale. Statutory clarification of this is essential.

10. Where an exemption is based upon end usage or the identity of the ultimate purchaser, regulations require an affidavit from the ultimate vendor, a superfluous requirement. An affidavit from the ultimate purchaser should be sufficient.

11. In order to validate a credit or refund with respect to articles exported, the regulations now require proof that the manufacturer had knowledge of the intended export of the goods prior to time of sale by him. This is a needless technicality. The law should authorize credit or refund where proof is submitted that goods were actually exported.

12. Diplomatic representatives are entitled to exemption from excise taxes only if the purchase is made directly from the manufacturer. This needless technicality should be removed so as to permit dealers to recover the tax from a manufacturer upon proof of sale to a tax-exempt diplomatic official.

13. Taxable articles sold for use in the further manufacture of a nontaxable end article are now subject to tax. To avoid indirect taxation of end articles not intended to be taxed, exemption should be granted to all articles used in the further manufacture of another article, whether or not taxable.

14. The tax imposed on radio and refrigeration repair and replacement parts should be repealed since it produces negligible revenues, is not required to prevent tax avoidance and presents difficult administrative problems. To prevent tax avoidance, however, it may be desirable to tax major elements of apparatus as end articles of manufacture; such as, cabinet, chassis, and tubes for radios and cabinet and refrigerating units for refrigerators.

15. The special exemption for refrigerator components sold for use in the manufacture of nontaxable refrigerating apparatus may be deleted—

(a) If all articles sold for use in the further manufacture of another article, whether or not taxable, is adopted as a general administrative section; or

(b) If all refrigerator parts are exempted.

16. The special exemptions for benzol, benzine, and naphtha used or resold for use other than as fuel for the propulsion of motor vehicles, motorboats, or

airplanes may be omitted since these articles used for these purposes are now subject to a tax at the retail level under the Excise Tax Act of 1954.

17. The provision relating to unexposed motion-picture films used or resold for use in the making of newsreel motion pictures is superfluous, since all commercial types of motion-picture film were specifically exempted under the 1951 Revenue Act.

18. The special exemption for articles manufactured by Indians was enacted when jewelry was subject to the manufacturers' excise tax. The exemption is no longer of significance and can be deleted.

19. At present a person who purchases on a tax-free basis becomes the "statutory manufacturer" of the article and is obliged to pay tax on his selling price if article is later sold in a taxable transaction. The law should permit payment of tax on the lower of sales price or purchase price.

20. Efforts to enforce this tax with respect to rebuilt and reconditioned articles, principally automobile parts, have created administrative problems out of proportion to revenues derived. Rebuilt and reconditioned articles should be exempt from tax. If the theory of tax on rebuilt parts is continued, exclusion of value of parts received in exchange should be made a general administrative provision and not limited, as at present, to auto parts.

21. The definition of "sales price" should be improved so as to clearly exclude elements such as product warranties, service charges, and the like not properly a part of the sales price of the article itself.

22. The Secretary or his delegate should be authorized to fix the tax base in an "arm's length" transaction at not more than the fair manufacturers' price at the first level of distribution within the industry.

23. Accessories for taxable end articles should be taxed, if at all, only as they are specifically enumerated and defined in the code. The practice should be abandoned of taxing otherwise nontaxable articles "when sold on or in connection with" the sale of a taxable end article since it is capricious in its application and readily avoided.

24. The Tax Court should be given jurisdiction to determine excise-tax liabilities to correct a serious deficiency in existing appellate procedures.

25. The most serious and widespread complaint directed against the entire selective excise-tax system is that of the lack of adequate published rulings. The law should expressly authorize and direct the Secretary to publish all excise-tax rulings in a separate Revenue bulletin.

The CHAIRMAN. Mr. Benjamin Johnson.

STATEMENT OF BENJAMIN O. JOHNSON, GENERAL COUNSEL OF SPARTAN MILLS

The CHAIRMAN. Be seated, please, make yourself comfortable and identify yourself to the reporter.

Mr. JOHNSON. Mr. Chairman and members of the committee, my name is Benjamin O. Johnson and I am a resident and citizen of Spartanburg, S. C. I am a member of the tax division of the American Bar Association, and a member of the tax committee of the American Cotton Manufacturers Institute. I am general counsel for Spartan Mills and affiliated companies and appear here in their behalf.

Senator FREAR. Are you a friend of Mr. Walter Montgomery?

Mr. JOHNSON. I am very closely associated with Mr. Walter Montgomery.

I am also counsel for and director of a number of other business corporations.

My appearance here relates only to the subject of redemption of stock by corporations for the purpose of paying death taxes.

Section 303 of H. R. 8300 sets forth limitations on distributions in redemption of stock to pay death taxes that qualify for treatment as an exchange under section 302 (a) (6), and resultant capital exchange

treatment. Section 303 (b) (2) as now contained in H. R. 8300 permits redemption for payment of death taxes only if the particular stock of the corporation for estate-tax purposes comprises either 35 percent of the value of the gross estate or more than 50 percent of the taxable estate of a decedent. Two or more corporations may be treated as a single corporation only if the decedent owned more than 75 percent in value of the outstanding stock.

It is my position that these percentage limitations on capital redemptions for payment of death taxes are arbitrary, discriminatory, without rational purpose in the tax law, and contrary to the stated purposes of H. R. 8300:

to remove inequities, to end harassment of taxpayers, and to reduce tax barriers to future expansion of production and employment.

The discrimination in favor of estates meeting the test of the stated percentages is compounded by extending the benefits of redemption as an exchange in a qualified case (*a*) to early redemption of nonparticipating stock under section 309, and (*b*) to early redemption or disposition of stock of an inactive corporation under section 353.

In order to correct this inequity and further the declared objectives of H. R. 8300, I advocate complete deletion of the percentage of ownership standards required to qualify redemptions to pay death taxes as an exchange under section 302 (a) (6); or, in short, the elimination of section 303 (b) (2) in its entirety. I do not object to the other limitations of section 303, except to say that the extent of redemption should be clarified to permit a net redemption after provision for any gains taxes that may be involved in the redemption so as to leave the net amount required to pay the items which are stipulated in section 303 (a).

It is not believed that elimination of section 303 (b) (2) will materially affect the public revenue that might otherwise be derived from its enactment into law.

Some of the reasons for my position are as follows:

(1) The percentage limitations tend to produce uncertainty in estate planning and execution in that they depend on the ultimate variable fact of proportionate valuation which inevitably and unpredictably changes from time to time. A condition of eligibility for exchange treatment may be transformed to one of ineligibility and vice versa because of ever-changing factors affecting proportionate value of assets. Even after death, the same unpredictable change may occur between date of death and the optional valuation date of 1 year later with disruptive effect. In borderline cases, disputes of value may be decisive and thus disputes and litigation will inevitably be fostered by the percentage limitations.

At this point I wish to turn aside simply for the purpose of registering a strong objection to the proposed conditional use of the optional valuation date as now contained in section 2032 of the proposed bill which prevents the use of the alternate valuation date of 1 year after death unless there has been a diminution of at least one-third in the gross value of the estate. That point will be covered by other witnesses so I will not elaborate.

(2) The percentage limitations place a premium on inordinate investment in a single enterprise.

(3) The estate of a nonconforming decedent or small stockholder is denied use of the important channel of liquidation of stock for payment of death taxes through corporate redemption afforded to the qualified decedent.

(4) Full advantage of other relief sections of subchapter C, including proper corporate separations and distributions to shareholders of stock and securities of controlled corporations would be denied in most cases without changing a status of eligibility to one of ineligibility due to the extreme requirement of 75 percent or more ownership in each of the 2 or more resultant corporations.

(5) Application of the accepted principle of diversification of risk is denied proper protection and unwarranted reward is placed on overconcentration of investment in a single enterprise.

(6) Investment in close corporations and corporations without established market for their shares is discouraged by undue limitations on the power of the corporation to trade in its own shares and to redeem its stock for payment of death taxes in every proper case without discrimination between shareholders.

The restrictions are particularly detrimental to the growth and survival of small corporate business, which, in the usual case, has a very limited market outside of the corporation for sale or redemption of its shares. In order to encourage investment in small corporate enterprises, the right of redemption as an exchange to the extent of death taxes and administration expenses should be unfettered by any complicated percentage test.

I point out that section 302 (a) now defines categorically five specific classifications in which corporate distributions are permitted on an exchange basis other than redemptions for payment of death taxes. Obviously, in many cases, estates of decedents could redeem stock as an exchange by compliance with a particular subsection of section 302 (a) other than subsection (6), such as (*a*) complete redemptions under subsection (3), or (*b*) substantially disproportionate redemptions under subsection (4), or (*c*) redemptions by a shareholder holding less than 1 percent of the participating stock under subsection (5). It is the important case of a partial redemption falling outside of the qualifying percentage requirements prescribed by section 303 (b) (2), and the otherwise qualified substantially disproportionate redemptions under section 302 (a) (4) that would be adversely affected. In practice, section 303 (b) (2) would defeat any partial redemption needed for payment of death taxes that could not conveniently meet the substantially disproportionate redemption test now defined in section 302 (a) (4). This discrimination should be corrected in the public interest. Deletion of the arbitrary percentage requirements under section 303 (b) (2) will accomplish the desired result.

I wish to add that I have spoken briefly to some of the principals in the Treasury Department who appear to be sympathetic to our view but have expressed no ultimate opinion about it. As I see the situation, the percentage limitations as now contained in 303 (b) (2) simply confuse the picture. They do not serve any useful purpose for public revenue. In a great many cases redemption could be effected through these other subsections of section 302 (a), but in many other cases where it is not possible due to practical business considerations or inconvenience, either to the corporation or to the estate, to meet the

disproportionate redemption rule, the percentage limitation of section 303 (b) (2) would impose a hardship upon the decedent's estate.

I appreciate this opportunity to appear here and express my views on this phase of H. R. 8300.

The CHAIRMAN. We have been very glad to have you. Thank you very much, indeed.

Mr. McFarland.

STATEMENT OF ELDEN McFARLAND, WASHINGTON, D. C.

The CHAIRMAN. Make yourself comfortable and identify yourself to the reporter.

Mr. McFARLAND. Mr. Chairman and members of the committee, my name is Elden McFarland of Washington, D. C. I have been engaged since 1935 in the practice of law, specializing in matters of taxation, and prior thereto, I was a member of the legal staff of the Internal Revenue Service and the Treasury Department. I am a member of the bars of the States of California, Massachusetts, and the District of Columbia.

Subchapter C of chapter I of subtitle A of H. R. 8300, "Corporate distributions and adjustments," is one of the most far-reaching parts of the bill from the standpoint of its effect on business. The legislative objectives, according to the House committee report, are threefold, namely:

1. To make the law more certain;
2. To postpone recognition of gain or loss in cases which do not involve any distribution of assets to shareholders, and which involve merely shifts in the form of the corporate enterpise; and
3. To close a number of existing tax-avoidance loopholes.

In order to accomplish the objective of certainty the drafters have provided in general—but not exclusively—a number of objective tests thus eliminating to a large extent the subjective tests—such as intent, business purposes, and so on—inherent in the 1939 code reorganization provisions.

The device of using objective tests undoubtedly promotes certainty. But it also increases rigidity or inflexibility which, unless the provisions are modified, will produce some undesirable results.

With certain important exceptions, the second objective is attained, in general by providing in sections 350, 354, 305, 306, 352, and 353 for tax postponement in the case of corporate mergers or consolidations or corporate acquisitions of stock control or of the corporate assets of other corporations, all of which involve merely shifts in the form of corporate enterprise and do not involve any distribution of assets to shareholders. This is reasonable because the shareholder's interest is still in corporate solution in the continuing enterprise. He has not actually realized any income from the reorganization. Except to the extent which he received "boot"—that is cases or property—which is taxable, he still owns merely a shareholder's interest not yet converted into money.

One of the more important exceptions, referred to above is the case of the small-business corporation, which, as a general rule is closely held. We find such corporations in every city and every town of any size, in the United States. And as a rule the corporate investment

therein represents the life earnings of some individual or small group, frequently related.

This bill is likely to affect most of these small-business corporations, and particularly the successful, growing small corporation that needs to expand its capital, and its production, sales, and distributional facilities.

Such corporations are singled out and severely restricted under the pending bill. This discrimination was particularly emphasized in the statement made before this committee on April 7 on behalf of the American Bar Association.

Section 359 (a) of the bill divides all corporations into two classes, namely, publicly held corporations and all other corporations. A corporation is "publicly held" unless 10 or fewer shareholders own more than 50 percent either of the total combined voting power or of the total value of all classes of stock of the corporation. I have referred to all other corporations as "closely held" corporations.

Any two or more publicly held corporations can merge tax free. But a closely held corporation cannot merge or consolidate tax free with either a publicly held corporation or with another closely held corporation unless its shareholders have a continuing corporation after the merger or consolidation.

Why should mergers or consolidations between closely held corporations be taxed when similar mergers of publicly held corporations are not? Surely, such reorganizations involve merely shifts in the form of corporate enterprise, without involving any distribution of assets—and the specifically stated second basic objective as announced in the House committee report on this bill was to postpone recognition of gain in such cases.

Mergers and consolidations are not taxed under existing law. They are not tax avoidances.

The tax-avoidance possibilities are extremely limited in such cases. True, after a merger the shareholder can sell his new stock and be taxed at capital-gains rates. But he also could have sold his old stock also subject to the same tax. Perhaps his new stock is more saleable. But if so, he sells for more money and the Government collects more tax.

If he doesn't sell, his interest is still in corporate solution at the risk of the business just as much as the interest of a shareholder of a publicly held corporation would be.

We submit that the distinction between publicly held and closely held corporations is arbitrary and unwarranted insofar as mergers and consolidations are concerned, and constitutes a severe discrimination against closely held corporations, which in general includes most small-business corporations. We believe this discrimination should be eliminated entirely. But if such a distinction is to be retained in the bill we specifically urge that section 354 (b) be revised so as to permit tax-free mergers or consolidations between 1 closely held corporation and 1—or more in the case of consolidations—publicly held corporation.

Similarly corporate acquisitions of corporate stock and corporate assets are severely restricted under section 359, being limited by the relative size of the corporations involved. This limitation would prevent or impede a great many sound business reorganizations which under existing law are nontaxable. Such transactions involve merely

shifts in the form of the corporate enterprise, without involving any distribution or severance of assets. Whatever tax is imposed should be imposed realistically at the time of subsequent realization of income. Otherwise, if the tax is imposed at the time of the corporate reorganization, the shareholder has received nothing with which he can pay the tax. He has only "paper profits" at most.

Furthermore, if in the future he disposes of his stock his actual or real profit may well be much less than his taxed "paper profit."

Rather than imposing a severe restriction on small-business corporations, the bill should encourage the normal business reorganizations of small corporations, which are often an essential step in the course of their growth and development.

The restriction as to relative size is unrealistic. A small-business corporation frequently will find the necessary business objectives prompting the reorganization only in a much larger corporation which has the financial resources and the broader sales and distributional organization and facilities to assure continued growth and success of the enterprise.

We therefore suggest that the relative size limitations contained in subdivisions (b) and (c) of section 359 be eliminated entirely.

The provisions as to corporate separations contained in sections 359 (d) and 353 (a) continue, and to some extent enlarge, the provisions of existing law with respect to corporate spinoffs, splitoffs, and splitups. But the accompanying provisions with respect to "inactive corporations"—that is, those in section 353—are particularly drastic in that (1) they allow no basis whatever in the event of a sale or redemption of the stock within 10 years and (2) a bona fide operating company which is not in fact an "inactive corporation" may become "inactive" if during a 5-year period it happens to have an operating loss, but at the same time may have a small amount of nonoperating income which qualifies as personal holding-company income. Such a bona fide operating company ought not be classed as an "inactive" corporation.

The bill apparently permits a nontaxable corporate separation such as a spinoff—by that I refer to the spinoff provisions currently contained in section 112 (b) (11) of the 1939 code—to be followed by a nontaxable merger—or consolidation or corporate acquisition of stock or property—involving only one corporation involved in the separation. Under existing law, and regulations such transactions are not accorded nontaxable treatment, if at the time of the spinoff the shareholders contemplated the subsequent merger or transfer of stock or assets of either corporation. The theory is that both steps are a part of the same plan of reorganization and hence, cannot be separated even though both steps, taken separately are nontaxable. The new law permits such bona fide business transactions.

There is an area of uncertainty in the present bill, however, which, unless clarified either in the bill or in the committee report may result in extended litigation. The revenue service might choose to interpret the words "single transaction" contained in subsection (b) of section 359 as having the same broad meaning as "plan of reorganization" under the existing law. A clarification by this committee would serve a useful purpose in avoiding a considerable amount of potential litigation.

A change in definition of the term "participating stock" will be required in order to make the bill workable. Many corporations would have no participating stock at all, under the bill. Your technical staff, including the staff of the joint committee as well as that of the Treasury Department is cognizant of this problem, and, therefore there is no need to discuss it at length.

I might point out, however, that the present definition leaves a considerable loophole in the operation loss carryover provisions (section 382) in that by the creation of a small amount of "participating stock" as now defined, a net operating loss carryover could be obtained by the simple expedient of holding the participating stock, but selling the major equity interest in the form of common stock which is not, technically, participating stock.

Bona fide operating loss carryovers ought to be allowed under section 382, provided an appropriate showing of bona fides is made by the acquiring shareholders. A somewhat similar condition or requirement is contained in section 356 and could easily be incorporated in section 382 thus permitting a carryover in cases of a bona fide acquisition.

Lastly, we come to the matter of the effective date which is of considerable concern.

The problem of the effective date is one of considerable concern. The present March 1, 1954, date contained in section 391 undoubtedly would be helpful to some taxpayers, but in the case of many others particularly those which entered into reorganization commitments prior to March 9, the March 1, 1954, date would be disastrous. We respectfully suggest that with respect to corporate reorganizations, as the term is known under existing law, the effective date be set at not earlier than 90 days after enactment of the bill, with the right of a choice election on the part of a taxpayer with respect to the 90-day period after enactment, to be governed by either the 1939 code or the new 1954 code.

I thank you for the privilege of appearing before the committee.

The CHAIRMAN. Thank you very much.

(Mr. McFarland's prepared statement follows:)

MEMORANDUM OF ELDEN MCFARLAND IN RE H. R. 8300, SECTION 403 (c) (1)—TRUSTS EXEMPT UNDER SECTION 165 (A) OF 1939 CODE

Section 403 (c) (1) provides that a stock bonus, pension, or profit-sharing trust established before the date of enactment of H. R. 8300 and which meets the requirements of section 165 (a) of the 1939 code shall continue to be exempt from income tax (even though it may not meet the requirements of section 501 (e) of H. R. 8300) so long as it continues, without interruption, to meet the requirements of such section 165 (a).

Many stock bonus, pension, and profit-sharing trust plans, particularly those older plans which were established many years ago, require minor amendments from time to time in order to meet changing conditions. Section 403 (c) (1) contains no specific reference to the effect of such amendments. It is believed that the legislative intent is to leave undisturbed presently qualified trust plans, as amended from time to time, so long as such amendments would not disqualify these plans under section 165 (a) of the 1939 code.

If such intent is not made clear, it is believed that from time to time in the future, as existing plans face a need for amendment, some trusts may find difficulty in obtaining administrative approval, even though such amendments would not disqualify them under section 165 (a). A clarification on this question would resolve any administrative doubts on this point and undoubtedly would avoid the possibility of needless litigation. The question is one of considerable importance to many existing qualified trusts.

It is, therefore, respectfully suggested that subparagraphs (A) and (B) of section 403 (c) (1) be amended to read as follows [the suggested changes being italic]:

> "(A) If such taxable year begins before January 1, 1954, such trust shall be exempt under section 501 (a) for each consecutive taxable year beginning after December 31, 1953, as to which such trust *as now constituted or as hereafter amended* would qualify for exemption under such section 165 (a), if such section applied to such taxable year, subject, however, to sections 503, 504, and 505; or
>
> "(B) If such taxable year begins after December 31, 1953, such trust shall be exempt under section 501 (a) for such taxable year and each consecutive succeeding taxable year as to which such trust *as now constituted or as hereafter amended* would qualify for exemption under such section 165 (a), if such section applied to such taxable year, subject, however, to sections 503, 504, and 505."
>
> Respectfully submitted.

ELDEN MCFARLAND.

The CHAIRMAN. Sit down, make yourself comfortable, and identify yourself to the committee.

STATEMENT OF C. ADDISON KEELER, SECURITY MUTUAL BUILDING, BINGHAMTON, N. Y.

Mr. KEELER. My name is C. Addison Keeler, Security Mutual Building, Binghamton, N. Y. I am attorney for Edwin A. Link and George T. Link, who own controlling interest and substantially all the stock in Link Aviation, Inc., in Binghamton.

I can present a specific, horrible example, I believe, of the effect of the retroactive date in section 301, in connection with the application of the new law to corporate acquisition of stock.

I will not go into the merits of these provisions, because they have been handled very capably by Mr. McFarland before me, and I would just like to cite the situation in which we are.

Twenty-five years ago, Mr. Edwin A. Link, brother of Mr. George Link, who is with me, here, invented what is known as a Link trainer, a device which simulates flying, on the ground, so that pilots could be instructed as to proper flight without risking their necks in the air, before they are proficient.

The original device was considerably simpler than it is today, because it relied on a bellows principle. He has developed the trainer so that now it is used by all of our Armed Forces in this country, and in many other countries, and it has been a very great help to the military service in connection with training aviation pilots.

However, as our technological advances continued, the bellows gave way to the new principles of electronics, to the extent that now, for the proper development of this device, it was necessary for the manufacturers of the trainer to consider a wider acquisition of know-how, particularly along the lines of electronics.

Consequently, last summer definite negotiations were carried on by Mr. Link and his brother for the transfer of their stock to the General Precision Equipment Corp., a corporation with an excellent staff in electronics, and a corporation that can be of great help in the development of this device. In November, there were specific provisions in typewritten form submitted to the Link Bros. as to a transaction whereby General Precision Equipment Corp. would acquire the stock, and Link Aviation would become a subsidiary of that com-

pany, with all of the advantages the Precision Co. could give from the standpoint of technological know-how.

About February 1, the directors of Link Aviation approved in principle the general plan for this acquisition. As in all deals of this kind, of course, there were many weeks that had to be spent in legal details, so that a definite contract was not finally written and signed until March 16, before, frankly, either one of the parties knew that there was a retroactive date in the new tax bill, that would fall so disastrously on the necks of these two stockholders.

Under the old law and under the law as it is today, it had been planned by both parties that it would be a transaction commonly called a tax-free reorganization, or exchange-of-stock, which was in reality a postponement of tax, and capital gains would be paid when the Link Bros. actually disposed of the new stock in General Precision Equipment.

By the terms of the contract of March 16, the Link stockholders undertook to exchange substantially all of their stock for stock of General Precision Equipment. Within a few days copies of the new tax bill were secured and it was discovered for the first time that the agreed exchange of stock could not qualify as a tax-free exchange under the terms of the new bill and also that all transactions entered into subsequent to March 1 would be governed retroactively by the provisions of H. R. 8300.

If the bill therefore is passed in its present form these stockholders would be liable to pay as a part of this year's tax the entire capital-gains levy on the exchange. Unfortunately for them, they will not have the cash to make this payment. Their gains have not as yet been realized. They will have only stock certificates in General Precision which may appreciate or go down in value.

It would be practically impossible for them to sell sufficient amounts of their new stock to secure currency for the very large tax. The sale of so large a block of securities in one company of relatively small size would seriously depress the market. Without question the stock would be sold at a sacrifice because there would not be sufficient demand for it to support a price reflecting its true value. A considerable part of the tax would then be paid from profits realized only on paper.

Consequently, we feel that in this particular instance, we can cite an example which illustrates the almost fatal impact of the retroactive date to March 1.

I haven't gone into the merits of the bill because it is the retroactive date which vitally concerns us. You have had excellent statements from others as to the substantive provisions of the proposed law. We cannot qualify under it. For that reason, we respectfully suggest in the interest of justice and equity to two parties who have negotiated this without any idea of avoiding taxes, and without realizing they were going to be penalized by this retroactive date—we respectfully suggest that the date be changed to one sometime after the act has been passed.

I greatly appreciate the privilege of coming before your committee.

The CHAIRMAN. We have been very glad to have you here, and as I said before, the staff is giving very careful attention to that and related problems, and so are the members of the committee.

Mr. Barrett, make yourself comfortable and identify yourself to the reporter.

STATEMENT OF RICHARD F. BARRETT, BOSTON, MASS.

Mr. BARRETT. Through an error, I did not file the 50 copies of my statement with the committee. I have a limited number here for the committee, however, I would like to ask leave of the committee to file additional copies after the hearing today.

The CHAIRMAN. Very well.

Mr. BARRETT. My name is Richard F. Barrett. My address is 30 Federal Street, Boston, Mass. I am a tax attorney and have been practicing as a tax attorney in Boston and New York since 1936.

I would like to direct 90 percent of my remarks this morning to section 303 of the proposed code. That is the successor to section 115 (g) (3) of the present code. There is one very important area which section 115 (g) (3) does not cover now, and this omission is continued in section 303 of the proposed code.

Section 115 (g) (3) was enacted in 1950 to effectuate Congress' purpose that the impact of death taxes upon owners of closely held family corporations would not result in the forced-sale liquidation or loss of control of such corporations. Congress expressly recognized the inequity and injustice of such corporations being damaged or wrecked in certain cases, by the necessity of payment of estate taxes, and also the undesirability to the general economy of having owners of small businesses forced to sell out their interest in the business to big business in order to prepare for, or to pay, estate taxes.

Accordingly, Congress added section 115 (g) (3) to the present code, which provides, in substance, that if the interest owned in a corporation constitutes a certain percentage of the value of the taxable estate, the stock representing such ownership could be sold to the corporation free from the hazard that the proceeds would be taxed as an ordinary dividend and largely wiped out by such a dividend tax.

However, section 115 (g) (3), and now the proposed section 303 of H. R. 8300, does not provide this protection in situations where there is, after the death of the owner, a substitution of stock for the stock owned at the date of death. As an example, if a merger, recapitalization or reorganization takes place after the death of the stockholder, the new stock received by the estate in exchange for the stock held at the date of death does not qualify under section 115 (g) (3) or the proposed section 303 of the proposed code.

Accordingly, the estate could not turn in such stock for redemption without grave risk of the proceeds being wiped out by the taxing of them as an ordinary dividend.

The CHAIRMAN. Has the staff considered that problem?

Mr. SMITH. I believe this is under study.

The CHAIRMAN. Will you give it your attention, please?

Mr. SMITH. Yes, sir.

Mr. BARRETT. I have submitted statements on this to the joint committee staff, Mr. Chairman, and to the Treasury Department.

Accordingly, you have this undesirable result which may also accrue for example in another simple situation, which is quite normal in the

transaction of corporate affairs—that is, where one class of common stock is split into voting and nonvoting stock; also it can occur where the decedent held his stock of the operating business in a personal holding company which was liquidated after his death, as is quite customary with estates, and the stock of the operating company thus received, in exchange for the holding company, would not qualify under the present code or the proposed new provision as stock which could be sold to pay death taxes.

Now, obviously the purpose of Congress is defeated in such situations by what constitutes mere technicalities in the purely evidentiary form of ownership of the business interests. The situations I have described can meet all the requirements of section 115 (g) (3) and come 100 percent within its spirit and purpose, and yet by a mere technical change in the form of the ownership, in the form only, the estate can be deprived of the relief which Congress intended such estates to have.

Attached to my statement is a proposed additional paragraph to be added to section 303 which would take care of this, and I might say in final clarification of this point, that it only relates to the simple nontaxable types of exchanges which the code has never recognized as being closed transactions, but as merely a change in the form of ownership, or to the situation where the operating business is held in a personal holding company and is then liquidated out of it.

I would like, also, to point out, with regard to section 303, that under the present law, section 115 (g) (2), which relates to the sale of parent-company stock to subsidiaries—so-called Wanamaker-type of sales—sale of this type under the present structure of the code, where 115 (g) (2) and 115 (g) (3) are interrelated, could qualify under section 115 (g) (3), as an exchange or sale rather than a regular dividend.

The form of the proposed provisions in the proposed code are such that they separate those 2 into 2 separate sections, section 303 is the old 115 (g) (3), section 304 is the old section 115 (g) (2), and by the mechanics of separating them, the coordination between them is lost so that now a right that exists under the present code is removed, namely, the right to qualify under 115 (g) (3) by a sale of parent stock to the subsidiary, and I suggest this may be merely a defect in drafting and not an intended removal of a presently existing right.

Now, the last 1 percent that I spoke of is simply to add my——

The CHAIRMAN. You didn't speak of that. You said you were going to take care of 99 percent, but you didn't mention the remaining 1.

Mr. BARRETT. Now, I would like to utilize that final 1 percent, if I may, to add my voice and recommendation to the proposal that subchapter C be made effective January 1, 1955. This, in addition to the general objections to it. I have a number, or several, very difficult and hardship situations that have arisen because of the proposed effective date, and I will cite only one, giving you a thumbnail sketch of the situation in which an application for a closing agreement for a merger was made in June of 1953. The closing agreement was finally written in the latter part of 1953, in December. The Treasury Department then changed its procedure on closing agreements to have them approved by the Commissioner, rather than the Secretary of the Treasury or an Under Secretary.

That necessitated calling it back. It was not finally issued until February of 1954. In the meantime, the director's votes had been taken and all the plans had been laid to carry this through, subject only to a final vote of the stockholders, after a closing agreement satisfactory to counsel was secured.

At that point, H. R. 8300 came over the horizon, and now this company which has been planning this transaction for 2 years, and which started the necessary mechanics in June of 1953, will find itself unable to carry through with it.

Perhaps the provisions of the new law could be held to apply to our situation. However, the closing agreement is just a scrap of paper under a provision that such agreements have in them, that if there is any change in the law affecting the transaction, the closing agreement is nullified. So we would start all over again after H. R. 8300, and have to wait until the Treasury Department and the Service clarified the law and issued enough rulings and regulations—which I think might be sometime along in 1955. I submit that corporate transactions should not be impeded by such unexpected intervention of new law.

The CHAIRMAN. Thank you very much.

Mr. BARRETT. Thank you very much for the opportunity to give my statement.

The CHAIRMAN. We have been glad to have you.

(Mr. Barrett's information follows:)

STATEMENT OF RICHARD F. BARRETT, BOSTON, MASS.

SECTION 303. DISTRIBUTIONS IN REDEMPTION OF STOCK TO PAY DEATH TAXES

Section 303 of the proposed code is the successor to section 115 (g) (3) of the present law. There is one important area which section 115 (g) (3) does not cover, and this omission is continued in section 303. It is therefore proposed that section 303 be revised to supply the coverage of the important area now omitted, as described below.

Section 115 (g) (3) was enacted in 1950 to effectuate the purpose of Congress that the impact of death taxes upon owners of closely held family corporations would not result in the forced sale, liquidation, or loss of control of such corporations. Congress expressly recognized the inequity and injustice of such corporations being wrecked by the necessity of payment of estate taxes and also the undesirability to the economy of owners of small businesses being forced to sell out to big business in order to prepare for or pay estate taxes. Accordingly, Congress added section 115 (g) (3) providing in substance that if the interest owned in a corporation constituted a certain percentage of the value of the taxable estate, the stock representing such ownership could be sold to the corporation free from the hazard that the proceeds would be taxed as an ordinary dividend and largely wiped out by such a dividend tax. However, section 115 (g) (3) and now the proposed section 303 of H. R. 8300 do not provide this protection in situations where there is, after the death of the owner, a substitution of stock for the stock owned at the date of death.

For example, if a merger, recapitalization, or reorganization takes place after the death of the stockholder, the new stock received by the estate in exchange for the stock held at the date of death does not qualify under section 115 (g) (3) or proposed section 303. Accordingly, the estate could not turn in such stock for redemption without grave risk of the proceeds being wiped out by the taxing of them as a dividend. The same undesirable result accrues in the case of an exchange of common for new common in a stock split occurring after death. Similarly, where the decedent held his stock of the operating business in a personal holding company, which was liquidated after his death and the stock of the operating company received by the executors in exchange for the holding-company stock.

Obviously, the purpose of Congress is defeated in such situations by mere technicalities in the purely evidentiary form of ownership of the business interests. The situations described can meet all the requirements of section 115 (g) (3) and come 100 percent within its spirit and purpose, and yet by a mere technical change in form of stockownership be deprived of the relief intended by Congress. It is therefore recommended that section 303 of the proposed code be amended to read as below in order that this defect in the law and discrimination between taxpayers be eliminated.

It is also pointed out that the separation of section 115 (g) (2) and section 115 (g) (3) of the present law into section 303 and section 304 of the proposed code deprives taxpayers of a right existing under present law. This is the right to sell stock of a parent corporation to the controlled subsidiary under the protection of section 115 (g) (3) from dividend tax. It is submitted that this right should be reinstated in the proposed code by a revision of section 304 to the effect that said section does not apply if the parent corporation stock sold to the subsidiary would qualify under section 303 if sold directly to the parent corporation.

"SEC. 303. DISTRIBUTIONS IN REDEMPTION OF STOCK TO PAY DEATH TAXES.

"(a) IN GENERAL.—A distribution of property by a corporation to a shareholder in redemption of participating stock, the value of which is included in determining the gross estate of a decedent in accordance with section 2031 which is not in excess of the sum of—

"(1) the estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of such decedent's death, and

"(2) the amount of funeral and administration expenses allowable as deductions to the estate under section 2053 (or under sec. 2106, in the case of the estate of a decedent nonresident, not a citizen of the United States),

shall, subject to the limitations provided in subsection (b), be treated as a distribution in full or part payment for such stock.

"(b) LIMITATIONS ON APPLICATION OF SUBSECTION (A).—Subsection (a) shall apply only—

"(1) to an amount which is distributed after the death of the decedent and—

"(A) within the period of limitations for the assessment of estate tax provided in section 6501, determined without the application of any other section, or within 90 days after the expiration of such period, or

"(B) if a petition for redetermination of a deficiency in such estate tax has been filed with the Tax Court within the time prescribed in section 6213, at any time before the expiration of 60 days after the decision of the Tax Court becomes final,

"(2) to amounts distributed with respect to all or part of the stock of a corporation the value of which for estate-tax purposes comprises either—

"(A) more than 35 percent of the value of the gross estate of such decedent, or

"(B) an amount equal to more than 50 percent of the taxable estate of such decedent.

For purposes of this paragraph, stock of two or more corporations, with respect to each of which there is included in determining the value of the decedent's gross estate more than 50 percent in value of the outstanding stock, shall be treated as the stock of a single corporation."

(Following Is New)

"(c) SUBSTITUTE STOCK.—If stock of a corporation is received with respect to or in exchange for stock described in paragraph (a) and paragraph (b) (2), a distribution of property by such corporation in subsequent redemption of all or a part of the stock so received shall be treated as a distribution in full or part payment for such stock, if

"(1) such distribution is not in excess of the sum prescribed in paragraphs (1) and (2) of subsection (a) and is made within the period of time prescribed in subparagraphs (A) and (B) of paragraph (1) of subsection (b), and

"(2) the stock so received was received by the shareholder without inclusion with respect to such stock of any amount in the income of or recognition of gain or loss to such shareholder under section 305 or section 371, or

"(3) the stock so received was received by the shareholder in a distribution in redemption of stock of a personal holding company as defined in section 542 and was stock of a value at the applicable date for determination of the value of the gross estate of such decedent—

"(A) more than 35 percent of the value of such gross estate, or

"(B) more than 50 percent of the taxable estate of such decedent.

For the purposes of this paragraph, stock of two or more corporations, with respect to each of which there is received in a distribution 50 percent or more in value of the outstanding stock, shall be treated as the stock of a single corporation.

"(d) LIMITATION ON TOTAL DISTRIBUTIONS.—Distributions of property treated as in full or part payment for stock under subsection (a) or subsection (b) shall be so treated only to the extent that the total amount of such distributions is not in excess of the sum prescribed in paragraphs (1) and (2) of subsection (a), provided, that in determining such total amount the amount of a distribution in subsequent redemption of stock received in a distribution described in paragraph (3) of subsection (c) shall be taken into account only to the extent of the excess of such amount over the value of such stock at the date so received."

SUBCHAPTER C—DEFINITION OF LIQUIDATION

Section 336 of the proposed code defining "partial liquidations" contains a requirement that separate books and records must have been maintained by the corporation for the part of its business which is being distributed in liquidation. This is an addition to the requirement that the part of the corporate business being distributed constitutes a separate business and has been operated separately from the other businesses of the corporation for a period of 5 years preceding the distribution.

The separate records requirement seems to be a surplusage if the other facts of separateness are established, and also will no doubt frequently constitute a discriminatory trap for small businesses. Large corporations would doubtless have no difficulty in meeting this requirement and would be adequately alerted by their advisers that the requirement must be met. However, small businesses are not only less likely to keep books of account and records to the precise extent required by this provision, but for obvious reasons are not constantly advised by lawyers and accountants as to refined technicalities of tax law. There is little difficulty in the view that it would be unjust for a small corporation maintaining two clearly separate businesses for the requisite 5-year period to be deprived of the right to a partial liquidation because of unfamiliarity with this provision until the time for liquidation arrived.

It is submitted that this provision should be stricken from section 336.

SUBCHAPTER G—ACCUMULATION OF SURPLUS

Subchapter G incorporates the provisions now found in section 102, imposing a penalty tax for accumulation of earnings and profits for the purpose of avoiding surtax on shareholders.

There is one important defect in the proposed new provisions, consisting of the omission under section 535 to permit deduction of the 85-percent transfer tax imposed by section 309 in determining the net income subject to the penalty tax. As section 535 reads, a corporation could pay the 85-percent tax on redemption of preferred stock, and then, if the penalty tax on accumulated earnings were imposed for the same year, pay a 38½-percent tax on the same amount paid to the Government for the 85-percent tax.

The new provisions also have not remedied a major defect and inequity existing under section 102 of the present code. This is the taxation of accumulated earnings for a taxable year which are retained by the corporation for clear and unquestioned business reasons and needs, if there are additional earnings also retained which it is established are not retained for business purposes. This is a familiar defect, and is simply illustrated by stating that if a corporation needs to retain $90,000 for unquestioned business requirements, but retains $100,000, the penalty tax is imposed upon the full $100,000. This has never made any sense, and correction of the defect is the type of correction for which the revision was undertaken and for which there was a crying need.

It is submitted that both these defects be eliminated by appropriate amendment of sections 531 through 536.

SUBCHAPTER J—65-DAY RULE

Subchapter J dealing with taxation of estates and trusts eliminates the so-called 65-day rule contained in the present law. Under present law, distributions by trusts and estates in the first 65 days of 1954 are deemed to be distributions to beneficiaries on December 31, 1953, and accordingly taxable to beneficiaries as 1953 income. Many such distributions have been made by trusts and estates, and tax returns of both the fiduciaries and the estates for 1953 have been filed in reliance upon this present law.

Subchapter J proposes to change this rule and by section 683 of the proposed code retroactively with respect to distributions made in the first 65 days of 1954. This result would not only be in conflict with returns that have been filed, but would impose a penalty in the form of additional tax liability upon estates and trusts involved. The 65-day distributions are deductible by the estates and trusts in computing their tax liability, and this deduction would be lost with a consequent increase in overall tax liability for fiduciaries and beneficiaries for 1953.

It is submitted that it is undesirable and inequitable to change the tax rules retroactively in this respect, particularly when tax planning and tax returns have been in reliance upon present law. It seems particularly inappropriate since the proposed retroactive change will make the law effective for the year 1953, which is an extent of retroactive effective date approach which is most extreme.

SUBCHAPTER J—INCOME DISTRIBUTED OR HELD FOR GRANTOR

Section 677 of the proposed code takes the place of section 167 of the present law, which taxes to the grantor income of a trust which is or may be distributed or held for distribution to the grantor. Under section 167 the courts have held that income used to discharge a legal obligation of the grantor is taxable to him. This has been applied in a few cases covering situations where the grantor has borrowed money and utilized the trust to make payment of the loan. It has never been applied to a situation where the grantor has transferred property by gift to a trust, subject to the liability for gift tax on the transaction. Many such transfers have been made without challenge, but the risk that 167 would be applied has also prevented gifts of this type being made.

It seems doubtful that 167 is intended to apply to such gift transactions for several reasons. Such gifts are common when made outright to individuals and not in trust, and it is clear that payment of the gift tax by the donee does not make the income from the property given taxable to the donor. This is also true as to other types of liabilities, such as where property subject to a mortgage is made the subject of a gift, in which case it is clear that payment of the mortgage by the donee involves no tax to the donor. However, gift-tax liability is of a type even less appropriate to cause such tax liability, since it is a joint liability of both the donor and the donee under the code. The liability for tax is a lien against the property given and the donee is secondarily liable for the tax. If the tax is not paid when due, the donor and donee both have a primary joint liability for the tax.

It is therefore submitted that the proposed section 677 should be revised to include provision that discharge by a trust of liability for gift tax subject to which the gift is made to the trust, will not be deemed to be a distribution of income to the grantor. This provision would state what appears to be present law, but eliminates a troublesome uncertainty. It would also put grantors of trusts clearly on an equal basis with donors of gifts made outright and not in trust.

SUBCHAPTER J—CLIFFORD RULE

The new provision for estates and trusts incorporates the so-called Clifford rule regulations with respect to taxation of grantors of trusts. Section 675 (3) provides that the grantor shall be taxed with the income of the trust in each case where he has borrowed from the trust and not completely repaid the loan and interest before the beginning of the taxable year. The one exception is where the loan has adequate interest and security, and is made to the grantor by a trustee other than the grantor or a related trustee subservient to the grantor.

This would penalize grantors who for bona fide reasons have made loans, even for a short period, for a perfectly sound security and bearing adequate interest,

so long as there is a related trustee, either acting alone or as cotrustee with an independent trustee, as long as the related trustee is deemed to be subservient to the grantor. Since the question of determination or claim of subservience by the tax authorities is one fraught with uncertainty and entirely unpredictable, grantors will find themselves in perfectly valid situations unable to make necessary loans because of the risk of assertion of income-tax liability. The liability could accrue even in a situation where the grantor had made a thoroughly sound loan for a period of 3 years, and had 90 percent of the loan repaid by the beginning of the third year. In such case, all the income of the trust would be taxable to the grantor during the third year, even though full repayment was completed on January 2 of the third taxable year.

It seems that prevention of tax avoidance would be adequately served if borrowing were permitted in any case where the loan was for adequate security and interest and was made by a trustee or trustees other than the grantor. As the provision now reads, a loan made by a corporate trustee and a related trustee acting jointly in the decision to loan could create the tax liability. Therefore, without detracting from the foregoing recommendation, it would seem that at least this type of loan should be permitted.

The CHAIRMAN. Mr. Walter Mack, please.

Sit down and make yourself comfortable, Mr. Mack, and identify yourself to the reporter.

STATEMENT OF WALTER MACK, PRESIDENT, NATIONAL PHOENIX INDUSTRIES

Mr. MACK. Thank you. My name is Walter Mack. I am president of National Phoenix Industries, which is a publicly held company with about 18,000 stockholders, listed on the American Exchange and actively traded.

We have a number of wholly owned subsidiaries, one being Nedicks, a chain of snack bars feeding about 50 million people a year. We also own control of the B. & G. Sandwich Shops, which are known throughout the country.

We have another wholly owned subsidiary of which I am also president, known as Cantwell and Cochran, who are in the process of manufacturing and canning soft drinks in cans for the entire country, with quite a number of plants.

Senator Millikin and members of the committee, I appear here today to acquaint you with a hardship case which has suspended us in midair, and we can't move ahead until the situation is clarified.

In our growth, we had last year worked out an arrangement for a tax-free reorganization with the Croft Co. of Boston under the old revenue law. We were advised by two different sets of tax lawyers that the transaction was a tax-free reorganization, and we went out and signed an agreement last year, in December, presented the plan to the SEC in January, and after they had passed on it, called the necessary meetings of the two companies. The Croft Co. is also a publicly held company, with 6,000 stockholders, listed on the American Exchange.

The CHAIRMAN. What is their business?

Mr. MACK. They used to be the old brewing company and own a large building, real estate, and manufacturing and canning facilities in New England, which would or could be used for our expansion purposes, of Cantwell and Cochran.

They have discontinued and sold the brewery company to another brewer in Boston, so they are no longer in the brewing business, although they own the facilities.

The plan was consummated with their directors and submitted to their stockholders for a vote of approval. Their stockholders met on February 24 and approved the plan of reorganization. The plan was submitted to them on the basis that it was a tax-free transaction, and also was submitted to them under a written plan in which the reorganization had to be consummated by April 30 of this year. It was submitted to my stockholders for approval at a stockholders meeting on March 3, and was unanimously approved, or tremendously approved by 78 percent of the stockholders voting for the plan on March 3.

The plan was presented to National Phoenix stockholders also in writing as a tax-free reorganization to be consummated on or before April 30.

What has happened is that under the new revenue law, section 391, subchapter C of chapter I, which nobody—at least I am advised nobody knew a thing about it until it was published on or around March 9, so there was no way we could have protected ourselves—made the transaction, now, a taxable one, so that we have a plan approved by all stockholders, we are ready to transfer the assets, and find ourselves suspended and unable to do anything because the new regulation makes it taxable effective to March 1, and our last meeting took place on March 3. We are therefore suspended in the position that we can't move ahead and if something isn't done by April 30, all our work, expense, plans, and representations cannot be gone along with because under the new bill it is taxable.

We acted in good faith under existing law and I come to you to ask your help in trying to rectify the situation because I know there have been certain assurances given that that was not the intention to put anybody in that position, and I am sure everybody is aware that House Chairman Reed, on the first day of the hearing made the committee aware of his feeling that the result of which I am claiming was in error and should be corrected, and that your expert, Colin Stam, has also, I believe, prepared a statement that has been approved by the Treasury Department, that there was an error in the situation. It was never intended it would be retroactive to a transaction of that sort.

I come to you to plead, because I am told by my taxmen that the only way it can be rectified is by the Senate Finance Committee acting because the bill as it is written, while this may be in error, it is really up to the committee to rectify that situation. Therefore, I come to you personally to acquaint you with the manner in which we are suspended in midair, with a contract that terminates on April 30, and ask you if you would in some way give it your early consideration in your executive sessions so that the public and people in my position can be acquainted with what you are thinking of, if possible, before the 30th of April.

The CHAIRMAN. Thank you very much, Mr. Mack.

Mr. MACK. Thank you for letting me come here and plead my case.

The CHAIRMAN. We have been glad to have you.

Mr. MACK. May I file this?

The CHAIRMAN. Please do.

(The prepared statement of Mr. Mack follows:)

STATEMENT OF WALTER S. MACK

My name is Walter S. Mack. I am president of National Phoenix Industries.

I appear before this committee to acquaint it with a hardship case resulting from the provisions of subchapter C of chapter I of subtitle A of H. R. 8300, the pending tax bill. Section 391 makes these provisions retroactive to March 1, 1954, and makes our corporate transactions of the last 3 months taxable when they were not taxable under existing tax law at the time we undertook them. Take our particular case.

Under the old law, the Internal Revenue Code of 1939, the transfer by National Phoenix Industries of all of its assets for stock of the Croft Co. was a nontaxable reorganization.

Being so advised by eminent tax counsel, and operating under the old law, National Phoenix and Croft entered into a contract, on January 15, 1954, under which National Phoenix agreed to transfer its assets for stock of Croft, if approved by the Securities and Exchange Commission and the respective stockholders of the two companies.

The plan of reorganization was promptly submitted to the Securities and Exchange Commission prior to the end of January, so that the legal notices to stockholders could be sent out prior to the end of that month.

Notices were immediately sent, and on February 24, 1954, the stockholders of Croft, numbering over 6,000, approved the plan.

On March 8, 1954, the 18,000 stockholders of National Phoenix overwhelmingly approved the plan. Mind you, this was not a plan of reorganization by closely held or family corporations. Both were publicly owned corporations, the stock of both of which is listed and traded on the American Stock Exchange.

By the contract, as approved by the stockholders, the transfers of assets and stock were required to be made on or before April 30, 1954, and the transaction, as I have said, was not taxable under existing law.

Then, on March 9, out of the clear blue sky, came H. R. 8300, which makes the whole transaction taxable because everything had not been completed prior to March 1, 1954.

We—National Phoenix and Croft—acted in good faith, under existing law. The directors advised their stockholders, on the basis of the advice of company counsel, that under existing law this was in every way a tax-free reorganization. Today we cannot perform the contract because the law proposed, as passed by the House, makes the transaction taxable.

The Senate committee was advised by its chairman, on the first day of the public hearings, that Hon. Daniel Reed, chairman of the Ways and Means Committee, feels that the result of which I complain was an error and should be corrected. In that statement, prepared by your expert, Colin Stam, the Treasury Department agrees that this is an error and should be corrected.

However, I am in this position. I am advised by my counsel that, notwithstanding all of this, the bill, as it passed the House, must be changed by the Senate, and if unchanged, that we cannot proceed to carry out our contract on April 30.

I am therefore here, appealing to your committee to make the required change in H. R. 8300 so that the law under which we were acting shall remain the applicable law to the transactions I have described.

I realize that the Senate will have to accept the change, as well as the conferees of the House, but I feel that what I ask is so eminently fair that once this committee has acted in the right direction, the others will readily go along. The public statement of Mr. Reed, of the Treasury Department, and of Mr. Stam, support my opinion in this respect. Thus, the action of this committee is the key to our entire problem.

Apparently other organizations and the financial community are upset, and at a standstill, due to the present uncertainty. The situation is such that it is submitted that your committee could and should promptly meet, agree upon, and make a public announcement, as soon after the public hearings as possible and prior to April 30.

Thank you.

STATEMENT OF WESLEY E. DISNEY, WASHINGTON, D. C., REPRESENTING THE NATIONAL BUILDING GRANITE QUARRIES ASSOCIATION, INC.

The CHAIRMAN. Sit down and be comfortable, Mr. Disney.

Mr. DISNEY. Mr. Chairman and members of the committee, my name is Wesley E. Disney, 501 World Center Building, Washington, D. C.

Senator CARLSON. I would like to state for the record that it was my privilege to serve on the House Ways and Means Committee for several years with Mr. Disney and I certainly at that time never anticipated that I would be sitting here to hear him as a witness.

Mr. DISNEY. You are sitting in judgment on me.

The CHAIRMAN. It is a pleasure to have you.

Mr. DISNEY. It is my pleasure to be here this morning.

I represent the National Building Granite Quarries Association, Inc. You will recall that within recent years you gave granite 5 percent depletion. We are not squealing but we need some help.

At page 156 of the bill, at paragraph (f), we propose and hope the committee will adopt an amendment on this order, that—

> In the case of granite, limestone, marble, sandstone, slate, and other natural stones, ordinary treatment processes shall include any of the following: Sawing, grinding, cutting, polishing, and otherwise fabricating to dimension.

Our proposed amendment may include others who are not interested in it, in which event the committee may be at liberty, so far as we are concerned, to eliminate the words "limestone, marble, sandstone, and slate," so as to make the amendment read:

> (f) In the case of granite and other natural stones, ordinary treatment processes shall include any of the following: Sawing, grinding, cutting, polishing, and otherwise fabricating to dimension.

A quick glance at the definition of ordinary treatment processes, which begins on page 155, will illustrate that the Congress heretofore has singled out many minerals—for instance, coal, sulfur, iron, and so on—to give its expression as to what ordinary treatment processes shall be considered in the specific instances.

The uses of granite are many. For example, it is used as a building material, bridge material, crushed stone for construction and roadbuilding, street curbing, poultry feed, monuments, and other uses. Building material, usually under architectural specifications, is required to be processed to form. Likewise bridge material. Street curbing must undergo a process to shape it for uniformity. One member of our association makes large quantities of slabs or markers for cemetery uses. These are required to be within certain specifications by the War Department.

We are led to believe that the Treasury has the impression that the point at which percentage depletion begins is that point at which the rough blocks of granite are loaded on cars or trucks at the quarry, and the transportation to the processing mills will not be allowed, nor will the milling of the rough blocks be allowed. This would seem to be in the face of what the Congress has provided in its definition of what "ordinary treatment processes" includes, when it has said, in paragraph (2), page 155 of the present bill:

> The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied

by mine owners or operators in order to obtain the commercially marketable mineral product or products.

Now, section 613 (a) in the definition of ordinary processes goes ahead to specify, in certain instances.

I believe that statement will be readily recognized by every member of the committee.

There is a very good reason why this matter should be clarified by the Congress at this time. The granite producers are convinced that they are entitled, in making their calculations for percentage depletion, to have included therein ordinary treatment processes. They are further convinced that the courts will hold, in line with the other provisions already in the law defining ordinary treatment processes, and as a matter of statutory construction, that they will be allowed what is provided in our proposed amendment. However, we do not want to have to resort to or rely on the courts, if the Congress will make its definition. It can readily be seen how much litigation will be avoided if the committee will adopt this amendment, because it will put granite and other natural stones in a class where ordinary treatment process is specifically defined. This will not only aid the granite producers but will be of assistance to the Treasury Department, to have a definite understanding what ordinary treatment process in the granite business should consist of. In other words, if the Congress indicates the cutoff point at which percentage depletion ends, it will be a clarification of the statute that will be of great value.

For instance, talc producers, under a decision of the Tax Court, are allowed as ordinary treatment process to fine grind the talc into its ordinarily merchantable product before the cutoff point attaches, and this bill makes the fine grinding of talc a part of the ordinary treatment process. Other illustrations might be offered relating to iron, sulfur, coal, et cetera.

The question of the cost might naturally arise. One friend, in writing to Senator Byrd, makes the statement that "by spelling out the processes in our proposed amendment, it is going to cost the Treasury no more than was provided for in the enactment of this section," and he cites the other defined treatment processes provided at paragraph (4).

We cannot believe that the cost will be considerable, if any. If it will lose the Treasury an inconsiderable amount of money, it may be said that by the very paragraph which we are seeking to amend, other industries are accorded a cutoff point by the definition of ordinary treatment processes which the Treasury follows.

If it should be contended that granite is a type of mineral which, under paragraph (C) is "customarily sold in the form of a crude mineral products," our answer is that very little of the granite produced in the United States is sold in its crude form, although there is a small quantity of granite that is sold as crude granite.

The term "crude mineral product" as defined in the regulations and as used herein, means the product in the form in which it emerges from the mine or quarry. There is practically no market for granite in its crude form. Only a small portion of that produced in the United States is sold crude. It is necessary to subject the crude granite to various processes before it has a market value. Granite

is sold in various grades or forms for various uses, and the treatment processes are determined by those uses.

In general, the types of equipment used and the types of treatment processes applied for a particular use, are similar throughout the industry. From these facts, it appears that the "gross income from the property" in the case of a granite producer is the gross sales of the product, whether sold in the form or grade for building material, bridge material, crushed stone for construction and roadbuilding, street curbing, poultry feed, or monuments, or for any other use. The statute does not contemplate nor require a producer to change or disturb its ordinary and usual business operations.

We understand that this bill is for the purpose of clarification of the law to the end, among other reasons, that less litigation will ensue rather than more difficulties with the Treasury. With that purpose in mind, this amendment will make definite the cutoff point for depletion for granite, rather than leaving that to the courts in the many cases that are sure to arise. Attention to this detail at this time, will contribute to taxpayer satisfaction, lessen his costs, and enable him to avoid many troublesome problems.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Disney.

Senator CARLSON. You mention that little granite would be sold as quarried. That would apply to most stones, wouldn't it?

Mr. DISNEY. That is right. Most of our granite has to be processed in order to sell it, at all. For instance, street curbings here in Washington. If you go anyplace in Washington, you will find granite. In our area, they are concrete, but here they are granite and they have to be processed. There would be no sale for it at all in crude blocks as it comes from the quarry.

The CHAIRMAN. Don't they have establishments that do nothing but the final finishing of the granite?

Mr. DISNEY. Yes. For instance, 1 mill I have visited up in Massachusetts, they have a huge quarry and they get the granite out in huge chunks in rough form and then it is moved over there 2 or 3 miles to a mill that has all the modern sawing and polishing equipment.

The CHAIRMAN. Is that mill owned by the quarry?

Mr. DISNEY. Owned by the same corporation, yes, sir. It is a part of it.

Seantor CARLSON. That same would be true out in our section, limestone that is now cut and processed for building stone, and Bedford lime which is used for trim all over the Nation, which is an Indiana stone.

The CHAIRMAN. Thank you very much.

We are glad to have had you with us.

Mrs. Springer, do we have any more witnesses?

Mrs. ELIZABETH B. SPRINGER, clerk. We have no more witnesses.

The CHAIRMAN. We will meet at 10 o'clock, Monday morning.

(By direction of the chairman, the following is made a part of the record:)

THE O'MALLEY LUMBER CO.,
Phoenix, Ariz., April 17, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SIR: Following instructions of Elizabeth Springer, chief clerk of your Finance Committee, I am submitting the enclosed written testimony for your tax hearings.

I appreciate this opportunity of being able to express my views and those of my associates on this very important matter.

Sincerely yours,

JAMES C. O'MALLEY,
Secretary and Sales Manager.

TESTIMONY OF MR. JAMES C. O'MALLEY BEFORE THE FINANCE COMMITTEE OF THE UNITED STATES SENATE

My name is James C. O'Malley, of Phoenix, Ariz.; where I am the secretary and general sales manager of the O'Malley Lumber Co. I come before your committee to speak for myself as an individual businessman interested in the tax problems of business and my country, and also as a delegated representative of the following organizations:

Arizona Retail Lumber & Builders Supply Association, Inc.
Implement Dealers Association of Arizona
Arizona Agricultural Chemicals Association
Arizona Pest Control
Northside Hay Mill & Trading Co. (Glendale)
Arizona Association of Security Dealers
Arizona Hotel Association
Southwest Flour & Feed
Phoenix Retail Merchants Association
Arizona Plant Food
Arizona Cotton Traders Association
Arizona Appliance Merchandisers Association
Retail Grocers Association of Arizona
Arizona Tire Dealers Association
Arizona Automobile Dealers Association
Arizona Liquor Dealers Association
Comptrollers Association of Arizona

I myself and these organizations and their members are deeply concerned with the subject of Federal taxation, particularly as it relates to tax exemptions or favoritism granted to cooperative and mutual types of businesses competing with me and also many members of these organizations. But I wish also to call your special attention to the fact that several of these organizations and their members, for whom I speak, have no direct competition from tax-exempt groups, but nevertheless are equally concerned about being called upon to pay higher taxes because others are permitted to escape their fair share of the load. I am certain you will find that this feeling exists not only in my own State, but in all States of the Republic.

Populationwise, Arizona is relatively a small State, but the growth of cooperative and mutual corporations in our State, on tax-free earnings, is following the same pattern as that which exists to a greater degree in other and larger States. In spite of this, I do not know of any instance where businessmen or any of their various organizations have come before this or any other committee of Congress seeking punitive legislation against these cooperative and mutual competitors. But I do know that all across this Nation there is a deep resentment, and a growing one, by businessmen and their organizations—whether directly affected competitively or not—that there is no longer any excuse, if there ever was one, for tax discrimination against one type of business and tax favoritism for another.

The technical aspect of this problem has been presented to you many times. I have seen and read much of it. It is not my purpose to go into the technicalities. Your own staffs are fully familiar with them and have, I know, made them available to you.

Most of our members have grown with the State. As a matter of fact, some of them, or their forbears, first came here and established their businesses during

territorial days—for example, our corporation was established in June of 1908, during the territorial days, and we have paid our full share of taxes at the corporate level ever since the tax law has been in existence. They believe in fair play and justice and have always placed their duties as citizens above their personal interests. It is only natural, therefore, that they question the integrity of these so-called nonprofit businesses that have begun to invade the State but are unwilling to accept the full responsibilities of citizenship, including that of taxpaying.

In the late twenties and early thirties we began to notice cooperatives being formed to market citrus produce and cooperatives to gin and market cotton; these were soon followed by retail stores marketing complete lines of farm machinery, lumber, fertilizer, hardware, petroleum products, furniture, and other farm supplies. The volume of business conducted by these cooperative groups has risen from $10 million in 1947 to $26 million in 1952, according to the Farm Credit Administration. That business should produce an income tax of a half million dollars from our little State alone. The business conducted by mutual financial institutions and certain types of mutual fire and casualty insurance companies, according to authoritative sources, has increased even more than that of cooperative businesses.

There are specific deals being offered all the time to various businesses in our State. I called the attention of our two Senators in February of 1951 to a proposal by a charitable trust from California offering to purchase over 3,000 acres of one of our most successful farming operations in the valley. The general manager of the farm told me the transaction was patterned so as to escape taxes.

Now, we do not object to cooperative or mutual business as such, but the taxpaying citizens of Arizona object to having to reach into their own pockets to make up one-half million dollars to a million dollars or more. That is the reason our automobile dealers, investment bankers, and others have joined to protest this malicious imposition of taxes.

Your committee has before it House bill 8300, a comprehensive bill to revise the internal revenue laws of the United States. In the general statement accompanying that bill, I found this all-important statement:

"In general, the purpose of these changes has been to remove inequities, to end harassment of the taxpayer and to reduce tax barriers to future expansion of production and employment.

"The restrictive effects of the present tax law on economic growth have been obscured and somewhat offset during the past decade by the inflationary pressures of the war and postwar periods. It is now apparent that prompt adoption of this new tax law is especially timely in order to create an environment in which normal incentives can operate to maintain normal economic growth."

That is a lofty expression of purpose and we know that it is fundamentally right. We have only to look at the tremendous advance made by cooperatives and mutuals to see what expansion can be made when there are no restrictive tax hurdles to overcome.

In view of the fact that the President had asked for a removal of the inequities in our tax law, I was pleased to see this statement of purpose at the opening of your report on the bill now before you. I looked in vain, however, for any provision that would place cooperative and mutual competitors on the same basis as their taxpaying friends.

The general statement also states that the bill has provisions to remedy many problems of small business. I quote:

"The bill contains many provisions which are important to the growth and survival of small business. These include more adequate depreciation, a more realistic policy with respect to retained earnings, more liberal provision for research and development expenditures, a stimulus to equity financing through dividend relief, recognition of business practices for tax-accounting purposes, and simplified procedures for partnerships and corporate reorganizations."

Now, I am appearing for small-business men who realize that they need a more realistic policy for setting up depreciation, for providing research and development expenditures, and for equity financing. Yes; we need all of those things but what good are they to us if the big loophole is still left open for our competitors to compete with us on a tax-free basis. The greatest deterrent of many small businesses today is not restrictive provisions of our present tax law but the failure to apply the same tax law to their competitors.

I appreciate this opportunity to let you know how the businessmen and taxpayers of Arizona feel about this problem.

I feel, as do they, there is only one honest answer in the light of all the facts that have been developed by your own experts and that is this:

In all fairness to the taxpayers of this country—both individual and corporate—these cooperative and mutual corporate businesses must be made to shoulder the same burdens of Federal taxation that the rest of us must and are glad to bear for the privilege of carrying on business under the rights and protection of this great Republic.

STATEMENT ON BEHALF OF THE INDEPENDENT REFINERS ASSOCIATION OF AMERICA

My name is Elmer E. Batzell. This statement is submitted on behalf of the Independent Refiners Association of America, for which the firm of Moyers & Batzell, of which I am a partner, is counsel. The Independent Refiners Association of America has members in the principal refining areas of the country, except in California.

Last summer we had the opportunity of appearing before the House Ways and Means Committee. At that time a rather lengthy statement was submitted recommending the adoption of a more adequate depreciation policy under the internal revenue laws of this country. Since that time this problem has been carefully considered by the House committee and by the House itself. Legislation has passed the House which materially alters the depreciation policy now in effect. This legislation is before this committee for consideration.

It is my understanding that this committee will be given the full benefit of the views that have been previously expressed. It would unnecessarily burden the record to reiterate in full the position which was taken last summer. The association wishes to go on record, however, as fully supporting the views which it has expressed previously. It urges very careful consideration by this committee of the position then taken.

In essence the association has recommended first that the Congress adopt a more flexible depreciation policy; and second, that the method employed be the simple and direct arrangement whereby each taxpayer would be permitted to select the rate at which he would depreciate his facilities. The association continues to believe that ultimately it is to the best interests of a dynamic economy and to this country to permit the taxpayer to select the depreciation period, his election once made being binding upon him thereafter unless specific permission to change is granted by the Government.

In the statement of the association before the Ways and Means Committee it was pointed out, however, that a variation of the complete freedom of election principle could be adopted with material assistance to the small operator and without ultimate loss of revenue to the Government. This "would be an arrangement permitting depreciation on a substantial portion of a newly installed facility in the early period of its life, letting the unrecovered portion of the total cost be over the remaining longer period." It is this arrangement which appears in the House bill, and while the preference of the association remains that of complete freedom to the taxpayer to select his depreciation period, the association certainly subscribes now, as it did in making its original recommendation to the Congress, to the principle which has been incorporated in the pending legislation.

We stated, in our discussion of last June, that "the rules as to accelerated depreciation" should "be self-operating and without review by Government in the selection of facilities to which the rules may be applied." This principle has been adopted in the current legislation and the association firmly believes that it should be sustained.

In my own experience in Government service, recently as finance counselor and as Assistant Deputy Administrator and General Counsel of the Petroleum Administration for Defense, and during World War II as special assistant to the Deputy Administrator of the Petroleum Administration for War, I had continuing direct relationships with the so-called accelerated amortization provisions of the Internal Revenue Code. These experiences have convinced me that a rapid depreciation program is basically a sound concept for assuring continued expansion of industrial activities of this country without ultimate loss of revenue to the Government. The experiences have also convinced me that rules for applying depreciation should, in general, be self-operative and not dependent upon Government review of particular facilities before the taxpayer is entitled to apply those rules.

Any proposal involving Government review involves a program which can be carried out only in accordance with relatively inflexible standards which neces-

sarily presume a degree of knowledge on the part of the Government administrator which he cannot possibly possess; and no matter how honestly, how objectively, and how consistently such rules would be administered, inequities would arise leaving the Government open to charges and countercharges of discrimination and unfairness. Accordingly, any long-range program such as that envisaged in the present legislation, which the association here supports, should be operative without review by the Government prior to the installation of the facilities to which the accelerated depreciation will apply.

The circumstances which have led to the recommendations which are here made were set forth at length in the previous statement of the association to the Congress. In brief, to petroleum refining, where, in the 46 years since 1908, 5 revolutions have occurred in the art of refining crude oil, the ability to depreciate facilities in accordance with their useful economic life is critically important. The pending legislation goes a long way to make this possible.

Three other factors discussed in detail in the statement before the House Ways and Means Committee should be emphasied:

(1) Depreciation based on the physical life of existing equipment cannot take into account intrinsically higher replacement costs of existing facilities arising by virtue of tremendous increases in the steel, copper, brick, fabrication, and labor costs which go into a plant.

(2) The new processes which frequently make obsolete already installed facilities in a quarter to half of their useful physical life have invariably required increases in the size of basic refining facilities in order that maximum efficient operation can be obtained.

(3) New processes are themselves intrinsically more expensive than the ones which they replace.

These characteristics make it imperative to have a revised depreciation policy, such as that now proposed, if aggressive economic and technological development is to continue and the participation of the smaller refiner in that development is to be made possible.

Although historical developments in the refining industry make clear that an adjustment such as that proposed to the existing depreciation rules is of significant importance to the industrial development of the Nation and is of particular importance to the smaller segments of industry, considerable resistance to a more flexible policy has been exhibited by the Government in the past. The chief objection seems to have been a fear in the Treasury Department that the loss in current revenues could not be absorbed in the face of the tight fiscal position of the Government. Such a consideration seems to us completely to overlook the far more important consideration that an accelerated depreciation program will inevitably assist in a more rapid development of the industrial base of this Nation and in the aggregate income subject to taxation.

The additional cash available to businessmen arising out of a more realistic depreciation policy inevitably will find itself returned to the business for generation of increased income and increased profits. An inflexible depreciation policy, on the other hand, stifles this growth opportunity and is especially disadvantageous to the small segments of an industry. It may, indeed, both in the short and long run, mark the difference between whether a business succeeds or fails.

There are a number of precedents in the experience of other nations for adoption of a flexible depreciation policy, the most recent of which is the petroleum law of Turkey, enacted in March of this year, which permits the operator to select his depreciation period based upon his "estimate of the number of years that the property can be economically employed in the service of which it was originally installed or erected." Britain has found such a policy absolutely essential as a means of maintaining a continuing flow of investments into new and improved productive facilities. The laws of Canada, Norway, and Sweden all provide for a flexible depreciation policy; and it is not without significance that Canada and Norway under a modern depreciation chargeoff program are the nations which show the greatest industrial expansion since World War II. Any economy which depends for its stability upon a dynamic industrial base must make adequate provision for continued investments and reinvestments in facilities which will insure the continued vigorous growth of that industrial base.

The long-rage security of this Nation depends, just as does the short-range security, upon our industrial might. An important inducement in maintaining that industrial strength is a policy with respect to depreciation which will permit a reasonable payout of facilities during periods when there is demand for the production from those facilities. If the facilities have continued use-

fulness at the end of the period, the revenues derived from them will be subjected to full taxation without benefit of depreciation allowance. If the facilities have no such utility, sound accounting would require an orderly writeoff within the limited period of their useful life.

While it is not now of direct concern to this committee in its present deliberations, there is a matter of long-range import to the United States in these troubled times which is closely allied with the taxation policies that have been discussed. As a result of strenuous efforts to increase industrial production against the day when it might be needed to supply industrial and military activity in times of emergency, a considerable excess productive capacity has been developed which creates grave economic problems for individual businessmen. This is especially true in industries such as petroleum refining; and the impact of this excess capacity upon the independent refiner, when it continues to be used without restraint, threatens the very existence of this small but significantly important segment of the petroleum industry.

One of the members of the Independent Refiners Association, Mr. D. W. Hovey, of Houston, Tex., has personally brought to the attention of the Members of the Congress a program by which, through appropriate taxation adjustments, the adverse economic effects of excessive productive facilities, constructed for emergency purposes, may be minimized. It is premature here to recommend any specific form for minimizing such adverse effects through tax policies. It is not premature, however, to call this matter to the serious consideration of this committee and to commend to its study this particular problem and the steps which might be taken through tax legislation to handle the problem of maintaining idle capacity for emergency use.

The association urges the passage of a flexible depreciation law such as that now pending before this committee. Tax rates today are such that, very literally, the refiners of this Nation are not securing sufficient capital to replace the facilities which they are presently utilizing in turning out superior products. A flexible depreciation policy will help to assure a proper adjustment to current income so that the opportunity for continuing an improved, efficient, productive industrial mechanism will exist now and in the years to come. If the independent refiner is to continue his ability to deliver competitive products and hence to remain in business, he must be assured of a flexible depreciation policy now and in the future.

STATEMENT OF JOHN F. FLOBERG, ESQ., WASHINGTON, D. C.

Mr. Chairman and members of the committee, my name is John F. Floberg and I am a member of the law firm of Kirkland, Fleming, Green, Martin & Ellis with offices in Washington, D. C., and Chicago, Ill. I appear here today on behalf of United States citizens who are resident in foreign countries.

United States citizens residing in foreign countries find themselves in a position where they must pay duplicate income, estate and gift taxes. The obvious result is that they are at a severe disadvantage as compared either (1) to United States citizens living at home or (2) to the nationals of the country in which the United States citizens are resident, or (3) to the citizens of third countries who are resident in the same country as the United States citizens in question and competing with them in trade or business. The duplication is largely the result of the conflict betwen the United States primary principle of taxation on the basis of citizenship and the fundamental of most of the other countries of the world of taxation on the basis of residence.

Substantial strides have been made toward removing the inequities of the double tax burden on these particular United States citizens, but there is still considerable room for improvement both in the fundamental tax laws which you gentlemen are curently considering and in the conventions, designed to eliminate the double tax burden, between the United States and other countries, which come to the attention of you gentlemen from time to time. This satement will discuss some of those difficulties and will propose solutions for your consideration in the revision of the tax laws which you are currently studying.

STATEMENT OF GENERAL POLICY

It is fundamental national policy at the present time, and has been for several years, for the United States to encourage the economic growth and the capitalistic prosperity of all nations in the free world. This policy has been implemented during the past few years principally by large Government-operated programs of

financial assistance to other nations. These programs have been through various phases and have had various identifying titles, including Marshall plan, Economic Cooperation Administration, Mutual Security Administration, MDAP (which had a good many economic aspects to it), UNRRA (principally American financed), point 4, Foreign Operations Administration, etc.

In spite of the fact that the great bulk of the reconstruction, physical, moral, and economic, of the free world since World War II has been financed by United States Government funds, there can be little doubt that such a financing by private United States capital, to the extent that the projects financed were suited to private investment, would have been and would continue to be far more effective, efficient, and economical than a Government program ever could be. The inevitable cumbersomeness, and consequent relative inefficiency, of any large Government program, plus the fact that our Government does such business not with foreign capitalists but with foreign governments which may have highly questionable efficiencies and policies of their own, creates many obvious and inescapable disadvantages.

The most valuable capital items which the United States can export are its management and supervisory personnel. The managers of American capital, conscious as they must be of the magnified difficulties inherent in doing business in foreign countries, can hardly be expected to invest large sums of money, toward which they have a fiduciary responsibility, in those countries unless they have carefuly appraised the extraordinary demands which will be made on the talents and capacities of the personnel to whom they delegate the management and supervision of such activities. Inducement to invest must always be measured by the prospects of financial profit as compared to the risks involved. When the financial risks grow as disproportionately large as they do in most of the free countries which are our allies and friends and in the health and prosperity of which we have a strong national interest, top-flight United States personnel must be on the scene.

High Government officials for several years have stated all these principles and have attempted to encourage American capital to invest in foreign areas so as privately to accomplish what are really national governmental objectives of the United States. When private American capital does invest in the countries of the free world, furthermore, it has the additional highly beneficial effect of acting as a catalyst for the capital native to the particular foreign country in question. The strengthening of private enterprise, capitalism, and democracy becomes chain reactionary.

Encouragement to United States citizens to invest or to work abroad, however, has more often been limited to exhortation and platitude than it has been fortified with demonstrable advantages to the investor or employee. All too frequently a niggardly fear that a foreign investor or the employee of a foreign investor might "get away with something," a penny-wise-and-pound-foolish attitude toward the few dollars of Federal taxes paid by relatively few individuals while ignoring the alternative of billions of dollars of Federal foreign expenditures paid by all the taxpayers, has operated as an effective block on the achievement of our broad national objectives. It is time for a statesmanlike and courageous approach based on sound economics and international realities, divorced from politics, to dictate a course of national action in this matter.

Although various tax conventions have made the situation obviously better now than it was a few years ago, there can be little doubt that the improvement has failed to keep pace with the increase in the urgency of our national objectives. Far from encouraging individual United States citizens to follow American capital abroad, our tax laws in most cases in effect say to the individual: "You have three choices: (1) Give up your American citizenship, (2) go back home and stop your crying, or (3) grin and bear it." The first of these suggestions seems to be downright immoral and accepting it seems even more so; citizenship, and the patriotism which is corollary to citizenship, should have a nobler foundation than a tax advantage; and yet some United States citizens have felt themselves compelled to do just that and have actually surrendered their citizenship rather than continue bearing tax burdens which neither their fellow citizens in the United States nor their neighbors in the particular foreign country have to bear. The second suggestion is directly contradictory to fundamental national policies and frustrates our objective of strengthening foreign economies and democracies by the services of United States money and know-how. The third suggestion hardly seems a fair one to put to Americans who are directly—more directly than any of their fellow citizens—daily playing an active part in the promotion of some of our most fundamental national policies.

Specific corrective action, sometimes by basic amendment to the Internal Revenue Code and sometimes by enlargement or amendment of existing tax conventions or entering into new tax conventions, is suggested below.

INCOME TAX

Under existing law (and existing conventions) a United States citizen residing in a foreign country must pay income taxes to the United States on all of his income, except "earned income" in the foreign country within the definition of section 116 of the code (sec. 911 of H. R. 8300). He must normally also pay the income tax of the foreign country, because of his residence there, on his entire income both from that country and the United States. Tax conventions and the provisions of section 131 of the code (secs. 901-905 of H. R. 8300) allow a credit for taxes paid to the other country for the same income, but the credit is subject to a proportionate limitation. Even if the credit system worked perfectly, the result would be that the taxpayer would pay either the foreign or United States income tax, whichever is higher, but since each country normally allows different deductions and since each frequently taxes different types of income, the proportion does not always result in even the elimination of double taxation.

The ideal solution in justice and logic would be for each country to tax only income arising from sources within its borders. On the assumption, however, that the millennium has not yet arrived, our suggestions below are less ideal but more practical.

Charitable contributions

The Internal Revenue Code, section 23 (o), provides for the deductibility of contributions or gifts to various political units, to certain war veteran organizations and fraternal societies, and to "a corporation, trust, or community chest, fund, or foundation, created or organized in the United States or in any possession thereof or under the law of the United States or of any State or Territory or of any possession of the United States, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for * * *."

Suggested solution

Amend section 23 (o) to read "* * * created or organized in the United States or in any possession thereof or in the country in which the taxpayer is resident or under the law of the United States or of any State or Territory or of any possession of the United States or of the country, or any political subdivision thereof, in which the taxpayer is resident, * * *" or make similar adjustments in the language of section 170 of H. R. 8300.

United States citizens resident in a foreign country are naturally expected to contribute to charities in the country of their residence; they are expected to have, and should have, the same attitude toward the activities of the community in which they live as have their neighbors. It must be readily apparent that the motives which stimulate a contribution to the Canadian Red Cross are not much different from those that stimulate a contribution to the American Red Cross; similarly, the community chest of the foreign town in which the United States citizen is resident as compared to the community chest of his hometown; contributions to the church in the foreign town in which he is resident as compared to contributions to the church in the United States town in which he formerly resided; etc. The fact of the statutory 20 percent limitation on the deductibility of charitable contributions prevents any unlimited avoidance of income taxes via this route. At the same time, it must also be readily apparent that the same United States citizen will have many loyalties to charities back home to which he will want to continue contributing even after he has moved his residence to a foreign land.

The provision in the present Internal Revenue Code limiting the charitable deductions to United States charities is of relatively recent origin, for it dates back only to 1938. Under the Revenue Act of 1936 and prior revenue acts, the deduction of charitable contributions by an individual taxpayer was permitted without being limited to United States organizations. Under the 1936 act, section 23 (o) (2) merely provided for the deduction of specified charitable contributions in language similar to the present law but without making any reference to the country in which the organization was created or located.

Section 23 (o) (2) was amended by the Revenue Act of 1938 to provide that such contributions should be deductible where made to "a domestic corporation,

or domestic trust, or domestic community chest, fund, or foundation." The reason for this change is set out in the report of the House Ways and Means Committee on the revenue bill of 1938 (C. B. 1939-1, pt. 2, p. 742), which states as follows:

"Under the 1936 act the deduction of charitable contributions by *corporations* is limited to contributions made to domestic institutions (sec. 23 (q)). The bill provides that the deduction allowed to taxpayers other than *corporations* be also restricted to contributions made to domestic institutions. The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare. *The United States derives no such benefit from gifts to foreign institutions*, and the proposed limitation is consistent with the above theory.[1] If the recipient, however, is a domestic organization the fact that some portion of its funds is used in other countries for charitable and other purposes (such as missionary and educational purposes) will not affect the deductibility of the gift." [Italic supplied.]

The committee report refers to the similar limitations in the case of corporate charitable contributions. It might be noted that the deduction of corporate charitable contributions was first added to the law by the Revenue Act of 1935 and that from the beginning this deduction was limited to contributions made to domestic organizations. The theory upon which the change as to individual contributions was based, according to the committee report, was that contributions to foreign charities did not relieve the Government from any financial burden and did not result in the promotion of the general welfare.

This provision of the 1938 Revenue Act was further amended by the Revenue Act of 1939 to allow deductions to organizations created or organized in, or under the laws of, any possession of the United States. No further amendments have been made to section 23 (o) (2) on this subject up to the present time.

In view of the relatively short time that this limitation to domestic charities has been a part of the law, it does not appear to be so firmly entrenched as to constitute an integral part of the United States tax law. It seems logical that the policy behind the limitation, a policy not especially surprising as a product of a decade considerably more isolationists and less enlightened than the current one, and a policy shown by the last sentence of the quotation to be inherently contradictory, might well be reexamined at this time—especially as to contributions made to charities in contiguous countries—at the very least when they are the countries of residence of the United States citizens in question.

The United States estate and gift taxes do not limit the deductibility of charitable contributions to bequests or gifts to charitable organizations created or organized in the United States. See section 812 (d) of the Internal Revenue Code (sec. 2055 of H. R. 8300) and section 1004 (a) of the Internal Revenue Code (sec. 2522 of H. R. 8300) for the estate and gift tax provisions, respectively. The income tax should be brought into line with them.

The rationale quoted above in connection with section 23 (o) (2) for distinguishing contributions to United States charities from contributions to other than United States charities—the theory that the Government is compensated for the loss of revenue by being relieved from the financial burden which would otherwise have to be met by appropriations from public funds—is largely fallacious. While this theory might have some validity in the case of orphanages, homes for the indigent, homes for old or disabled persons, or even hospitals and elementary schools, it certainly breaks down in the broad bulk of charitable organizations. In most cases, as a matter of fact, the charitable organizations exist for the specific purpose of performing a function which Government either definitely will not undertake at all or else will undertake on a deficient scale, and private citizens have banded together to fill a void which otherwise would remain empty. Examples could be multiplied almost without end merely by reference to the Internal Revenue Bureau's list of charities approved for tax deductibility purposes, but reference might be made to the Audubon Society, Naval Historical Foundation, the American Bar Foundation, National Geo-

[1] The 1938 rationalization to the effect that the United States does not benefit by the operation of foreign charities has been belied by our whole multi-billion-dollar post-World War II program of loans, grants, etc. The major premise of that program has been that the health, wealth, happiness, and political solidarity of all free peoples are indispensable to the security of the United States.

graphic Society, scholarship funds, research organizations, and specific research campaigns (Cancer Fund, etc.), the March of Dimes, the various military relief societies (Navy Relief Society, etc.), the Seeing Eye Foundation, churches, museums, symphonies and other musical organizations, libraries, literary or artistic groups, missionary societies, some schools of higher and professional and sectarian education, and countless others.

Capital gains

The inclusion of capital gains within section 117 of the Internal Revenue Code results in a double tax on such gains realized by a United States citizen resident in foreign countries that do not tax such gains. I would be happy to furnish the staff of the committee with drafts of several different alternative provisions which would cure this inequity and at the same time prevent any wholesale tax reduction in favor of investment income.

Taxation of capital gains under the United States tax laws puts United States citizens resident in foreign countries which do not tax capital gains in an unfavorable position as compared to both their neighbors and their fellow citizens at home. In Canada, for example, where capital gains are neither included in the definition of income nor separately taxed, it is obviously impossible for United States citizens to deal upon an equal tax basis with Canadian citizens. The solutions which I propose attempt to grant relief in this respect by eliminating the tax on capital gains realized outside the United States by nonresidents of the United States.

The United States citizen residing in Canada, for example, is subject to Canadian income tax upon all of his income regardless of whether such income is derived from Canadian sources or from United States sources. The Canadian income-tax law, however, does not impose any income tax on capital gains as such. Therefore, the United States citizen residing in Canada is required to pay Canadian income tax on all of his income but since capital gains are not included in gross income, they are not a part of the tax base for computing the tax credit.

In order to prevent the double taxation which would arise in cases such as that of a United States citizen residing in Canada, section 131 of the United States Internal Revenue Code (sec. 901–905 of H. R. 8300) was enacted to provide a credit against the United States income tax for income taxes paid to a foreign country. This credit, under section 131 (b) (sec. 904 of H. R. 8300) is limited to the proportion of the United States tax which the taxable income from the foreign sources bears to the entire net income for United States tax purposes. Since the Canadian income-tax law, for example, does not impose any tax on capital gains and since such capital gains are subject to income tax in the United States, the result of the proportionate limitation is ordinarily that a United States citizen residing in Canada will have to pay United States income tax on his capital gains both from Canada and the United States and will not obtain sufficient credit for the Canadian taxes which he pays upon his other income to cover the United States tax on the capital gains arising in the United States. This can be true even when the foreign tax is at a higher rate than the United States tax. In any case where the foreign tax does not specifically cover capital gains, the proportionate credit is changed and the result is that the taxpayer does not get the full credit for the foreign taxes which he has paid and, in addition, is required to pay the United States tax on his capital gains.

When one thinks of a United States citizen, resident for perhaps many years in Canada, who buys a share of stock in a Canadian company through a Canadian broker on a Canadian exchange, holds it in a Canadian safety-deposit box and subsequently sells it through a Canadian broker on a Canadian exchange, it is difficult to see what right the United States Government, which has contributed nothing to the transaction, has to tax the proceeds from it.

It seems logically inferable that in the case of foreign tax bases which do not include capital gains, the base consequently being narrower than if it did include them, the rates must correspondingly be higher. Thus, although the Canadian law theoretically does not tax capital gains, the result for a United States citizen is that the higher rate in practical effect taxes his capital gains by taking his earned income at a higher rate than otherwise in Canada even though the gains are not specifically mentioned in the Canadian law. The failure of the Canadian law to permit any credit for the United States tax on capital gains in practical effect permits Canada to collect a higher tax than it otherwise would and the result is that the United States citizens are subjected to double taxation on such capital gains.

Statute of limitations

It is presently possible for a taxpayer to be whipsawed between the varying periods of limitations in the United States and the country of his residence and thus to have a severe injustice visited upon him. Section 6511 (d) (3) of H. R. 8300 effectively remedies this situation and should be enacted.

ESTATE TAXES

Once again the best solution is logical justice to the estate-tax dilemma would be for a country to tax the descent of only the property located within its borders. We assume again, however, that any such solution is too far advanced for current acceptance and so proceed on the assumption that the present basic systems of estate and succession taxes and the bases for levying them will continue to be citizenship in the case of the United States and domicile in the case of other countries. The two criteria overlap in many cases.

The United States citizen domiciled in Canada, for example, finds it impossible to take advantage of the marital deduction which his fellow citizens domiciled in the United States can utilize in the distribution of their estates by will.

Solution

Modify sections 813 (c) and 936 (c) of the Internal Revenue Code so that the United States estate taxes collected will give credit to the estate for the additional taxes paid in a foreign country by virtue of the absence of any marital deduction there similar to that in the United States.

The 1948 Revenue Act provided for the deduction of up to 50 percent of the gross estate for property left to a surviving spouse if such property is left either outright or in a trust over which the spouse has what amounts to a general power of appointment. The effect of this deduction is to remove half of the decedent's estate from the application of Federal estate taxes. This half of the estate will be subject to United States estate taxes as a part of the spouse's estate on the spouse's death.

If the United States citizen resident in a foreign country shapes his will to take advantage of this tax benefit, his United States estate taxes will be substantially reduced since half of the estate will be taxed on his death and half on his wife's death; both est...es are thus in lower tax brackets than if all the estate had been taxed on the death of the husband. In the foreign country, however, the entire estate may be taxed on the husband's death and all or part of it may be taxed again on the wife's death. This double tax on some or all of the estate more than offsets the advantage gained in the United States taxes by means of the marital deductions. Thus, instead of attempting to take advantage of the martial deduction available to his fellow citizens, it may be more advantageous for the United States citizen residing in a foreign country to leave a life estate to his wife and the remainder to his children or others and, thus, to subject the entire estate to death taxes in both countries on his death but, thus, to eliminate any additional death taxes in either country on the death of the surviving spouse. Some provision should be made whereby the United States citizen residing in a foreign country could have the benefit of the United States martial deduction without subjecting all or part of his estate to a double tax.

GIFT TAX

At the present time a United States citizen resident in a foreign country must pay both a United States and a foreign tax on any gifts he chooses tc make.

Solution

An appropriate credit section, similar to the income-tax credit (I. R. C., sec. 131; secs. 901-905 of H. R. 8300) and the estate tax credit (I. R. C., secs. 813 (c) and 936 (c); sec. 2014 of H. R. 8300) sections, should be enacted.

The United States gift tax is part of an overall tax system applicable to the distribution of a man's assets either inter vivos or upon his death. The gift tax is closely integrated with the estate tax, and was originally enacted to supplement the estate tax and to prevent avoidance of estate taxes by the making of inter vivos gifts which had been up to that time tax free; actually the system is designed, by differences in tax rates and by offering certain other advantages, to encourage distribution, although not tax-free distribution, of an estate during the owner's lifetime. This whole fundamental objective, however, is frustrated

by double taxation on any inter vivos gifts. Hardly could a more effective determent to inter vivos distribution be practically imagined.

CONCLUSION

In view of the present position of the United States in world affairs and in view of the importance attached to the political and economic strengthening of the nations of the free world, every effort should be made to make more rather than less favorable the tax position of United States citizens resident in foreign countries. This statement has endeavored to outline some of the existing problems and some proposed solutions to those problems, and we urge their immediate consideration and as prompt adoption as possible for the good of not only our own country but of the entire free world.

STATEMENT OF COMMITTEE OF EXECUTIVES ON TAXATION OF THE AMERICAN GAS ASSOCIATION, NEW YORK, N. Y. ON H. R. 8300

LIST OF SECTIONS COMMENTED ON

Section:	Subject
104, 105 and 106	Sickness and Disability Benefits.
116	Partial Exclusion of Dividends Received by Individuals.
165	Losses—Worthless Securities—Securities in Affiliated Corporations.
171	Amortizable Bond Premium.
172	Net Operating Loss Deduction.
243	Deduction for Dividends Reveived by Corporations.
247	Dividends Paid on Certain Preferred Stock of Public Utilities.
248	Capital Stock Issuance Expense.
305	Distribution of Stock and Stock Rights.
309	Corporate Distributions—Tax on Transfers in Redemption of Nonparticipating Stock.
331–336	Corporate Liquidations.
391	Effective Date of Subchapter C.
461	General Rule for Taxable Year of Deduction.
481	Adjustments Required by Changes in Method of Accounting.
1341	Computation of Tax Where Taxpayer Restores Substantial Amount Held Under Claim of Right.
1505	Consolidated Returns for Subsequent Years.
1514	Elimination of 2-percent Penalty on Consolidated Returns.
1732	Consolidated Returns—Earnings and Profits.
6016, 6074, 6154, and 6655	Corporate Modified "Pay-As-You-Go" Proposal.

Sections 104, 105, and 106—Sickness and disability benefits

Most gas companies provide sick and disability pay for their employees. In some instances the sick pay is provided through accident or health insurance, with benefits paid to the employees and premiums paid by the employers. Under section 22 (b) (5) of the Internal Revenue Code, the benefits are excluded from gross income subject to tax.

Other companies pay sick benefits directly to their employees, without using an insurance company as an intermediary. In such cases, the benefits paid to employees have been held to be taxable by the Internal Revenue Service and the employer is obliged to withhold income tax on the sick pay.

The necessity to clarify the tax status of sickness and accident benefits, whether under an insured or noninsured plan, by providing a uniform set of rules was recognized by the House Ways and Means Committee and resulted in the inclusion of Sections 104, 105, and 106 in the Internal Revenue Code of 1954.

However, certain provisions of section 105 require further clarification in order to eliminate discrimination between different sick plans of various employers and the increased administrative difficulties of employers in connection with their withholding responsibilities. To eliminate such discrimination and

for further clarification it is recommended that favorable consideration be given to the following suggestions:

1. Distinguish by definition, "compensation for personal injuries or sickness" and "payment of compensation for loss of wages during a period of sickness."

2. For the purpose of defining a qualified employer's accident, sickness or health plan, adopt a definition similar to that contained in subsection 1426 (a) (2) of the 1939 code (relating to the exclusion of such payments from the definition of wages for social-security-tax purposes).

3. No waiting period should be required in order to qualify an employer's plan.

Section 116—Partial exclusion of dividends received by individuals

In section 116 of H. R. 8300, resident individual taxpayers are allowed to exclude from gross income—

(1) $50 of dividends received in the case of taxable years ending after July 31, 1954, and before August 1, 1955; and

(2) $100, in the case of taxable years ending after July 31, 1955.

In addition to the income exclusions under section 116, credits are also provided under section 34 against individual income tax for percentages of dividends received and included in gross income, in taxable years ending after July 31, 1954, as follows:

(1) 5 percent of dividends received after July 31, 1954, and before August 1, 1955; and

(2) 10 percent of dividends received after July 31, 1955.

It is believed that the provisions in sections 34 and 116 of H. R. 8300 constitute desirable steps in the direction of alleviation of double taxation of dividends. It is desired at this time to express appreciation for the earnest consideration given this matter and to urge, as a minimum, that these provisions be retained by the Senate Finance Committee in the bill.

Section 165—Losses—worthless securities—securties in affiliated corporations (capital gains and losses)

An inequity in the existing code results from the nondeductibility by corporations of net long-term capital losses when they are in excess of net short-term capital gains for the current tax year. The fact that capital losses may be carried forward for a period of 5 years as an offset to net capital gains in those years does not relieve the inequity since gas companies ordinarily do not have substantial capital gains.

Such net losses are usually the result of transactions which are an integral and essential part of the corporation's operations. For example, investments have been made in corporations engaged in research for new products for natural gas and oil with the knowledge that partial or complete failures may result in some instances.

If the corporate taxpayer owns less than 80 percent (present law 95 percent) of each class of the capital stock of the corporation invested in, it will not meet the requirements of section 165 (g) (3) (A) of H. R. 8300 for an ordinary loss.

It is urged that in order to arrive at true corporate net income for any tax year, section 165 (g) (3) (A) of H. R. 8300 be amended so that all net losses of corporations in investments, when made for the purpose of advancing their main business, and which are incidental thereto, will be allowed in full as an ordinary loss in the year the loss occurs.

Section 171—Amortizable bond premium

Section 171 (b) (1) (B) restricts the holder of a bond the original call date of which is not more than 3 years from date of issue from amortizing the premium which he paid over a period shorter than that determined by the maturity date of the issue. The objective of such a restriction—to curb the abuse described in the House committee report on page 26—is commendable. However, the provision has a collateral effect on the issuer of the bond in that it will probably hamper flexibility of financing programs in the gas industry.

The effect of this provision will be to discourage new bond issues having a call date earlier than 3 years from date of issue. Largely at the behest of the Securities and Exchange Commission, recent bond flotations in the gas industry have been callable on 30 days' notice. The purpose of such a short call period is to permit the issuer to refund the bonds should changes in the money market so warrant. As a matter of fact, several issues sold last summer or fall at coupon rates ranging up to 4 percent or more are now in the process

of being refunded. If these particular issues had first-call dates no earlier than 8 years from date of issue, such refunding would not now be possible.

In order not to hamper the financing necessary to support the construction program now under way in the gas industry, currently estimated to cost $2.3 billion in 1954-55-56, it is requested that this provision be modified to overcome the objection outlined above.

As a minimum, it is urged that the provision be made effective no earlier than the effective date of the Internal Revenue Code of 1954.

Section 172—Net operating loss deduction (computation of net operating loss)

Section 122 of the Internal Revenue Code of 1939 provides a net operating loss carryover to other years. However, before this loss carryover may be applied as a deduction to taxable income the following adjustments are required to be made to both the taxable year in which the loss occurred and to the net income of each year or years to which the loss may be applied:

1. The excess of percentage depletion over cost depletion must be restored.
2. Wholly tax-exempt interest, less any nondeductible interest paid or accrued to carry the exempt securities must be included in gross income.
3. The net operating loss deduction must be restored.
4. No deduction or credit is given for intercorporate dividends received.

These adjustments to both the year of the loss and the year to which it is carried purported to be justified on the economic-loss theory. However, income taxes are not paid on economic income, but on taxable income, and sound principles of taxation should provide that the carryover provisions apply to taxable income and not to economic income concepts.

Section 172 of H. R. 8300 provides some changes in the above method of computing net operating loss. It eliminates entirely the adjustment for tax-exempt interest received, and while it continues the adjustments for other items in the year giving rise to the loss, it does not require them for the first year to which the loss is carried. This is a partial recognition of the inequities which at present exist in the operation of the loss carryover and carryback provisions, but it does not cure them. The economic loss theory is still retained in part.

The adjustments which are still required in determining the net operating loss under H. R. 8300 by companies having such transactions result in higher taxes being paid by some risky businesses which incur losses in some years, than is paid by less risky businesses with more stable income, and such a result cannot be justified under any equitable theory of taxation.

Therefore it is strongly urged that the adjustments be eliminated not only for the taxable year in which the loss occurred but also for each year or years to which the loss may be carried.

Section 243.—Deduction for dividends received by corporations

Section 243 of H. R. 8300 provides that in the case of a corporation, there shall be allowed as a deduction an amount equal to 85 percent of the amount received as dividends. The deduction allowed by this section is limited by section 246 (b) to an amount not in excess of 85 percent of taxable income. The deduction allowed under this section merely replaces the credit provided in section 26 (b) (1) of the present Internal Revenue Code.

Thus, H. R. 8300 fails to correct the inequity which was recognized by the President in his message to Congress on January 21, 1954, in which it was stated, "I also recommend that the penalty tax on consolidated returns and intercorporate dividends be removed over a 3-year period." The gradual elimination of this inequity, in line with the President's recommendation, could be accomplished by increasing the deduction to 90 percent for the year 1954, 95 percent for the year 1955, and 100 percent thereafter.

Historically, payments of intercorporate dividends have been treated for Federal income-tax purposes as nontaxable transfers of funds from one corporation to another. Prior to the Revenue Act of 1936, a corporation receiving dividends was allowed a deduction in the amount of 100 percent of such dividends and thus incurred no tax thereon. This deduction was allowed because a corporate tax had already been paid upon the earnings which were distributed as dividends. In 1936, with a corporate income tax rate of only 15 percent, the effective tax rate on intercompany dividends was only 2.25 percent. Under the present 52 percent tax rate, the effective rate on intercompany dividends is 78 percent. Thus, the burden of this economically unsound tax has become much more serious than when first imposed.

The only reason for and the only possible justification for taxing intercorporate dividends is contained in a message to Congress by the President of the

United States dated June 19, 1935, in which the then President recommended the substitution of a corporation income tax graduated according to the size of corporation income in place of the then uniform rate of 13¾ percent. The President followed this recommendation with the following:

"Provision should, of course, be made to prevent evasion of such graduated tax on corporate incomes through the device of numerous subsidiaries or affiliates, each of which might technically qualify as a small concern even though all were in fact operated as a single organization. The most effective method of preventing such evasions would be a tax on dividends received by corporations."

This reason, however, should not be controlling as regards the taxation of a public-utility system. In many instances, a regulated public utility is required to furnish part of its services through the medium of subsidiaries. For example, some States require that a utility operating within their geographical limits shall be incorporated within the particular State, even though the separate corporation is a part of an integrated utility system operating in several States. The result is that a separate utility corporation must be set up within the limiting State. In other cases, the use of a subsidiary to supply part of the service, or some of the facilities through which the service is supplied, is required because of joint ownership of property, franchise requirements, or similar causes over which the regulated public utility has no control.

The situations outlined above have prevented many utility companies from merging into one single corporation. In these cases, the utility must, under the present provisions of the Internal Revenue Code, either file a consolidated return, and pay a penalty tax of 2 percent, or pay tax at the rate of 7.8 percent on dividends received from its subsidiaries. There is no real justification for either the penalty or dividend tax, since the utility is forced to pay a Federal tax penalty because of the requirements of State or local law, or other conditions over which the utility has no control.

The following example will illustrate the real burden of tax as corporate earnings pass through the hands of other corporations before distribution to the beneficial owners.

Corporation P (parent company) owns 90 percent of the voting stock of Corporation S. Under existing law, because of the lack of 95 percent stock ownership, neither of the corporations can be included in a consolidated return. Thus, the full impact of the tax on intercompany dividends must be borne under the present law. Here is what happens:

Corporation S with a net income before tax of $1,000,000 pays a tax of	$520,000
And out of its net income after tax pays $432,000 ($480,000 × 0.90) in dividends to Corporation P.	
Corporation P pays a tax of 7.8 percent of its dividends from Corporation S, or a tax of $432,000 × .078	33,696
Thus, the total tax paid is	553,696

In the above example, an effective tax rate of more than 55 percent has been paid. If the system had been operated as a single corporation, the effective rate would not have exceeded 52 percent. Yet the difference between an affiliated group of utilities and a utility which has been able to consolidate all of its operations into a single corporation is only a matter of form.

This obvious inequity should be corrected by eliminating the present tax on dividends from one domestic corporation to another. In the absence of immediate discontinuance of this tax, it is urged that the deduction be increased to 90 percent for the year 1954, 95 percent for the year 1955, and 100 percent thereafter.

Section 247.—Dividends paid on certain preferred stock of public utilities

Under section 247 of H. R. 8300 a public utility is given a deduction for dividends paid on certain of its preferred stock. This deduction is the same as the credit for dividends paid on utility preferred stock now allowed under section 26 (h) of the 1939 code. Under section 275 of H. R. 8300, however, no deduction, otherwise allowable, will be allowed for any amount paid with respect to nonparticipating stock. Inasmuch as preferred stock described in section 247 is nonparticipating stock within the meaning of section 275, no deduction would be allowed for dividends paid on utility preferred stock under the new code; a result obviously not intended.

Section 247 (a) of H. R. 8300 should be amended by inserting before the words "In the case of a public utility," the words "Notwithstanding the provisions of section 275,".

Section 248—Capital stock issuance expense

Section 248 provides that certain organizational expenditures of a corporation may, at its election, be treated as deferred expenses and amortized over not less than the first 5 years of the corporation's existence.

The provision will continue to deny as a deduction from gross income, expenses of a corporation incident to the issuance of its capital stock, such as Securities and Exchange Commission filing fees; State corporate filing fees; State regulatory filing fees; Federal, State, and local taxes; legal, engineering, and accounting services; investment counsel fees; transfer agent and registrar fees; printing, engraving, advertising, selling, and other expenses in connection with issuance of capital stock.

It is common knowledge that large amounts of new money are required continually in the development and expansion of the gas industry. The recurring issuance of stock is thus a regular part of the gas business, and expenses associated therewith are just as much an ordinary and necessary expense as any other operating expense. It is equitable, therefore, that these expenses should be permitted as a deduction in the determination of the net income when they are such an integral part of the year-by-year operations of most gas companies.

The proposed Internal Revenue Code of 1954 should be changed to permit an election to deduct currently or amortize the expense of each capital stock issue.

Section 305—Distribution of stock and stock rights

The normal refinancing of a preferred stock often incorporates an offer of exchange of new preferred stock or new bonds for presently outstanding preferred stock or bonds, with the unexchanged stock or bond being redeemed pursuant to a call provision.

Section 305 (c) (1) (B) may treat these normal call provisions as options, with the result that they take the form of an exchange but are taxed to the holder as a redemption.

It is suggested that section 305 (c) (1) be clarified so that an option shall not be deemed to be held by a shareholder by reason of the presence or exercise of a call or redemption provision.

Section 309—Corporate distributions—Tax on transfers in redemption of nonparticipating stock

This section was inserted to prevent the withdrawal of earnings from a corporation at capital gain rates instead of at ordinary income rates. To the extent that it achieves its purpose, it is worthy of retention. It operates by levying a transfer tax at the rate of 85 percent on money and property paid out by the corporation in redemption of preferred stock, with certain exceptions.

One of the exceptions provides, in effect, that if preferred stock was issued for securities or property, the transfer tax applies only to the money or property paid out in redemption which exceeds 105 percent of the value of the money or property paid in at the time the stock was issued.

Many preferred stocks which were issued for cash in public sales bear call prices in excess of 105 percent of the proceeds of sale. For instance, a list of 323 utility preferred stocks compiled by Spencer Trask & Co., a large brokerage firm, on June 15, 1953, includes 158 issues the call prices of which are in excess of 105. Many of the issues in this list were sold at competitive bidding. From time to time it is desirable for the issuing company to redeem these stocks. A frequent reason for such redemptions, particularly in the gas industry, is a change in the money market which makes possible the refunding of preferred stock with new preferred stock bearing a lower dividend rate. This type of transaction in a publicly held corporation is a legitimate business transaction in which tax avoidance is not a consideration. Under section 309, however, such a redemption at a call price in excess of 105 cannot be made prior to January 1, 1964, regardless of the date of issuance of the stock, without the transfer tax being applied to the proceeds of redemption in excess of 105.

The provisions relating to the redemption of nonparticipating stock should be changed to make clear that corporations whose ownership is as widely distributed as that of most public utilities can refinance or redeem their nonparticipating stock without being subjected to the severe penalty now proposed.

Sections 331–336—Corporate liquidations

Under the present code, the merger or liquidation of a subsidiary into the parent corporation normally results in no income or loss to either the parent or the subsidiary corporation. Such a transaction is governed by section 112 (b) (6). Section 113 (a) (15) provides that the basis of the assets of the sub-

sidiary in the hands of the parent shall be the same as in the hands of the subsidiary. Section 112 (b) (6) has no precise counterpart in H. R. 8300. All corporate liquidations are covered by new sections 331 through 336, inclusive.

Whether or not a liquidation results in gain or loss to the shareholders of the liquidated corporation under section 331 would depend on the relationship to each other of the (1) fair market value of the assets distributed, (2) the adjusted basis of the assets distributed, and (3) the adjusted basis of the stock redeemed. The extent of such gain or loss, if any, and the basis of the assets in the hands of the distributee shareholder all would require that the fair market value of the assets distributed, both individually and in the aggregate, be ascertained.

The determination of fair market value of assets distributed presents particularly difficult problems for the gas industry. Most of the assets of a utility consist of specially designed plant and equipment required to furnish service to its customers. This plant and equipment has little if any commercial value other than for the purpose for which it was built. Hence, the determination of fair market value would present almost insurmountable problems to the utility, particularly where the earnings experience is less than a fair rate of return on the net investment in assets.

If the basis of assets received in liquidation as provided under section 334 is the fair market value of the assets at the time of distribution, the utility will be required to maintain different property records for tax and for regulatory purposes. This conflict arises from the requirements of regulatory authorities, such as the Federal Power Commission, that the utilities under their jurisdiction maintain their property records on a cost basis.

It is therefore urged that taxpayers be given an election to be governed by the existing sections 112 (b) (6) and 113 (a) (15) or by the new sections 331 to 336.

Section 391—Effective date of subchapter C

Subchapter C of H. R. 8300 deals with corporate distributions and adjustments. As is stated on page 34 of the House committee report, "* * * your committee's bill represents a complete structural overhaul of existing law in this area." The provisions of this subchapter are made effective by section 391 to transfers or distributions occurring after March 1, 1954.

Because of the sweeping changes made and the complexity of the new provisions, taxpayers will need additional time to study and understand subchapter C. Moreover, it is inequitable to apply the changes in the law to the many pending transactions which were begun in good faith prior to March 1, but which have not yet been completed.

It is therefore recommended that the provisions of the proposed code affecting corporate distributions and adjustments not be applied to transfers and distributions occurring prior to January 1, 1955.

Section 461—General rule for taxable year of deduction

Section 461 (c) (1) of H. R. 8300 requires a taxpayer who reports income and deductions on the accrual basis to accrue real property taxes ratably over the period to which such taxes are related. Section 461 (c) (2) provides that the foregoing rule does not, however, apply to any real property tax to the extent that such tax was allowable as a deduction under the 1939 code for any taxable year beginning before January 1, 1954. The operation of these two provisions may result in considerable inequity to some accrual basis taxpayers for the year 1954. That inequity can be illustrated by the following situation.

In most States and taxing subdivisions thereof, real property assessments are made on other than calendar-year bases. Under practice approved by the Commissioner of Internal Revenue for many years, an accrual-basis taxpayer may accrue real-property taxes as of the lien date, even though such taxes are for the succeeding taxable year. Hence, such taxpayers can accrue on their 1953 Federal income-tax returns real-estate taxes assessed during that year even though the tax so assessed is in fact attributable in whole or in part to 1954.

For example, under section 461 (c) (2) of H. R. 8300, an accrual-basis taxpayer who had accrued as of July 1, 1953, real-estate tax attributable to 1954 would thus be denied any deduction on his 1954 return for real-estate taxes. The reason for such a result is that the real-estate tax assessed as of July 1, 1954, could be deducted only in 1955 under H. R. 8300 inasmuch as such tax is attributable to that year. Unless, therefore, a deduction is allowed on the 1954 return for real-estate taxes, a heavy and inequitable penalty is inflicted on the taxpayer for 1954.

The elimination of such a penalty is clearly indicated, since Congress obviously did not intend such a result. It is suggested that the taxpayer be given an

election to continue the method heretofore consistently followed in accruing real-property taxes.

Section 481—Adjustments required by changes in method of accounting

Section 481 provides that "In computing the taxpayer's taxable income for any taxable year, if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding year was computed, then 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 entirely omitted."

On page A164 of the report of the Committee on Ways and Means of the House of Representatives, it is stated, "It is only those omissions or doubling ups which are due to the change in method which must be adjusted."

Such a provision, however, will apply inequitably to taxpayers whose accounting is prescribed by the Federal Power Commission and by the various State regulatory commissions.

For example, for some years natural gas companies subject to regulation by the Federal Power Commission or State public service commissions have been storing natural gas underground in depleted gas sands or other formations favorable for the storage of gas.

Under the uniform system of accounts prescribed for natural gas companies by the Federal Power Commission, it has been provided that the inventory of gas stored underground shall be priced at cost and that "transmission expenses for facilities used in moving the gas to the storage area and expenses of storage facilities shall not be included in the inventory of gas except as may be authorized by the Commission."

It is believed that this method meets the requirement of section 22 (c) of the 1939 code and section 471 of the proposed new code in that it conforms to the best accounting practice in the trade or business and most clearly reflects the income.

The Federal Power Commission has proposed a change of accounting practice in its docket R-130, in which the cost of transmission and storage would be added to the cost of the inventories of gas stored.

If the Federal Power Commission's proposed rule should be adopted, the Secretary or his delegate might consider the accounting change one that would authorize the application of section 481 and would make retroactive adjustments of inventories vastly exceeding the amount of such adjustments effected and recognized by the Federal Power Commission. For example, even though the Federal Power Commission's change would take effect with only the inventory increments in the current year, the Secretary or his delegate might undertake like adjustments for periods of years prior thereto.

To avoid this result, there should be a clear expression in the code that an accounting change instituted by a regulatory authority and in turn elected by the taxpayer or imposed by the Secretary or his delegate, shall have no greater retroactive effect than that created by the regulatory authority.

This may be accomplished by adding to subsection (b) of section 481 the following:

"(3) The change in the method of accounting is required by a regulatory authority having jurisdiction over the rates of the corporation, the adjustments taken into account under subsection (a) shall have no greater retroactive effect than that created by the regulatory authority."

Section 1341—Computation of tax where taxpayer restores substantial amount held under claim of right

Section 1341 provides for an alternative computation of tax where a taxpayer restores a substantial amount which was included in gross income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to the item of income.

The section is specifically made inapplicable to sales of stock in trade or property of a kind properly includible in inventory. The report of the Committee on Ways and Means of the House of Representatives at page A294 indicates that the reason for this is that "an accrual basis taxpayer may instead estimate sales returns and guaranties in accordance with section 462."

Taxpayers subject to regulation are frequently in the position of collecting revenue during a period in which their rates are under review by a regulatory authority. As the result of the decision of the regulatory authority, they may be required to refund to their customers amounts included in gross income in a prior taxable year.

In order to make it clear that the relief will apply to taxpayers subject to State and Federal regulation, section 1341 (b) (2) should be amended by changing the period at the end to a comma, and adding the following:

"unless the deduction arises out of refunds or repayments required to be made by a corporation whose rates are fixed by a State or political subdivision thereof, or by a public service or public-utility commission of a State, or a political subdivision thereof, or of the District of Columbia, or by an agency or instrumentality of the United States."

Section 1505—Consolidated returns for subsequent years

Section 1505 provides that if a consolidated return is made for a taxable year, a consolidated return must be filed for subsequent years unless subsequent to the election the code has been amended so as to make consolidated returns substantially less advantageous than separate returns. Furthermore, the expiration of any provision in the code is considered an amendment.

However, the report of the Ways and Means Committee, page A298, indicates that the applicable year of the change is not to be considered, and that if an affiliated group files a consolidated return for the calendar year 1953 subsequent to the date of enactment of the Internal Revenue Code of 1954, it must file a consolidated return for the taxable year 1954. This is required even though the new code does not take effect until 1954, and even though the excess-profits-tax provisions expired in 1953.

This particular provision of the section is inequitable, and a new election should be given in the first applicable year of any amendment to the code that makes it substantially less advantageous to file consolidated returns.

This correction of H. R. 8300 may be accomplished by striking the clause "regardless of the effective date of such amendment" from subsection (a) (2) of section 1505.

Section 1514—Elimination of 2 percent penalty on consolidated returns

H. R. 8300 continues the present 2 percent penalty when consolidated returns are filed. For the reasons outlined below, we feel that the imposition of this penalty can no longer be justified and that it should be eliminated. Similar conclusions were reached by two congressional committees:

First:

"* * * Your committee recommends that this additional tax be eliminated. It sees no justification for it. The provisions for consolidated returns under the present law and regulations recognize sound accounting practices and require tax liabilities to be determined on the basis of the true net income of the enterprise as a whole. No improper benefits are obtained from the privilege. Your committee believes that it is highly desirable, both from the point of view of the administration of our tax laws and the convenience of the taxpayer, that the filing of consolidated returns by affiliated groups of corporations be continued, particularly in view of the changes made in the Revenue Act of 1928 and in the regulations promulgated by the Secretary of the Treasury thereunder. It is difficulty to justify the exaction of a price for the use of this form of return. * * *"

Second:

"* * * Your committee considered at length the question of abolishing the consolidated return. Our subcommittee originally recommended this action. The Treasury believed this policy undesirable. The Treasury pointed out that the one way to secure a correct statement of income from affiliated corporations is to require a consolidated return, with all intercompany transactions eliminated. Otherwise, profits and losses may be shifted from one wholly owned subsidiary to another, and their separate statements of income do not present an accurate picture of the earnings of the group as a whole. For all practical purposes, the various subsidiaries, though technically distinct entities, are actually branches or departments of one enterprise. For these reasons, consolidated statements of income have been the rule for ordinary business purposes, and for 10 years, the income-tax law has provided for consolidated returns. The administration of the income-tax law is simpler with the consolidated return since it conforms to ordinary business practice; enables the Treasury to deal with a single taxpayer instead of many subsidiaries; and eliminates the necessity of examining the bona fides of thousands of intercompany transactions.

"Consequently, after careful consideration of the question, the committee decided that it would be undesirable to abolish the consolidated return at this time. It appeared in the hearings that such action would be especially burdensome to

many corporations, such as the railroads, which are frequently obliged to maintain separate corporate structures in the several States in which they operate, although for all ordinary business and accounting purposes, the subsidiaries form a single operating system. * * *"

The first of the foregoing statements was made by the Senate Finance Committee in May 1932, the second by the Committee on Ways and Means in February 1934. Both were correct when made, both very nearly cover the situation today.

In addition, the President, in his budget message of January 21, 1954, recommended that the penalty tax on consolidated returns be eliminated.

Many public utility systems are required to operate through the medium of subsidiaries because of State laws, franchise requirements, etc. For example, some States require that a utility operating within their geographical limits shall be incorporated within the particular State, even though the separate corporation is a part of an integrated utility system operating in several States. The result is that a separate utility corporation must be set up within the limiting State. In other cases, the use of a subsidiary to supply part of the service, or some of the facilities through which the service is supplied, is required because of joint ownership of property, franchise requirements, or similar causes over which the regulated public utility has no control. Thus, we feel that it is improper to require the payment of a Federal tax penalty because of the requirements of State or local law, or other conditions over which the utility has no control.

At the time the penalty tax was first imposed by the Revenue Act of 1932, one of the arguments in support thereof was that the filing of a consolidated return was of great benefit because the loss of one corporation could be used to reduce the net income of another. With the present and proposed carryover provisions, separate corporations are permitted to take advantage of net losses within a period of several years. Hence, the consolidated group does not have the advantage over the separate corporation as existed when no such carryover provisions were included in the code and this argument can no longer be used to support a penalty tax.

Thus, there remains no justification for the 2-percent penalty when consolidated returns are filed. We strongly urge that this penalty be eliminated.

If the immediate discontinuance is not feasible because of revenue needs, it is urged that the penalty be progressively eliminated over the next 3 years.

Section 1732—Consolidated returns, earnings and profits

This section provides for an election of a method for allocation of consolidated income-tax liabilities among the various members of the group for earnings and profits purposes in the first consolidated return to be filed for a taxable year beginning after December 31, 1953. Once an election is made, the particular method of allocation must be continued as long as consolidated returns are filed. Most gas companies filing consolidated returns allocate the consolidated return tax liabilities in accordance with rules prescribed by the Securities and Exchange Commission. It is possible that subsequent to the enactment of the proposed code that SEC might change its method of allocation of consolidated tax liabilities. The rules outlined in section 1732 do not provide for such a contingency with the result that one method of allocation would be used for Federal income tax purposes and another method would be used for SEC purposes.

This objection to section 1732 would be obviated by providing that subsection (a) (4) thereof be changed as follows:

"(4) The tax liability of the group may be allocated in accord with any other method selected by the group at any time with the approval of the Secretary or his delegate."

Sections 6016, 6074, 6154, and 6655—Corporate Modified "Pay-as-You-Go" Proposal

H. R. 8300 would require certain corporate taxpayers to estimate, declare, and pay a portion of their normal tax and surtax during the current taxable year.

The operation of the proposal would more often than not result in the payment of tax on income which is not earned, or is indeterminate, as of the date of payment. A law is unjust if it forces a taxpayer, whether corporate or individual, to estimate income, which cannot be determined with finality until many months later, and then levies a penalty for failure to make a satisfactory estimate.

The periodic determination of taxable income is on the basis of the calendar or fiscal year. Corporations should not, as a matter of principle, be forced to determine taxable income on a basis other than a completed taxable year, even

though such requirement may be rationalized by the use of the word "estimate."

It may well be true that the irregularity of tax receipts increases the problems of managing the public debt and is an unsettling influence in the money market. It is equally true that the irregularity of corporate taxable income also makes it harder for corporations to manage their financing.

Therefore, it is submitted that the solution of problems of managing the public debt should not give rise to even greater problems in corporate financing. That such greater problems would arise is particularly evident in the gas industry, in which seasonal variations of receipts and expenditures are substantial and depend on such imponderables as the weather, the public regulation of gas rates, and the results of exploration for gas.

STATEMENT OF WILLIAM B. BARNES, MUNCIE, IND., ON SECTION 1235, H. R. 8300

My name is William B. Barnes. I am a resident of Muncie, Ind., a professional mechanical engineer (Indiana Registry No. 5412) for the past 34 years specializing in automotive engineering, subsequently to receiving the first of two university degrees appropriate to the field of my endeavors. For the past 22 years I have been in business for myself, my livelihood coming almost entirely from the proceeds of the sale of patent rights created solely by my own personal efforts.

This statement is for the purpose of presenting objections to certain provisions of section 1235, which, if enacted into law, will almost certainly reduce to the vanishing point what little remains of the badly-needed incentive to the inventive effort which has been the cornerstone of our great industrial growth, is now the basis of much of our present strength, and may, on some future day, tip the balance which ultimately supports our country's final defense. In the order of the appearance of these objectionable features in the measure:

(1) Objection is taken to the sweeping restriction of capital asset treatment to the creator of the invention, ignoring the property rights of others without whose support, in one form or another, the invention could not have been brought to a workable stage. As inventions rise in importance above the status of mere gadgetry, their complication increases, and even in the stages of relatively crude development, their costs rise beyond the means of most inventors, especially the younger ones, the beginners who need encouragement most. Common procedure is to enlist the support of others, usually relatives or friends, who chip in, either with or without incorporation, for a share of the risks and a share of the ownership and the net prolts therefrom. Those embarking upon such speculative ventures are well aware of the risks, and only the hope of making (and keeping) better-than-ordinary returns will ever stimulate such ventures with their high probability of total loss; there are too many other forms of speculation with less risk. Perhaps of greater need is a form of moral support, statistically (and coldly) evident in the records of the United States Patent Office, which reveal that many wives of inventors share in the ownership of their husbands' inventions. While many of these wives have doubtless made financial contributions to such enterprises, the great majority of such assignments are in consideration of their patient endurance of varying degrees of privation, as in my case, during the years before the returns come in. It can hardly be disputed, that without a wife's patient understanding during such periods, the home can be a little hell in which the so-called flame of inventive genius can easily be extinguished. In all common fairness, should her rights be ignored in a sweeping restriction probably aimed at the large corporations?

As a matter of information for your committee, long and fairly wide experience in such matters qualifies me to state that the large corporations almost invariably do not speculate in patent rights. When they acquire such rights, it is for the primary purpose of manufacturing and selling the patented article. They may exchange licenses with competitors, or they may grant licenses for money considerations, but they very seldom sell them outright. If this restriction is intended for the corporate speculator, it is aimed at a phantom target. But it will discourage a small but vital segment of the American system of free enterprise, and it might as well be aimed at the inventor himself as at the financial and other more personal forms of backing, without which the small operator cannot exist.

(2) Objection is taken to the provision that the inventor must retain no interest whatsoever in the patent right except as to installment payment rights

therefor. What about his right to sue third-party infringers in order to protect his proceeds from the sale, which, for reasons of sales policy, the buyer cannot do, because the infringer is frequently a customer? Common procedure is for the seller to grant an exclusive license to the buyer, retaining the bare legal title to the patent, giving him the right to sue infringers. The United States Supreme Court has held that the grant of an exclusive license is a sale of the invention (*Waterman* v. *MacKenzie*, 1892), and a long, and continuing, series of decisions from the various Federal courts beginning with the Myers case in 1946 (68 U. S. P. Q. 346) has upheld capital gains status of such transactions.

Is it intended that the small operator be denied capital-gains benefits, unless he is willing to be placed in a position where he would be denied the right to take independent action, in court, to protect the proceeds of his sale, against the numerous potential infringers who are certain to appear, about in proportion to the extent to which his invention is of value to society?

(3) Objection is taken to the provision that the entire proceeds of the sale must be taken within 5 years of the date thereof, if capital gains treatment is to be accorded to such proceeds. Is it intended thereby to deny capital-gains treatment to the returns from practically all inventive effort above the level of the most trifling gadgetry? It may, and frequently does, require 5 years and more to get inventions in the serious technologies developed to the stage of marketability. No buyer of such inventions is willing, in any such period, to make payment therefor in any amount exceeding a small percentage of what the seller would consider to be its true worth; he simply will not take any such gamble. On the other hand, if the seller will take his chances along with the buyer, with a small portion (perhaps under 1 percent) of the selling price of each unit as sold, as his return, that return over the 17-year life of the patent may be quite substantial, if his invention serves society well.

This last provision, for all practical purposes, completely denies capital gains treatment to even the creator of any returns from the sale of patent rights, unless the sale is made under conditions whereby he cannot possibly get adequate returns. Just what, if anything, it attractive in such return for a dedication to hard work, with a high probability of failure and total loss?

These three provisions are objectionable because they bear adversely upon certain aspects of established practices long and generally employed to assure adequate returns from the sale of patent rights. These practical considerations are well understood by those with experience in independent activity in the fields of invention, although they may not be familiar to others. Apparently, such qualified observers had no opportunity to submit either oral or written statements relative to the proposed provisions when they were under consideration by the House Ways and Means Committee; if such competent advice had been available to that committee, it almost certainly would not have advanced these objectionable provisions to their present status. The committee evidently recognized the need for giving encouragement to the development of new inventions, because, in reporting out the new code to the House, it made the following statement relative to its purpose in reporting out section 1235: "The present distinction between amateur and professional inventors and between royalty income and installment payments is both arbitrary and confusing. Moreover, the present treatment tends to discourage scientific work." If section 1235 is any less confusing than the present treatment, its restrictions are even more arbitrary.

It is respectfully urged that the proposed remedy is worse than the conditions it was intended to rectify, and that, rather than enact the proposed section 1235, it would be preferable to let the present treatment stand unchanged rather than discourage inventive activity further. The courts have largely reduced the confusion, and to some extent, the arbitrary treatment under the present system, for many inventor-taxpayers who have asserted their rights in court. Such procedure is an exhausting and expensive nuisance, and an unnecessary burden upon the courts, but it is preferable to new legislation whose restrictions clearly reduce incentive to the vanishing point.

The potentials for inventive output are one of our greatest natural resources. It differs from other natural resources in the peculiar characteristic that it is at the same time a wasting asset and an inexhaustible one. It is a wasting asset because it involves human effort, lost with the mere passage of time, if not availed of. It is an inexhaustible asset because it comes from the minds of men, and expands with exercise. It thrives only with development and use.

It has been an established policy of Congress to encourage the development of other natural resources by favorable tax treatment, at some cost to the Treasury Department's returns, to be made up from some other segment of the economy.

Bearing in mind that your committee must be always mindful of the Treasury Department's well-established needs, it is submitted that any cost from tax concessions at the inventive source is not only self-liquidating, but pays handsome returns in taxes on the commercial profits of any enterprise arising from such stimulation. As a concrete example, believed to be conservatively representative, in 1954, the corporate profits taxes from sales of finished devices will yield at least $100 for each dollar that I would pay in income taxes, at ordinary rates, on the proceeds from the sale of the underlying inventions. Bearing in mind that tax sources based on inventions are pulled from the air, in general, the tax proceeds from such sources do not represent a redistribution of taxes which are already assured; they are new taxes from new sources. Of all the interested parties, the Treasury Department stands to gain the most from increased incentive to inventive activity, or to be the biggest loser as these incentives are decreased. If, to increase such incentives, your committees should consider the complete exemption from all income taxation of the proceeds from inventive activity, it should be remembered that only successful inventive ventures earn taxable income; and they earn it only as others have taxable earnings many times as large, from the same inventive roots. If such tax inducement should fail as an incentive, or if the inventive ventures prove unsuccessful, such concessions represent no losses in tax collections whatsoever. The returns from successful inventions would insure tax gains of 100 to 1, or better, on their cost. Probably no other venture in Government financing is so completely assured of favorable returns.

If, for other reasons of public policy, your committee cannot consider such exemption, it is respectfully urged that, recognizing that a patent right is a property, accord the proceeds from its sale the right to capital gains treatment, without limitations as to ownership, or to the manner in which the installment payments are received, or to reservations made by the seller to enforce his rights against infringement.

When this writer first considered the venture into inventive activity as a means of livelihood, the uncertainties as to returns were present in 1929, as now, but there was the possibility of keeping most of those returns. Anyone contemplating such a considered risk in 1954 faces the probability of those uncertain returns being largely lost through taxation. It is easily understandable why the annual filings of patent applications per unit of population have fallen off to about half the rate of 1920. It is apparently not worth the trouble and the risks.

Contrary to what may be a widespread misconception, the records of the Patent Office will reveal that most of the inventive activity is not carried on by the "kept" inventors, employed by the large corporations, but by those working independently, with neither an economic cushion under them, nor a ceiling of opportunity over them. For them, it is the venture of a lifetime, and the one incentive is the pot of gold at the rainbow's end. But there is little incentive to follow the rainbow to its end, only to have taxation take the gold, and be left holding the pot.

Statement of James A. Gorman, President, the National Society of Public Accountants

We are aware that the Committee on Ways and Means of the House of Representatives has worked long and diligently to revise the Internal Revenue Code with a view toward simplifying this extremely complex body of tax law and, at the same time, attempting to eliminate the many inequities which have developed over the years. The members of that committee brought wisdom and patience to bear on a task which required a full measure of each. We are certain that the members of the Senate Finance Committee will complement the work of their colleagues on the House side and that the citizens of our country will be the beneficiaries of this joint effort. It is in the spirit of cooperation that our society—as the spokesman for practicing public accountants the country over—offers these suggestions for your consideration.

The members of our organization are vitally interested in this legislation for reasons which are obvious. The Commissioner of Internal Revenue has estimated that 6½ million taxpayers receive professional help in the preparation of their tax returns. The public accountant renders the lion's share of this service. Moreover, when a dispute arises between the taxpayer and his Government with respect to a tax liability, it is the public accountant who must relate accounting

data to code provisions in an effort to reach a settlement which is fair to his client and to the Government.

We recognize that the House Committee on Ways and Means has done much to improve many of the specific sections to which we refer below; however, we remain convinced that the adoption of our recommendations, as set forth below, would result in even greater improvement.

(*a*) We recommend that section 53 (a) of the Internal Revenue Code be amended so as to provide that tax returns, individual, partnership, and corporation, for the calendar year, be filed on or before April 15 of each calendar year instead of March 15, and that a tax return made on a basis of a fiscal year, be made on or before the 15th day of the 4th month following the close of the fiscal period.

(*b*) That sections 58 (a), 58 (d), 60 (a), and 60 (c) of the Internal Revenue Code be amended to provide that individuals who are employed during a calendar year and file form W-2, shall not be required to file an estimated tax return on or before March 15 of each calendar year, but must file a final income tax return, form 1040, on or before February 15 of each calendar year, and further recommended that this provision be applied to those individuals engaged in agriculture.

(*c*) That sections 294d (1) and 295d (2) of the Internal Revenue Code be amended to provide that the penalty for failure to file an estimated tax return or a gross underestimation of tax, or for failure to pay the tax, be limited to an offer in compromise with interest not to exceed 3 percent of the tax involved, prorated over a period of 1 year.

(*d*) That section 58 (d) of the Internal Revenue Code be amended to provide that an estimated tax return for individuals, except those exempted under section 58 (d), must be filed on or before June 15 of each year, with payments of estimated tax being made quarterly, with final date of payment being March 15 of the following year.

(*e*) That sections 292 (a) and 377 (a) of the Internal Revenue Code be amended to provide that interest on tax deficiencies be reduced from 6 percent to 3 percent, and that on claims for refund, the interest rate be reduced to 3 percent of the amount refunded.

(*f*) That section 25 (b) (3) of the Internal Revenue Code be clarified, so that the test of dependency will not discriminate against individuals who support their aged parents or other relatives residing in the household of the taxpayer.

(*g*) That section 12 (c) of the Internal Revenue Code be amended to provide that an individual who is single and supports his or her family, be granted an additional exemption of $600 if necessary to employ some person to care for his or her dependents, and that all handicapped individuals be granted the same exemption as now provided for the blind.

(*h*) That in all cases in which fraud is involved, the Commissioner of Internal Revenue or his agents be required to notify the taxpayer by letter that he is under investigation for fraud, and that the Commissioner be further required to advise the taxpayer as to his constitutional rights to be represented by counsel.

(*i*) That section 272 (a) (1) of the Internal Revenue Code be amended so as to provide that in cases where a deficiency has been determined, the letter of transmittal to the taxpayer be in such form as to show a detailed statement of all proposed changes.

(*j*) That sections 3693 (c) and 3701 (c) of the Internal Revenue Code be amended so as to provide that in the case of a jeopardy assessment by the Commissioner or the Director of Internal Revenue, said Commissioner or Director of Internal Revenue be prohibited from disposing of the property of the taxpayer seized under said warrant of distraint until a final determination of the tax liability by the Tax Court of the United States.

(*k*) That section 276 (b) of the Internal Revenue Code be amended to provide that where the Commissioner requests a waiver of the statute of limitations from the taxpayer, at the time of the executing of said waiver all interest on the deficiency be stopped until said deficiency shall have been finally determined by the Commissioner.

(*l*) That section 1100 of the Internal Revenue Code be amended to provide that the Tax Court of the United States be made a court of record, and that the Commissioner of Internal Revenue be required to publish their decisions and so instruct his field force. However, if the Commissioner does not agree with the decision of the Tax Court of the United States, he be required to appeal said decision to the United States Court of Appeals.

STATEMENT OF THE NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS CONTAINING THE SOCIETY'S RECOMMENDATIONS RELATIVE TO H. R. 8300, INTERNAL REVENUE CODE OF 1954, SUBMITTED FOR THE CONSIDERATION OF THE UNITED STATES SENATE COMMITTEE ON FINANCE

PART II

Since filing our earlier statement on this bill, another inequity in the existing tax laws has been brought to our attention by members in the West. Section 23 (c) (1) (E) and Treasury Income Tax Regulations 118, paragraph 39.23 (c)-3, treat assessments *by an irrigation district*—even though these assessments are of a *general* nature against *all* the land within the district—as local benefits. Hence, only that portion of the assessment which can be attributed to maintenance and repair or interest charges can be claimed as a deduction for Federal income tax purposes. If, however, the taxpayer resides in a district for which *the county* collects funds along with county taxes, even though the funds are payments toward similar permanent capital assets, they are fully deductible. In other words, the distinction is based on the agency which collects the funds rather than the use to which they are put. Taxwise, this appears to be a distinction without a difference.

The laws of California are very specific on this question, allowing as a deduction from gross income "any irrigation or other water district taxes or assessments which are levied for the payment of the principal of any improvement or other bonds for which a *general* assessment on *all* lands within the district is levied as distinguished from a special assessment levied on part of the area within the district." Moreover, the Water Code of California declares assessments of such districts to be charges for services furnished and not a capital investment of the landowners.

H. R. 6007 (exhibit I) introduced by Congressman Phillips was drafted to correct the tax inequities outlined above. We urge your committee to adopt this amendment as a part of H. R. 8300.

JAMES A. GORMAN, *President.*

EXHIBIT I

[H. R. 6007, 83d Cong., 1st sess.]

A BILL To amend the Internal Revenue Code to permit certain water district taxes to be deducted from gross income

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 23 (c) (1) (E) of the Internal Revenue Code (relating to deduction for taxes) is hereby amended by inserting before the semicolon at the end thereof the following: ", nor shall this paragraph exclude the allowance as a deduction of any irrigation or other water district taxes or assessments which are levied for the payment of the principal of any improvement or other bonds for which a general assessment on all lands within the district is levied as distinguished from a special assessment levied on part of the area within the district".

SEC. 2. The amendment made by the first section of this Act shall apply only with respect to taxable years ending after the date of the enactment of this Act.

(Whereupon, at 12:43 p. m., the committee recessed, to reconvene at 10 a. m., Monday, April 19, 1954.)

THE INTERNAL REVENUE CODE OF 1954

MONDAY, APRIL 19, 1954

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

The committee met, pursuant to recess, in room 312, Senate Office Building, at 10:05 a. m., Senator Eugene D. Millikin (chairman) presiding.

Present: Senators Millikin, Butler, Flanders, Malone, Carlson, George, Frear.

The CHAIRMAN. The meeting will come to order. Mr. Fernald. We are glad to see you, Mr. Fernald. Sit down and be comfortable. Identify yourself to the reporter.

STATEMENT OF HENRY B. FERNALD, CHAIRMAN, TAX COMMITTEE, AMERICAN MINING CONGRESS

Mr. FERNALD. I am Henry B. Fernald, of Montclair, N. J., chairman of the tax committee of the American Mining Congress. I am appearing on behalf of the mining industry with respect to the pending bill H. R. 8300, Internal Revenue Code of 1954. Speaking briefly, I can mention only a few points, noting others in statements I shall file with you.

First, as to the bill in general: We appreciate the immense amount of work in its preparation, with a result far better than many of us felt would be possible. Some revision we believe should be made before its passage, which will not change the purpose of the bill, will better express its intent, enable it better to carry out the thought expressed in the committee report, and will aid in its administration.

Undoubtedly some changes will prove necessary after its passage, and as these become manifest, there should be a willingness to make needed amendments.

We accordingly urge the passage of this bill, with such revisions as we believe can and should be made prior to enactment.

We particularly urge the following points for revision:

1. DEPLETION, SECTIONS 611–614, PERCENTAGE DEPLETION

We are in accord with the plan of the bill to include a blanket provision extending percentage depletion to minerals in general, and to omit the discovery depletion provision.

Some do not like to see their minerals, previously specified, no longer mentioned by name, fearful that adverse inference may be drawn therefrom. A major reason, however, for their disturbance,

and for disturbance of others who would be newly included in the blanket clause, is because of the limitations or qualifications written into section 613 (b) (6).

The first qualification is that a 5 percent, rather than a 15 percent, rate shall apply to such "other minerals" when "used or sold for use as riprap, ballast, road material, rubble, concrete aggregates, dimension stone, ornamental stone, or for similar purposes." As written, the taxpayer might be put to a negative proof of ultimate use of all or some part of the mineral. If, for example, rock containing a valuable mineral were sold for its mineral content, the taxpayer certainly should not be prejudiced if some remainder, after extraction of the valuable mineral, should be used for road fill or similar purpose. The law should make this clear by amending the section to read "when used, or sold for use, by the mine owner or operator as * * *."

Further qualifications are set forth in subparagraph (B). Exclusion from percentage depletion of "minerals from sea water or the air" does not seem objectionable, since it is merely the expression of an existing rule that the taxpayer has no depletable interest in minerals in place in the air or in sea water. The difficulty comes with the further wording which would make the exclusion applicable to minerals "from sources which, by commonly accepted economic standards, are regarded as inexhaustible." This is new wording, never heretofore used, and is subject to much uncertainty as to its meaning and the burden of proof it might impose on the taxpayer. One reason for adopting percentage depletion was the difficulty of establishing what mineral there might be below the surface in any property, its extent, its character, and its recoverability. No such test should now be reimposed. We believe the full intent would be met by making the specification read simply "minerals from sea water, the air, or similar inexhaustible sources."

We understand there is no intention to allow depletion on ordinary water, although water itself may be classed as mineral. This purpose could be clearly evidenced by including "water" specifically under subparagraph (A) in addition to the specification of "soil, sod, dirt, turf, or mosses" which are excluded from the percentage depletion allowance. This, of course, will not affect the depletion allowance on minerals extracted from brines or mixtures of brines.

The Supreme Court has laid down the basic rule that depletion—percentage or otherwise—is allowable only to the taxpayer having an economic interest in the mineral in place. If deemed necessary, this test might be specifically written into the law and would certainly be better than introducing new and uncertain wording as a new limitation. These are simply details of expression in the law and there is no intent to change the purpose of the provisions.

(b) Waste or residues:

Provision is made in sections 611 (a) and 613 (c) (3) for depletion on the extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining. This is very desirable, from the standpoint of equity and to avoid present uncertainty and conflict of decisions.

Such right is denied to a purchaser of such waste or residue or rights thereto. There should not, however, be such denial in case of acquisition of the mine, together with waste or tailings of prior

mining. In such case the acquiring owner of the mine should be entitled to the depletion on any production from such waste or tailings previously mined in the same way as he is entitled to depletion on the waste or tailings which result from his own operation of the property. This should be made clear by inclusion of a specification to that effect in section 613 (c) (3).

Certainly, there should be no question that such a carryover right should be granted where the property was acquired in a tax-free transaction. That could be covered by including in section 381 (c) a new paragraph which would state this as one of the carryovers specified in that section.

(c) Definition of property, section 614:

There should be a rule in the law to permit the taxpayer to aggregate his mineral interests for computing depletion; cost as well as percentage depletion. Anyone acquainted with mining will recognize the difficulties which may arise from the assembling of various property interests or claims—sometimes conflicting and overlapping, sometimes complicated by an applicable apex law—which may be brought together to make a single successful operating property. Simplicity of operation and of administration, in the interest of the Treasury as well as the taxpayer, will result if the same aggregate rule is applied both to cost and percentage depletion. There are also technicalities of the rule as stated in the bill which should be amended. These are more fully set forth in exhibit A hereto, and we urge that these changes be made.

2. EXPLORATION EXPENDITURES, SECTION 615

The bill continues the present limitation of $75,000 in any year and for 4 taxable years. We urge these limitations be removed for the reasons set forth in exhibit B.

3. FOREIGN INCOME, SECTIONS 901-958

The American mining industry operates throughout the world and is therefore particularly interested in foreign income, the tax imposed thereon, and the foreign tax credit allowable. The provisions of the bill with respect to foreign income are generally desirable and will be of benefit to this country as well as to the general development of the world. However, we feel there are a number of important changes needed so that the provisions may be more practically applicable and may better meet their intent. We urge their revision as set forth in exhibit C.

Time does not permit statement as to certain other points, also important to the mining industry, set forth in exhibit D attached, including:

(*a*) Consolidated returns, sections 1501-1733.

(*b*) Net operating loss, section 172.

(*c*) Depreciation, section 167.

(*d*) Corporate distributions, liquidations, etc., sections 301-382.

(*e*) Advance declarations and tax payments by corporations, sections 6016, etc.

(*f*) Deduction for charitable contributions, section 170.

(*g*) Ordinary treatment processes—coal, section 613.

(*h*) Silver bullion tax, sections 4891–4897.

We again repeat what we have stated earlier, that with the changes made which we believe can and should be made before passage of this bill, and with recognition that other changes may later be required, we urge the enactment of the new code at this session of Congress.

(Exhibits A, B, C, and D, above referred to, follow:)

EXHIBIT A

DEFINITION OF PROPERTY, SECTION 614

It is desirable that there should be a rule in the law to permit the taxpayer to aggregate his mineral interests for the purpose of computing depletion. The rule should not, however, be limited, as it is in the bill, merely for the purpose of computing percentage depletion, but the same rule should also be applicable for computing cost depletion. Only confusion and difficulties will arise from trying to have one rule or series of rules as to the property unit for percentage depletion and different rules for cost depletion. For simplicity of operation and of administration it is in the interest of the Treasury as well as the taxpayer that the rule should apply both to cost and percentage depletion.

This has long been recognized by the Treasury in its administration. In the beginning, when 1913 valuations were first being made, the operating unit was generally recognized and made the basis for depletion allowances. The same principle has to a considerable extent been followed through the subsequent years. There is need for definite statement of the appropriate rule for combining separate acquisitions and separate interests into appropriate aggregations, both for percentage and for cost depletion.

Often a single mining property may be the result of acquisition of many different claims, sometimes conflicting and overlapping one another. Frequently a successful mining operation has been made possible only by assembling a number of differently owned properties to constitute an operating unit, whether or not all property interests are actually contiguous. Sometimes there may be reason why each should be subject to separate accounting. In general, however, it is not necessary and it may be quite difficult, if not impracticable, to try to keep the separate accounting as to the ore which may come from each of the several acquisitions or interests which have been brought together in a single operating unit. This is particularly true in States where the so-called apex law is in effect.

We accordingly urge that section 614 should be made applicable both for cost and percentage depletion, but with certain further changes as follows:

The rule as stated permits forming one aggregate group of interests in an operating unit but requires that all others not included in the single aggregate should continue to be treated as separate properties. The limitation to one aggregate group in an operating unit introduces a most undesirable element of rigidity both with respect to past practices as well as future operations. In some cases it may be appropriate to form more than one of such aggregate groups. For example, acquisitions A, B, and C might well form one group, where acquisitions D and E might well form another. This should be permitted. It is urged that section 614 (b) (1) should be modified so that the taxpayer may elect to form one or more aggregations of operating mineral interests within one operating unit.

The provisions for taxpayer's election as stated in section 614 (b) (2) seem unduly restrictive. There is no question that when the taxpayer has established his operating unit and made his election as to a property aggregate he should expect to follow that election consistently so long as the conditions under which the election was made continue unchanged. However, circumstances may change. Properties which have been separately operated may be brought together as a single operating unit. Additional properties may be acquired or previously owned properties may be disposed of. There may be question whether properties not yet in production should or should not be included in the aggregate. These and other changes in the circumstances might dictate a different aggregation of properties than the circumstances which existed at the time of original election. The taxpayer should be permitted a new election at any time when any such material change in circumstances and conditions arise.

If the taxpayer is permitted to aggregate his interests for cost depletion in the same manner as for percentage depletion, certain provisions which relate to

apportionment of depletion allowances, such as section 614 (b) (4) and the last sentence of section 613 (a), appear to be superfluous and could be deleted.

It is the evident intent that aggregation of lessors' royalty interests should not be permitted. We feel lessors should be permitted to elect reasonable aggregation of royalty interests.

EXHIBIT B

LIMITATION ON DEDUCTION OF EXPLORATION EXPENDITURES, SECTION 615

Exploration for mines is a more pressing necessity in this country than ever before, and no undue restrictions should discourage such efforts. But under section 23 (ff) of the 1939 Code, as amended, taxpayers are allowed to deduct or to treat as deferred expenses expenditures for mine exploration, but subject to a limitation of $75,000 in each year, and allowable in only 4 taxable years. Development expenses on a mine are allowable as deductions or deferments without any such limitations. Expenditures for exploration should not receive less favorable treatment than is now accorded those for development. There are difficult questions raised as to the dividing line between exploration and development. For larger projects the $75,000 allowance is quite inadequate.

The removal of these limitations on exploration expenditures will further encourage exploration and the difficult questions of when a property passes from the exploratory to the development stage will be removed or their importance minimized.

It is accordingly recommended that both the $75,000 annual limitation and the 4-year limitation be removed.

EXHIBIT C

INCOME FROM SOURCES WITHOUT THE UNITED STATES

1. FOREIGN TAX CREDIT

(a) Foreign tax for which credit is to be allowed

The credit for tax specified in our Federal income-tax law was intended to encourage foreign enterprise by our nationals. Under our Federal tax laws, a national operating abroad would be subject to a tax imposed by the foreign country or countries of operation and another tax on the fruits of the efforts by the United States. To eliminate such unequal competition between an enterprise operating abroad, in whole or part, and a purely domestic one, the credit against United States income taxes on account of foreign taxes was created. But because the credit for foreign taxes was against our income taxes the law was interpreted so that the foreign taxes, to be creditable, had to be based on our income-tax standards. The differences in tax concepts, in tax terminology and definition of what constituted taxable income soon raised questions as to what should or should not be considered a foreign tax on income for which credit was allowable. Few countries adopt exactly our standards for determining gross income and the allowable deductions and resulting net income, yet even though such taxes may not parallel ours (and particularly may not include all the deductions as we include them in our computation) they are in effect taxes on income. Furthermore, there are other foreign taxes which, though they may be somewhat differently measured, in effect are alternatives to an income tax or may be imposed in lieu thereof.

This had given considerable difficulty before 1942 and had resulted in denying, on the basis of technicalities, credits for taxes which it was recognized should be taken into account as against the income tax imposed by the United States. Our code was amended in 1942 by adding section 131 (h) to specify that foreign taxes which were creditable should include taxes which were in lieu of income taxes. The administrative interpretation, however, unduly narrowed the intended scope of this in-lieu provision, as Senator George has so well brought out in his letter to the Secretary of the Treasury dated May 29, 1952. (Congressional Record, June 27, 1952.) The omission of the in-lieu provisions from the bill would relegate the taxpayers to the same deficient situation which existed prior to 1942.

We believe the intent of the new provisions of section 901 et seq., of the bill should be and are intended to be a broadening of the scope of taxes for which credit may be allowed. It accordingly specifies that a principal tax is creditable but it makes such an allowance an alternative to the allowance for income tax and eliminates the in-lieu provision of section 131 (h) of the present law. It is firmly believed that this will, in many cases, result in far less tax credit than is presently allowable under the in-lieu provisions. We do not believe such a result was the intent of these new proposals. Moreover, the specifications as to what may be taken into account as a principal tax are exceedingly technical and leave serious and doubtful questions as to what, if any, taxes might be thereby included. We believe that as written the new provisions will tend to discourage rather than to encourage foreign trade and investments.

We urge that these provisions be revised so that income, war profits, and excess profits taxes for which credit may be given will include any taxes imposed upon or measured by income or profits and whether or not, in the computation of income or profits, allowances made for all the deductions and to the same extent specified for the computation of net income under our law. Such taxes should also include any taxes which are, in fact or in effect, in lieu of income, etc., taxes, as well as those intended to be included in the principal tax.

(b) Limitation on amount of credit

The elimination in section 904 of the present double limitation on the amount of credit allowable is a desirable change.

2. WESTERN HEMISPHERE TRADE CORPORATIONS

Sections 921–2 propose in substance no change in the existing provisions relative to a Western Hemisphere trade corporation other than a parenthetical reference in the third line of section 921 to incidental purchases. It has generally been assumed that making purchases outside the Western Hemisphere, not for the purpose of carrying on the principal business of a Western Hemisphere trade corporation but as an incident to the carrying on of such business, was not doing business outside the Western Hemisphere within the meaning of section 109 of the present statute. It is assumed that was the intended meaning of the phraseology of section 921 and the parenthesized words were merely added to emphasize past practice. A statement in the Senate report somewhat to this effect would be helpful:

"The reference in section 921 in parentheses to 'incidental purchases' is intended merely to make it clear that in this bill, as in the past, purchases made outside the Western Hemisphere of equipment, supplies, machinery, and the like, and used to implement the conduct of the operations would not disqualify a corporation from being a Western Hemisphere trade corporation."

3. BUSINESS INCOME FROM FOREIGN SOURCES

Section 923 would allow a credit of 14 percent with respect to taxable income derived from sources within any foreign country. On page 75 of its report, the committee, after referring to the Western Hemisphere trade corporation provisions, stated: "Your committee believes that similar treatment should be extended to income from business investment in other parts of the world." We believe that a desirable purpose is intended to be accomplished but find the technical provisions of this section are unnecessarily complicated and restrictive. It is uncertain just how some of them should be interpreted and to what extent they might deny reasonably intended inclusions.

Accepting the standard, apparently fixed, of granting this credit with respect to foreign income where the foreign income is derived from or in connection with substantial investments, facilities, or establishments abroad, we submit that the provisions of section 923 (b) which specify an exclusion with respect to purchase or sale (other than at retail) of goods or merchandise may be a difficult test to construe and we believe that because of its obscure but apparently restrictive language, it is apt to exclude business never intended to be excluded.

This limitation and the further exclusion set out in section 923 (b) arising from "the maintenance of an office, or employment of an agent, other than a retail establishment * * * to import or facilitate the importation of goods or merchandise" seem harsh and unintended restrictions in the light of the explanations of the intent of these provisions found on A255 of the report, viz:

"If the trade or business activities consist principally in the production or manufacturing and sale of goods or merchandise, and incidentally in the pur-

chase and sale of goods or merchandise, such trade or business will not be excluded under the first exclusion. A similar result would follow if the trade or business activities consist principally in the operation of a retail establishment in a foreign country. The exclusion applies to purchase or sale of goods. Hence, if goods are purchased and are then processed, manipulated, or changed in form before sold, this exclusion does not apply."

"The second exclusion would exclude a trade or business which consists of the maintenance of an office or the employment of an agent to import or to facilitate the importation of goods or merchandise from the United States or elsewhere. The maintenance of an office or the employment of an agent to import goods which are incident to the operation of a trade or business through a factory, etc., in the foreign country, would not fall within this exclusion."

The provisions of 923 (a) (1) for including branch income only if the deferred income election of part IV is made, seem unnecessarily to bar from inclusion the income of a nonelected branch which we urge should equally be included if the committee's intent as quoted above is to be made effective. We should like to add that we consider that the quotation from the committee report states the proper principle and goal to be achieved. Undoubtedly, there are cases where the provisions for deferment of branch income will prove exceedingly desirable. However, those provisions are exceedingly technical and it may not always be easy to comply with them. If the taxpayer is willing to waive the deferment and currently to include branch income, there seems no reason why he should not equally be entitled to the benefit of section 923. Many taxpayers will not elect the deferral provisions of part IV, as those provisions are now drafted, because of their extreme technicalities and their resulting denial of percentage depletion and denial of the right to use branch losses to offset other income, but that is certainly no reason for denying these taxpayers the right to use the 14 percentage point tax credit.

It is indicated in the committee report (p. A258, and see also A260) that section 923 might be applied to a corporation which was also eligible for a Western Hemisphere trade corporation deduction if the taxpayer so desired. This point might be made much clearer if the provisions of section 923 (d) (1) were to read: "has elected and is allowed a deduction under section 922 (relating to Western Hemisphere trade corporations);" or by similar appropriate amendment.

4. DEFERRED INCOME FROM SOURCES WITHIN FOREIGN COUNTRIES

Part IV, which consists of sections 951–958, provides for deferment of income from sources within foreign countries. It is exceedingly desirable that such a provision be included in the law but the proposed provisions should be revised to make them fair and practical in application.

Certain provisions of section 951 should be revised to conform with revisions we have urged with respect to section 923.

The general intent of these provisions is to place an elected branch in much the same situation as a subsidiary. However, in so doing there seems no occasion for a denial of percentage depletion, as would be done by section 953 (d) (2).

Section 954 contains specifications as to determination of withdrawal of branch income. A particular point which should be made clear is that, in computing investment in the branch as a standard for withdrawal, determination of current accounts receivable and payable between branch and home office should not be treated as affecting investment account. It is required for the purpose of this provision that transactions between the home office and elected branch should be treated as if between separate entities; consequently, profit and loss must be computed thereon and other appropriate standards observed when dealings are on an arms' length basis. Thus, as between separate entities, there must be what would constitute accounts receivable and payable which naturally would be expected to be the subject of current cash remittances or payments. These might represent goods produced in the United States by the home office and shipped to the elected branch for sale (assume for present purposes at retail so as not to raise other doubtful questions) or purchases made by the home office for account of the branch. As these would be normally handled during the year, remittances to cover them would be recognized as normal interoffice remittances and liabilities outstanding at the close of the year with respect thereto would be treated as though the branch and the home office were separate entities. It should be made clear that any of such accounts which were in transit or unsettled at the end of the year would retain a similar status and

would not be required to be taken into account as an increase or decrease of the investment account.

The provisions for election of a branch and termination of such election are also provided for in a very technical manner. We are quite in accord with the principle of consistent handling of affairs in accord with an election once made. But it should be clearly provided that when and as conditions materially change, there should be reasonable provisions for new election without penalty or detriment of any kind. Perhaps the authority given for a new election, subject to the approval of the Secretary or his delegate, will adequately recognize this but that is not clear from the proposed provisions.

Section 956 provides for termination of election if a branch in any year becomes ineligible for the income deferment. This ineligibility may be due to circumstances over which the taxpayer has no control. It is even possible that without the taxpayer's knowledge of their existence, conditions will turn out to have been such that later it will be found the branch became ineligible or was disqualified. If the taxpayer is knowingly or unknowingly disqualified for any year, a new election for deferment would be required but could only be granted with the consent of the Secretary or his delegate. These elections and withdrawals as now specified are so difficult to comprehend under the bill as written that a taxpayer through inadvertence may suffer a detriment not intended by Congress. We urge that further consideration be given to the provisions under part IV before they are enacted into law.

EXHIBIT D

(a) Consolidated returns, secs. 1501–1733

The bill includes as chapter 6, provisions with respect to consolidated returns, writing into the code much that has heretofore been the subject of regulations. There are a number of particulars as to which we urge amendment before enactment.

(1) *The 2 percent penalty tax.*—We again urge the abolition of the 2 percent additional tax imposed on income where consolidated returns are filed. The report of the House committee (page 87) indicates this 2 percent additional tax has been retained because it was not believed appropriate at this time to change the provision allowing only an 85 percent deduction with respect to intercorporate dividends. While we have repeatedly urged that intercompany dividends should not be again subjected to tax when received by another corporation, we urge that whether or not this can be presently done the 2 percent additional tax on consolidated returns should be eliminated, as President Eisenhower has recommended.

(2) *Includible corporations, section 1502 (b)*.—The bill would require inclusion of domestic corporations substantially all of whose income was from sources without the United States wheih under the present code, sec. 141 (a) (7), are permitted to be omitted from the consolidated group. It is true that sec. 141 of the present Code makes reference to the specifications as to such a corporation which are included under section 454 of the excess profits tax provisions of the code. However, their exclusion from the consolidated group for income-tax purposes was in no way dependent upon whether or not an excess-profits tax was applicable. The present provisions in this regard should be continued by including in sec. 1502 (b) a new paragraph as follows:

"(7) Domestic corporations satisfying the following conditions:

"(A) If 95 percent or more of the gross income of such domestic corporations for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources other than sources within the United States; and

"(B) If 50 percent or more of its gross income for such period, or such part thereof, was derived from the active conduct of a trade or business; but not including such a corporation which has made and filed a consent, for the taxable year, or any prior taxable year ending after March 31, 1954, to be treated as an includible corporation. Such consent shall be made and filed at such time and in such manner as may be prescribed by the Secretary."

(3) *Consolidated returns for subsequent years, section 1505.*—The bill proposes to write many of the existing consolidated return regulations into the law. In so doing some of the rules are made even more severe than under present regulations. Moreover, the Treasury will be left with much less freedom in modification of specific provisions of the law than it has been as to modification

and interpretation of its own regulations. Section 1505 (a) (2) would write into the code a provision similar to that in the regulations which has been far from satisfactory and most difficult of interpretation. As it has stood in the regulations in recent years it has, however, not been too serious because the Treasury has been ready to rule almost year by year that changes made in law or regulations were such as would generally give new elections. This may not be so easy for the Treasury to do under specific provisions of the law as distinguished from regulations. When the election for filing consolidated returns has been made it is to continue in effect unless certain specified conditions occur. One of these conditions is that the change in the Code makes the continued filing of consolidated returns substantially less advantageous to affiliated groups as a class. It is difficult if not impossible for taxpayers to determine the nature and scope of this test. The earlier test previously prescribed in the regulations was that of whether a change made the continual filing of consolidated returns less advantageous to the affiliated group or any of its members. We believe that is the test which should be applied and that it should continue to refer both to a change in the code and a change in the regulations with respect thereto.

A further point is that the test is to be applicable only with respect to changes made subsequent to the election whether or not the changes had any effect on the year for which the election was made. The committee report, page A208, presents an example of a situation of a consolidated return filed for the calendar year 1953 on September 15, 1954, in which case if the new code had been enacted prior thereto even though not applicable to the year 1953, the election on the 1953 return would be binding for the year 1954 return. The taxpayer in such case would have no opportunity to determine fully what effect the new code might have nor to know what regulations might be issued thereunder. Any intelligent election by the taxpayer at that time would be impossible. We submit the rule now proposed is illogical and unreasonable. If changes in law or regulations are such as to entitle the taxpayer to a new election, the new election should be granted as to the year for which the provisions are effective.

We accordingly recommend that section 1505 (a) (2) should be amended as follows:

"(2) Subsequent to the exercise of the election to make consolidated returns, subtitle A of the code or the regulations issued with respect thereto, to the extent applicable to corporations, have been amended and any such amendment is of a character which makes less advantageous to the affiliated group or any of its members the continued filing of consolidated returns, or"

In addition, the last sentence of section 1505 should be amended to read as follows:

"For the purpose of (2) above, the expiration of a provision shall be considered an amendment, and the right to change to separate returns shall be allowed with respect to the first year to which an amendment applies."

(b) *Net operating loss, section 172*

The provisions of the bill with respect to net operating loss allowance are a definite improvement over existing provisions. They do not go as far as we should like in some particulars, but they are much fairer and we urge their enactment.

(c) *Depreciation, section 167*

We commend the new provisions and urge their adoption.

Special provisions should be made to permit facilities for abatement of stream and air pollution to be written off over not more than 60 months.

A technical change should be made in section 167 to make clear that application of certain special rules for depreciation, in accord with the special circumstances of mines, does not deny to mines the benefit of the new provisions of section 167.

There is the further point which we have heretofore urged that the provisions of section 1016 (a) (2) for adjustment of basis should apply the tax-benefit rule to depreciation allowable as well as to depreciation allowed.

(d) *Corporate distributions, liquidations, etc., sections 301–382*

There are many points which should be carefully considered with regard to these new provisions which differ so greatly from those of the present code. These we believe are otherwise presented to you, and we would only note briefly the following particular points:

(a) The new provisions should not be given retroactive application and should become effective only 90 days after their enactment.

(b) The 10-year provision of section 309 and the 20-percent requirement of section 359 should be modified.

(c) The dividend provision of section 312 would seem to indicate abandonment of the long-established rule (see regulation 118, section 39.115 (a)-1 (d)) that dividends should be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands. This rule is applicable to stockholders on the accrual basis as well as to those on the cash basis. We believe it should be continued. The optional right might be given to account for dividends either as of the date when stock becomes "ex dividend" on the exchange, or on the dividend declaration date. However, the legally sound and long-established rule of accounting for dividends when their amount is unqualifiedly made available to the stockholders should not be changed.

(e) Advance declarations and tax payments by corporation, sections 6016, 6074, 6154, 6655

We strongly urge that the provisions for advance declarations and tax payments by corporation should not be enacted. It will be exceedingly difficult for many corporations to form any reliable advance estimates of their taxable income for the year, and very many corporations will find it a serious drain on their finances. Some corporations, well established and well financed, could probably stand the burden without too great difficulty, but to those less favorably placed, particularly in a time of receding income, the financial drain would be serious. Many of our mining companies in particular have had to reduce the scale of their operations and would find it especially difficult to make the advance payments.

(f) Deduction for charitable contributions, section 170

It is often difficult for corporations to know what may prove to be the amount of the 5-percent allowance for charitable contributions. Corporation incomes, particularly those of mining companies, will fluctuate. Special demands for charitable contributions may come from time to time. Provision should be included so that if contributions by a corporation in any year prove to be in excess of the 5 percent of income allowable, the excess may be carried forward as a deduction in succeeding years within the limitations applicable to the allowance in each of such years.

(g) Ordinary treatment processes, coal, section 613 (c) (4) (A)

The rule in the *Black Mountain Corp.* case (21 T. C. No. 83) that oil treatment of coal does not qualify as a "further treatment process in mining" should be reversed in the law. The oil treatment is an improvement in providing a salable product.

(h) Silver bullion tax, section 4891–4897

This tax is included as subchapter F of chapter 39. The occasion for this tax has long since passed. It yields only a few thousand dollars a year in revenue, and is definitely a nuisance tax which should be repealed.

The CHAIRMAN. Thank you very much, Mr. Fernald. It has been good to have you here.

Mr. Palmer, have you heard the statement just made by Mr. Fernald?

Mr. PALMER. Yes, sir.

The CHAIRMAN. Do you have any differences of opinion with it?

Mr. PALMER. No, sir.

Senator GEORGE. Mr. Chairman, before the next witness proceeds may I make 1 or 2 requests; I am making them now because I have to leave here and I want to make them, at this time.

The CHAIRMAN. Proceed, Senator George.

Senator GEORGE. Mr. Chairman, first I would like to submit for the record a letter from Mr. Malon C. Courts, of Courts & Co., Atlanta, Ga., urging the adoption of provisions permitting certain unincorporated business enterprises to elect to be taxed in every respect as corporations, with accompanying amendment.

The CHAIRMAN. It will be made a part of the record as you desire.

(The letter referred to follows:)

COURTS & CO.,
Atlanta, Ga., April 17, 1954.

HON. WALTER F. GEORGE,
Senate Office Building,
Washington, D. C.

DEAR SENATOR GEORGE: I am writing to urge the adoption in the 1954 Internal Revenue Code of provisions permitting certain unincorporated business enterprises to elect to be taxed in every respect as corporations.

Such a provision was endorsed by President Eisenhower in his budget message in January. He associated it with a recommendation that certain corporations with a small number of active stockholders be given the right to elect to be taxed as partnerships.

I understand that the 1954 code as recommended to the Ways and Means Committee by the Treasury contained provisions carrying out the President's recommendations but that these were dropped as the result of a 13-12 vote of the members of the Ways and Means Committee. Mr. Sidney Camp has strongly urged the adoption of these provisions. Mr. Reed of New York introduced a bill accomplishing this result for proprietorships or partnerships on May 22, 1951, which was numbered H. R. 4214.

Our business, that is the business of Courts & Co., well illustrates the justice supporting a bill of this sort. Ours is a business where capital is a substantial income producing element and growth is dependent upon the accumulation of capital. A similarly situated business in the manufacturing field would undoubtedly have been incorporated in order to secure the privileges of accumulating needed capital free of individual surtax rates. Our position is such, however, that we are prevented by customs of the trade and rules of the cotton exchanges from incorporating. We must operate as a partnership in order to satisfy the cotton exchanges. The burden of high individual surtaxes is making it increasingly difficult for us to attract or retain capital that we need for expansion.

Most business partnerships or proprietorships if pressed by high surtax rates can incorporate and, as you know, many such businesses are incorporated. There are businesses, like our own, which must be operated in a partnership form in order to provide to creditors and to customers the individual responsibility of the partners. It is this type of business which would secure relief from the proposed bill and I am confident that it would result in a very nominal loss of revenue.

I want to make it clear that our opinion is that if the advantages are given it is only fair and proper that the disadvantages follow. This should be true with both portions of the provisions recommended by the Treasury. The problems of adapting the corporate tax to a partnership should be no different from the familiar problem of adapting the corporate tax provisions to associations and other unincorporated groups now taxed as corporations. The only language in the 1939 code providing for the taxing of associations as corporations is found in section 3797 (a) (3) reading: "The term 'corporation' includes associations, joint-stock companies, and insurance companies." The details have been handled by regulations and rulings.

I understand that some objections have been made based upon the technical difficulties of adapting such provisions to the new code. I have discussed these provisions with counsel here and am setting forth on the attached sheet some recommendations on the drafting of the bill. Our primary suggestion is that both portions of the bill should state generalities, and the detailed application of the provisions should be left to regulations prescribed by the Secretary.

I would like to telephone you in the early part of the week to discuss this. Because of the interest they have shown in this proposal, I am sending copies of this letter to Messrs. Reed, Camp, Stam, and Dan Troop Smith.

I trust you have recovered from your recent illness and look forward to seeing you soon.

With highest personal regards.

Sincerely yours,

MALON C. COURTS.

COMMENTS REGARDING PART II OF PROPOSED SUBCHAPTER R, ELECTION OF CORPORATIONS AND PARTNERSHIPS AS TO TAXABLE STATUS

PART II—ALTERNATIVE TAXABLE STATUS OF CERTAIN PROPRIETORSHIPS AND PARTNERSHIPS

(1) Section 1341 (b) (2): This provision seems designed to prevent the breaking up of a single business into several electing partnerships with substantially the same interests in order to secure more than one surtax exemption. The limitations of this subsection as drawn seem much too strict and would penalize all partners where a single partner had an interest in an entirely unrelated partnership which itself endeavored to elect the alternative taxable status. This provision does not seem to be needed in view of the fact that section 1731 of the proposed Internal Revenue Code of 1954, corresponding to section 15 (c) of the 1939 code, would be made applicable and would prevent the breaking up of partnerships without a business purpose just as it prevents the breaking up of corporations without a business purpose.

(2) The proposed section 1341 (c) makes the corporate provisions in general applicable, except to the extent otherwise provided. It would seem wise within this provision to prescribe that the corporate provisions shall be made applicable as prescribed under regulations issued by the Secretary or his delegate. H. R. 4214 introduced by Mr. Reed on May 22, 1951, 82d Congress, 1st session, incorporates this suggestion for handling the matter.

(3) The proposed section 1341 (d) provides that the partners or proprietors of the unincorporated enterprise are not to be considered employees for the purpose of section 501 (e) relating to employees' pension trusts, etc. There may be reasons not apparent to us which support this provision. However, we see no reason why our business, if it elects to be taxed as a corporation, should not have all of the corporate benefits, along with all of the restrictions imposed on corporations and their stockholders, and we would suggest that this exception be excluded, unless there are strong reasons to the contrary.

(4) Reconsideration should be given to the statement of constructive ownership set forth in section 1341 (g). The ownership of a partnership interest is to be determined in accordance with the rules of constructive ownership of stock as set forth in such section 207 (c). Section 207 (c) (3) provides that an individual owning any stock in a corporation shall be considered as owning the stock owned directly or indirectly by or for his partner. Under this every partner would be deemed to own 100 percent of the partnership. A saving clause could be inserted in section 1341 (g) excluding the applicability of section 207 (c) (3).

(5) It is possible that some of the other detailed provisions of this subchapter R could better be covered by regulations and rulings.

Senator GEORGE. I would like to have from Mr. Stam and his staff a tabulation showing the exact effect of the expiration of the last individual tax increase on the individual taxpayer. Of course, I know in a general way that it was a reduction across the board, but I would like to have tables inserted showing the breakdown.

(The tables referred to follow:)

Estimated distribution of the individual income-tax returns, adjusted gross income and tax liability under the Revenue Act of 1951 and after the Jan. 1, 1954 termination date

[Money amounts in millions]

Adjusted gross income classes	Number of taxable returns	Adjusted gross income	Total tax under [1]		Tax reduction due to Jan. 1, 1954, termination date
			Revenue Act of 1951 [2]	After Jan. 1, 1954, termination date	
Under $1,000	1,674,567	$1,303	$49	$45	$4
$1,000 to $2,000	6,231,984	9,497	802	723	79
$2,000 to $3,000	7,870,632	22,035	1,994	1,796	198
$3,000 to $4,000	9,116,451	31,759	3,024	2,724	300
$4,000 to $5,000	7,500,300	33,497	3,527	3,175	352
Total under $5,000	33,163,934	98,091	9,396	8,461	935
$5,000 to $10,000	9,037,730	58,408	7,691	6,919	772
$10,000 to $25,000	1,931,616	27,456	5,403	4,838	565
$25,000 to $50,000	329,031	11,090	3,442	3,086	356
$50,000 to $100,000	93,346	6,207	2,694	2,451	243
$100,000 to $250,000	24,119	3,435	1,827	1,721	106
$250,000 to $500,000	3,076	1,035	641	620	21
$500,000 to $1 million	817	559	369	359	10
$1 million and over	314	621	430	422	8
Total over $5,000	11,420,049	108,809	22,497	20,418	2,080
Total	44,583,983	206,900	31,894	28,879	3,015

PERCENTAGE DISTRIBUTIONS

Adjusted gross income classes	Number of taxable returns	Adjusted gross income	Revenue Act of 1951	After Jan. 1, 1954, termination date	Tax reduction due to Jan. 1, 1954, termination date
Under $1,000	3.53	0.63	0.15	0.15	0.13
$1,000 to $2,000	13.98	4.59	2.51	2.50	2.62
$2,000 to $3,000	19.60	10.65	6.25	6.22	6.57
$3,000 to $4,000	20.45	15.35	9.48	9.43	9.93
$4,000 to $5,000	16.82	16.19	11.06	10.99	11.67
Total under $5,000	74.39	47.41	29.46	29.30	31.01
$5,000 to $10,000	20.27	28.23	24.11	23.96	25.61
$10,000 to $25,000	4.33	13.27	16.94	16.75	18.74
$25,000 to $50,000	.74	5.36	10.79	10.69	11.81
$50,000 to $100,000	.21	3.00	8.15	8.49	8.06
$100,000 to $250,000	.05	1.66	5.73	5.96	3.52
$250,000 to $500,000	.01	.50	2.01	2.15	.70
$500,000 to $1,000,000	(3)	.27	1.16	1.24	.33
$1,000,000 and over	(3)	.30	1.35	1.46	.27
Total over $5,000	25.61	52.59	70.54	70.70	68.99
Total	100.00	100.00	100.00	100.00	100.00

[1] Includes normal tax, surtax, and alternative tax.
[2] Calendar year 1952 and 1953 liabilities.
[3] Less than 0.005 percent.

NOTE.—Detail may not add to totals due to rounding.

Source: Joint Committee on Internal Revenue Taxation.

Comparison of the individual income-tax liabilities under the law in effect prior to the enactment of the Revenue Act of 1951, under the Revenue Act of 1951, and under the present law for 1954

SINGLE PERSON, NO DEPENDENTS

Net income (after deductions but before exemptions)	Amount of tax under—		Tax increase, Revenue Act of 1951 over prior law		Tax decrease under present law for 1954	
	Law in effect prior to Revenue Act of 1951 and for 1954	Revenue Act of 1951	Amount	Percent	Amount	Percent
$800	$80	$44.40	$4.40	11.0	$4.40	9.9
$1,000	80	88.80	8.80	11.0	8.80	9.9
$2,000	280	310.80	30.80	11.0	30.80	9.9
$3,000	488	542.40	54.40	11.1	54.40	10.0
$4,000	708	788.40	80.40	11.4	80.40	10.2
$5,000	944	1,053.00	108.00	11.4	108.00	10.3
$8,000	1,780	1,992.00	212.00	11.9	212.00	10.6
$10,000	2,436	2,728.00	292.00	12.0	292.00	10.7
$15,000	4,448	4,968.00	520.00	11.7	520.00	10.5
$20,000	6,942	7,762.00	820.00	11.8	820.00	10.6
$25,000	9,796	10,940.00	1,144.00	11.7	1,144.00	10.5
$50,000	26,388	28,466.00	2,078.00	7.9	2,078.00	7.3
$100,000	66,798	69,688.00	2,890.00	4.3	2,890.00	4.1
$300,000	247,274	252,164.00	4,890.00	2.0	4,890.00	1.9
$500,000	429,274	436,164.00	6,890.00	1.6	6,890.00	1.6
$1,000,000	[1] 870,000	[2] 880,000.00	10,000.00	1.1	10,000.00	1.1

MARRIED COUPLE, NO DEPENDENTS

Net income (after deductions but before exemptions)	Law in effect prior to Revenue Act of 1951 and for 1954	Revenue Act of 1951	Increase amount	Increase percent	Decrease amount	Decrease percent
$1,500	$60	$66.60	$6.60	11.0	$6.60	9.9
$2,000	160	177.60	17.60	11.0	17.60	9.9
$3,000	360	399.60	39.60	11.0	39.60	9.9
$4,000	560	621.60	61.60	11.0	61.60	9.9
$5,000	760	843.60	83.60	11.0	83.60	9.9
$8,000	1,416	1,576.80	160.80	11.4	160.80	10.2
$10,000	1,888	2,104.00	216.00	11.4	216.00	10.3
$15,000	3,260	3,644.00	384.00	11.8	384.00	10.5
$20,000	4,872	5,456.00	584.00	12.0	584.00	10.7
$25,000	6,724	7,508.00	784.00	11.7	784.00	10.4
$50,000	19,592	21,880.00	2,288.00	11.7	2,288.00	10.5
$100,000	52,776	56,932.00	4,156.00	7.9	4,156.00	7.3
$300,000	222,572	229,352.00	6,780.00	3.0	6,780.00	3.0
$500,000	403,548	412,328.00	8,780.00	2.2	8,780.00	2.1
$1,000,000	858,548	872,328.00	13,780.00	1.6	13,780.00	1.6

MARRIED COUPLE, 2 DEPENDENTS

Net income (after deductions but before exemptions)	Law in effect prior to Revenue Act of 1951 and for 1954	Revenue Act of 1951	Increase amount	Increase percent	Decrease amount	Decrease percent
$3,000	$120	$133.20	$13.20	11.0	$13.20	9.9
$4,000	320	355.20	35.20	11.0	35.20	9.9
$5,000	520	577.20	57.20	11.0	57.20	9.9
$8,000	1,152	1,281.60	129.60	11.3	129.00	10.1
$10,000	1,592	1,773.60	181.60	11.4	181.60	10.2
$15,000	2,900	3,236.00	336.00	11.6	336.00	10.4
$20,000	4,464	5,000.00	536.00	12.0	536.00	10.7
$25,000	6,268	7,004.00	736.00	11.7	736.00	10.5
$50,000	18,884	21,088.00	2,204.00	11.7	2,204.00	10.5
$100,000	51,912	56,032.00	4,120.00	7.9	4,120.00	7.4
$300,000	221,504	228,272.00	6,768.00	3.1	6,768.00	3.0
$500,000	402,456	411,224.00	8,768.00	2.2	8,768.00	2.1
$1,000,000	857,456	871,224.00	13,768.00	1.6	13,768.00	1.6

[1] Subject to maximum effective rate limitation of 87 percent.
[2] Subject to maximum effective rate limitation of 88 percent.

Source: Joint Committee on Internal Revenue Taxation.

I would also like to make a request of the Treasury that the exact number, if now known, and if not, the approximate number of returns for fiscal year 1953, of last year, be inserted in the record, and the actual number of returns percentagewise of the number of taxpayers.

I know in a general way, many returns are joint and they cover both husband and wife, or two taxpayers. I would like to have that definite figure.

Then, Mr. Chairman, from the Treasury—and I presume some Treasury representative is present—I would like to have a statement of the number of tax warrants now pending and unsatisfied in the Bureau and whether or not—and I would like the answer to be specific—a rule or custom exists to issue no tax warrant if the tax liability is $10 or less, and whether the Bureau is now considering increasing this minimum to $25 in lieu of the $10. I would appreciate that very much. Mr. Chairman, at the suggestion of my doctor that I shall be away for a week or so, and may not be able to return by the time the committee reads these subjects in executive session.

Therefore, I would like to now record myself as saying that I favor the 2-year carryback. Under existing law, there is a 1-year carryback allowed, but I think it should go back 2. I also think that the depreciation formula is sound, assuming, however, that it is optional with the taxpayer, and that no basis could arise for the exercise of discretion by the Bureau to reimpose the old original Virginia Hotel Co. rule that we corrected, here, by legislation.

On the question of taxation of dividends paid, I have not had an opportunity to study the formula. It seems a bit complex, and I wonder why it couldn't be simplified, but I am in harmony with the general principle and think there should be some deductions in computing the taxable income of the taxpayer against dividends paid on which a corporate rate has been actually paid, but I withhold any statement on that, hoping I will get back before you finally dispose of that question which may be a somewhat troublesome one, and because I have been not quite able to understand why we could not simplify the formula, rather than make it more complex.

I thank you very much, Mr. Chairman. I regret that I have been unable to be here during the hearings. I will, of course, try to read all the testimony before we actually get down to executive consideration of the bill, but I wished to make these two statements, one especially with reference to the 2-year carryback, and the other with reference to the depreciation.

The CHAIRMAN. We shall miss you very much, Senator, and we hope you will take good care of yourself.

Will the staff see that the things are supplied and have the Treasury do the things which are necessary.

(The information requested by Senator George follows:)

APRIL 23, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Committee on Finance, United States Senate,
Senate Office Building,
Washington, D. C.

MY DEAR MR. CHAIRMAN: During the Senate Finance Committee Hearings on H. R. 8300, April 19, 1954, Senator George requested that the Treasury Department supply the committee with information about the number of individual tax returns and taxpayers and also the number of tax warrants outstanding in the Internal Revenue Service.

The latest final statistical compilation of individual income tax returns is for the 1950 income year and is presented in Statistics of Income, part 1, 1950. These data show a total number of returns filed of 53,060,008, of which 31,586,090, or about 60 percent, were the joint returns of husbands and wives. Since both persons reporting on a joint return are regarded as filing the return, the number

of joint returns may be added to the total number of returns to show the total number of individuals included in the filing process. On this basis, there were 84,646,181 individuals filing income-tax returns for 1950.

To find the number of individuals who were taxable on their 1950 incomes, the number of taxable joint returns may be added to the total of taxable returns. On this basis, 60,831,391 individuals had tax liabilities for 1950 incomes. The 1950 data are summarized in the following table:

	Nontaxable	Taxable	Total
Number of all returns	14,873,416	38,186,682	53,060,098
Joint returns of husbands and wives	8,941,381	22,644,709	31,586,090
Number of individuals filing returns	23,814,797	60,831,391	84,646,188

The most recent data showing the total number of returns filed are based on administrative reports of the Internal Revenue Service. These data, which are preliminary, indicates that during the 1953 calendar year, 56,841,351 individual income-tax returns were filed, relating for the most part to 1952 incomes. The data as reported do not show the number of returns filed by particular types of taxpayers. However, it is estimated that this total includes 42.5 million taxable returns representing 69 million individual taxpayers.

For the current income year, 1954, it it estimated that 47.2 million taxable returns will be filed. These returns will represent an estimated 77.7 million individuals with tax liability.

The additional information requested in regard to the current status of tax warrants in the Internal Revenue Service is being assembled and will be forwarded in a separate letter as soon as it is available.

Sincerely yours,

M. B. FOLSOM,
Under Secretary of the Treasury.

(Note: The additional data was subsequently submitted directly to Senator George and is not included in the hearings.)

The CHAIRMAN. Go ahead, Mr. Packard.

Mr. PACKARD. Thank you.

STATEMENT OF ARTHUR J. PACKARD, CHAIRMAN, GOVERNMENTAL AFFAIRS COMMITTEE, AMERICAN HOTEL ASSOCIATION

Mr. PACKARD. I have with me Mr. Vernon Kane of the firm of Horwath & Horwath, who are our tax consultants, and our legal counsel, Charles W. Merritt.

We have filed with you, Senator, a brief which involves about 10 pages, but in the interest of time there are just two points I would like to stress orally.

We are very grateful, of course, for the job that has been done in H. R. 8300 as it stands today, and we feel it goes a long way toward removing numerous longstanding inequities—also it closes numerous loopholes in the Revenue Code.

Further, we feel that in most respects Congress did a good job in the passage of the excise tax amendment 3 weeks ago. Our industry, together with all segments of American business, and the public at large, will profit from the careful deliberations of Congress. There was only one instance in the items which meant the most to the hotel business, where factual evidence, we feel, was swept aside. We regretted very deeply the fact that your committee recommendation was rejected when the bill reached the floor of the Senate, and that body declined to reduce the 20 percent tax on entertainment rooms in hotels,

even though the Treasury's own figures reveal that that levy has long since passed the point of diminishing returns.

On the other hand, we are very grateful for what we think is equitable taxation as far as our industry is concerned; but to hurry along, there are two particular items in this bill in which we are primarily interested and which we would like to discuss. The first is tax-exempt establishments.

For several years, now, spokesmen for the hotel industry have been urging Congress to close some of the loopholes in section 101 of the existing Revenue Code. Congress did make a beginning in this direction in the 1950 Revenue Act, when it exposed to Federal income-tax liability the proceeds from unrelated business activities of certain categories of 101 organizations. I do stress for you today, however, gentlemen, that one of the most serious inequities remaining in the code reposes in this particular section, and unfortunately, H. R. 8300, as it stands today, fails to further tighten these provisions.

I have here for your information, and they will be filed if you like, the type of exhibits which we have been assembling for several years and turning over to appropriate authorities. These have been filed with congressional committees and with the Internal Revenue Service. They reveal an increasing volume of instances where tax-exempt establishments are catering to the general public, for profit, and in serving luncheons, dinners, receptions, and so forth. This provides utterly unfair competition to taxpaying establishments.

There are even some of these organizations today which are providing transient rooms for the general public, and operating as hotels. This certainly goes beyond the original concept of services to members for which these organizations were initially granted a tax-exempt status.

The Treasury Department has estimated that 5.5 percent of all consumer expenditures are channeled into business-type receipts of exempt organizations. If this measurement is applicable, for instance, in food service, it means that $550 million worth of hotel and restaurant business is avoiding Federal income tax. These tax-exempt organizations have a terrific advantage over us.

First, they can undersell us considerably because they are not subject to Federal income tax, which all private corporations must pay. Second, operating in the guise of organizations which cater only to their members, they frequently solicit public groups to have dances and other forms of entertainment without payment of cabaret or admissions taxes, and so forth. It is essential that Congress provide the Internal Revenue Service with authority, and funds, which will permit a better policing job in this particular field.

In 1950, the Congress stipulated that certain 101 organizations were to be subjected to the Federal income tax. These were 101 (1), (6), (7), and (14). All references are to existing code sections, incidentally.

I would like to ask your committee, if I may, a question. Is it your interpretation of the code that 101 organizations not covered by 1950 amendment, such as 101 (3), can be deprived of its tax-exempt status if found to be engaging repeatedly in catering to public functions, for a profit, in fields which are entirely unrelated to the purpose for which it was originally chartered?

As an illustration of what I mean, we will say there is a fraternal organization, classified as 101 (3) which today is neither susceptible to income-tax returns, nor is it obliged to file information returns. Where one such establishment caters to public functions every day in the week for profit, it seems incredible that such a practice can be continued without the Treasury Department advising that establishment that it has lost its tax-exempt status by repeatedly benefiting from this unrelated income.

For instance, it is just such an organization as we have been describing here where Commissioner Andrews himself is to be the principal speaker in a Midwest city this week. I have the advertisement here in my hand. It is expected that an attendance of 600 people will be present. The meeting has no possible bearing upon the purposes for which that fraternal organization was chartered, and incidentally the State itself is already imposing certain real-estate taxes on that particular establishment growing out of a finding that a large part of its activities were in fields unrelated to the purposes for which it was chartered. But that group goes along merrily, year after year, doing an annual volume estimated to be well in excess of $100,000. How much longer shall the tax-paying establishments of the country be required to endure this degree and type of inequity? We are willing, Mr. Chairman, to face up to any kind of competition such groups want to give us—if they want to enter the food business, as an example. But we do insist that when they cater to public groups, for profit, they should be exposed to Federal income tax on such profits, the same as we are.

To that end, we propose two amendments which I won't read, but which are incorporated in my brief, and which would cover what we think would be the inequities involved in these particular tax-exempt organizations.

Then I would like to speak briefly on the subject of depreciation.

On behalf of the hotel industry, we would like to offer a few remarks on proposed section 167 relating to depreciation. The typical hotel of America was built in the 1920's and consequently today is 25 or 30 years old. Considering that the average useful life of hotel structures is about 40 years, this means that the great majority of American hotels today have a remaining life-time of from 10 to 15 years, possibly in some cases, 20 years. During the 14-year period of 1930 to 1953, motor courts of this country increased from 13,500 to over 50,000 which is an increase of 370 percent. During the same time there was very little hotel construction with the result that hotels increased in numbers by less than 10 percent. However, many thousands of hotels are in direct competition with motor courts and one advantage of the motor court is their newness. There is no obsolescence in motor courts, today. A number of hotels have been renovated and improved in appearance and, by reason of the expected benefits from the declining balance method of depreciation, more hotels may see fit to invest in renovations and improvements. Therefore, it seems appropriate that we should request that some means be devised of assuring two things to the hotel industry, and other elements of business similarly situated.

First, that renovation and improvements taking place after January 1, 1954, be permitted to be depreciated by use of the declining

balance method of depreciation described in code section 167 (b) (2). We assume that this is covered by the use of the term "reconstruction," in section 167 (e) (1).

The second thing is that the renovation and improvement of older hotel structures will not be used as a reason to generally extend the life of hotels for depreciation purposes. There is nothing in the proposed code that assures this to the hotel men who wish to make these improvements. Some reassurance on that score is badly needed.

One of the objectives of revising these depreciation procedures is to stimulate additional investment in American enterprises. And we conclude this particular section of our brief, with certain recommended modifications of this law, or of these sections of the law which would be beneficial to the hotel industry, and would give them an opportunity to rehabilitate their properties, make a further investment to the general welfare of the business, and to the traveling public as a whole.

The CHAIRMAN. Thank you very much indeed.

Mr. Rolla D. Campbell.

(The prepared statement of Mr. Arthur J. Packard follows:)

STATEMENT OF ARTHUR J. PACKARD ON H. R. 8300

Mr. Chairman and gentlemen of the committee, I am Arthur J. Packard, president, Packard Hotels Co., with headquarters in Mount Vernon, Ohio. I am chairman of the governmental affairs committee of the American Hotel Association.

The hotel industry wants to take this opportunity to congratulate everyone who has played a part in the development of H. R. 8300 as it stands today. We do feel that it goes a long way toward removing long-standing inequities, and closes numerous loopholes in the revenue code.

Similarly, we do feel that, in most respects, Congress did a good job in passage of the excise-tax amendments 3 weeks ago. Our industry, together with all segments of American business, and the public at large, will profit from the careful deliberations of the Congress. There was only one instance in the items which meant the most to the hotel business, where factual evidence was swept aside. We regretted deeply the fact that when your committee bill reached the floor of the Senate, that body declined to reduce the 20-percent tax on entertainment rooms in hotels, even though the Treasury's own figures reveal that that levy has long since passed the point of diminishing returns.

Convenience rule

We do want to acknowledge gratefully the action of the House in spelling out section 119 so that a problem of long standing in our business shall be largely resolved. This is the stipulation regarding the placing of evaluation on meals and lodging for withholding-tax purposes.

Net operating loss deduction

We are also appreciative of the inclusion of section 172, which proposes to extend the net operating loss carryback period to 2 years, instead of 1 year, as at present. This postwar readjustment period has been a difficult one for hotels, and it is quite likely that this provision will prove extremely helpful to many individual properties.

Delay of effective date of subchapter C

Subtitle A of the Internal Revenue Code contains chapter 1 which in turn includes subchapter C, relating to corporate distribution and adjustments. This subchapter is designed to eliminate much of the confusion now present in existing law with respect to corporate reorganizations generally. The hotel industry generally was refinanced in the 1930's. Many of these refinancing measures still affect a number of hotels today with the result that the hotel industry may be materially affected by subchapter C. The extent of this effect cannot be gaged in the brief time that is available for the study of subchapter C. Moreover, even a brief study of this subchapter reveals certain conflicts that might result

in more confusion than is present in the existing law. As an example, IRC section 312 (g) of the proposed law states that the terms defined in sections 312 (b) to (f) inclusive shall be applicable only with respect to subchapter C. However, section 275 of the preceding subchapter B refers to section 312 (d) for definitions. This seems to make section 275 inoperative by reason of the exclusive application of section 312 (g). There are a number of other apparent conflicts in subchapter C which cannot be positively stated but which seem to require extensive study before this subchapter is enacted into law.

The American Hotel Association recommends that subchapter C, of chapter 1, subtitle A, be eliminated from the proposed code and the existing law be permitted to stand until the proposed subchapter C is given further study. As an alternative, it is recommended that subchapter C be made effective not earlier than July 1, 1955. If this later date is adopted, adequate time will be available for Congress to clear up apparent conflicts in subchapter C when it meets in 1955.

Tax-exempt establishments

For several years now spokesmen for the hotel industry have been urging the Congress to close some of the loopholes in section 101 of the existing revenue code. Congress did make a beginning in this direction in the 1950 Revenue Act, when it exposed to Federal income-tax liability the proceeds from unrelated business activities of certain categories of 101 organizations. I do stress for you today, however, gentlemen, that one of the most serious inequities remaining in the code reposes in this section. And unfortunately H. R. 8300, as it stands today, fails to tighten further these provisions.

I hold in my hand the type of exhibits which we have been assembling for several years and turning over to appropriate authorities. These have been filed with congressional committees and with the Internal Revenue Service. They reveal an increasing volume of instances where tax-exempt establishments are catering to the general public, for profit, and serving luncheons, dinners, receptions, etc. This provides eminently unfair competition to taxpaying establishments. There are even some of these organizations today which are providing transient rooms for the general public, operating as hotels. This certainly goes beyond the original concept of services to members for which these organizations were initially granted a tax-exempt status.

The Treasury Department has estimated that 5.5 percent of all consumer expenditures are channeled into business-type receipts of exempt organizations. If this measurement is applicable in food service, it means that $550 million worth of hotel and restaurant business is avoiding Federal income tax.

These tax-exempt organizations have a terrific advantage over us. First, they can undersell us considerably because they are not subject to Federal income tax which all private corporations must pay. Second, operating in the guise of organizations which cater only to their members, they frequently solicit public groups to have dances and other forms of entertainment without payment of cabaret or admissions tax, and so forth. It is essential that Congress provide the Internal Revenue Service with authority and funds which will permit a better policing job in this field.

In 1950 the Congress stipulated that certain 101 organizations were to be subjected to Federal income tax. These were 101 (1), (6), (7), and (14). (All references are to existing code sections.) Now let me ask the committee a question. Is it your interpretation of the code that 101 organizations not covered by the 1950 amendments, such as a 101 (3) organization, can be deprived of its tax-exempt status if found to be engaging repeatedly in catering to public functions, for a profit, in fields which are entirely unrelated to the purposes for which it was originally chartered? As an illustration of what I mean, we will say there is a fraternal organization, classified as 101 (3), which today is neither susceptible to income-tax returns, nor is it obliged to file information returns. Where one such establishment caters to public functions every day in the week for profit, it seems incredible that such a practice can be continued without the Treasury Department advising that establishment that it has lost its tax-exempt status by repeatedly benefiting from this unrelated income. For instance, it is just such an organization as we are describing where Commissioner Andrews himself is to be the principal speaker in a Midwest city this week. It is expected that an attendance of 600 persons will be present.

The meeting has no possible bearing upon the purposes for which that fraternal organization was chartered, and incidentally, the State itself is already imposing certain real-estate taxes on that particular establishment, growing out of a

finding that a large part of its activities were in fields unrelated to the purposes for which it was chartered. But the group goes merrily along, year after year, doing an annual volume estimated to be well in excess of $100,000. How much longer shall the taxpaying establishments of the country be required to endure that degree of inequity? We are willing, gentlemen, to face up to any kind of competition those groups want to give us, if they wish to be in the food business. But we do insist that when they cater to public groups, for profit, they should be exposed to Federal income tax on such profits, the same as we are.

To that end, may we propose two amendments. First, may we propose that you consider including in the present bill a provision amending title 26, section 54 (f), of the present code, by striking section (5). The effect of this amendment would be to require information returns from fraternal beneficiary societies now exempt under section 101 (3). Section 54 (f) (5) now provides that no information return need be filed by those groups. We feel very sure that if the Treasury began to assemble information returns from these fraternal beneficiary groups it would soon learn what a prodigious volume of unrelated business activities are annually experienced.

Then may we respectfully suggest that you amend title 26, section 421 (b) (1) (A) in the bill to read, "The taxes imposed by subsection (a) (1) shall apply in the case of any organization (other than a church, a convention, or association of churches, or a trust described in paragraph (2)) which is exempt, except as provided in this supplement, from taxation under this chapter by reason of paragraphs (1), (3), (6), (7), (8), (9), or (10) of section 101. Such taxes shall also apply in the case of a corporation described in section 101 (14) if the income is payable to an organization which itself is subject to the tax imposed by subsection (a) or to a church or to a convention or association of churches." Such an amendment would expose to Federal income tax the following categories of organizations: 101 (3), (8), (9), and (10).

Depreciation

In behalf of the hotel industry we would like to offer a few remarks on proposed code section 167, relating to depreciation. The typical hotel of America was built in the 1920's and consequently today is 25 to 30 years old. Considering that the average useful life of motel structures is about 40 years, this means that the great majority of American hotels today have a remaining lifetime of 10 to 15 years, possibly in some cases 20 years. During the 14-year period of 1939 to 1953, the motor courts of this country increased from 13,500 to over 50,000—an increase of 370 percent. During the same time there was very little hotel construction with the result that hotels increased in numbers by less than 10 percent. However, many thousands of hotels are in direct competition with motor courts and one advantage of the motor courts is their newness. A number of hotels have been renovated and improved in appearance and, by reason of the probable benefits of the declining balance method of depreciation, more hotels may see fit to invest in renovation and improvement. Therefore, it seems appropriate that we should request some means be devised of assuring two things to hotels:

First. That renovation and improvement taking place after January 1, 1954, be permitted to be depreciated by use of the declining balance method of depreciation described in code section 167 (b) (2). We assume that this is covered by the use of the term "reconstruction" in section 167 (c) (1).

Second. That the renovation and improvement of older hotel structures will not be used as a reason to extend the life of hotels for depreciation purposes. There is nothing in the proposed code that assures this to hotels.

One of the objectives of revising depreciation measures of the Internal Revenue Code is to stimulate additional investment in American enterprises. The stimulation is afforded by permitting higher writeoffs in the early years of the life of assets and we believe that this point has been so thoroughly covered in testimony and explanations that we need not dwell further on it. However, the hotel industry, like other industries of this country, would not be so encouraged if the result of investment in renovation and improvements of property results in action by the Secretary or his delegates to extend the life of such property. Manifestly, this would remove a great deal of the incentive for reinvestment in existing property and would shift the advantage to investors in completely new property. We don't believe that this is the intention of Congress.

A careful study of the proposed code indicates that only code section 167 (e) respecting dispute as to useful life and rate, is the only section that provides any protection at all against indiscriminate extensions of useful life of prop-

erty. Even this section is not directly on the point of concern to the hotel industry and to other indusries in a similar position. There is no real guidance for the investor in the proposed code that will encourage him to renovate and improve existing property without fear that such will be used as an excuse for extension of useful life. To this end, it is believed that a mutual service will be rendered if the following addition to the proposed code be made and known as section 167 (e) (3), as follows:

"The burden of responsibility for proving that the useful life of property should be extended shall fall upon the Secretary and his delegates whenever in any taxable year expenditures in the nature of capitalized renovation and improvement are made to existing depreciable assets in amounts not exceeding 10 percent of the original basis for depreciation."

Such a provision in the proposed code, together with the other proposed provisions, would provide the very best guaranty that American hotels and other industries would give the utmost consideration to the renovation and improvement of their properties.

Before leaving the subject of depreciation, we feel obliged to make one other observation respecting code section 167 (c). Subsection (c) (2) denies the use of declining balance depreciation to hotels that were built before December 31, 1953, but which have been acquired by new owners subsequent to that date. This is a severe penalty to place upon investors in hotels that acquired their interests subsequent to December 31, 1953. Equitable considerations would seem to require that section 167 (c) (2) be amended by striking out any reference to "original use" of property acquired after December 31, 1953. Subsection (c) (1) permits the use of declining balance depreciation only to property constructed after December 31, 1953, or to such portion as is completed after that date. This would appear to impose a tedious mathematical problem on investors of property that was in process of completion on that date. One could conceive of a situation where one-half of a building completed in 1953 had to be depreciated on one basis and the other half, completed in 1954, could be depreciated on another basis. It seems therefore that this should be obviated by having section 167 (c) (1) read "the construction, reconstruction, or erection of which is completed after December 31, 1953," and eliminate the balance of the presently stated section.

STATEMENT OF ROLLA D. CAMPBELL, NATIONAL COUNCIL OF COAL LESSORS, INC.

The CHAIRMAN. Identify yourself to the reporter.

Mr. CAMPBELL. Mr. Chairman and gentlemen of the committee, my name is Rolla D. Campbell, of Huntington, W. Va. I am a lawyer. I am president of a company which owns coal lands and leases them to operating companies. I am vice president of National Council of Coal Lessors, Inc., and was one of its organizers several years ago.

I wish to compliment those persons who have worked on preparing H. R. 8300 and the accompanying report. The bill and report are monumental and they embody many long-needed improvements in the code. I hope that the bill will be reported out by this committee and passed at this session.

However, it is inevitable that in a complex work of this type some corrections are needed. It is my purpose today to call your attention to some of the changes made by the bill and to some needed corrections in the bill in which the members of the National Council of Coal Lessors are particularly interested.

First, I wish to direct your attention to sections 631 (b) and 272 (b) of the bill. These sections amend sections 117 (j) and 117 (k) (2) of the present code, which accord capital-gains treatment to gains from coal and timber royalties.

We are not interested in the changes proposed with respect to timber royalties. While most of the members of the National Council of

Coal Lessors are also owners of timber, it is not our purpose to speak for timber lessors or operators. I understand they have a presentation which they will make to you and I would like to say that we have no objection to anything that they propose.

The first amendment contained in section 631 (b) is to state that a sublessor of coal is an owner entitled to capital-gains[1] treatment on his gains from royalties. The amendment is designed to correct a ruling of the Internal Revenue Service to the effect that a sublessor of coal in place is not an owner. We think the ruling was wrong and that the amendment conforms the statute to the original intent of Congress.

The Internal Revenue Service has ruled that successors in title to the owner who executed the contract of disposition are entitled to the benefits of section 117 (k) (2) of the present Internal Revenue Code. That is, in our opinion, a correct interpretation of the law. The bill does not undertake to change this interpretation.

The second amendment, which is contained in both sections 631 (b) and 272 (b), provides that the expenses of administration of the contract of disposition and of preserving the economic interest of the royalty recipient should be deducted[2] from the royalty income and not from nonroyalty income. This is a proper change which will promote equality among royalty recipients and we approve it. In our opinion, it does not alter the original intent of the present code, as such expenses are necessary and attributable to the sale out of which the royalty income arises and should be charged against them. The Internal Revenue Service has not ruled on this point and field agents have taken different positions, usually depending on which will produce the larger tax.

It is possible that a royalty recipient might realize a loss on his royalty income. Under the present law, section 117 (j) of the code, such a loss is treated not as a capital loss but as an ordinary loss. The counterpart of that section in the bill, section 1231, continues such treatment. But section 272 (b) of the bill, when fitted into the context of sections 63 (a) and 161 of the bill, apparently denies such a loss either as an ordinary loss deductible under section 165 (a), or as a capital loss carry-forward under section 1212, or as a carrying charge to be added to base under section 266. Moreover, we have not been able to reconcile the meaning of section 272 (b) of the bill, as written, with the comments thereon contained in the report at pages 59–60, A68, A190–191, and A272.

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[1] The new language appears in the third sentence of sec. 631 (b) and reads: "* * * and the word owner means any person who owns an economic interest in coal in place, including a sublessor."

[2] This is accomplished by the addition to the first sentence of sec. 117 (k) (2) IRC of the words "plus the deductions disallowed for the taxable year under sec. 272." Sec. 272 (b) of the bill disallows as a deduction under sec. 161: "* * * expenditures attributable to the making and administering of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract." It also provides: "This subsection shall not apply to any taxable year during which there is no production, or income, under the contract." This last sentence of sec. 272 (b) is new. It is unobjectionable as to substance but is subject to technical criticism. Reference to the report (p. A68) shows that the two commas in the sentence should be deleted and that the word "or" should be changed to the word "of," so that the sentence was obviously intended to read: "This subsection shall not apply to any taxable year during which there is no production of income under the contract." Since there may be more than 1 such contract and since, under sec. 1231, all must be considered in 1 computation to determine the gain or loss from the group, the last sentence should preferably read: "This sentence shall not apply to any taxable year during which there is no production of income under the contract, or if there is more than one contract, under such contracts."

It is our opinion that losses sustained with respect to royalty income should be treated as presently provided for in the code under section 117 (j), and we urge the committee so to provide. Drafts of changes in the bill necessary to accomplish this result are attached.[3]

If, however, the committee desires to write into the bill the results as to losses described in the report, the language necessary is also attached.[4]

Another desirable amendment to section 631 (b) of the bill is to change the word "lessee" contained in the fifth sentence to "producer." This will clarify, but, in our opinion, will not change, the meaning. We recommend this amendment.[5]

Since all the foregoing amendments contained in the bill and additional changes in the bill recommended by us are merely clarifying and are not intended to represent any basic or fundamental change, we strongly urge that they should be made retroactive to January 1, 1951. If adopted, they will not have any material effect on the revenue, but will tend to increase rather than decrease revenue payments by affected taxpayers.

Second, I wish to direct your attention to the definition of the term "property" in connection with the depletion allowances, both unit and percentage, contained in section 614 of the bill. The definition, which appears for the first time in the code, is a departure from the provisions of the regulations 118—section 39.23 (m–1) (i)—and would require a separate accounting by lessors and producers, whether or not taking percentage depletion, as to each separate mineral interest, which in the case of coal would be each seam in each separate tract as described in the deeds of acquisition, and would deny to lessors any right of aggregating into a single property all seams in a boundary of land composed of two or more contiguous tracts, a right they have

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[3] To conform the rule as to losses sustained in connection with royalty income, as now provided in section 117 (j) of the code with respect to losses sustained on the disposition of "property used in trade or business," sec. 272 (b) of the bill should be rewritten as follows (it being understood that the Council is suggesting changes only with respect to coal):

"(b) Where the disposal of coal or timber is covered by sec. 631 (b), no deduction shall be allowed for expenditures attributable to the making and administering of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract, except that when in any taxable year such expenditures plus the adjusted depletion basis of the coal or timber disposed of exceed the amount realized under the contract, such excess shall, to the extent not availed as a reduction under sec. 1231, be a loss deductible under sec. 165 (a). This subsection shall not apply to any taxable year during which there is no production of income under the contract, or if there is more than one contract, under such contracts."

[4] To conform the rule as to losses sustained in connection with royalty income as described in the report on page A88, sec. 272 (b) of the bill should be rewritten as follows (it being understood that the Council is suggesting changes only with respect to coal:

"(b) Where the disposal of coal or timber by the taxpayer is covered by sec. 631 (b), no deduction shall be allowed for expenditures attributable to the making and administering of the contract under which such disposition occurs and to the preservation of the economic interest retained under such contract, except that when in any taxable year the expenses (other than apportioned property taxes) plus the adjusted depletion basis of the coal or timber disposed of exceed the amount realized under such contract, such excess, to the extent not availed as a reduction of gain under sec. 1231, shall notwithstanding the provisions of sec. 1231 be treated as a capital-loss carryover under sec. 1212. Taxes paid by the owner on land subject to such contract or contracts shall first be apportioned between the value of the land attributable to the timber or coal covered by the contract or contracts and the value attributable to other elements of value. To the extent that the apportioned part of such taxes plus the taxpayer's other expenditures disallowed by this section and the adjusted depletion basis of the coal or timber disposed of exceed the amount realized from such contract or contracts, the taxes shall be deductible under sec. 164. In making this computation, the income under such contract shall first be reduced by the other expenditures and the adjusted depletion basis and then by the taxes. This subsection shall not apply to any taxable year during which there is no production of income under such contract, or if there is more than one contract, under such contracts."

[5] With such change, the fifth sentence will read: "In determining the gross income, the adjusted gross income, or the taxable income of the producer, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection."

enjoyed and exercised for years. It is our understanding that this result was not intended by the draftsmen of section 614. In any event, section 614 as it now reads is highly objectionable.

The CHAIRMAN. What do we know about that?

Mr. SMITH. That was not the intention.

The CHAIRMAN. Will you be prepared to clarify that?

Mr. SMITH. Yes.

Mr. CAMPBELL. Unless changed, it would impose a great expense and nuisance on royalty owners, operators, and the Internal Revenue Service and would accomplish no useful purpose whatever.

It is our recommendation that section 614 of the bill should be completely rewritten; that taxpayers reporting income from depletable property should have the optional right to aggregate their mineral interests into one or more aggregations each of which is to be treated as a single property as they may elect with the right to revise their election upon the happening of any substantial change in their holdings or operations, and that apportionment of depletion allowances to any single mineral interest be required only when such an apportionment becomes necessary, as for example, when such an interest is sold. A suggested redraft of section 614 incorporating these proposals is attached.[6]

If such an approach cannot be made by the committee, then we strongly urge that a special rule should be added to section 614 which would recognize and preserve existing practice with respect to aggregating tracts for computing unit depletion by royalty recipients.

The CHAIRMAN. I invite your attention to section 614 (b):

> For purposes of the preceding sentence, operating mineral interests which constitute all or part 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. The taxpayer may not elect to form more than one aggregation of operating mineral interests with any one operating unit.

Mr. CAMPBELL. Mr. Chairman, as I read that language, it is limited to the election allowed to those taking percentage depletion to form

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[6] Redraft of sec. 614 is 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) ELECTION TO AGGREGATE SEPARATE INTERESTS. If a taxpayer owns two or more separate mineral interests, he may elect—

"(A) to aggregate two or more of such interests into one or more aggregations, each of which shall be considered as a separate property; and

"(B) to treat as a separate property each such interest which he does not elect to include within an aggregation referred to in subparagraph (A).

"(c) MANNER AND SCOPE OF ELECTION. The election provided by subsection (b) shall be made, in accordance with regulations prescribed by the Secretary or his delegate, not later than the time prescribed for filing the return (including extensions thereof) for the first taxable year beginning after December 31, 1953, with respect to mineral interests owned by the taxpayer at the end of such year. Such election may be revised by the taxpayer with respect to all mineral interests of the taxpayer not later than the time for filing the return (including extensions thereof) for any subsequent taxable year during which the taxpayer acquires or disposes of a mineral interest or changes any mineral interest from a development stage to a production stage or abandons operations in any mineral interest. An election made by the taxpayer shall be binding on the taxpayer for all subsequent taxable years unless revised under the preceding sentence or unless the Secretary or his delegate shall consent to a different treatment of the interest with respect to which an election has been made.

"(d) APPORTIONMENT OF DEPLETION ALLOWANCES. Where there has been an aggregation of mineral interests under subsection (b), the depletion allowance with respect to the aggregation shall be reasonably apportioned among the mineral interests aggregated for the purpose of determining the adjustment to basis of each such interest under section 1011 whenever it becomes necessary so to do."

an aggregation within one operating unit and does not apply to royalty owners or recipients who do not take percentage depletion.

Now if that language were made applicable to what is described in there as nonoperating mineral interests, which would be the royalty recipient, it would be entirely all right.

The CHAIRMAN. Bring that to the attention of the staff.

Mr. CAMPBELL. I am sure there is a defect in draftsmanship which just didn't occur to the draftsmen when they were working on it, since they had their attention primarily focused on the problems connected with percentage depletion.

Senator CARLSON. Mr. Chairman, I remember the many appearances of Mr. Campbell before the House Ways and Means Committee and he usually came in with good suggestions, so I would hope his remarks will be given their due regard before this committee.

The CHAIRMAN. I hope the staff will pay special attention to this when we get into executive session.

Mr. CAMPBELL. Thank you very much, Mr. Chairman.

Continuing, I suggest a special rule which should be substantially as follows:

(c) SPECIAL RULE AS TO NONOPERATING MINERAL INTERESTS. If a taxpayer owns 2 or more separate nonoperating mineral interests in a single tract or parcel of land, or in 2 or more contiguous tracts or parcels of land, the taxpayer's interests in such mineral properties may be considered to be a single property, provided such treatment is consistently followed by the taxpayer.

This is substantially the language of present regulations 118, section 39.23 (m–1(1)).

The CHAIRMAN. Have you discussed this with members of the staff?

Mr. CAMPBELL. Yes, I have. I have with the Internal Revenue Service, but not with Mr. Stam and his staff.

The CHAIRMAN. I suggest you make a date with Mr. Stam.

Mr. CAMPBELL. Thank you very much, sir. I will be happy to do so.

If the committee retains a difference in treatment between operating and nonoperating mineral interests, we do not suggest that a nonoperating mineral interest should be combined in one aggregation with an operating mineral interest.

While this subject is highly technical, it is of extreme importance to taxpayers affected and deserves the most careful and discriminating attention both as to substance and as to technical language.

I thank you for the privilege of appearing before this distinguished committee.

The CHAIRMAN. We thank you.

Mr. J. Rutledge Hill was scheduled to present an oral statement in behalf of the National Sand and Gravel Association. He was unable to appear today because of illness but his statement will be made a part of the record in lieu of his personal appearance.

(The statement of J. Rutledge Hill follows:)

STATEMENT OF J. RUTLEDGE HILL, DALLAS, TEX., CHAIRMAN OF COMMITTEE ON TAXATION, NATIONAL SAND AND GRAVEL ASSOCIATION, ON PERCENTAGE DEPLETION

My name is J. Rutledge Hill. I am president of Gifford-Hill & Co., Inc., Dallas, Tex., which has sand and gravel operations in Texas, Louisiana, and Arkansas. I appear before you as chairman of the committee on taxation of the National Sand and Gravel Association.

I was a witness before the Ways and Means Committee of the House of Representatives in the public hearings conducted by that committee last year. This statement will not duplicate the testimony offered at that time and will be confined, as you request, to the additional recommendations which my industry has to offer on the basis of the bill which passed the House and is now pending before your committee.

I should make it clear at this point that although at the public hearings conducted by the Ways and Means Committee, I represented both my association and the National Industrial Sand Association, this morning I appear only for sand and gravel producers and not for producers of industrial sand, whose products and problems in this connection are quite different from ours.

The bill passed by the House proposes a percentage depletion allowance of 15 percent for chemical and metallurgical grade limestone for whatever purpose used. My industry believes that this is a sound proposal and is fully justified by the national policy of granting a percentage depletion allowance to industries with wasting assets. It is our hope that the wisdom and the justification of this proposal will be recognized by your committee; but I must say in behalf of the industry which I represent that the same considerations which led to this decision by the House apply with equal force and logic to the sand and gravel industry, whose percentage depletion allowance of 5 percent the House does not propose to change.

Sand and gravel producers and producers of crushed limestone used for construction and building purposes are in competition with each other all over the United States for common markets. Each should therefore get the same consideration from the Congress under the national policy of encouraging the mining industries to explore and develop new sources of supply in order that the mounting demands of the country for mined products may be fulfilled.

I should therefore like to ask your committee to include the sand and gravel industry in the category of mining industries entitled to the 15 percent percentage depletion allowance. Another competitor of our industry, with whom we must compete in many areas for highways and streets is the rock asphalt industry, which has been entitled to a percentage depletion allowance of 15 percent since 1943. There is no evidence in the public record that this industry is entitled to more consideration than the sand and gravel industry and we hope that your committee will eliminate this competitive inequality imposed on the sand and gravel industry. To a lesser extent, but nonetheless acute in certain phases of our operations, we will be at a disadvantage if the proposal of the House of Representatives to increase the percentage depletion allowance for slate from 5 percent to 15 percent is approved by your committee without increasing our own rate by a corresponding amount.

I ask for your committee's consideration of the demonstrated need for equality of treatment in the application of the percentage depletion policy. We do not wish to be regarded as asking here any reduction in the percentage depletion rates provided for in the bill which passed the House. We believe that the action of the Ways and Means Committee and its later approval by the House is easily justified on the facts and in full accord with a wise national policy; but we do urge upon your committee the propriety of according to all industries in the same mining family the same rate for percentage depletion in order that obvious inequalities may not be imposed.

The sand and gravel industry is second only to the bituminous coal industry in annual tonnage produced in the United States. Our country is exhausting its economically available sand and gravel reserves at a distressing rate. We face the prospect of serious sand and gravel shortages in many areas, and while I realize that it is a grave but common error to suppose that sand and gravel can be found almost everywhere, the grim truth is that under modern conditions vast sums of money must be spent first to explore for and locate a satisfactory sand and gravel deposit and then to build a plant which will produce and process the materials in conformity with the severe specification standards now required to be met before our materials will be accepted.

It is my deep-rooted conviction that our industry on the merits and on the basis of competitive equality, is entitled to an increase in percentage depletion allowance from 5 percent to 15 percent.

The CHAIRMAN. Mr. Barker——

STATEMENT OF RICHARD B. BARKER, BIBB MANUFACTURING CO., MACON, GA.

Mr. BARKER. My name is Richard Barker. I have offices in the Southern Building, Washington, D. C., and I represent the Bibb Manufacturing Co., of Macon Ga. I ask permission to put my written statement in the record and I will summarize it orally, if I may do so.

The CHAIRMAN. You may do so.

(The prepared statement of Mr. Barker follows:)

STATEMENT OF RICHARD B. BARKER REPRESENTING BIBB MANUFACTURING CO., MACON, GA.

The enclosure has been prepared for use in acquainting members of Senate Finance Committee with the status of the pending House legislation pertaining to the suggested revision in the Revenue Code to permit the use of the lower of LIFO cost or market, and in soliciting support of an amendment to the current tax revision bill by the Senate Finance Committee to include this much needed revision.

MEMORANDUM ON H. R. 5295 AND H. R. 5296

There are pending before the House Ways and Means Committee, two bills (H. R. 5295 and H. R. 5296) the enactment of either of which will remove from the Internal Revenue Code an inequity among taxpayers whose taxable income is substantially affected by inventory methods. These bills, by amending section 22 (d) (1) of the Internal Revenue Code, permit a taxpayer who adopts the last-in, first-out method of inventorying, to value his inventory on the generally accepted method of cost or market, whichever is lower, instead of forcing him to use only the cost basis.

On July 21 in the hearings before the Committee on Ways and Means, testimony was given by representatives from all industries urging that the contents of these bills be included in the current tax revision legislation. This testimony included representatives from:

The American Cotton Manufacturers Institute
The American Mining Congress
The American Retail Federation
The National Retail Dry Goods Association
The National Association of Manufacturers
The National Coal Association
The American Institute of Accountants

and many other groups and individual taxpayers.

It is understood that when this item was brought up for discussion in committee, the item was not acted upon favorably, primarily because of a misunderstanding of its principles. Subsequent discussions with individual members of the Ways and Means Committee who opposed the item, clarified their understanding, and they stated they would change their views upon any subsequent action. However, they also stated that it was inopportune to attempt to call for a reconsideration and suggested that the only immediate course of action would be through an amendment originating in the Senate Finance Committee. Hence, the following information is submitted.

The need for this legislation will be evident from the following brief survey of the present situation with respect to the effect of inventory methods on financial statements and on the amount of taxable income.

Section 22 (d) (1) of the Internal Revenue Code provides that all taxpayers may use the last-in, first-out (LIFO) pricing principles in determining inventory valuations. These provisions were enacted by Congress in the Revenue Act of 1939 for the express purpose of providing a means through which the increased cost of carrying the same required inventory investment, due to price rises, would not be considered business profits.

For 10 years following enactment in 1939, administrative interpretations and regulations issued by the Bureau of Internal Revenue discouraged, and in many instances specifically prohibited the use of LIFO except for very simple inventories.

The Bureau did not broaden its regulations until compelled to do so as the result of several Tax Court decisions in 1947 (*Hutzler Bros.*, 8-TC-14; *Edgar A. Basse* 10-TC-328, and *Sweeney & Co., Inc.*, 7-TCM-121), which upheld practical mechanics of applying the last-in, first-out method for complex inventories. This was in 1949—10 years too late—and by that time prices had risen more than 100 percent over the 1939 levels. As a matter of fact, the procedural opposition of the Bureau of Internal Revenue to the adoption of the LIFO method of valuing inventories by taxpayers has not disappeared even today--15 years after Congress acted on the matter. As recently as February 1954, the Bureau issued instructions whereunder for the first time they recognized practical methods whereunder so-called specialty stores could adopt LIFO.

It is this silent but powerful opposition of the Bureau and the Treasury to the approval of sensible applications of the LIFO principle which justifies and merits relief action by Congress at this time. It has been estimated that only about 10 percent of the country's inventories are valued on a LIFO basis. A large part of the remaining 90 percent of the inventories of the country undoubtedly would have elected the LIFO method prior to the present time but for the fact that the Bureau of Internal Revenue either advised the taxpapers that they were prohibited from adopting the method or advised them that, if the method was permissible, the procedures acceptable to the Bureau were such as to make the use of LIFO completely impracticable.[1]

In short, there has been a step by step forced and reluctant retreat by the Bureau and Treasury with respect to the LIFO problem and it is submitted that under such circumstances it is entirely appropriate that Congress should enact relief legislation so that the taxpayers who were misled by the Government can now adopt the LIFO method.

While most of the administrative blocks of the past have now been eliminated, still it is unreasonable to ask a taxpayer to make such an election when all the economic factors indicate that prices are at their cyclical peak. This is occasioned by the fact that the present statute requires LIFO taxpayers to value their inventories at cost rather than at "cost or market, whichever is lower" as is permitted FIFO taxpayers. No one in their right mind would freeze their inventory prices at costs determined at the peak of a price cycle. Thus, while taxpayers who have heretofore been dissuaded by the Bureau tactics from making the election, now, for the first time, have what can be considered a free election, but the timing of the free election destroys its validity.

The Treasury, to date, has indicated orally its objections to the relief bills. It is difficult to understand the Treasury position in the light of the past performance of the Bureau of Internal Revenue. There has been no published statement by the Treasury to the effect that the relief bills would cause any immediate loss of revenues—and it is doubted that any such claim can be validly made in the light of the stationary position of commodity price indices and the fact that if prices go down, the 90 percent not on LIFO under their present inventory pricing basis will write down their inventories accordingly and if prices go up and LIFO is adopted by any of the 90 percent, any income which is thus deferred to future years will be more than offset by the increase in profit from turnover of inventories during the period of acceleration.

Also, prices would have to drop generally about 60 percent below their present levels before the inventories of the 10 percent now on LIFO would be affected so these are not relief bills for those now on LIFO.

The long range advantage to both the Government and the taxpayers from adoption of the amendment to the law can be best summarized by the following twelve points:[2]

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[1] Proof is available that taxpayers were advised that if they adopted LIFO they must use so many subclassifications of inventory as to make the method unworkable. For example, one textile concern was advised it would have to set up 24 different classifications of cotton—one for each grade and staple of cotton used even though all their finished goods were coarse carded yarns or fabrics made therefrom. For years the Bureau used pressures to make taxpayers exclude labor costs from their LIFO inventories on the threat that, if included, the taxpayer would have to use impractical subclassifications of goods. Even today the Bureau requires a separate classification of labor costs from material costs even though they are both cost elements of the finished goods. For over 2 years the Bureau has been considering, but to date has not published, a mimeograph advising taxpayers who, because of pressures exerted on them at the time they made their elections, made impractical classifications of their inventories, how they can adjust this situation through the use of the so-called dollar value method. Numerous other detailed examples could be presented which demonstrate the unsympathetic and noncooperative attitude of the Bureau.

[2] See hearings before Committee on Ways and Means, 83d Cong., 1st sess., pt. 1, pp. 633, 634 (McAnly).

1. Encouraging the adoption of LIFO by permitting all companies to use the lower of LIFO cost or market, will provide an opportunity to prevent further paper profit inflation if and when prices go up and thus prevent these additional paper losses if and when prices go down.

2. Giving all taxpayers who adopt LIFO, the right to write down to the current cost or market, will give them no greater deductions from accumulated income than they will have if they postpone their shift to LIFO until a lower price level.

3. Under the present law (without the amendment) all companies not on LIFO now have the right to take write-downs to current cost or market when prices recede and then shift to LIFO.

4. Likewise, under the existing law (without the amendment), new companies which come into existence at high-cost-level periods, will wait until prices recede before adopting LIFO and thus they, too, will be forced to write up their inventories if prices go up before a decline takes place. On the other hand, companies which adopted LIFO early in the picture and have subsequently expanded their operations in the more recent high-cost years, find themselves with large portions of their expanded inventories frozen at these more recent high-cost levels.

5. The amendment to permit the lower of LIFO cost or market will provide the possibility of at least partially eliminating the inequities among taxpayers caused by the restrictive administration of the original LIFO provisions for a period of 10 years subsequent to 1939 during which prices doubled.

6. Over a complete price cycle, the same amount of business profits will be available for taxation—profits are merely shifted to the year in which they are realized—within the cycle. Again quoting from the United States Department of Commerce Survey of Current Business, May 1953, on page 20:

"Over a complete price cycle total profits before taxes will tend to be similar, for any one firm, under either (LIFO or FIFO) method."

7. For shorter periods of less than a complete price cycle, the effect upon taxable revenues will be to level out profits—a definite benefit to both the business economy and the Treasury. Another quotation from the Survey of Current Business, page 20, of the May 1953, issue is pertinent:

"Another reason for the spread of LIFO is the greater stability of LIFO profits relative to FIFO profits over an extended period. LIFO profits are lower in times of rising prices when profits are typically high. Conversely, reported profits are greater (or losses smaller) under LIFO than under FIFO in times of falling prices when profits are typically low. To many businessmen, the smoother, more stable picture of earnings provided by LIFO is one of the more attractive features of the method."

8. Taxpayers will be able to adopt LIFO for tax purposes and still continue to keep their accounts in conformity with sound business principles and accepted accounting practices, i. e., that income should not be recognized until realized, and that provision should be made for losses when it appears likely that they will occur.

9. It will permit uniformity and clarification of financial reports.

10. The possible shift to LIFO which might be encouraged by the amendment would be a gradual one with a relatively minor effect upon tax revenues in any one year—and then only in a period of rising prices. During such periods, the windfall of taxable realized profits from the effect of price increases as inventories are turned over several times during an annual period, far exceed the unrealized "paper profits" in inventories which are shifted to a future year through LIFO application.

11. It is significant that the United States Department of Commerce in its national income accounting uses a method of inventory valuation which closely resembles the LIFO method. The National Income Supplement to the Survey of Current Business (1951 edition) on page 39 states:

"The LIFO method of inventory accounting yields results most akin to national income practice."

Also on page 21 of the May 1953 issue of the Survey of Current Business, the statement is made that:

"The basic principle of the LIFO method, the charging of current costs to current revenues, is essentially the same as that embodied in national income concepts."

It would seem, therefore, that the LIFO tax law should be amended to remove the obstacle which prevents its adoption by industry generally.

12. Basically and most important of all, it will provide a single method of inventory pricing through which all taxpayers can at all times keep price infla-

tion out of inventory valuations, and business profits determined thereunder will be realized profits fully available for distribution as dividends, taxes, etc. Only through the combination of the LIFO order of pricing and the lower of cost or market inventory valuation method can business be conducted in accordance with sound principles and taxation of business profits placed upon the solid foundation of only taxing profits that have been realized.

One other facet of the problem deserves attention. The advocates of H. R. 5295 and 5296 have attempted in every possible way to meet the Treasury representatives more than half way on the proposal to amend the LIFO provisions of the code. On April 8, 1952, H. R. 7447 was introduced by Representative Camp, of Georgia, and on April 23, 1952, H. R. 7554, an identical bill, was introduced by Representative Reed, of New York, in an attempt to effectuate a reasonable compromise of this problem. Representatives of the Treasury had argued that the bills introduced in the present session of Congress (H. R. 5295 and H. R. 5296) gave an indefinite period within which there could be a permanent write-down of costs to market values. Although rightfully no limitation period is a part of the basic principles involved in this problem, since we are dealing with matters of established business and accounting practices, a 5-year permanent write-down period was included in those compromise bills. Such a provision would at least protect the taxpayers from electing the LIFO method at a time when it appears we are at the very peak of the price cycle.

The advocates of the bills introduced during the present session are still willing to accept the compromise proposals. They cannot believe that the present Treasury officials would oppose the compromise if they were fully aware of all the numerous impediments strewn in the taxpayers' path in the past with respect to the right to use, and methods of application of, LIFO.

Mr. BARKER. There were introduced in the House last year two bills, identical in form, H. R. 5295 by Mr. Byrnes of Wisconsin, and H. R. 5296 by Mr. Camp of Georgia. The purport of these two bills was not included in H. R. 8300. They deal with a revision of section 22 (d) of the Internal Revenue Code, dealing with the method of costing inventories and more particularly whether or not "last in, first out" taxpayers should be allowed the privilege that "first in, first out" taxpayers are allowed i. e., of costing their inventories at cost, or market, whichever is lower.

May I say that the purport of these bills is backed by such associations as the National Association of Manufacturers, the American Retail Federation, the National Retail Drygoods Association, the American Iron and Steel Institute, the American Cotton Manufacturers' Institute, the American Mining Congress, and the National Coal Association.

The CHAIRMAN. What is the thing that you are trying to do?

Mr. BARKER. Specifically, what we are trying to say, Senator, is this: That under the Internal Revenue Code, taxpayers are entitled to use their "first in, first out," or "last in, first out," as a method of evaluating their inventory.

For years, "fi-fo" taxpayers have been allowed to use cost or market whichever is lower. Whereas, "li-fo" have been restricted to the use of cost in pricing out their inventories, and are not entitled to use market when market is below cost.

The reason why we feel this relief provision should be included in the Internal Revenue Code is because, frankly, although Congress passed provisions in section 22 (d) entitling taxpayers to use "li-fo" in 1939, the administration quietly and subtly was opposed to the use of "li-fo" and frankly blocked it in every possible way.

Now for example, I know that my particular client, the Bibb Manufacturing Co. came up here in 1941 or 1942 and inquired as to how it could utilize the "last in, first out" method of valuing its inventories.

They were advised that if they wanted to use "li-fo" they would have to split up their inventories into so many subclassifications, as to make the use of it impractical.

For example, for 10 years, the Bureau of Internal Revenue told department stores that they couldn't use "li-fo" and it wasn't until we took a test case to the courts and fought it out in bitter litigation that the Bureau was told that they were wrong and that Congress intended that all taxpayers had the right to use "li-fo" and the Bureau of Internal Revenue had no right to say that any particular group or class of taxpayers could not use it.

For 10 years, the Bureau fought a practical method of applying "li-fo" where labor costs were used in determining the value of the goods. It was not until January or February of this year, 1954, that the Bureau came out with regulations permitting specialty stores to use "last in, first out" methods of valuing inventories on a practical basis. The Bureau has had under consideration for 2 years a mimeograph, which is not yet issued, advising more complicated businesses of the practical methods of using indexes for valuing their inventories. So there has been this opposition by the Bureau and the Treasury Department to the advising of taxpayers of practical means by which they could use this "last in, first out" method of valuing inventories, with the result, Senator, that only about 10 or 15 percent of the taxpayers of this country have taken advantage of the provisions of law that Congress put into the Internal Revenue Code in 1939.

Now under these circumstances, we maintain that it is only fair and equitable to give those taxpayers who were dissuaded from using "li-fo" an opportunity to go on and take advantage of that provision of the Internal Revenue Code. But no taxpayer in his right mind is going to elect to go on "li-fo" at the time when your price indexes are at a possible peak, because if we are restricted to using cost, as the statute now requires, we will have our costs frozen and if there is a recession in the price indexes, we will have to continue to carry them at cost, whereas "fi-fo" taxpayers can write them down to market.

Now the provisions of these two bills, H. R. 5295 and H. R. 5296, which are identical, provide that taxpayers can, on the "li-fo" basis, use cost or market, whichever is lower, just as "fi-fo" taxpayers can use it. I must say, I understand the Treasury is opposed to these bills. I must also say there was a difference of opinion in the House Ways and Means Committee as to whether the provision should be put into H. R. 8300. I do want to call attention, however, to the fact that 2 years ago, largely with the help of Mr. Stam's office, a compromise bill was drafted in the 82d Congress, H. R. 7447, by Mr. Camp, and H. R. 7554 by Mr. Reed. The compromise bill doesn't say that "li-fo" taxpayers can write down their inventories to cost or market, whichever is lower, on a permanent basis, but it does say because of the past inequitable administration of section 22 (d) of the Internal Revenue Code, taxpayers for a period of 5 years shall be allowed to write down their inventories to cost or market, whichever is lower, and establish a new low-cost base.

After the 5-year period, while they can still write down to market, if the market goes below cost, thereafter if prices rise, they will pick up income so that there will be no permanent loss of revenue to the Treasury Department.

I believe that a happy solution to this problem of working out the inequitable situation that has existed in the past, could be accomplished if this committee would take the compromise bill and put it into the Internal Revenue Code.

I do feel that some correction should be made because of the atttiudes of the Bureau and the Treasury Department, as proven by the fights that we have had to have with them over a period of 10 years on this subject. We respectfully urge that the compromise measure would solve the problem and very frankly I can say this, that in my opinion, Senator, this is one provision that would not cost the Treasury any immediate revenue, because our price index level is more or less at a stationary point. It would correct an inequity and not cost the Government money at the present time.

Thank you very much.

The CHAIRMAN. Thank you very much.

Mr. Higgins——

STATEMENT OF ALLAN H. W. HIGGINS, BOSTON, MASS.

Mr. HIGGINS. Mr. Chairman and members of the committee, my name is Allan H. W. Higgins, of Boston, Mass., and I represent a group of real estate and investment trusts and their beneficiaries. These trusts were formed about the turn of the century—that is, most of them were—before there were any income taxes and were formed for the purpose of providing a means of diversified investment in real estate, real estate then being deemed to be even more of a trustee's investment than were stocks and bonds. These trusts were formed largely by soliciting subscriptions from shareholders for shares of beneficial interest and the proceeds from these subscriptions were held by the trustees who used them to acquire locations for, chiefly, office and mercantile buildings in various sections of the country, and in most cases built the buildings, although in some cases they later acquired other buildings by purchase.

The trusts were performed to provide centralized management and diversification of investment, and minimizing of risk because even in those days it had gotten to the point where very few individuals could build a large office building. However, many small individuals could combine together and provide the capital for the building and by doing that in a number of different instances, could diversify the risk of investment in any one piece of real estate.

Now, for many years, these trusts were taxed as strict trusts but in the late 1920's or early 1930's, gradually by court decisions they were held to be more like corporations than like trusts and were subjected to the corporate tax.

By that time, however, the real estate situation with reference to mercantile buildings was in such a poor economic condition that the impact of the corporate tax was not very serious, as most of these trusts had very little income, at that time, and many of them had losses. As the older leases expired and new leases were written so that the trusts made income, the payment of the corporate tax has become exceedingly serious.

The amendment which we propose, would incorporate the substance of H. R. 5418 (which was introduced in the House by Representative Goodwin) in H. R. 8300. It applies to these real estate investment trusts the same tax treatment as was applied to the security-invest-

ment trusts in the Internal Revenue Code, that is, to tax the trust beneficiaries on the income from the rents, dividends, and interest which is currently distributed by the trust, to tax the trust beneficiaries on distributions of capital gains, and to relieve the trust of the corporate tax on such distributed income which is imposed by present law. That is very much as the system works with reference to security investment trusts, that is, it applies the so-called conduit theory.

Now the justification for the tax treatment of real estate trusts, like that of security investment trusts, is that these trusts are inequitably subjected to a corporate tax on all their net income under present law, whereas the security investment trusts are not. This corporate tax on real estate trusts is confiscatory in that if a trust buys a building which an individual could buy on a 6-percent basis, the trust, after the 50-percent corporate tax, has only 3-percent net to distribute to its beneficiaries. These real estate trusts are substantially similar in form and substance to security investment trusts. As I said, the security investment trust got relief from the corporate tax on the theory that they were mere conduits of the income received, which was then largely distributed to shareholders, and that the shareholders really had an indirect or beneficial ownership in the underlying assets. The very same thing is true of these real-estate investment trusts.

For instance, comparing a bond investment trust with real estate investment trusts, it appears that rental real estate is just as much an investment as are bonds. The interest on the bond is paid for the use of the money, and rent is paid for the use of the real estate. Both types of investment trusts were formed for the same purposes; namely, centralized management, diversification of investment, and the minimizing of risks.

The management duties of trustees and real estate trusts are substantially similar to the duties of the trustees of security investment trusts, that is, they handle the investment, they employ field forces to go out and look over the various corporations in which they own securities. The same is true of the real estate investment trust.

The CHAIRMAN. Does the real estate investment trust occupy an active management role?

Mr. HIGGINS. I don't think they do occupy any more of an active management role than do the security trusts. The security trusts maintain large staffs of research people and fieldmen who not only consider the financial statements of these corporations but go out and investigate them and decide whether or not they are going to invest in them. The same thing is done with the real estate trusts.

Furthermore, in many cases with reference to the real estate trust, and in fact in most cases, they employ a management firm of real estate managers to manage the property. Now that is a very interesting thing because, if you consider a business organization, such as a manufacturing or sale organization, they will not go out and employ a firm of managers to manage that manufacturing or sale corporation. People do go out and employ real-estate managers to manage an office building—it is a very common practice, and the reason for that comparison is because real estate in that sense is an investment. It is true that the handling of that investment requires a little different operation than the handling of security trusts, but certainly a much less staff, and the employees in an office building in most instances

are not in the employ of the trust, they are in the employ of the management firm who collects the rents, handles the employees, and distributes the net to the trust so that the employees, the elevator operators, and so on, are in the employ of the management firm rather than in the employ of the trust, directly, so that the trustees devote their time largely to investing possibilities of investment in real estate, or the acquisition of additional rental properties. They deal with the managers with reference to whether the rents should be raised or lowered or whether there ought to be possibly a new front put on the building, but the management firm is the one which actually does the operation.

The same is true with reference to investment trusts. There frequently is a management firm which manages the security investment trust.

Now the effect on Government revenues from this we believe would be minor, in that there is a provision in here, in our suggested relief for these real-estate trusts, similar to the provision with reference to security investment trusts, that the trust must distribute 90 percent of its income to its beneficiaries, so if they save the corporate tax, of necessity the amount of the corporate tax would then be distributed to the beneficiaries, and would be subjected to tax at surtax rates, in the hands of the individual beneficiaries, which in many cases might be considerably higher than the corporate-tax rate.

As it is now, half of the income is being taken by the Government at a 52-percent rate, and that isn't distributed.

The CHAIRMAN. What would you like to do?

Mr. HIGGINS. Our proposal specifically, Senator, is to take subchapter M, chapter 1, of subtitle A, which covers regulated investment companies, and divide that into two parts. Part I would cover the regulated investment companies, and part II would cover the real-estate investment trust.

Then we would specifically provide that 90 percent of the income of these trusts must be from interest, dividends, and rent, or income from real estate. At the moment, in the case of the security-investment trusts, 90 percent of their income must come from interest and dividends on stocks and bonds. This merely adds rent to that definition.

Then we provide, as do the security-trust provisions, that not more than 30 percent of the trust gross income may consist of short-term gains on security sales, and then we go one step further and provide that not more than 30 percent of its gross income should come from sales of real estate, held for less than 5 years.

Now, we put that provision in advisedly after consultation with the staff, because we wanted to make doubly clear that these trusts are not in any sense real-estate dealers. They don't buy for resale; they buy for long-term holding investment purposes. And we didn't want to get our type of operation confused with the real-estate dealer who invested for a quick speculation.

The CHAIRMAN. Supposing you have a real-estate trust which sells everything it has. What is the tax effect to the trustees and to the beneficiaries?

Mr. HIGGINS. If it were to completely liquidate?

The CHAIRMAN. Yes.

Mr. HIGGINS. First, if the present law prevailed, if the trust sold, you would have a capital-gains tax on the sale by the trust of its under-

lying real estate and, secondly, upon liquidation to the beneficiaries, if it was complete liquidation, the beneficiaries would realize gain or loss, depending on what they had paid for their shares of beneficial ownership in the trust, based on the amount that was distributed to them in connection with the liquidation.

Now, there is a very serious danger of forced liquidation on these trusts, due to the fact that the market value of these shares is dependent almost entirely (as can be demonstrated for a period of 30 years) on the capitalization of the dividends they pay. Due to the corporate tax, the dividends have been halved, and the value of these shares has gone down substantially. On the other hand, it can be demonstrated that the market value of the underlying assets is considerably higher than the value of the shares which is based on the dividend.

So, if these trusts were completely liquidated, the shareholders would undoubtedly get more in liquidation than they can get by selling their shares, and there is considerable pressure as a result of the corporate tax to liquidate these trusts.

The CHAIRMAN. Do the beneficiaries have a voice in this?

Mr. HIGGINS. Generally the trustees have the complete power, but in a good many instances, the beneficiaries can vote to force a liquidation by a two-thirds or three-fourths vote of the beneficiaries. In some of the trusts the beneficiaries have some authority with reference to the selection of successor trustees. In other cases, the trust is self-perpetuating.

I would like to say, Senator, that a statement has been filed by Henry M. Channing which develops that point quite substantially, and I hope will be incorporated in the record right after our statement so that the two may be together.

The CHAIRMAN. It will be so incorporated.

(The statement referred to follows the prepared statement of Mr. Higgins.)

Mr. HIGGINS. I would like to say we have prepared a detailed statement with the proposed provision for amending H. R. 8300, which I would like to ask permission to file and have incorporated in the record.

(The detailed statement referred to appear sat p. 1280a.)

(The summary of the statement referred to follows:)

SUMMARY STATEMENT RE PROPOSED AMENDMENT TO H. R. 8300 TO TAX REAL-ESTATE INVESTMENT TRUSTS LIKE SECURITY INVESTMENT TRUSTS

I. Purpose of the amendment

To apply to real-estate investment trusts the same tax treatment as is applied to security investment trusts, namely:

(*a*) To tax to the trust beneficiaries the income from rents, dividends, and interest which is currently distributed by the trust;

(*b*) To tax to the trust beneficiaries all distributions of capital gains, and

(*c*) To relieve the trust of the corporate tax on such distributed income which is imposed by present law.

II. Justification for tax treatment of real-estate trusts like that of security investment trusts

(1) Real-estate investment trusts, as compared to security investment trusts, are inequitably treated under the Federal tax law, in that the former are subjected to a corporate tax on all their net income, whereas the latter are not.

(2) The corporate tax on real-estate trusts is confiscatory in that if a trust buys a building which an individual could buy on a 6-percent basis, the trust, after the 50-percent corporate tax, has only 3 percent net for its beneficiaries.

(3) Real-estate investment trusts are substantially similar in form and substance to security investment trusts.

(4) Security investment trusts got relief from corporate tax on the theory that they were mere conduits of the income received, which was then largely distributed to shareholders, and that the shareholders really had an indirect or beneficial ownership in the underlying assets. The same is true of real-estate investment trusts.

(5) Comparing the bond investment trusts with real-estate investment trusts, it appears that rental real estate is just as much an investment as are bonds. Interest is paid for the use of money and rent is paid for the use of real estate.

(6) Both types of investment trusts are formed to provide centralized management, diversification of investment, and minimizing of risks.

(7) The management duties of trustees of real estate trusts are substantially similar to the duties of trustees of security investment trusts.

(8) The effect on Government tax revenues will not be serious, because, in order to get relief from the corporate tax, the trusts will have to distribute 90 percent of their income to the beneficiaries, and thus the savings in corporate tax will be passed on to the beneficiaries who, in turn, will be subjected to individual income taxes thereon.

(9) The granting of such relief will give an economic lift to equity investment in real estate through the medium of trusts, just as the granting of such relief to security trusts gave a lift to investment in securities.

III. Safeguards to prevent abuse

(*a*) At least 60 percent of the gross income of the trust must be derived from rents and other real estate income, and at least 90 percent from these sources plus dividends and interest.

(*b*) Not more than 30 percent of the trust's gross income may consist of short-term gains on security sales.

(*c*) Not more than 30 percent of the trust's gross income may be from gains on sales of real estate held for less than 5 years.

(*d*) At least 90 percent of the trust's net income must be distributed to its beneficiaries.

These safeguards parallel generally those applicable to security investment trusts, but are stricter in some respects (e. g., the 5-year holding period under (c) above).

IV. Form of amendment

To change the title of subchapter M of chapter 1, subtitle A (p. 201), to cover both regulated investment companies as part I and real estate investment trusts as part II. Part II will include sections 856–859, inclusive, which follow the general pattern of sections 851–855, relating to the regulated investment companies.

SHAREHOLDERS' STATEMENT IN SUPPORT OF H. R. 5418, AS REVISED, BEING A BILL TO AMEND THE INTERNAL REVENUE CODE TO PROVIDE A SPECIAL METHOD OF TAXATION FOR REAL ESTATE INVESTMENT TRUSTS AND REAL ESTATE INVESTMENT ASSOCIATIONS WITH TRANSFERABLE SHARES OR BENEFICIAL INTERESTS, INTRODUCED BY MR. GOODWIN OF MASSACHUSETTS

SUMMARY

1. Who the witness hereinto is; a fiduciary shareholder with no connection with the management of any real estate trust.

2. Economic and social justification of real estate trusts; what they were designed to do, what they can do for the economy of the country.

3. Effect of income taxation on trusts, including destruction of market for shares, depressed value of shares leading to destructive speculation; withering of these trusts compared with mushroom growth of investment trust and insurance companies.

4. Effect of removal of discriminatory tax: (*a*) No windfall involved which shareholders cannot get by one of these means.

(*b*) Release of creative energy in commercial real estate at critical time in country's growth.

5. Certain arguments against the bill invalid.

1. Who the witness herein is

Henry M. Channing, whose name is attached hereto by the undersigned as his attorney, is an attorney at law and professional trustee of almost 40 years' experience. Mr. Channing was formerly, and for over 20 years counsel for several of the trusts involved, and has a long and intimate knowledge of their

problems. He has presently no connection with the management of these trusts, and has not had for some 15 years. Mr. Channing is interested in H. R. 5418 only by virtue of his ownership as a fiduciary, mostly for persons of moderate means, of several substantial blocks of real estate trust shares. Mr. Channing is also a director of Minot Kendall & Co., Inc., a firm of stock brokers located in Boston, Mass., members of the Boston Stock Exchange and of NASDI, and is hence familiar with the market for these shares from a broker's viewpoint. Mr. Channing has been a director of a number of business corporations, and has held positions of substantial public responsibility, including having served with counsel to the War Industries Board in the First World War.

2. Economic and social justification of real-estate trusts

At the turn of the century there were a number of attorneys practicing in Boston who had great familiarity with real estate conveyancing and probate law, and who handled the property and affairs of a considerable clientele of persons of means. Real estate and interests therein were then a traditional medium of fiduciary trust investment. But at the time referred to, with an almost phenomenal growth taking place in our country, particularly in the West, parcels of commercial property, and the buildings thereon, were rapidly becoming far too expensive and large for individual investment consistent with proper diversification and limitation of risk.

The real-estate trust was conceived and thought of as a medium of common investment in the improvement of real estate by persons of moderate means investing conservatively, but investing at the same time with a view to gradual growth in the value of their holdings. These entities were set up as trusts partly because their founders thought in trust terms as probate lawyers. Their financing was a model of conservative soundness, being (as far as we know) entirely in common shares, and usually with a limitation on the trustees' power to mortgage the properties purchased for more than a percentage (30 percent for example) of the par value of the shares. Thus, the attractiveness of the shares was not at all in "leverage"—the mercurial reaction of a narrow equity over a large debt—which modern taxation has made so deceptively attractive—but in the soundness of a picture unembarrassed by debt and managed by persons combining the caution of the experienced fiduciary with the imagination necessary to conceive of growing communities in distant places. The type of persons who subscribed to the shares justified the plans and the intentions of the promoters. Shares were not bought to be traded or sold for quick profit, but to be held for income and growth. Thus was created a flexible yet stable medium whereby persons of ordinary means could own interests in diversified real estate. Tens of millions of dollars were invested in these trusts, and capital flowed out from Boston not only through New England, but into communities as far west as Seattle and as far south as Alabama and was heavily invested in growing cities like Detroit, St. Paul, Kansas City, and Denver, to mention examples. While the original investments were of Boston capital, there is no formal limitation in that regard, and today shares are owned by persons in many different States. That this was all in the national interest hardly is worth debating.

3. Effect of Federal corporate income taxation on real estate trusts

The last real estate trust designed for public ownership, of which the author is aware, was formed in 1937. Since that time, the corporate income tax, as it has increased, has gradually destroyed the market for these shares, and by destroying that market will, in the writer's opinion, gradually strangle the trusts themselves. Because, as will be explained, the corporate income tax does not destroy the market for the real estate the trusts own, the shareholders will not suffer, but in the liquidation of that real estate in winding up the trusts a medium will be lost which could do a great deal to ward off depression by encouraging the small man to invest in real property. What has happened to real estate trust shares, and what will happen if H. R. 5418 fails of passage, is simply an example of the unintended but nonetheless fatal economic consequences of legislation designed only for revenue purposes, and the following is a sketch of how it operates in this case.

Income producing shares on the stock market will usually sell on a "times earnings" or more accurately "times dividend" basis, which varies as between stocks of different categories, and varies with money rates over a period of time. If you have two categories of owners, one who by virtue of some rule of law or device derives twice as much income from a property as another, it will be worth twice as much to him. Thus, a typical real estate trust share paying a $7

dividend might sell for $100 on today's market. But, before Uncle Sam got his 52-percent cut, who will buy on the basis of the same yield of 7 percent, you will find a man who will pay on the basis not of $100, but of much more. And, in the case of real estate, that is exactly what you do find. For every parcel of commercial real estate, there is a wealthy speculator or syndicate who, because they act individually, are exempt from the 52-percent corporate tax.

Since credit has been easy, and since for a wealthy man the income-tax law cuts interest charges in half or better, what could be more attractive than paying on a basis to yield 7 or 8 percent for a narrow equity in the property we have described? Thus, the small man, in paying 50 percent of income for diversification and limited liability, cannot compete with the large. Thus the trustees of these real-estate trusts, who are acting entirely for the small man, cannot compete for properties with the tax free individual—nor can they interest capital for a 3 to 4 percent yield, which is the yield on sound corporate bonds. Because of a general realization that real-estate trusts were going nowhere in particular and could go nowhere in particular as they have been taxed, the investing public has gradually turned away from them. Thirty years ago, trust companies and trustees of large charities and universities would buy these shares for investment, which they would not consider today. At the tag end of the depression and into the postwar era, the shares of some trusts became bait for big speculators. At least one fortune was made through buying shares cheap on the depressed market for shares, and compelling liquidation of the trust on the much higher market for real estate. The share market today has become largely restricted to the managers of the trusts and interests they control. When sold to the public these shares are never sold without reference to a possible profitable liquidation. Meanwhile, insurance companies have grown, and investment trusts have grown, only because insurance companies are subject to entirely different taxation when investing, and investment trusts to no corporate taxation at all (when complying with certain legal requirements). If tomorrow investment trusts were subjected to income taxation at 50 percent, they would experience exactly what real-estate trusts have—a constriction of the market for their shares, and inevitable slow extinction. Because the stockholders would sell on the basis of the full market to persons free of tax they would not suffer; only the medium of common investment would be lost, with inevitable social damage.

4. Effect of H. R. 5418 in stimulating investment in real estate

No one can assess the future, but anyone is a fool to fail to provide for its obvious dangers. The country stands now at the end of a long extraordinary effort that began with Pearl Harbor. Everyone remembers and bears the scars of 1929 and the depression which ensued. Everyone recognizes the necessity to stimulate the economy in this year 1954. Everyone recognizes further that at the basis of the economy the construction industry lies as an important cornerstone. There is today no recognized medium for investment by which the weight of public interest and widely held funds can be brought to bear in this field, because the tax law keeps the field confined to the big individual or the special purpose corporation, usually a tool of some other interest and always loaded to the gunwales with debt. At the same time our population is increasing. Even more important immediately it is decentralizing. The revolution the automobile made possible is just beginning its ultimate momentum. Now our industrial and commercial cities are beginning, and just beginning, to indicate their future shape—covering areas many times the present size, linked by superhighways, supported by garden cities where people work and live as they were meant to, and not in the rabbit warrens the industrial revolution brought into being. To implement and carry out this great change, vast resources will be needed, and H. R. 5418 removes an impassable obstacle to another economic revolution such as the model T so largely brought about. It should be borne in mind its effect is not limited to Massachusetts organizations; similar entities can be and would be formed anywhere, depending only on the particular provisions of local laws.

5. Arguments against the bill are invalid

1. It has been said that the bill gives the stockholders a windfall. Western Real Estate Trustees for example was started in about 1900, and capital was subscribed at $100 per share. The market value of shares today is about $100. It has been reliably estimated that if the underlying properties were sold today they would bring around $170. It is submitted that taking the decline of the value of the dollar into account that is no "windfall." But if it is the passage or nonpassage

of this bill has nothing to do with a liquidation at $170. If it is this "windfall" which is to be prevented, legislation should prevent not only liquidation, but merger with an investment trust as well.

2. It has been argued that these entities are too narrowly held to be regarded as public. It is true the tax has narrowed the holdings. It is also true that these trusts are as widely held today as investment trusts once were, and it must be apparent they will grow if given a fair chance to do so, and that many new ones could be expected to spring up.

3. It has been argued that by this legislation revenue will be lost. This is not so. Because the trusts are being driven to liquidate or become investment trusts the revenue will be lost in any event. Repeal of taxation in this instance will lead to much larger revenues to all sorts of persons and businesses subject to tax, precisely as happened with investment trusts.

Respectfully submitted

HENRY M. CHANNING,
By his attorneys:
LAURENCE M. CHANNING.
FRANK S. KETCHAM.

APRIL 19, 1954.

Mr. HIGGINS. This is a very serious situation. I believe these trusts would have gotten the same benefits and treatment as the security-investment trusts had they come in in 1936 and 1940, when those were corrected, but at that time most of the real estate investment trusts had very little income and the impact of the corporate tax didn't force them into it. As it is now, it has become so serious that this very substantial source of investment money in real estate is going to dry up.

Now, conversely, if this provision were included, we believe that you might get a tremendous lift in real-estate investment, as has occurred in the case of the security-investment trust. I well remember when I was before your committee in 1936 and 1941, that there was grave doubt as to whether it wasn't going to cost a tremendous amount of revenue. The reverse situation occurred, namely, that a great many small investors all over the country who hadn't before invested in stocks and bonds, took up this idea of the security investment trust, with the result that there has been a very substantial increase in revenue, rather than a decrease.

Now, we believe that in this economic period, if we could get the same relief for the real-estate investment trusts, you would get that same effect—of many thousands of beneficiaries all over the country putting in funds to invest in and build new buildings throughout the country.

Thank you.

The CHAIRMAN. Thank you very much.

Senator FLANDERS. Might I ask a question?

The CHAIRMAN. Certainly.

Senator FLANDERS. I would like to inquire about the size of this operation. I must confess that it was something of which I had no knowledge until you came to the committee with these suggestions.

Are there many who invest in real-estate investment trusts? Do their total investments aggregate to a considerable amount?

Mr. HIGGINS. Well, I know, Senator, of about 25 or 30 of these trusts—and there are undoubtedly more that I haven't heard of—I would say that more than 50 percent of them are located in New England, but there are a good many I hear about as a result of previous

appearance before the Ways and Means Committee, in other parts of the country.

It would be very difficult for me to make an estimate as to their total assets, but I would say that it runs into probably several—maybe $125 million or $130 million at least, maybe more. I know the security trusts were very small when they first got their relief, and have gone up 3,000 or 4,000 percent since then.

As to shareholders, I believe from figures I have been able to corral around New England, that there are at least 5,000 to 7,000 shareholders in that area alone, and probably an equivalent number outside.

Senator FLANDERS. Thank you.

The CHAIRMAN. Thank you very much.

(The detailed statement referred to on p. 1276 follows:)

DETAILED WRITTEN STATEMENT OF ALLAN H. W. HIGGINS IN SUPPORT OF INCLUSION OF PROVISIONS OF H. R. 5418 IN H. R. 8300, AN ACT TO PROVIDE FOR A SPECIAL METHOD OF TAXATION OF REAL ESTATE INVESTMENT TRUSTS AND REAL ESTATE INVESTMENT ASSOCIATIONS WITH TRANSFERABLE SHARES, OR BENEFICIAL INTERESTS IN SUBSTANTIALLY THE SAME MANNER AS SECURITY INVESTMENT TRUSTS

This bill was introduced by Representative Goodwin on May 27, 1953. Witnesses appeared before the Ways and Means Committee on August 6, 1953, and testified at length in support of the bill. (See Hearings on General Revenue Revision, pt. 3, pp. 1490–1505.) Due to pressure of time, the bill was not brought to a vote in the committee, or in the House, but was held for further consideration. The bill has been amended to provide additional limitations and safeguards, which were not in the bill as introduced but appear in the form of the first bill attached hereto, as the result of conferences with representatives of the Treasury Department and the joint committees. Also is attached a revised form of the bill to integrate it as part II, subchapter M, subtitle A of H. R. 8300.

I. SUMMARY OF THE PROVISIONS OF THE BILL

1. Provides for a new supplement V in the present Internal Revenue Code (or pt. II of subchapter M, subtitle A of H. R. 8300), covering the taxation of real estate trusts and associations with transferable shares or beneficial interests.

2. Provides that real estate investment trusts be granted the same relief from corporate tax as is now given to security investment trusts under supplement Q (secs. 361, 362) of the present Internal Revenue Code. It accomplishes this result by providing that real estate trusts and associations, which meet certain conditions, shall receive a dividends paid credit in computing the net income subject to tax at corporate rates.

3. Provides that such a trust or association can qualify for the credit under 2 supra, only if—

(a) At least 90 percent of its gross income is derived from dividends, interest, rents of real estate, and gains from the sale of real estate.

(b) At least 60 percent of its gross income is derived from rents of real estate, interest on real estate mortgages, gains from the sale or other disposition of real estate or similar income derived directly or indirectly from real estate.

(c) Less than 30 percent of the gross income comprises net gain from the sale or other disposition of securities held for less than 6 months.

(d) Less than 30 percent of its gross income comprises net gain from the sale of real estate held for less than 5 years.

(e) Ninety percent or more of its net income is distributed to the shareholders or beneficiaries each year, computed without regard to net long-term or short-term capital gains.

II. STATEMENT IN SUPPORT OF THE BILL

1. Purpose of the bill

The purpose of H. R. 5418 is to relieve an inequity and unjustifiable hardship under the Internal Revnue Code with respect to imposition of a corporate tax on small investors or beneficiaries who have pooled their funds and interests

in order to secure or maintain investments in real estate or interests in real estate, including real estate mortgages, and shares of real estate trusts or real estate associations.

2. Real estate investment trusts should be taxed in the same manner as security investment trusts

Under supplement Q (sec. 361 and 362) of the Internal Revenue Code, regulated investment companies, i. e., security investment trusts are relieved from a Federal corporate income tax, provided they meet certain conditions, and especially if they distribute during the taxable year to their shareholders as taxable dividends, other than capital gain dividends, an amount not less than 90 percent of their net income for the taxable year.

On the other hand, real estate investment trusts have, in recent years, by judicial decision been subjected to a Federal corporate income tax. The imposition of a corporate income tax on such real estate trusts is especially unfair, when it is considered that the purpose of such trusts is principally to hold investment real estate, as well as securities, provide unified management, and distribute substantially all their income to their beneficiaries or shareholders annually, just as security investment trusts do. In this respect the trusts are, in fact, conduits of income, just as are stock investment trusts, whose unique status has been specially recognized under the Internal Revenue Code.

The proposed act attached hereto would grant substantially the same treatment to real investment estate trusts as is now given to security investment trusts under the Internal Revenue Code. This would be accomplished either by inserting a new supplement in the present code, to be known as supplement V, or by adding equivalent provisions as part II of subchapter M of subtitle A of H. R. 8300. Such similar treatment of the two types of trust is not only fair and equitable, it is also completely justified when their purposes and operations are analyzed.

The justification for granting special treatment to security investment trusts under supplement Q was that such trusts permitted a group of investors to pool their funds and obtain competent management of their investments, diversification, and the minimising of risks. These objectives would not be obtainable to such investors if, with their limited capita, they tried to invest directly in stocks and bonds for themselves.

The proposed act would grant the same privilege to a group of investors who pool their funds to invest in rental real estate by means of a real estate investment trust.

3. The conduit theory should be applied to all investment trusts to eliminate double and triple taxes

Relief from the corporate tax was given to security investment trusts on the theory that they were substantially conduits of income, and that the investment income should not be subjected to double taxation, by first having the income subjected to a Federal corporate income tax in the hands of the trust and then by having the distributions from the trust received by the beneficiaries or shareholders taxed again.

In the case of stocks held by security investment trusts, it was argued that there had been a triple tax, namely: First, a tax on the corporation that issued the stock and paid the dividends thereon, next a tax on the dividends received, and lastly a tax on the distribution by the trust to its shareholders. It should be noted, however, that the alleged second tax was only on 15 percent of the dividends received by the trustee.

In the case of bonds held by security trusts, there was at most only a double tax, in that the corporation paying interest, although it had paid a corporate tax, received a deduction for the interest paid. Nevertheless, the so-called bond funds or bond investment trusts were given the same relief from corporate tax, as were the stock investment trusts.

In the case of the real estate investment trust, the rent received by such trust is completely analagous to the interest received by the bond investment trust. In the one case the paying company is paying interest for the use of money and in the other case it is paying rent for the use of property. In both cases the payor corporation, whether paying interest or rent, is nevertheless subjected to tax on its business income. The source of the income of real estate trusts is principally rents from commercial real estate occupied by business tenants. An income tax burden falls first on the business of the tenant, second on the real estate trust, and finally on the distribution by the trust to its beneficiary.

In giving relief to security investment trusts, the conduit theory was further applied by recognizing that to a certain extent the distributions retained the same character in the hands of the shareholders as they did when received by the trusts. For example, in the case of the provisions with regard to security investment trusts, under section 362 (b) (7) of the code such trusts are permitted to distribute capital gains received and the shareholders in turn are permitted to treat such distributions as long term capital gains in their individual income tax returns.

Since the conduit theory has been applied to security investment trusts so as to grant relief from corporate tax on the interest, dividends and gains received by them and distributed to their shareholders, the real estate investment trusts should be exempted from corporate tax on the rents as well as interest, dividends and gains received by them and distributed to their beneficiaries.

4. Rental real estate and real estate mortgages are as much investments as are stocks and bonds

The investments of regulated investment companies under section 362 are confined to stocks and bonds. The investments of real estate trusts are confined largely to rental real estate or interests in real estate, including real estate mortgages, and shares of real estate trusts or real estate associations. From time to time available funds of real estate trusts are also invested in stocks and bonds, and certainly at least the dividends and interest on such investments should be exempt from corporate tax, the same as similar income of stock investment companies.

Rental real estate and real estate mortgages have for generations been recognized as investments. Individuals, as well as trustees under wills and trustees under inter vivos trusts, have long recognized real estate as a sound investment.

As has been stated above, interest is received for the use of money. On the other hand, rent is received for the use of property. In either instance the income is distributed by the trust to its beneficiaries.

Accordingly, the rent received by a real estate investment trust should be relieved from the corporate tax, just as much as interest received by a security investment trust is relieved from the corporate tax.

5. Real estate trusts and security investment trusts were both formed to provide centralized management, diversification of investments and minimizing of risks

Both real estate trusts and security investment trusts were formed to provide centralized management, diversification of investment, and the minimizing of risk. Real estate trusts are analogous to stock investment trusts in that the purpose of each is to provide competent centralized management of investments. The average small investor is unable to give the time and attention to the management of such investments. When the investment is with respect to an interest in real estate, such management is most essential. It is also essential in connection with selecting the real estate to be invested in. Although some real estate trusts have an investment in only one property, many real estate trusts have investments in several properties. From time to time these properties may be sold and the proceeds reinvested in other properties.

Just as with investments in stocks and bonds, diversification is desirable in real estate investments. This diversification has been achieved by setting up real estate trusts, so that no one investor would have too large a percentage of his investments in any one property, and could invest in a real estate trust owning several properties, or in several trusts owning single properties. In this respect the real estate trusts are analogous to the stock investment trusts. Additional diversification is obtained in that a multiple building has numerous tenants engaged in different businesses. When one business is off the others may be good and thus the risk is minimized.

Historically, real estate trusts were formed as the result of two different types of situations, but both had the fundamental purposes of providing centralized management, diversification, and minimizing of risks.

First, are the real estate trusts which were set up in order to enable investors to pool their funds and acquire and build real estate developments, office buildings, individual stores, or blocks of stores, apartments, etc., in major cities. Many of the real estate trusts which were set up in the eastern seaboard in the early days were partly responsible for the development of the major cities in the West such as Chicago, St. Paul, Minneapolis, Seattle, etc. Small investors thus pooled their resources, contributed them into a real estate trust, and the trustees then proceeded to carry out the investment of these funds in real estate.

In many cases these investors were trustees of individual testamentary or inter vivos trusts who desired to invest part of their trust funds in real estate. Since they did not want to put too large an amount of their trust funds in any one property, they participated in the formation of real estate investment trusts in order to obtain diversification and minimize the risks.

A second cause of the formation of real estate trusts arose from situations where a long-term testamentary or inter vivos trust terminated and the many remaindermen involved suddenly found themselves as tenants in common with an undivided interest in certain real-estate properties. It was wholly impractical for such individuals to join together in signing leases or deeds or managing these properties. In many instances the remaindermen were minors and it was necessary to get guardians appointed for them. As a means of securing centralized management of these properties, all of the individuals involved got together and formed a real estate trust. They designated one or more trustees who would manage the properties, collect the rents, pay the expenses, and distribute the net income to the beneficiaries. In some instances the beneficiaries held no actual certificates but had merely a pecentage beneficial interest. In other cases certificates of beneficial interest were distributed which facilitated the transfer of such certificates to members of the family either during their lifetime or upon their death.

In both of the foregoing types of situations in which real estate trusts were formed, the same principles of centralized management, diversification of investment, and minimizing of risks in real estate investments prevailed, as is the case with security investment trusts.

6. Present law favors the large real-estate investor as opposed to the small investor

Since rental real estate is just as much an investment as stocks and bonds, there is no reason why the small investor who wishes to put part of his funds into real estate should not have the privilege of pooling his funds with others similarly situated in a real-estate investment trust and not suffer the burdens of the corporate tax.

Under present law, a wealthy investor can purchase a building individually without the imposition of a corporate tax. If a group of small investors pool their funds and form a real-estate investment trust and buy the same building, they are penalized by the corporate tax. For example, if the building shows a 6-percent net return on the investment to the wealthy investor, the individuals who pool their funds, form a real-estate investment trust, and buy the same building are penalized by a 50-percent Federal tax and thus secure only a maximum return of 3 percent by way of distributions from the real-estate investment trust.

The small investor who wishes to put part of his assets into real estate cannot obtain an interest in a large office building or other large property without pooling his investment with others similarly situated. This privilege has been granted to small investors in security investment trusts and should be granted to the small investors in real-estate investment trusts.

7. The holding and renting of real estate as an investment is clearly distinguishable from ordinary business operations

Rental real estate held for investment, by its very nature, requires management, such as the making of leases, collecting rents, making repairs, and servicing the property.

Individuals or groups owning rental real estate frequently employ a real-estate management firm or bank as agent or trustee to make leases, collect rents, make repairs, and service the property—in other words, to manage the real-estate investment.

An owner of a manufacturing or sales company, on the other hand, would not employ a management firm or bank to operate such a company because it is a business and not something held for investment.

Actually, the beneficiaries or shareholders of a real-estate trust have merely employed the trustees to manage their property, just as a single individual or a partnership would do. The underlying rental real estate is still an investment, just as the underlying securities of a security investment trust are investments.

It is significant that in most instances, when a management firm manages rental real estate, the service employees, such as janitor, elevator operator, porters, and cleaners, are on the payroll of the management company and not on the payroll of the owner of the building. The owner merely has an

investment in rental real estate and employs a management firm as agents or trustees to manage the investment.

If an individual or joint owner of real estate can employ a real-estate management firm to manage his real-estate investments without being subjected to a corporate tax, certainly a group of investors in real estate should be permitted to form a real-estate investment trust and have trustees, or a management firm of trustees, manage the real-estate investment.

Such a situation is clearly distinguishable from that in which shareholders of a manufacturing or sales company invest in that business. There the operation is a business operation—manufacturing, buying, selling, etc.—which is clearly distinguishable from the management of an investment, such as securities or rental real estate.

8. The duties of management of trustees of real-estate trusts are substantially similar to duties of trustees of security investment trusts

SECURITIES TRUST	REAL-ESTATE TRUST
1. Purchase of securities.	1. Purchase of real estate and securities.
2. Sale of securities.	2. Sale of real estate and securities.
3. Other management duties:	3. Other management duties:
(*a*) Expert services and research organization to determine types of business and quality of management of businesses invested in.	(*a*) Expert services and research organization to determine locations of real estate to invest in and type and quality of tenants.
(*b*) Collection of interest and dividends.	(*b*) Collection of interest, dividends, and rent.
(*c*) Protection of securities, and regular followup of companies invested in, employment of field men to investigate and study operations of companies in which trust holds securities.	(*c*) Protection of real estate by proper insurance and maintenance, and regular followup of tenants' businesses and of rental values.
(*d*) Getting up and sending reports to shareholders.	(*d*) Same to beneficiaries.
(*e*) Payment of dividends.	(*e*) Same to beneficiaries.
(*f*) Preparation of tax and other Government returns.	(*f*) Same.
(*g*) Active sales organization for sales of shares of the trust itself.	(*g*) No comparable activity because corporate tax on real-estate trusts discourages investors.

9. Economic and fiscal effects of the bill

Looking at the question from the broad overall economic point of view, Federal tax laws should encourage investment in real estate, the stimulation of new real estate developments, and the construction of buildings. Many eminent congressional leaders as well as economists and financial leaders have expressed concern with respect to the difficulties of securing equity venture capital. The granting of relief to real estate trusts would stimulate such venture capital in a field which is most important to the welfare of the country. Only relatively few individuals can by themselves supply the large amount of capital required today to build an office building or an apartment house. However, if the corporate tax were eliminated on real estate trusts, thousands of small investors, each putting in a few hundred or a few thousand dollars, could pool their funds and thus supply the tremendous amounts of capital needed to build new buildings and apartments. The stimulation of activity in this field would be of great help to the economy of the country at this time.

The cost to the revenue, as the result of the adoption of the proposed act may be minor, and, in fact, may ultimately result in an increase rather than a decrease of the revenue. The bill would require that such real estate trusts distribute 90 percent of their net income to the beneficiaries or shareholders. In other words substantially all the tax saving to the trust—by elimination of the corporate tax—would have to be distributed to the shareholders and, in turn, be taxed to them. With individual tax rates as high as they are today the additional distributions which the trusts will be able to make will be subjected to high individual tax rates, which may well enhance the revenue.

When supplement Q was included in the law with respect to the taxation of security investment trusts, some concern was expressed by the Treasury representatives that the revenue might be adversely affected. It is now a matter of common knowledge that as a result of such beneficial tax legislation, the growth of security investment trusts has been enormous. Many people who never owned a share of stock before, have bought shares in security investment trusts with the result that the tremendous distributions by these trusts have swelled the national income and greatly enhanced the tax revenue. The growth of real estate investment trusts is now impossible because of the impact of the Federal tax, just as the growth of security investment trusts was impeded by the corporate tax before they secured relief under supplement Q. It is to be anticipated that, if the relief is granted to real estate investment trusts as proposed in H. R. 5418, a comparable growth will be experienced in real estate trusts.

The Treasury Department and the Congress have, for many years, sought to encourage organizations to distribute substantially all their earnings to shareholders or beneficiaries so that the Treasury will obtain taxes at individual rates on such distributions. This was the purpose of the so-called 1936 undistributed-profits tax and also section 102 of the present Internal Revenue Code. A similar object was sought by the so-called 65-day rule applicable to distributions by trusts. Accordingly, the provision in the proposed act requiring real estate trusts to distribute 90 percent of their income to beneficiaries or stockholders would carry out recognized objectives of the Treasury Department and the Congress.

CONCLUSION

In conclusion it is submitted that the proposed act should be enacted by the Congress and incorporated in H. R. 8300 for the following reasons:

1. It corrects an existing inequity in the revenue law with respect to the taxation of real estate investment trusts.
2. It taxes real estate investment trusts on substantially the same basis as security investment trusts.
3. It will enable small investors to invest in real estate and to get the benefit of experienced centralized management, diversification of investment, and minimizing of risks.
4. It will encourage equity investment in real estate and stimulate activity in the construction industry.
5. It will encourage the distribution of substantially all the income of real estate investment trusts to their beneficiaries.
6. It will not substantially reduce and may in fact increase the revenue. By increasing the income distributed by real estate investment trusts to their beneficiaries it would increase the income subject to taxation at individual tax rates.

ALLAN H. W. HIGGINS,
Attorney, Boston, Mass.

(NOTE.—The following is a revision of H. R. 5418, containing conditions and safeguards which were not in the original bill.)

[H. R. 5418, 83d Cong., 1st sess.]

A BILL To amend the Internal Revenue Code to provide a special method of taxation for real estate investment trusts and real-estate investment associations with transferable shares or beneficial interests

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subchapter C of chapter 1 of the Internal Revenue Code is amended by adding at the end thereof the following new supplement:

"SUPPLEMENT V—TAXATION OF REAL ESTATE INVESTMENT TRUSTS AND REAL ESTATE INVESTMENT ASSOCIATIONS WITH TRANSFERABLE SHARES OR BENEFICIAL INTERESTS

"SEC. 426. DEFINITION.

"(a) IN GENERAL.—For the purposes of this supplement, the terms 'real estate investment trust with transferable shares' and 'real estate investment association with transferable shares' mean a nonincorporated trust or association managed by one or more trustees, the beneficial ownership of which is evidenced by transferable shares or certificates of beneficial interest, and which (except for this supplement) would be taxable as a corporation and the gross income of which

is principally derived from the ownership of real estate or interests in real estate, including real estate mortgages and shares of real estate trusts or real estate associations.

"(b) LIMITATIONS.—Notwithstanding the provisions of subsection (a), a real estate investment trust or real estate investment association shall not be taxed under this supplement for any taxable year unless—

"(1) At least 90 per centum of its gross income is derived from dividends, interest (including interest on real estate mortgages), rents of real estate, gains from the sale or other disposition of stock or securities, or real estate, interests in real estate or real estate mortgages or abatements or refunds of local real estate taxes;

"(2) at least 60 per centum of its gross income is derived from rents of real estate, interest on real estate mortgages, gains from the sale or other disposition of real estate or interests in real estate or real estate mortgages, or from dividends or distributions on, or gains from the sale or other disposition of, shares or transferable interests in other real estate trusts or associations, or abatements or refunds of local real estate taxes;

"(3) less than 30 per centum of its gross income comprises net gain from the sale or other disposition of stock or securities held for less than six months; and

"(4) less than 30 per centum of its gross income comprises net gain from the voluntary sale or other disposition of real estate held for less than five years; and

"(5) it distributes to its shareholders or holders of beneficial interests not less than 90 per centum of its net income for the taxable year computed without regard to net long term and net short term gains.

"(c) The term 'rents of real estate', as used in subsection (b) (1), shall not include amounts received or accrued by hotels, inns or lodging houses from guests, boarders or lodgers in consideration for the occupancy of furnished rooms or furnished apartments or for food, refreshments, or personal services rendered.

"SEC. 427. TAX ON REAL ESTATE INVESTMENT TRUSTS AND REAL ESTATE INVESTMENT ASSOCIATIONS WITH TRANSFERABLE SHARES, AND ON CAPITAL GAIN DISTRIBUTIONS TO SHAREHOLDERS.

"(a) METHODS OF TAXATION OF REAL ESTATE INVESTMENT TRUSTS AND SHAREHOLDERS.—In the case of a real estate investment trust or real estate investment association with transferable shares:

"(1) Its supplement V net income shall be its adjusted net income (computed by excluding the excess, if any, of the net long term capital gain over the net short term capital loss) minus the basic surtax credit (excluding capital gain dividends) computed under section 27 (b) without the application of paragraphs (2) and (3). For the purposes of this paragraph the net income shall be computed without regard to section 47 (c).

"(2) Its supplement V surtax net income shall be its net income (computed by excluding the excess, if any, of the net long-term capital gain over the net short term capital loss) minus the dividends (other than capital gain dividends) paid during the taxable year increased by the consent dividends credit provided by section 28. For the purposes of this paragraph and paragraph (5) of this subsection, the amount of the dividends paid credit shall be computed in the same manner as is provided in subsections (d), (e), (f), (g), (h), and (i) of section 27 for the purpose of the basic surtax credit provided in section 27. For the purposes of this paragraph the net income shall be computed without regard to section 47 (c).

"(3) There shall be levied, collected, and paid for each taxable year upon its supplement V net income a tax equal to 30 per centum of the amount thereof.

"(4) There shall be levied, collected, and paid for each taxable year upon its supplement V surtax net income a tax equal to 22 per centum of the amount thereof.

"(5) There shall be levied, collected, and paid for each taxable year a tax of 26 per centum of the excess, if any, of the net long term capital gain over the sum of the net short term capital loss and the amount of the capital gain dividends paid during the year.

"(b) METHOD OF TAXATION OF CAPITAL GAIN DIVIDENDS TO SHAREHOLDERS OR HOLDERS OF BENEFICIAL INTERESTS IN REAL ESTATE INVESTMENT TRUSTS AND ASSOCIATIONS WITH TRANSFERABLE SHARES.—

"(1) A capital gain dividend shall be treated by the shareholders or holders of beneficial interests as gains from the sale of capital assets held for more than six months.

"(2) As used in this section, the term 'capital gain dividend' means any distribution or part thereof which is designated by the trust or association as a capital gain dividend or distribution in a written notice mailed to its shareholders at any time prior to the expiration of thirty days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the trust or association is greater than the excess of the net long term capital gain over the net short term capital loss for the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that portion of the amount so designated which such excess of the net long term capital gain over the net short term capital loss bears to the aggregate amount so designated."

PROPOSED AMENDMENTS TO SUBCHAPTER M, CHAPTER 1, OF SUBTITLE A OF H. R. 8300, TO PROVIDE FOR A SPECIAL METHOD OF TAXATION OF REAL ESTATE INVESTMENT TRUSTS

1. To change the title (p. 201) to read as follows:

"Subchapter M—Regulated Investment Companies and Real Estate Investment Trusts".

2. To add, immediately following said title, the following subheading:

"Part I—Regulated Investment Companies".

3. To add the following, immediately after section 855 (p. 206):

"Part II—REAL ESTATE INVESTMENT TRUSTS.

"SEC. 856. DEFINITION OF REAL ESTATE INVESTMENT TRUST.

"(a) IN GENERAL.—For the purposes of this part, the term real estate investment trust' means a nonincorporated trust or association managed by one or more trustees, the beneficial ownership of which is evidenced by transferable shares or certificates of beneficial interest and which (except for the provisions of this part) would be taxable as a corporation, and the gross income of which is principally derived from the ownership of real estate or interests in real estate, including real estate mortgages and shares of real estate trusts or real estate associations.

"(b) LIMITATIONS.—A trust or association shall not be considered a real estate investment trust for any taxable year unless—

"(1) at least 90 per centum of its gross income is derived from dividends, interest (including interest on real estate mortgages), rents of real estate, gains from the sale or other disposition of stock or securities, or real estate, interests in real estate or real estate mortgages or abatements or refunds of local real estate taxes:

"(2) at least 60 per centum of its gross income is derived from rents of real estate, interest on real estate mortgages, gains from the sale or other disposition of real estate or interests in real estate or real estate mortgages, or from dividends or distributions on, or gains from the sale or other disposition of, shares or transferable interests in other real estate trusts or associations, or abatements or refunds of local real estate taxes;

"(3) less than 30 per centum of its gross income comprises net gain from the sale or other disposition of stock or securities held for less than six months; and

"(4) less than 30 per centum of its gross income comprises net gain from the voluntary sale or other disposition of real estate held for less than five years.

"(c) RENTS OF REAL ESTATE.—The term 'rents of real estate', as used in subsections (b) (1), and (2) shall not include amounts received or accrued by hotels, inns or lodging houses from guests, boarders or lodgers in consideration for the occupancy of furnished rooms or furnished apartments or for food, refreshments, or personal services rendered.

"SEC. 857. TAXATION OF REAL ESTATE INVESTMENT TRUSTS.

"(a) REQUIREMENTS APPLICABLE TO REAL ESTATE INVESTMENT TRUSTS.—The provisions of this Part shall not be applicable to a real estate investment trust unless—

"(1) it distributes to its stockholders or holders of beneficial interests not less than 90 per centum of its net income for the taxable year computed without regard to net long term and net short term gains, and

"(2) the real estate investment trust complies for such year with regulations prescribed by the secretary or his delegate for the purpose of ascertaining the actual ownership of the shares or certificates of beneficial interest of such trust.

"(b) METHOD OF TAXATION OF REAL ESTATE INVESTMENT TRUSTS AND HOLDERS OF SHARES OR CERTIFICATES OF BENEFICIAL INTEREST.

"(1) IMPOSITION OF NORMAL TAX AND SURTAX ON REAL ESTATE INVESTMENT TRUSTS.—There is hereby imposed for each taxable year upon the real estate investment trust taxable income of every real estate investment trust a normal tax and surtax computed as provided in section 11, as though the real estate investment trust taxable income were the taxable income referred to in section 11. For the purposes of computing the normal tax under section 11, the taxable income and the dividends paid deduction of such real estate investment trust for the taxable year (computed without regard to capital gains dividends) shall be reduced by the deduction provided by section 242 (relating to partially tax-exempt interest).

"(2) REAL ESTATE TRUST TAXABLE INCOME.—The real estate investment trust taxable income shall be the taxable income of the real estate investment trust adjusted as follows:

"(A) There shall be excluded the excess, if any, of the net long-term capital gain over the net short-term loss.

"(B) The deductions for corporations provided in Part VIII (except section 248) in subchapter B (section 241 and following, relating to the deduction for dividends received, etc.) shall not be allowed.

"(C) A deduction shall be allowed for the dividends (other than capital gains dividends) paid during the taxable year computed in accordance with the rules provided in section 562.

"(D) The taxable income shall be computed without regard to section 443 (b) (relating to computation of tax on change of annual accounting period).

"(3) CAPITAL GAINS.—

"(A) Imposition of Tax.—There is hereby imposed for each taxable year in the case of every real estate investment trust a tax of 25 percent of the excess, if any, of the net long-term capital gain over the sum of—

"(i) the net short-term capital loss, and

"(ii) the amount of capital gain dividends paid during the year. For purposes of this subparagraph, the amount of dividends paid shall be computed under the rules provided in section 562.

"(B) Treatment of Capital Gain Dividends by Shareholders.—A capital gain dividend shall be treated by the shareholders or holders of beneficial interests as a gain from the sale or exchange of a capital asset held for more than 6 months.

"(C) Definition of Capital Gain Dividend.—A capital gain dividend means any dividend, or part thereof, which is designated by the real estate investment trust as a capital gain dividend in a written notice mailed to its shareholders or holders of beneficial interests at any time prior to the expiration of 30 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the trust (including capital gains dividends paid after the close of the taxable year described in section 859) is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital-gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated.

"(c) EARNINGS AND PROFITS.—The earnings and profits of a real estate investment trust for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year.

"SEC. 858. LIMITATIONS APPLICABLE TO DIVIDENDS RECEIVED FROM REAL ESTATE INVESTMENT TRUST.

"(a) CAPITAL GAIN DIVIDEND.—For purposes of section 34 (a) (relating to credit for dividends received by individuals), section 116 (relating to an exclusion for dividends received by individuals), and section 243 (relating to deductions for dividends received by corporations), a capital gain dividend (as defined in section 857 (b) (3)) received from a real estate investment trust shall not be considered as a dividend.

"(b) OTHER DIVIDENDS.—

"(1) GENERAL RULE.—In the case of a dividend received from a real estate investment trust (other than a dividend to which subsection (a) applies)—

"(A) if such real estate investment trust meets the requirements of section 856 for the taxable year during which it paid such dividend; and

"(B) the aggregate dividends received by such trust during such taxable year are less than 75 percent of its gross income.

then, in computing the credit under section 34 (a), the exclusion under section 116, and the deduction under section 243, there shall be taken into account only that portion of the dividend which bears the same ratio to the amount of such dividend as the aggregate dividends received by such trust during such taxable year bears to its gross income for such taxable year.

"(2) NOTICE TO SHAREHOLDERS.—A real estate investment trust to which paragraph (1) is applicable for any taxable year shall, in a written notice to shareholders or holders of beneficial interests mailed not later than 30 days after the close of the taxable year, designate the portion of dividends paid by the real estate investment trust during such taxable year which may be taken into account under paragraph (1) for purposes of the credit under section 34, the exclusion under section 116, and the deduction under section 243.

"(3) DEFINITIONS.—For purposes of the subsection—

"(A) gross income does not include gain from the sale or other disposition of stock, securities or real estate, and

"(B) the term 'aggregate dividends received' includes dividends only to the extent that such amounts would be taken into account as a dividend under paragraph (1).

"SEC. 859. DIVIDENDS PAID BY REAL ESTATE INVESTMENT TRUST AFTER CLOSE OF TAXABLE YEAR.

"(a) GENERAL RULE.—For purposes of this chapter, if a real estate investment trust—

"(1) declares a dividend prior to the time prescribed by law for the filing of its return for a taxable year (including the period of any extension of time granted for filing such return), and

"(2) distributes the amount of such dividend to shareholders or holders of beneficial interests in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration,

the amount so declared and distributed shall, to the extent the trust elects in such return in accordance with regulations prescribed by the Secretary or his delegate, be considered as having been paid during such taxable year, except as provided in subsections (b) and (c).

"(b) RECEIPT BY SHAREHOLDER.—Amounts to which subsection (a) is applicable shall be treated as received by the shareholder or holder of beneficial interest in the taxable year in which the distribution is made.

"(c) NOTICE TO SHAREHOLDERS.—In the case of amounts to which subsection (a) is applicable, any notice to shareholders or holders of beneficial interests required under this subchapter with respect to such amounts shall be made not later than 30 days after the close of the taxable year in which the distribution is made."

The CHAIRMAN. Mr. Avent.

STATEMENT OF I. M. AVENT, ATTORNEY, INDEPENDENT NATURAL GAS ASSOCIATION

The CHAIRMAN. Identify yourself to the reporter, please, and make yourself comfortable.

Mr. AVENT. Mr. Chairman, and gentlemen, my name is Ira M. Avent, of Shreveport, La. I am an attorney and member of the tax committee of the Independent Natural Gas Association.

The CHAIRMAN. Speak a little louder, if possible. We have a little noise in here. Let the group be in order, please.

Mr. AVENT. I appear today in behalf of the Independent Natural Gas Association of America, whose membership consists of oil and gas producers, both corporate and individual, as well as companies engaged in the transmission and distribution of natural gas.

Senator MALONE. Could the witness talk a little louder?

The CHAIRMAN. If you could talk a little louder, it would be much appreciated.

Mr. AVENT. A statement has been filed with the clerk of the committee, setting forth the suggestions and comments of this association with respect to treatment of various items in H. R. 8300, Internal Revenue Code of 1954.

The CHAIRMAN. The audience will be in order, please.

Mr. AVENT. It would be appreciated if that statement could be incorporated in the record.

The CHAIRMAN. Incorporate it, please.

(The statement referred to follows:)

STATEMENT OF INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA, RE PROVISIONS OF THE INTERNAL REVENUE CODE OF 1954, H. R. 8300

The Independent Natural Gas Association of America submitted to the House Ways and Means Committee several suggestions as to changes in the Internal Revenue Code that it believed would be helpful to the Government and to the taxpayer. For your ready reference copies of data on some of the topics presented to such committee are attached hereto as appendix A. A brief outline of the treatment in H. R. 8300 of the topics on which suggestions were made, is submitted in the following pages with our further comments thereon. Your attention is respectfully directed to such comments, to the new subject-matter submitted herein under the caption "General and New Matters," and particularly to the suggestion regarding the effective date of the proposed code.

Topic 4, deductions of charitable contributions, interest, taxes, and casualty losses

Our recommendations under this topic were primarily that stamp taxes on bond and stock issues should be allowed as deductions as taxes paid in the year in which stamps were purchased and affixed. The memorandum submitted by this association may be found on page 170 of the published hearings of the Committee on Ways and Means of the House of Representatives, 83d Congress, 1st session and on page 1 of appendix A attached.

We find no provision in H. R. 8300 that permits a deduction of this expense as taxes. For the reasons expressed in our previous presentation as above referred to, it is urged that further consideration be given to this question and that the relief requested be granted.

Topic 22, capital gains and losses (H. R. 8300, sec. 165)

It was our recommendation that the Internal Revenue Code be amended so that, in the case of a corporation, the net long-term capital losses incurred as a result of investments in a corporation entered into for business purposes, should be allowed as a deduction. The present law provides that this loss will be allowed only as an offset against capital gains except where the corporation owning the securities holds 95 percent or more of the stock of the company on which the loss was incurred. Our presentation on this question may be found on page 1195 of the published hearings of the House Ways and Means Committee and on page 2 of appendix A attached.

We find in H. R. 8300, section 165 (g) (3) (A) that the stock ownership in the subsidiary where the loss is allowed as an ordinary loss, is reduced from the 95 percent to 80 percent.

For the reasons stated in our previous memorandum above referred to, we urge the stock ownership limitation be eliminated entirely and that where losses are incurred in investments incidental to the principal business, then such losses should be allowed as an ordinary loss without regard to whether or not the investing company was in control of the company in which the investment is made.

Topic 24, the net operating loss (H. R. 8300, sec. 172)

It was the recommendation of this association that the net operating loss carryover should be the tax loss incurred. Our memorandum on this subject may be found at page 1238 of the published hearings of the House Ways and Means Committee and page 3 of appendix A attached.

Partial relief in this loss carryover situation has been provided for in H. R. 8300, section 172; however, it is urged that the full tax loss be carried over without adjustment to either the year of loss or the year to which the loss is carried.

Topic 26, consolidated returns and intercorporate dividends

It was our recommendation that the present 2 percent surtax penalty for filing consolidated returns be removed and the tax on intercorporate dividends received be eliminated. Our memorandum on this topic may be found at page 1294 of the published hearings of the House Ways and Means Committee and page 4 of appendix A attached.

The Ways and Means Committee first agreed in principle to both of our recommendations and tentatively approved amendments to the code which provided that the 2-percent surtax penalty and the tax on intercorporate dividends would be eliminated, a part each year over the next 3-year period.

After these provisions were tentatively approved by the House Ways and Means Committee they were recalled and reconsidered, and the previous approval was rescinded. H. R. 8300 as passed by the House, therefore, does not have any provision in it allowing the equitable relief requested and apparently recognized. It is, therefore, again urged that further consideration be given this topic and the unjust penalty on consolidations and the duplication of taxes on intercorporate dividends be removed.

Topic 33, the determination of taxable income—inclusions and exclusions (H. R. 8300, sec. 248)

It was the recommendation of this association under the above subject that a corporation be permitted to amortize the expenses incurred in its organization or reorganization and in the issuance of its capital stock either at organization or thereafter. Our memorandum on this may be found on page 1573 of the published hearings of the House Ways and Means Committee and on page 5 of appendix A attached.

H. R. 8300, section 248, provides that certain organization expenditures incident to the creation of the corporation, subsequent to January 1, 1954, may be amortized over a period of 5 years.

The report of the House Ways and Means Committee reflects that the amounts to be amortized do not include the expenses of issuing shares of stock incurred either in the creation or reorganization of a corporation.

It is urged that the definition of organization expenses be broadened to include the cost of issuing stock and also to include all other organization and reorganization expenses, including stock issuance stamp taxes if such expenses are not otherwise allowed as a deduction for the year in which they were incurred.

It is further urged that the provision of allowing organization expenses as a deduction be extended to companies who have previously incurred such expenses and who have not heretofore been permitted to take such expenses as deductions against taxable income. The limiting of this deduction to new companies can only be considered as discrimination against the older companies.

General and new matters

A partial and incomplete review of H. R. 8300 discloses many items which, in our opinion, should be corrected. Some of these are as follows:

Section 11, tax imposed.

Section 461, general rules for taxable year of deduction.

Section 481, adjustments required by changes in method of accounting.

Section 1341, computation of tax where taxpayer restores substantial amount held under claim of right.

Section 6016, declarations of estimated income tax by corporations.

Section 6074, time for filing declarations of estimated income tax by corporations.

Section 6154, installment payments of estimated income tax by corporations.

Section 6655, failure by a corporation to pay estimated income tax.

Section 7851, applicability of revenue laws.

Memoranda are attached hereto on these last numbered sections which briefly set out the objections thereto.

These data are submitted after only a very incomplete review of H. R. 8300, Internal Revenue Code of 1954 and since it will be impossible to properly review the bill within the time allowed for its consideration we earnestly urge that the proposed law be made applicable as outlined in our memorandum under section 7851—applicability of revenue laws—hereto attached.

SECTION 11. TAX IMPOSED

In H. R. 8300 it is proposed to increase the tax on corporate earnings in excess of $25,000 from 47 percent as exists in the present code to 52 percent, such rate to be effective for taxable years beginning after March 31, 1954.

A great deal has been said for and against the increase in tax rates from 47 percent to 52 percent (54 percent for a corporation filing a consolidated return) when the Nation is in a peacetime economy.

It is not our purpose to repeat here the many arguments which have been presented against such an extremely high tax rate. We must, however, point out that the increase in the tax rate as set out in section 11, H. R. 8300, results in an excessive and undue burden on businesses in general and that we hereby register our objections to such increase.

SECTION 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION

The section above referred to provides for the accrual of real property taxes of a taxpayer, using the accrual method of accounting, over the definite period of time to which the real property tax applies, and further provides that such rule shall not apply for a taxable year which began before January 1, 1954.

There may be many cases of a taxpayer who has followed the accepted practice of accruing real property taxes for taxable periods covered by the 1939 code, and who has taken deductions for real property taxes for the last taxable period under the provisions of the 1939 code. Should these taxes, accrued after January 1, 1953, and prior to January 1, 1954, have been ratably distributed, then the amount undistributed at January 1, 1954, will not be allowable as a deduction in 1954 under the provisions of H. R. 8300. The taxpayer would thus lose a deduction for taxes to which he is entitled. In order to prevent this injustice it is suggested that for the first taxable year, a taxpayer, in existence for

one or more taxable years next preceding the first taxable year under this code, shall be entitled to a deduction for real property taxes for such first taxable year in an amount which is the greater of the amount allowable under the provisions of this code, or the amount to which the taxpayer would have been allowed for such first taxable year in the absence of this section.

SECTION 481. ADJUSTMENTS REQUIRED BY CHANGES IN METHOD OF ACCOUNTING

The above section provides (a) in computing the taxpayer's taxable income for any taxable year * * *

1. If such a computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding year was computed, then

2. There shall be taken into account those adjustments which are determined, by the Secretary or his delegate, to be necessary solely by reason of the change in order to prevent amounts from being duplicated or entirely omitted.

The report of the House Ways and Means Committee, on page A-164, carries this statement: "It is only those omissions or doubling up which are due to the change in method wihch must be adjusted."

The committee report on page 50 carries the statement that: "Under certain circumstances, however, where a change in accounting method is made involuntarily, the courts have denied the Internal Revenue Service the right to require these adjustments * * *."

The committee's bill provides that the necessary adjustments will be made in all cases when there is a change in the method of accounting regardless of whether the change is voluntary or involuntary.

Many taxpayers are required by law to keep their accounts according to rules of regulatory bodies. In the proceess of regulation, the current and future earnings of such taxpayers are regulated and where a change in the method of accounting is ordered commencing with the current year, the regulated taxpayer company is placed under an undue financial hardship under this section because the retroactive income taxes plus interest resulting from the compulsory change are not recoverable in the normal regulatory process. It is therefore urged that adjustments shall be made under this subsection only for the year in which the accounting change is made where such change is involuntary or compulsory and made in accordance with rules and regulations of a regulatory body exercising control over the accounting procedure of the taxpayer.

SECTION 1341. COMPUTATION OF TAX WHERE TAXPAYER RESTORES A SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT

This section provides a method for the computation of taxes where amounts received under a claim of right have been properly reported as income in prior years but in a later year the taxpayer is required to refund all or a part of such income. The deduction allowed the taxpayer under this section is the lesser amount of tax determined under two different methods.

The provision for one of the above computations applies to adjustments for a period not in excess of 3 years. In addition, subsection (b) (2) provides that this section will not apply to certain transactions.

Regulated public utilities are frequently involved in rate proceedings and litigation which may sometimes take longer than a 3-year period. Such companies would therefore be unable to avail themselves of the provisions of this section for income received prior to the 3-year period specified in H. R. 8300.

In addition, the restrictive provisions of subsection (b) (2) of this section might otherwise operate to deny to taxpayers the use of the alternative tax computation provided by this section.

It is therefore urged that this section be modified so that the period in which adjustments can be made will include all of the taxable years during which the proceedings were pending.

It is also urged that where the adjustment provided for in this section arises out of refunds or repayments resulting from final determination of proceedings above referred to, is required of a corporation whose rates are fixed by a State or political subdivision thereof, or by a public service of public utility commission of a State, or a political subdivision thereof, or of the District of Columbia, or by an agency or instrumentality of the United States, such adjustments shall come within the provisions of this section.

SECTION 6016. DECLARATION OF ESTIMATED INCOME TAX BY CORPORATIONS—SECTION 6074. TIME FOR FILING DECLARATIONS OF ESTIMATED INCOME TAXES BY CORPORATIONS—SECTION 6154. INSTALLMENT PAYMENT OF ESTIMATED INCOME TAX BY CORPORATIONS—SECTION 6655. FAILURE BY A CORPORATION TO PAY ESTIMATED INCOME TAX

The above-enumerated sections contain provisions for a new system of advance payments of corporation income tax. Under this system a corporation is required to make and file a declaration of estimated tax on the 15th of the 9th month of the taxable year. Advance payments are to be made during the 9th and 12th months during the taxable year. The amount to be paid at each installment will graduate from 5 percent of the amount estimated to be due for the entire year 1955 to 25 percent in 1959 and later years.

The provisions do not apply to corporations whose yearly tax liability cannot reasonably be expected to exceed $50,000. (The current payment requirements are limited to that portion of the tax in excess of $50,000.)

The effect of advancing tax payments on corporations is to reduce their cash working capital. This reduction in working capital might well result in many corporations being forced to reduce their expenditures for expansion and investment in plant and equipment. This will produce a result directly contrary to the purpose of the act as expressed by the House Ways and Means Committee (p. 1) as it will undoubtedly have some unfavorable influence on future expansions.

Companies whose cash working capital is reduced because of the increased current tax payments may well be influenced by such a situation in their declaration and payment of cash dividends. Any reduction in dividend payments will reduce the overall taxable income of the country since dividends are generally taxable in the hands of the recipients. A reduction in dividend income would work an undue hardship on many citizens and would be a deterring influence on the Nation's overall economy.

Because of the above it is urged that H. R. 8300 be amended by eliminating therefrom all references to changes in methods of advancing payments of income taxes by corporations and the filing of declarations of estimated taxes, and substitute therefor the provisions now in effect in the Internal Revenue Code.

SECTION 7851. APPLICABILITY OF REVENUE LAWS

The House Ways and Means Committee state in their report (p. 1) on H. R. 8300 that "The purpose of these changes has been to remove inequities, to end harassment of the taxpayer and to reduce barriers to future expansion of production and employment."

This association is in agreement with the proposal as above stated and is of the opinion that many of the changes recommended by the House and incorporated in H. R. 8300 will tend to accomplish the expressed purpose. It must, however, be recognized that such an undertaking as a complete revision of the Internal Revenue Code however desirable, cannot possibly be accomplished without the occurrence of errors and omissions.

The problems of taxes is complex and the laws applying to such problem must, of a necessity, be complicated. To these complexities is added the many provisions of the proposed law which provide that procedure and tax practice be controlled by regulations prescribed by the Secretary or his delegates. The Commissioner of Internal Revenue has been publicly quoted as saying that these regulations cannot possibly be written and in the hands of the taxpayers during this taxable calendar year. Taxpayers will therefore be without any official interpretation of the code until the year 1955. Because of the numerous changes proposed and the lack of official clarifications they are now faced with a sea of uncertainty as to the tax effect of transactions occurring from day to day in their normal business operation. The many presentations made to your committee has pointed out many errors and omissions in H. R. 8300 all of which increases the difficulties under which a taxpayer is placed by the proposal that this law in general will apply to taxable years beginning after December 31, 1953. Such a proposal certainly does not tend to end harassment of the taxpayer and to reduce barriers to expansion of production and employment. On the contrary, it tends to create confusion, uncertainty and delays in expansion of production and employment.

The bill undoubtedly contains many provisions which will be helpful to taxpayers and will promote the prime purpose of the bill as above expressed. It must be realized, however, that the uncertainties of the tax effect on many

transactions will be a deterring effect on business activities during the transition period from the present Internal Revenue Code to the Internal Revenue Code of 1954.

The Independent Natural Gas Association of America therefore recommends that to eliminate the uncertainties hereinbefore mentioned, at least for the current year, and to accomplish the fundamental purpose of the tax-revision bill, the taxpayer be permitted to compute his taxes for the taxable year beginning after December 31, 1953, and prior to December 31, 1954, under the provisions of the Internal Revenue Code of 1939, as amended, or under H. R. 8300, Internal Revenue Code of 1954, whichever produces the lower taxable income.

This suggestion may appear unusual, however, a study will indicate that the following will be accomplished:

1. It will provide a method whereby the benefits to the taxpayers said to be in H. R. 8300 can be immediately passed on to taxpayers.

2. Taxpayers will not become victims of the traps and pitfalls in H. R. 8300 until they have had more time to study its provisions.

3. It will allow the Treasury Department time in which to write their regulations and get them in the hands of taxpayers before the law becomes exclusively final.

4. It will permit a comprehensive study of H. R. 8300 during this transitory period and the timely correction of defects by legislation prior to its becoming exclusively effective.

5. It will do away with the many uncertainties which are now deterring business activities.

6. It will provide for the much needed rearrangement of the tax laws.

7. It will be fair and equitable to the taxpayer and to the Government.

8. It will accomplish the prime purpose as expressed by the Committee on Ways and Means which reads: "* * * to remove inequities, to end harassment of the taxpayer and to reduce tax barriers to future expansion of production and employment."

For the reasons expressed we urge your earnest consideration to this proposal.

APPENDIX 4

(House Ways and Means Committee, 83d Cong., 1st sess., p. 170, published hearings)

Topic 4.—Deduction of charitable contributions, interest, taxes, and casualty losses.

We recommend that stamp taxes imposed by section 1800 and section 3480 of the Internal Revenue Code upon the issuance of corporate securities, capital stock., etc., be allowed in full as a deduction in the year in which incurred. At the present time, as set forth in I. T. 3806 CB 1946–2, 31, issued by the Bureau of Internal Revenue, stamp taxes on bond issuance are allowable as a deduction upon an amortized basis over the life of the bonds to which they apply; stamps purchased in connection with stock issues are not allowed as deductions except for the possibility of deduction as an organization expense at the time of corporate dissolution.

We fail to see a distinction in essence getween these stamp taxes and any other kind of taxes, and we believe that in equity and in fairness they should be allowed as deductions from gross income, either as a tax or otherwise, in the determination of taxable net income for the year in which the stamps were purchased.

(House Ways and Means Committee, 83d Cong., 1st sess., p. 1195, published hearings)

Topic 22.—Capital gains and losses including problems relating to basis

An inequity that has existed in the Internal Revenue Code deals with the nondeductibility by corporations of net long-term capital losses when they are in excess of net short-term capital gains for the corporation's current tax year. The fact that such excess of capital losses may be carried forward for a period of 5 years as an offset to net capital gains in those years does not relieve the inequity or hardship on corporations.

Such net losses in the case of a corporate taxpayer are usually the reasult of transactions which are an integral and essential part of the corporation's opera-

tions. With respect to utility companies, investments may be made in the capital stock of local industries with the object of promoting local employment and business activity which in turn will increase the utility's revenues and scope of operations. Also, two or more corporations may jointly invest in the stock of a new corporation at the request of some governmental authority to promote the national-defense effort or for the public good in general. For example, a group of electric utilities have recently organized a separate corporation to develop electric resources for the Atomic Energy Commission. Additional investments in varying proportions of capital requirements have been made in corporations engaged in research for developing new products from natural gas and oil. The electric industry is joining chemical companies in research toward the development of generating electricity from nuclear energy. Such necessary exploratory and research undertakings are made, in many instances, through separate corporations with the knowledge that partial or complete failures will obtain in many instances.

In any of the cases mentioned, the corporate-taxpayer will in most instances own less than 95 percent of each class of the capital stock of the corporation invested in and thus will not come within the requirements of sections 23 (g) (4) (A) and 23 (k) (5) (A). These code sections provide that if 95 percent or more of each class of stock of the affiliated corporation is held by the corporate taxpayer, then such stock will be deemed not to be a capital asset and will not therefore come under the capital gains and loss provisions of section 117, so that any loss is an ordinary loss.

We urge that in order to arrive at true corporate net income for any current tax year, code section 117 (d) (1) should be amended so that the excess of net long-term capital losses over net short-term capital gains, in the case of corporations, when incurred as a result of a transaction entered into for business purposes, should be allowed as deduction, regardless of the percentage of each class of stock owned as set out in code sections 23 (g) (4) (A) and 23 (k) (5) (A).

(House Ways and Means Committee, 83d Cong., 1st sess., p. 1238, published hearings)

Topic 24—The net operating loss

Section 122 of the Internal Revenue Code permits a net operating loss of any year to be carried back to the immediately preceding taxable year and to the extent that the loss is not absorbed by net income of that year, it may be carried forward to each of the 5 succeeding taxable years.

This, on the surface, is fair and equitable. However, before a net operating loss carryover may be applied as a deduction from taxable income, the following adjustments are required to be made to both the taxable year in which the loss occurred and to the net income of each year or years to which the loss may be applied:

1. The excess of percentage depletion over cost depletion must be restored;
2. Wholly tax-exempt interest, less any nondeductible interest paid or accrued to carry the exempt securities, must be included in gross income;
3. The net operating loss deduction must be restored; and
4. No deduction or credit is given for intercorporate dividends received.

The above adjustments have the effect of reducing the net operating loss and increasing the taxable net income against which the net operating loss is applied. The adjustments purport to be justified on the economic loss theory. The requirement that the adjustments be applied to both loss and income years cannot be justified, and sound principles should limit the carryover provisions to taxable income and not economic income concepts.

We urge that the so-called economic-loss limitations be removed from the statute.

(House Ways and Means Committee, 83d Cong., 1st sess., p. 1204, published hearings)

Topic 26—Consolidated returns and intercorporate dividends

To many corporate taxpayers the most discriminatory and inequitable provision in the Internal Revenue Code today is the 2 percent surtax penalty imposed for the privilege of filing a consolidated income tax by an affiliated group of corporations.

The first penalty on the privilege of filing a consolidated return by a parent corporation and one or more subsidiary corporations was imposed by Congress

in 1932 at a rate of three-quarters of 1 percent. This privilege was taken away 2 years later. The Second Revenue Act of 1940 partially restored the privilege when consolidated excess profits tax returns were authorized. The Revenue Act of 1942 restored the privilege of filing consolidated income-tax returns by an affiliated group of corporations and imposed the 2 percent surtax penalty which is presently in the Internal Revenue Code.

The argument attendant to the removal of the privilege in 1934 centered around the fact that losses of some companies could be offset against taxable net income of others resulting in a reduction of taxable income to the affiliated group. This argument is of no avail today because of the 1-year carryback and 5-year carryforward of net operating losses afforded to corporations filing tax returns on a separate company basis.

There appears to be no justification for the 2 percent penalty for the privilege of filing consolidated returns. In this respect, we quote the conclusion reached by the Senate Finance Committee in May 1932, as follows:

"* * * Your committee recommends that this additional tax be eliminated. It sees no justification for it. The provisions for consolidated returns under the present law and regulations recognize sound accounting practices and require tax liabilities to be determined on the basis of the true net income of the enterprise as a whole. No improper benefits are obtained from the privilege. Your committee believes that it is highly desirable, both from the point of view of the administration of our tax laws and the convenience of the taxpayer, that the filing of consolidated returns by affiliated groups of corporations be continued, particularly in view of the changes made in the Revenue Act of 1928 and in the regulations promulgated by the Secretary of the Treasury thereunder. It is difficult to justify the exaction of a price on the use of this form of return. * * *"

Certain corporations such as railroads and other types of public utility companies are required by State laws, in many instances, to maintain separate corporate structures in the several States in which they are doing business. We believe the exaction of a penalty is unwarranted when these corporations must have subsidiary companies because of legal requirements or business necessity. In this respect we quote from the conclusion reached by the House Ways and Means Committee in February 1934, as follows:

"* * * Your committee considered at length the question of abolishing the consolidated return. Our subcommittee originally recommended this action. The Treasury believed this policy undesirable. The Treasury pointed out that the one way to secure a correct statement of income from affiliated corporations is to require a consolidated return, with all intercompany transactions eliminated. Otherwise, profits and losses may be shifted from one wholly owned subsidiary to another, and their separate statements of income do not present an accurate picture of the earnings of the group as a whole. For all practical purposes the various subsidiaries, though technically distinct entities, are actually branches or departments of one enterprise. For these reasons, consolidated statements of income have been the rule for ordinary business purposes, and for 16 years the income tax law has provided for consolidated returns. The administration of the income tax law is simpler with the consolidated return since it conforms to ordinary business practices; enables the Treasury to deal with a single taxpayer instead of many subsidiaries; and eliminates the necessity of examining the bona fides of thousands of intercompany transactions.

"Consequently, after careful consideration of the question, the committee decided that it would be undesirable to abolish the consolidated return at this time. It appeared in the hearings that such action would be especially burdensome to many corporations, such as the railroads, which are frequently obliged to maintain separate corporate structures in the several States in which they operate, although for all ordinary business and accounting purposes the subsidiaries form a single operating system * * *."

We strongly urge that the present 2 percent surtax penalty for filing consolidated returns be removed and in addition that an annual election to file either separate or consolidated returns be made available to all affiliated groups of corporate taxpayers.

INTERCORPORATE DIVIDENDS

Subsequent to the year 1935, 15 percent of dividends received from domestic corporations have been subject to corporate income tax. Prior to that time all such dividends were entirely exempt from the tax. The congressional committees at that time were attempting to discourage the use of holding companies

and their complex corporate structures. The reports issued by both committees stated that they proposed to subject such dividends to only a small tax because it was really double taxation of corporate profits. In 1936 the corporation income tax rate was only 15 percent and the effective tax rate on dividends received from domestic corporations amounted to 2.25 percent. However, under the percent corporation income tax rate of 52 percent the effective tax rate on such dividends is 7.8 percent. The increase of 300 percent in the tax on intercorporate dividends can hardly be called a small tax any more. Mr. Roy Blough in his book entitled "A Federal Taxing Process," in speaking of the lack of precision in the income taxation of intercorprate dividends aid referring to the fact that only 15 percent of such dividends are subject to tax, says:

"Even at this rate, however, there is little if any justification for imposing the tax on holding companies in the public-utility field that are virtually required by State law if efficient system operations are to be achieved."

In addition the tax on 15 percent of dividends received from a domestic corporation has a pyramiding effect if some of the affiliated subsidiaries are parents of some of the affiliated companies so that the same corporate net income will be taxed greatly in excess of 52 percent.

We recommend that the economically unsound imposition of additional taxes on corporation earnings as they pass from one corporation to another before distribution by the recipient corporation, should be eliminated by making all dividends received by one domestic corporation from another 100 percent tax free instead of the present 85 percent allowance.

(House Ways and Means Committee, 83d Cong., 1st sess., p. 1573, published hearings)

Topic 33—The determination of taxable income—inclusions and exclusions

The Internal Revenue Code provides for amortization of expenses incurred on issuance of debt securities. Similar treatment is not allowed with respect to stock issuance expenses. Such variance in the treatment of issuance expenses between equity securities and debts securities is not equitable.

Debt securities have a fixed maturity date over which amortisation deductions may be measured. In most instances capital stock will not have such a maturity date. However, most equity capital issuances are for the purposes of plant expansion. The measurement period related to the stock issuance expense incurred in the average life of the plant.

We recommend that a new subsection be added to section 23 of the Internal Revenue Code which would permit corporations to amortize capital stock issuance expense over a period consistent with the average life of the property, plant, and equipment.

Mr. AVENT. It is my understanding that the statement filed will be briefed for you by your staff and it is not my purpose here to discuss in detail the points on which sugestions have been made, except the recommendation found on pages 15, 16, and 17 of our statement, to the effect that at least for the current year the taxpayer be permitted to compute his taxable income for the present taxable year under the provisions of the Internal Revenue Code of 1939, as amended, or under H. R. 8300, Internal Revenue Code of 1954, whichever produces the lower taxable income.

The CHAIRMAN. Has your point been discussed with our staff?

Mr. AVENT. We haven't had that opportunity.

The CHAIRMAN. Will you gentlemen see that this gentleman has that opportunity, if he wishes?

Proceed.

Mr. AVENT. We make this sugestion in order to eliminate for the current tax year, at least, the many uncertainties relating to the tax effect of H. R. 8300 and to permit the bill itself, which is the result of a tremendous amount of work by both the Government and taxpayers, and which extends benefits to many taxpayers, to finally become law.

The uncertainties are most apparent and need not be detailed here, since you have had before you many taxpayers and their representatives who have pointed out a great number of inconsistencies, omissions, and errors in the new and proposed legislation and who have made many recommendations for changes and corrections.

These uncertainties are a great deterrent to business but should a taxpayer know that the taxable effect of his business transactions will in no case be worse under the new act than is now provided under the present law, and that he can determine his taxable income under the new act if it is more favorable to him, then he will no longer hesitate to complete transactions or expand his production and carry our his business program because of the uncertainties of the applicable income laws.

The suggestion that we make, if incorporated in your final legislation, we believe will accomplish the following results:

1. It will provide a method whereby the benefits to the taxpayers said to be in H. R. 8300 can be immediately passed on to the taxpayers.

2. It will provide for the much needed rearrangement of the tax laws and accomplish the fundamental purpose of the tax revision bill.

3. It will allow the Treasury Department time in which to write their regulations and get them in the hands of taxpayers before the law becomes exclusively final.

4. It will permit a comprehensive study of H. R. 8300 during this transitory period and the timely correction of defects by legislation prior to its becoming exclusively effective.

5. It will prevent taxpayers from becoming victims of traps and pitfalls in H. R. 8300 before they have had an opportunity to study its provisions.

6. It will be fair and equitable to the taxpayer and to the Government.

7. It will do away with the many uncertainties which are now deterring business activities and will accomplish the prime purpose as expressed by the Committee on Ways and Means, which reads: "* * * to remove inequities, to end harassment of the taxpayer and to reduce tax barriers to future expansion of production and employment."

For these reasons it is urged that this suggestion be given your earnest and careful consideration.

Extending my remarks beyond this, we have submitted to your committee several new questions which have been discussed or will be discussed by other organizations, or other taxpayers, and we do not wish to take up your time in duplicating the arguments that I am sure they will present to you, so for that reason, we do not make any further presentation at this time.

The CHAIRMAN. Thank you very much for your comments.

Senator MALONE. Will the witness state what he hopes to gain by the changes—I see no changes discussed here, at all.

Mr. AVENT. Well, the change would be in section 7851, which would have to do with the effective date of the act. Under this proposal, for the current taxable year, a taxpayer could determine his taxable income under either the old law or the proposed law. The taxpayers as a class now know with a reasonable degree of certainty what the present law is. They may wish to enter into some transactions, make some reorganization of their business, or organize a partnership and

would not do this if they were doubtful of the tax effect of such transactions.

Senator MALONE. What else is it?

Mr. AVENT. Well, that would be the change. A taxpayer would hesitate to do it under H. R. 8300, because he doesn't know what the tax effect would be under that particular act.

Senator MALONE. What is the amendment you propose?

Mr. AVENT. It would be in section 7851.

Senator MALONE. What would it say?

Mr. AVENT. I haven't written the amendment out in detail. It would be an amendment which would merely permit the optional computation. It could be in section 7851 which sets up the effective date of the act.

(The following proposed amendment was subsequently submitted for the record:)

PROPOSED AMENDMENT TO H. R. 8300, INTERNAL REVENUE CODE OF 1954

Amend by adding subsection (A) as follows:

"SEC. 7851.—Applicability of Revenue Laws.

(a) * * * (1) Subtitle A * * *

"(D) Notwithstanding the provisions of subsections (A), (B) and (C) of subtitle A of this section, or any other provisions in the Internal Revenue Code of 1954, the taxable income of any taxpayer as determined for years beginning after December 31, 1953, and prior to January 1, 1955, shall not be in excess of the amount of taxable income as determined under the Internal Revenue Code of 1939."

Senator MALONE. Your income tax under either the old or the new one, in any case the Treasury could tell you definitely what to do.

Mr. AVENT. No, the taxpayer would tell the Treasury what they wished to do.

Senator MALONE. Whether they wanted to go under the old law or the new one?

Mr. AVENT. Yes, that is right.

The CHAIRMAN. Thank you very much.

Mr. Kamm, make yourself comfortable and identify yourself to the reporter.

STATEMENT OF JACOB O. KAMM, EXECUTIVE VICE PRESIDENT, CLEVELAND QUARRIES CO.

Mr. KAMM. Mr. Chairman and members of the committee, I am Jacob O. Kamm. I am executive vice president of the Cleveland Quarries Co., Amherst, Ohio. I appreciate very much the opportunity to appear before this committee.

Section 613 (b) of H. R. 8300 contains an amendment to the percentage depletion provision which, if it is not changed, will create a serious inequity against the refractory quartzite industry.

The CHAIRMAN. Tell us something about that.

Mr. KAMM. We have refractory quartzite as our principal product, which is applied to cupolas, Bessemer converters, soaking pits, and so on. We are the largest manufacturers in the country of those products.

The CHAIRMAN. Where are your quarries?

Mr. KAMM. Amherst, Ohio.

The CHAIRMAN. Proceed.

Mr. KAMM. It is my belief that the proposed inequity against the refractory quartzite arose in the first instance out of a misunderstanding, and that misunderstanding should be corrected at this time.

In the hearings before the Ways and Means Committee on the proposed—but, because of the Korean war, never enacted—Revenue Revision of 1950, Mr. E. A. Garber, president of the Harbison-Walker Refractories Corp., Pittsburgh, Pa., testified on behalf of more than 50 refractories who produce about 90 percent of the refractory material used in the United States. Mr. Garber asked the committee to provide percentage depletion for "refractory clays and quartzite." That is in the hearings at page 455. Mr. Garber made it clear that he was asking 15 percent depletion not for quartzite as such, but only for refractory quartzite, when he stated, at page 449:

> Chemically, refractory minerals must be pure * * * The term "refractory" modifying the words "clays and quartizite" has been suggested to embrace only the distinctively refractory minerals which fuse only at the highest temperature. The term "clay," "kaolin," and "quartzite," when used without the modifying term "refractory," include many materials having characteristics and properties which prohibit their use as refractories.

H. R. 8920 as passed by the House in 1950, provided 15 percent depletion for, among other things, "refractory and fire clay, quartzite * * *." Obviously a mistake occurred at that time. The refractory industry asked for 15 percent depletion for refractory quartzite, but in the preparation of the bill the language was changed so that "quartzite," without the modifying word "refractory," was granted 15 percent depletion.

H. R. 8920, as it passed the House in 1950, did not become law. However, the Revenue Act of 1951 included a number of revisions in the percentage depletion provision, and according to the report of the Committee on Ways and Means, those revisions were based on the 1951 hearings as well as on the revisions which were contained in H. R. 8920 as it passed the House in 1950. The Revenue Act of 1951 perpetuated the mistake which had occurred in 1950—it granted 15 percent depletion to "refractory and fire clay, quartzite * * *." In other words, the Revenue Act of 1951 failed to modify "quartzite" by the term "refractory."

In section 613 (b) of H. R. 8300 "quartzite" is dropped from the list of specific minerals, contained in paragraph (3) thereof, which are to receive 15 percent depletion, and falls instead within the catch-all category contained in paragraph (6). In other words, under H. R. 8300 "quartzite" will receive 15 percent depletion, "except that the percentage shall be 5 percent * * * when used or sold for use as riprap, ballast, road material, rubble, concrete aggregates, dimension stone, ornamental stone, or for similar purposes."

The report of the Ways and Means Committee on H. R. 8300 discusses this change, which was made with respect to several other minerals also, on pages 57 and 58, as follows:

> Under this revision there are a few increases, but no reductions, in the rates of percentage depletion allowed by present law and regulations. * * * All other minerals not specifically listed are placed in a general class to receive percentage depletion at the rate of 15 percent, subject to the limitation that if they are used for the same purposes for which stone is commonly used, they are to be regarded as stone and entitled to a percentage depletion rate of 5 percent. This end-use test is imposed to prevent discrimination in percentage depletion rates between materials which are used competitively for the same purposes. The general 15

percent category is intended to include, for example, quartz sands or pebbles when sold for their silica content and novaculite.

"Refractory quartzite" should have been included at 15 percent, and H. R. 8300 should be amended to retain "refractory quartzite" in the specific category in paragraph (3) of section 613 (b) since this was decidedly the concluded intent of the 1950 hearings as reflected in the 1951 act and in the House committee report accompanying H. R. 8300.

Refractory quartzite is used primarily for the construction of industrial furnaces. Quartzite, to be suitable for use as a refractory material, must be physically resistant to decrepitation and clear grain in texture and must be chemically pure, as even small amounts of impurities render it unfit for use in making refractories. Although quartzite occurs in abundance in several States, refractory quartzite is definitely scarce and must be searched for and found by geological studies, prospecting, sampling, and chemical analyses.

The principal deposits of refractory quartzite are contained in Pennsylvania, Wisconsin, Alabama, and Ohio. Smaller quantities are obtained from a few other States. The exceedingly critical need for refractories for the continuance of most of our major industries, particularly the iron and steel and aluminum industries which are so vital to the national defense in time of war and to the national economy in time of peace, demands that the refractory quartzite industry be permitted to retain a percentage depletion allowance adequate for maintenance of a healthy industry.

Most of the minerals which are dropped into the "all other minerals" category of paragraph (6) of section 613 (b) are minerals whose production involves little or no waste.

Most of the minerals which have been retained in paragraph (3) of section 613 (b) are minerals which do involve a considerable amount of waste in their production—chemical-grade limestone and metallurgical-grade limestone are good examples. The allowance for depletion in these cases is based on minerals in place in natural deposits. For minerals of this type, justice requires that they be specified in paragraph (3) so that all of the mineral receives 15 percent depletion even though it may be necessary to dispose of the waste resulting from processing the quarry material. Our mineral was in this 15-percent class in the 1951 act and should be retained in the 15-percent category represented by paragraph (3) of section 613 (b) of the current revenue bill.

The CHAIRMAN. How are you hurt?

Mr. KAMM. I can illustrate that very quickly. I have here a sample of refractory clay. Now, this is dropped out of paragraph 3 of section 613 (b), down to paragraph 6.

The CHAIRMAN. With what result?

Mr. KAMM. With a result that they retain 15 percent because no part of this is sold for use as riprap, ballast, and so on. In extracting this from the natural deposit, there is practically no waste involved.

Here I have a piece of sawed quartzite, as used in the industrial furnaces in this country. In order to get this, if you picture this as a natural deposit in the ground, we have to channel 18-inch holes into this rock in order to get it out, into the resource.

The CHAIRMAN. Is it your complaint that you are not receiving enough, or that others are receiving too much?

Mr. KAMM. My complaint is that our competitors are receiving 15 percent on the entire deposit that they have, and that in our case, we are not. We were in the 1951 act, but in this new H. R. 8300, we are not, as it stands.

The CHAIRMAN. Where do you run into this competition?

Mr. KAMM. We run into this competition in the sale of our products in Bessemer converters, in soaking pits throughout the country, and so on. We are the largest manufacturers of soaking-pit linings in the United States and are facing competition from the refractory clay people who are receiving 100 percent, 15-percent depletion.

My point is that in extracting our product, we have a waste as we extract the natural deposit in the ground. That is not true of this type of deposit.

The CHAIRMAN. Why isn't it true?

Mr. KAMM. It is not true because in extracting clay they do not have to channel 18-inch strips into the deposit in order to get the large blocks out. We have to sell this in the form of a block, and in order to get the block we have to cut down into the deposit to get it out.

Now, if we are to get 15 percent—5 percent on the material that we are losing as we channel this out, then we are being cut in two ways. We are being cut because the waste is sold for what we can get for it, which is a low price, and if we got 15 percent on that, it would automatically have a low percentage depletion amount, but if we get 5 percent on it, we are cut twice.

The CHAIRMAN. I must confess I am not clear on it. I hope you will try again. Give me another crack at it.

Mr. KAMM. All right. In extracting this, they can use a diesel shovel to take this out. There is no waste involved.

The CHAIRMAN. Now, what do they get?

Mr. KAMM. 15 percent.

Senator FREAR. On everything?

Mr. KAMM. On everything.

Senator FREAR. Including what in your industry is waste?

Mr. KAMM. Including what in our industry is waste.

Senator BUTLER. Mr. Chairman, might I ask a question there which may help us a little? I am confused, although I am rather familiar with this thing: What is the expense in discovering new deposits of this material? You know, when you are discovering—well, even coal. You have an expense of core drilling and so forth. What expense do you have?

Mr. KAMM. We have similar expenses, except that there is no definite record of future deposits available, and because they are indefinite, the expense may be tremendous in locating new deposits.

We have the same type of approach. We have to core drill; we have to explore; we have to have chemical analyses to determine the purity of the deposit. All of those expenses are coupled with exploration.

Senator BUTLER. I suppose a lot of discovery is accidental?

Mr. KAMM. In part it could be.

Senator BUTLER. Mr. Chairman, I have seen all these operations, and of course, as you know, I have never had any knowledge of the expense in discovering the raw material, and that is what I was trying to determine.

Mr. KAMM. It would be a very heavy and material expense, without any question.

The point I was making, Mr. Chairman and members of the committee, is that in extracting this particular product, there is practically no waste because you don't have to cut the block in order to get it out. In cutting the block here, you lose a great amount of the raw material as you are getting it out. It forms in chips as you are cutting through on the block.

Now, under this new bill, we would get 5 percent on the chips as we cut out these blocks, rather than 15 percent.

The CHAIRMAN. Doesn't the other fellow get 5 percent if he uses it for ballast and that sort of stuff?

Mr. KAMM. No. In the clay industry, you see, there is no such use of it and there is no waste to be put to that use.

The CHAIRMAN. I am looking at section 613.

Mr. KAMM. Yes.

The CHAIRMAN. Do you understand subparagraph 6? It says, "15 percent." "All other minerals, except that the percentage shall be 5 percent for any such other mineral when used or sold for use as rip rap, ballast, road material, rubble, concrete aggregate, dimension stone, ornamental stone, or for similar purposes."

Senator FREAR. Under (3) it also lists ball clay, aggregate clay and so forth, which his competitor is categoried under, is that not right?

Mr. KAMM. That is right.

The CHAIRMAN. The thing that bothers me is, what advantage do you want that the other fellow hasn't got, or vice versa?

Mr. KAMM. All we want is an equivalent position with our competitor. That is all we want. Under this act, as it now appears, we are not getting an equivalent position.

The CHAIRMAN. You are getting 15 percent on your main operation, is that right?

Mr. KAMM. We are getting 15 percent on the refractory product.

The CHAIRMAN. And you get 5 percent on the waste?

Mr. KAMM. That is right.

The CHAIRMAN. Now what do you want?

Mr. KAMM. We would like to have 15 percent on refractory quartzite, and have that cover the waste which is extracted while we are getting our product out.

The CHAIRMAN. Do the other people have the same advantage, where he gets his stuff out?

Mr. KAMM. Yes; he does, because he has no part of his product sold for riprap, ballast, or anything like that.

The CHAIRMAN. What does he sell his stuff for?

Mr. KAMM. Because it is clay; there is no byproduct usable for ballast or riprap. I wonder if I make myself clear?

The CHAIRMAN. No, not to me, but that may be my fault. That is what I am trying to find out. I am seriously trying to find out just exactly what your complaint is, because frankly, I don't understand it. Now, that is not your fault, that is my fault. We are here to learn, so try again and see if you can't clear me up on this.

Senator BUTLER. Before he goes on, Mr. Chairman, what is the percentage of waste in both classifications? I presume the expense of handling the waste is one of the things.

Mr. KAMM. Quite definitely. Our waste will run 30 percent in extracting the blocks. If you have a large quarry surface, in order to

get these solid blocks out which we sell to the furnaces, we have to waste a certain amount to extract the solid block.

Our competitors, who are the refractory clay people, in china clay, aggregate clay, and some of the other clays listed, they do not have that problem, because in getting it out, they don't have to cut and shuffle around. They can just go in with a shovel and take it out.

The CHAIRMAN. Now, what depletion do they get?

Mr. KAMM. Fifteen percent.

The CHAIRMAN. What do they get if they use it for ballast and these other things that are mentioned?

Mr. KAMM. Well, if they had any clay used for that purpose, they would get 15 percent.

The CHAIRMAN. They would get 5 percent, wouldn't they?

Mr. KAMM. That is only for stone used for those purposes.

The CHAIRMAN. I think it is a little clearer, but it isn't entirely.

Mr. KAMM. I am sorry. It is my fault.

The CHAIRMAN. No; it is not your fault, at all.

Senator FREAR. In this paragraph 6, it says, "When used or sold." Now, if they have any and don't sell it, that takes them out of that classification; does it not?

Mr. KAMM. That is right. You see, we are competing with the other fellow, and if we can sell any part of this, then we are getting in there on a price basis. It is a matter of price competition that we are concerned with.

Would you like me to continue, Mr. Chairman?

The CHAIRMAN. Please do.

Mr. KAMM. Although the Ways and Means report, as already quoted, states there are "no reductions in the rates of percentage allowed by the present law and regulation," this intent is not carried out with respect to refractory quartzite. H. R. 8300 will substantially reduce the depletion allowance of my company, the Cleveland Quarries Co.

The primary use of our product is for refractory purposes. However, as already stated, there is a good deal of unavoidable waste in the production of our product which is also the case of all other minerals in subsection 3. Even under present law, where we obtain 15 percent depletion for our entire output, we receive substantially less depletion for the waste portion which is sold for inferior uses, because the price received therefor is so much lower.

The CHAIRMAN. Could your point be stated this way, that in your operations, in your particular deposits, you have a percentage of waste which does not occur to the other fellow you are competing with; is that the whole point?

Mr. KAMM. Yes, it is.

The CHAIRMAN. Thank you very much.

Senator FREAR. But if he sells his waste, you are allowed only 5 percent on that, where the other fellow, if he has waste and doesn't use it or sell it, then he gets the total 15 percent all the way through; is that right?

Mr. KAMM. That is right.

The CHAIRMAN. Well, you get 15 percent for that which you sell.

Mr. KAMM. For refractory purposes; that is right.

The CHAIRMAN. And the other fellow doesn't make any money on that which he doesn't sell; does he?

Mr. KAMM. That is right.

Senator FREAR. But he still gets 15 percent depletion?

Mr. KAMM. That is right.

The CHAIRMAN. The whole point is whether the other fellow has the element of wastage which you have in your product.

Mr. KAMM. That is right.

The CHAIRMAN. And you are both being treated the same way on the same products that you make?

Mr. KAMM. That is right.

The CHAIRMAN. Go ahead.

Mr. KAMM. If, on top of this, Congress sees fit to enact section 613 (b) in its present form, we will be doubly penalized on this waste output, because not only will the lower price reduce our depletion allowance but, on top of that, we will receive only 5-percent depletion based on that lower price.

In summary, let me point out again that refractory quartzite is a vital, scarce commodity, involving the expenditure of large sums of money in its exploration and production. Refractory quartzite is presently receiving 15-percent depletion, and quite properly so.

Section 613 (b) of H. R. 8300, in its present form, would result in a serious reduction in the percentage depletion allowance for refractory quartzite.

The CHAIRMAN. Is your business profitable at the present time?

Mr. KAMM. At the present time, it is not.

The CHAIRMAN. When did it cease to be profitable?

Mr. KAMM. It ceased to be profitable about last November. We have had a period, here, where the steel mill decline has affected our business.

The CHAIRMAN. It would also affect the other fellow's business, too, would it not?

Mr. KAMM. It presumably would, yes.

The CHAIRMAN. Go ahead.

Mr. KAMM. At the same time, no corresponding reduction would be made in the depletion allowance granted to the materials with which refractory quartzite is competitive.

I, therefore, respectfully ask this committee to retain the present depletion allowance for refractory quartzite by amending section 613 (b) of H. R. 8300 to specifically include "refractory quartzite" in paragraph (3) thereof.

Thank you for the privilege of appearing before your committee.

The CHAIRMAN. Thank you very much for coming.

Will you bring that up in executive session, please?

Mr. SMITH. Yes, sir.

The CHAIRMAN. Now, Mr. Clarke, we will hear from you.

Where is Mr. Clarke?

Mr. William Quinette——

Mr. Quinette is with the Colorado Mining Association, and is accompanied by Mr. Bob Palmer.

STATEMENT OF WILLIAM QUINETTE, COLORADO MINING ASSOCIATION, ACCOMPANIED BY ROBERT S. PALMER, EXECUTIVE DIRECTOR, COLORADO MINING ASSOCIATION

Mr. QUINETTE. Mr. Chairman and members of the committee, I wish to thank you for this opportunity to appear before you.

My name is William H. Quinette, a certified public accountant in Denver, Colo., representing the Colorado Mining Association, who, in turn, represent substantially all of the independent producers of uranium in the United States.

Senator FREAR. What do you mean by independent producers of uranium?

Mr. QUINETTE. Well, that is a general term, and perhaps I shouldn't use it.

Senator FREAR. That means not Anaconda, or people of that kind?

The CHAIRMAN. Does it mean the little fellow as opposed to the big fellow?

Mr. QUINETTE. That is correct.

The CHAIRMAN. Not as "opposed," but contrasted to the big fellow.

Mr. QUINETTE. Yes.

The subject of my remarks will be, Need of Income Tax Modification to Stimulate Uranium Production.

Based upon the assumption that the present policy of the Government is to materially increase the domestic production of uranium, I respectfully make the following observation:

In applying the income-tax law and regulation to exploration, development and production—mining—or uranium, those versed in the complexities of income taxation become aware of many uncertainties, some of which probably will only be determined after lengthy, time-consuming and costly controversy, possibly in the courts, during which time the taxpayer should protect himself against the possible eventuality of being required to pay substantial additional income taxes.

This situation may constitute a trap for the many independent and small-operator taxpayers, who, at best, may be considered only generally informed as to the application and impact of income-tax on his operation. To those operator-taxpayers who may be classified as being reasonably informed, such knowledge brings to their attention many income-tax uncertainties, which, if coupled with prudent conservative protective thinking, will result in a cautious and restrictive policy of operation, geared to minimize the possible impact of income tax, all of which will hamper and slow down the taxpayer's operation, which otherwise would be actively producing uranium.

To alleviate, in part, the foregoing and based upon the costs of exploration, costs of development, and costs of production—mining—of uranium, together with the uncertainties of discovery and continued production of commercial ore, it is my opinion that to encourage and assist the development of new sources of domestic uranium production in the interest of the common defense and security, the new domestic uranium industry should be granted 40-percent percentage depletion allowance, the same allowance as granted by the State of Colorado for income-tax purposes.

Further, to aid small and other producers of marginal commercial deposits of uranium, the factor of 50-percent limitation of the taxpayer's taxable income should also be modified, that is, eliminated entirely in the case of taxable income up to, say, the first $75,000, and, say, changed to a 75-percent limitation of taxable income in excess of $75,000, and under $150,000, and that in the case of taxable income of $150,000 or more, the 50-percent limitation of taxable income be retained.

And further, that the foregoing proposed changes be limited and available only to taxpayer owners of operating mineral interests, that is only interests in respect of which the costs of production of the mineral are required to be taken into account by the taxpayer for purposes of the 50-percent limitation provided or would be so required if the mine or other natural deposit were in the production stage.

That last clause eliminates royalty and other economic interests which do not bear the cost of the venture or the production.

The CHAIRMAN. Well, they pay for what they get, and when you buy something, you take the risk of business, don't you?

Mr. QUINETTE. What I mean is, Senator, in stepping up the increased percentage which we think should be allowed, it should only be allowed those taxpayers who are operators, who are in the business of spending money in development. We don't think it should be upped in the case of a landowner who may own it free and, just by happenstance, be the owner when some operator comes along and wants to lease his land for production. He does nothing but sign a mineral lease.

The CHAIRMAN. Except he has uranium.

Mr. QUINETTE. That is true.

The CHAIRMAN. That is important, isn't it?

Mr. QUINETTE. It is a natural resource. We are asking that he also get relief. You and your committee wish to grant him relief. We will not debate that. We are just not for it. We are asking for relief for those people who have to put up capital.

The CHAIRMAN. What is the relation of the bonuses and one thing or another that the Government pays in this business?

Mr. QUINETTE. It is of a substantive nature. Due to your whole atomic energy program, various ways and proposals and means are being granted a uranium producer to help him. What we are proposing here, percentagewise, is not the only answer. It is going to take all of these things. It is going to take all kinds of subsidies.

I am presenting here what the State of Colorado has recognized for years. The uranium producer in Colorado gets 40 percent depletion. Now, I might say I am not an owner of any uranium. I have had many opportunities to go in with my friends and take leases, but they are too stiff for me. I put the pencil to them and my money came the hard way; I can't risk it.

And still, some of them hit the jackpot. But most of them will no. It is my observation that the non-Government money spent in the next few years to develop uranium will never be returned compositely to those in the aggregate, in relation to the amount of money spent.

The CHAIRMAN. That is true of the whole mining business, isn't it?

Mr. QUINETTE. That is right. It has been true for many years. There are a few people who hit the jackpot, but most of them spend their money and then go back to farming or business.

The CHAIRMAN. The point is to give them incentives that will continue to get them to take the risk; isn't that it?

Mr. QUINETTE. That is exactly what we are asking for. There is an added incentive. Dollarwise, it may not mean too much, but it sounds good. It is an incentive. And this country was built on incentive, and to a large extent on not being too well informed. Many people have become extremely successful by the fact that they were not informed. If they had known the heartbreak they would have gone through, they would have done something else.

The CHAIRMAN. I know there is some sympathy on this committee to help uranium mining. I don't know whether you have the right formula. It seems to me we are establishing what might be a little bad precedent by going as full-out as you have gone.

Can't you think of some approach that doesn't have such long teeth?

Mr. QUINETTE. Well, Senator, actually, the granting of percentage depletion, regardless, is to a large extent to most of the people who will spend money in the search for uranium, it is purely theoretical and psychological. Very few of them will ever obtain any percentage benefit, or ever receive any income of any consequence. Now, if the need for uranium ore for national defense is as serious as we have been told, we might well, for the purpose of extending and placing an incentive on this search, do like they do in Canada, and eliminate income tax on production for, say, 3 years. I would say if this Government eliminated income tax entirely on the production of uranium, certainly they would put a big impetus on the search.

There would be a few people hit the jackpot and come out with a pile of money. But you and I know that the average individual who makes a pile of money, whether it is taxable or otherwise, is not going to keep it.

The CHAIRMAN. We will catch up with him in the end.

Mr. QUINETTE. You will catch up with him. It is just a matter of time.

The CHAIRMAN. Well, several members of this committee, Senator Malone—two of us are members of the Joint Committee on Atomic Energy, and we know something about the necessity for getting increasing quantities of uranium. As I say, I think we have a sympathetic interest of making this as attractive as possible, but I am just wondering about your particular approach.

Mr. QUINETTE. I am just offering this. I am not saying it is the only way. You can spend money directly out of the Treasury, or you can create circumstances. I am offering you one of those circumstances. Let the money come directly from private individuals instead of the Treasury Department. You have the option.

The CHAIRMAN. Well, the whole mining business has been built, or was built in a day when, if you hit, you hit big.

Mr. QUINETTE. And in a day, if you made a dollar, you kept a dollar.

The CHAIRMAN. That is what I am talking about.

Mr. QUINETTE. Not 50 cents.

The CHAIRMAN. You hit big because you didn't get it all taxed away from you.

Mr. QUINETTE. That is right.

The CHAIRMAN. So your theory is, we have to put a few more carrots in front of the horse to keep him interested in this business?

Mr. QUINETTE. I believe that is right.

The CHAIRMAN. I think it is a sound policy.

Mr. QUINETTE. I believe that is right.

The CHAIRMAN. We on this Joint Atomic Energy Committee have—when we are started out—I am not releasing a secret, I am quite sure—we were unduly dependent upon foreign sources for our ore. Those of us who have had any experience with the mining business said the way to get the ore is to hang up a price and you won't get it unless you hang up the price. And every time they hang up the price a little bit, they get more ore. Giving tax advantage is another way of hanging up a price.

Senator FREAR. What does the State of Colorado allow for depletion on royalties?

Mr. QUINETTE. They allow 40 percent. As I say, I am not asking for that much. I am talking about the people who have to spend the money. If you want to go straight across the board and allow the royalty owner and the horse trader who gets in between the owner and the fellow who finally puts the money up, that is O. K.

The CHAIRMAN. That fellow who puts the money up starts from many sources, and he isn't always an operator, but he is a participant in something that bears the burden of the operation. The ownership is not clear of that burden.

Senator BUTLER. Mr. Chairman, he is oftentimes just a man with small savings who wants to take a chance to build up and, of course, he is usually a loser, because the percentage is so much against him in recovery, but that is what has made our country, and it is so much better to have it in the way of a depletion than it is by governmental subsidy, because when it is a depletion, it is still in the hands of the individual in question.

And when it is a subsidy, there is just not the same control over it as when it is through the incentive of a depletion. We have to have incentive in our country, and the big taxes that we pay have destroyed a lot of that incentive, so, Mr. Chairman, I am very much in sympathy—while I don't know anything about the business of procuring uranium, I am very much interested in encouraging the incentive from the citizen's standpoint, rather than the subsidy of the governmental standpoint.

The CHAIRMAN. I wish the staff would give careful consideration to the subject of uranium and maybe you can come up with some formula that will meet the need for uranium that may not fit the exact formula proposed.

Give us your best on that.

What do you have to say, Bob?

Mr. PALMER. Just this, Senator. We have been led to believe this industry is highly essential to the national interests.

The CHAIRMAN. It is.

Mr. PALMER. I might say that it is being found in Pennsylvania, as well as in the West, and we believe that an additional incentive is highly desirable, at this time, if we really are sincere in our desire to encourage production on the plateau.

The CHAIRMAN. We should be.

Mr. PALMER. I would like to reiterate the emphasis that Mr. Quinette has put on the complexities of the present tax situation. I think

that in consulting with most of the accountants and most of the lawyers who have to deal with this industry, that no clear-cut, concise opinion can be expressed as to their exact tax position, and that does have its effect, in addition to the complexities that you well know about the title situation on the plateau. That does add to the hesitancy on the part of a great many people to go into this vital industry.

The CHAIRMAN. You put your case on the smaller operators and I think that is very wise. The larger operator, what he loses on a peanut, he can make on the banana. But the fellow who is simply taking a flyer in one thing, he either hits or he doesn't, and if he hits, he loses because by the time we get through with him, he hasn't got much left.

Mr. PALMER. May I have this off the record, Senator, that the price of uranium in Canada is quoted at $7.25 in the form of concentrates?

Senator FREAR. Mr. Chairman, I have a great deal of respect for the Colorado Plateau, as well as the State of Nevada, and I now hear Pennsylvania is coming in on us. Is there any uranium in Delaware?

The CHAIRMAN. It would be a very good thing to have up there.

I wish it was all in Colorado, but it is in Utah, New Mexico, Arizona, Colorado.

Senator Malone, do you have anything to say to this?

Senator MALONE. Mr. Chairman, this estimate is very interesting to me, because I know that your Atomic Energy Committee is studying it and we know that the committee of which you are a member, Interior and Insular Affairs, is studying it.

All we know is that it started in two States. There are five States in the hub of production. Pennsylvania, I did not know about, but it seems to be a good deal like other minerals. If there is an incentive to look for them, you find them.

Now, we also have another important mineral. Titanium has developed to be something that you have to have to make planes and other things in national defense, but we have very little of it in production. We have to have 850,000 tons a year, and we are getting 200,000 tons. We are getting certain material from Australia and India, neither of which can be secured in time of war. We are getting, of course, the mineral you are testifying about this morning from the Belgian Congo and many speeches have been made about getting uranium from the Belgian Congo.

None of those things appear to be true in the investigations that have now been made. There is more alminite in the United States and Canada than we could use in 100 years, if we become dependent on it. If we are in danger of a war, really, you can't start using this material overnight, so you could be whipped before you get it into use.

Now, we come to your uranium. I will not ask you how much you are producing—all of this is confidential material, but we held 2 days' hearings there to see how our law was working that your committee—the chairman of the subcommittee; you are a member of it—we validated mining claims up to January 1, 1953, located on leases. Oil and gas leases. They have the preference, of course, but there is serious thought about extending that date.

This is something new. We do know one thing about it—and I want to ask this question for the record: The production and actual known deposits of some magnitude is retarded, now, because you get into a bracket in using up your material where the investors cannot

receive a return and, therefore, it is limited to production a few months a year, is that true?

Mr. QUINETTE. That is the tendency, pure and simple.

Senator MALONE. Of course, instead of having it so they could make some money and then spend money out of their depletion allowance to discover new deposits—that is your point, isn't it?

Mr. QUINETTE. That is right.

Senator MALONE. That they just quit operating and save what they have?

Mr. QUINETTE. That is right.

Senator MALONE. Mr. Chairman, I believe the witness has opened up the subject, and it has been opened in two other committees, and right at the moment we are discussing it with Mr. Strauss, and I know the Atomic Energy Commission is discussing it with him and it is a question of arriving at a reasonable approach to get enough uranium to do this country in an emergency.

I will ask you this question: I do not know whether you are well enough informed to answer it. It is not the conviction of the committee, but there is a feeling on the committee that a proper approach in taxation and other incentives, if that is arranged, we could become self-sufficient in the production of uranium in this country and certainly in the Western Hemisphere, where we could defend it. Do you have any opinion on that subject? That is, to do it within a reasonable time?

Mr. QUINETTE. My opinion cannot touch upon whether uranium is present or not, but I will express the opinion—and I run into this thing currently because I am a tax-practicing individual——

Senator MALONE. You hear the talk.

Mr. QUINETTE. I hear the talk. I am called in by institutions, lending institutions and bankers, to screen things. "Here is an operator who wants to borrow some money. They want to do this. They want to put in a mill."

I am brought in and I am one of the fellows who puts the pencil to it to see whether he can borrow the money to go into an operation and pay it back. And too many times I have had to tell the lender there isn't a chance. It is a good deal before taxes, but when you apply taxes and the controversies to it, it is no good.

Senator MALONE. Your silent partner gets all the money.

Mr. QUINETTE. That is right.

Now, I will say that if the proper income tax incentive—income taxes may, to a large extent be psychological, but still, one of the biggest factors of incentive to get people on the move—they may not thoroughly understand it, but they will part with their money. Let me say this: In my opinion, if 40 percent depletion is granted to the uranium people, there will be a lot of people who never heard of it before who will go out there and start buying shovels and try to find it.

Senator MALONE. Then you will find something.

Mr. QUINETTE. Somebody will find something.

Now, the uranium we are talking about, if it is there, will never do us any good as long as it is in the Colorado plateau, or back here in the Appalachians in Pennsylvania. It is only when it is extracted.

Senator MALONE. And you know where it is.

Mr. QUINETTE. And you know where it is, that it is worth anything to us in case of an emergency.

Senator MALONE. You see, Mr. Chairman, that depletion allowance, and other incentives, you see, we have about 77—we used to call them strategic and critical materials. We call them critical materials—about 39 of these 77 materials are minerals. It simply means that we cannot depend upon producing the amount of these minerals you need in wartime.

Now, why can't you? You could go in and talk a good deal of detail, but roughly, this is the situation—the same situation to a lesser degree you find in uranium, because the other minerals are better known, but the same tax situation holds them back and the more we accentuate the tax situation, the greater the strategic classification. That is, the smaller amount you produce. We have cut the production of lead and zinc in half in the last 4 or 5 years, and they are both strategic. There is no use going into all the detail, but, Senator, we have been waiting for you to attend the other meeting. We know you are tied up, but it is the same problem. That is one factor.

The CHAIRMAN. I will catch up with you some day, George.

I hope the staff gives this very careful study. I think the general tendency in the committee is to encourage the search for uranium, taxwise.

Senator MALONE. I would like to say I think the witness has done the National Defense Department a great service, just opening up the subject for discussion.

The CHAIRMAN. The next witness will be Mr. Friedman. Make yourself comfortable, and give the reporter your name.

STATEMENT OF WILBUR H. FRIEDMAN, CHAIRMAN, COMMITTEE ON TAXATION OF THE NEW YORK COUNTY LAWYERS ASSOCIATION, AND THE AMERICAN RETAIL FEDERATION

Mr. FRIEDMAN. My name is Wilbur H. Friedman. I am an attorney and a member of the bars of the State of New York and of the District of Columbia. My address is 11 Broadway, New York, and I am a member of the law firm of Proskauer, Rose, Goetz & Mendelsohn. I am chairman of the committee on taxation of the New York County Lawyers Association. I am appearing on behalf of the American Retail Federation and of said tax committee. The American Retail Federation is a federation of 26 national retail trade associations, and 34 statewide associations of retailers, representing in all more than 600,000 retail outlets.

The stated purpose of section 309 as appears from the report of the Committee on Ways and Means is to prevent the tax practice which was considered by the court in the Chamberlin case. In that case holders of common stock of a corporation received a dividend in preferred stock and by prearranged plan sold the preferred stock to an insurance company. There was provision for early redemption of the preferred stock. This is commonly known as a preferred stock bail-out. The Government contended that the transaction resulted in ordinary income, and the Tax Court so held; but the sixth circuit held that the stockholders realized a capital gain on the sale of the preferred stock. The Ways and Means Committee regarded this as an avoidance of taxes and in order to prevent the realization by

common-stock holders of capital gain with respect to a dividend in preferred stock, they inserted in the law section 309 which imposes an 85-percent tax on an issuing corporation at the time that it redeems preferred stock. The term actually used in the bill is nonparticipating stock, but what is meant is in most cases what we call preferred stock.

Our opposition to section 309 is along three lines: (1) It does not accomplish the purpose sought by the Ways and Means Committee of preventing preferred-stock bailouts, and it imposes the tax in many cases where there is no bailout. (2) The purpose of the Ways and Means Committee to prevent preferred-stock bailouts could be better accomplished in a different way. (3) section 309 improperly imposes the tax with respect to past transactions. I want to make it clear that I am not opposing legislation which by proper means closes the preferred-stock bailout loophole.

(1) The purpose of the Ways and Means Committee will not be accomplished by this bill. In cases where the corporation is not required to redeem the stock, the corporation will wait for 10 years, since under section 309 the 85 percent tax does not apply if the redemption takes place more than 10 years after January 1, 1954. In this way, the 85 percent tax could be avoided even though a sale of the preferred stock has been made promptly after its issuance in situations similar to that in the Chamberlin case. In situations where the preferred stock has not yet been issued, and the parties desire to accomplish the same result as in the Chamberlin case, section 309 as written can be circumvented. To give one example, section 309 is limited to the redemption of so-called nonparticipating stock. Nonparticipating stock is defined in such manner as to permit a corporation to issue subordinated bonds which would qualify as nonparticipating stock and therefore be tax free at the time of issuance, but which could then be sold to an insurance company at capital-gain rates as in the Chamberlin case. Thereafter the same corporate instruments would no longer be regarded as nonparticipating stock (because of the change in the identity of the holders) but would now be regarded as bonds, and when the corporation then redeemed such bonds from the insurance company, the redemption would not be subject to the 85 percent tax because it would not be a redemption of nonparticipating stock. In this and other ways it seems that for prospective transactions section 309 will be largely inapplicable and easily avoided and will therefore not accomplish the desire of the Ways and Means Committee. It is likely, therefore, that if section 309 is retained in its present form it will be applicable mainly in the case of corporations which are bound by their charters to redeem preferred stock already outstanding and legally issued and where the relationship between corporation and stockholders is such that the corporation will not be able to get a modification of its obligation to redeem the preferred stock. This is an extraordinary and unfair result.

(2) The result obtained by the stockholders in the Chamberlin case could easily and properly be prevented by imposing a tax on the shareholders at ordinary income rates at the time they sell the preferred stock received as a dividend. This is the solution suggested by the sixth circuit in the Chamberlin case. The committee report states that it has not imposed the tax at this point because it would be easier to administer the tax at the corporation level than at the shareholder

level. However, the bill itself in section 353 dealing with the spin off of inactive corporations shows how such a tax can be imposed at the shareholder level. If the method of section 353 were applied to section 309, section 309 would not impose a transfer tax on the corporation, but it would require that in the case of the distribution of preferred stock or so-called nonparticipating stock, the distribution would be tax free to the recipients only if they file an agreement with the Secretary of the Treasury or his delegate to report to the Treasury any disposition of the preferred stock within a given period of time. Section 309 could also provide as does section 353 that any such disposition would be taxed to the selling stockholders at ordinary income rates and not at capital-gain rates, and that if a shareholder failed to report such sale to the Treasury, the statute of limitations would remain open as it does under section 353. The imposition of the tax at ordinary income rates at the time of sale of the preferred stock should be made only in those cases where the redemption of the preferred stock at that time would be a dividend under section 302, and only where the purchaser of the stock would have the assurance, by reason of the corporate charter or contract, that the stock would be redeemed by the corporation within a short period of time. Such provisions would seem completely to satisfy the desire of the Ways and Means Committee to close up the Chamberlin loophole and it is our recommendation that section 309 be rewritten along these lines. Safeguards would have to be written into such a new provision to cover such cases as sale of the preferred stock after the death of the stockholder, and sale for bona fide business reasons, so as to make sure that the tax would be imposed on the sale of the preferred stock only in the Chamberlin type situation and related situations.

(3) Since the decision by the Supreme Court in *Eisner* v. *Macomber* in 1920, it has been considered settled law that the distribution by a corporation of preferred stock to common shareholders where no preferred stock was previously outstanding is tax-free to the recipients. During all these 34 years, it has never been considered that the redemption of such stock by the corporation would result in any tax to the corporation. The mere acts by the corporation of issuing and redeeming preferred stock were entirely normal corporate steps which have never been regarded as taxable events to the corporation. Section 309 would impose the 85 percent tax on the corporation regardless of the time when the preferred stock was issued, even if it had been issued 50 years ago. The tax is imposed regardless as to whether the issuance of the preferred stock was with a tax avoidance motive similar to that described in the Chamberlin case. In many instances the tax would be imposed regardless of whether there had been a sale of the preferred stock as was the situation in the Chamberlin case. In other words, the tax is not limited to the case where the parties are attempting a preferred stock bailout similar to that in Chamberlin.

Further, the tax would be imposed even if the issuing corporation is required by its charter to redeem the preferred stock, and such redemption provisions are entirely proper and usual with respect to preferred stock. The tax applies even though the issuing corporation is a publicly held corporation and even though the stock is listed on the Stock Exchange. It is most unreasonable to levy an 85 percent tax under these circumstances, quite contrary to the American spirit of

fair play. It is a kind of ex post facto imposition of a penalty on the completion of a transaction which was begun at a time when it was perfectly legal and proper. It is impossible to state how many such situations there are, but it is obvious that there must be a great number and I have been advised by representatives of the American Retail Federation that there are many, and to my knowledge there are instances of preferred stock issued by corporations whose stock is listed on a Stock Exchange which might be subject to this tax. The extreme nature of the penalty is indicated by the fact that if the redemption price is $100 per share, it would cost the corporation under this section $185 to redeem the stock.

I therefore suggest that the very least that should be done with this section if it is retained is to make it applicable only to preferred stock issued after the date of enactment of the law.

As regards the other provisions of subchapter C, we understand that major changes are to be made, and that many suggestions have been filed with this committee by other bar associations and groups. We have picked out a number of points which we are going to mention here in addition to the above points on section 309, but it is our view that many other changes are needed in subchapter C. In limiting ourselves to the points mentioned in this statement we do not mean to infer that subchapter C is otherwise acceptable in its present form. As regards sections 311, 352, 354, and 359, they make a material change in existing law by restricting the ability to merge and consolidate taxfree to publicly held corporations as defined.

Under existing law mergers and consolidations are tax free whether of publicly held corporations or of closed corporations. Further, under existing law certain acquisitions by one corporation of the stock or assets of another corporation in exchange for voting stock of the acquiring corporation are tax free, whereas under H. R. 8300 such transactions would be tax free only if the stockholders of the acquired corporation ended up with at least 20 percent of the so-called participating stock of the acquiring corporation. Generally speaking participating stock is what we usually call common stock.

We have two major objections to these provisions:

(1) They take effect as of March 1, 1954. Many reorganizations proper under the old law were in progress at that time but not completed. On April 1, 1954, Chairman Reed of the Ways and Means Committee stated that the new provisions should not be applicable where certain steps had already been taken regarding proposed reorganizations under the old law. We request that if the present provisions of H. R. 8300 are enacted, the effective date be postponed at least to January 1, 1955, and that existing law be kept in operation until that date as regards the reorganization provisions.

(2) We oppose the limitation of the tax-free benefits of statutory mergers and consolidations to publicly held corporations and we oppose the new restriction that corporate acquisitions will not be tax free unless the stockholders of the acquired corporation end up with at least 20 percent of the participating stock of the acquiring corporation. No satisfactory explanation appears in the House committee report why this major change in the philosophy of the reorganization sections as they have stood for the last 20 years should be made. For 20 years now the reorganization sections of the 1939 code and predecessor statutes have permitted tax-free mergers and consolida-

tions of closely held corporations as well as of publicly held corporations, and have validated reorganizations where property or stock of one corporation is acquired by another corporation solely for voting stock, whether common or preferred. Ample safeguards have been established by Supreme Court decisions by the establishment of the business purpose and continuity-of-interest tests, among others, to assure that reorganization provisions are not used for tax-avoidance purposes. In the absence of a convincing showing in the committee report as to the need for this change in philosophy, we submit that the substance of the old provisions should be retained.

Under the new bill a merger or consolidation by a parent corporation listed on a stock exchange and publicly held with its controlled subsidiary would not be tax-free. We disagree with this and we suggest that this provision be modified by amendment to section 311 or to section 359 permitting the tax-free merger or consolidation of a publicly held corporation with a subsidiary of which it owns more than 50 percent of the stock.

To sum up: It is our view (1) that the existing reorganization provisions should remain in effect until January 1, 1955; (2) that subchapter C as proposed in H. R. 8300 should be amended to eliminate the limitation of tax-free mergers and consolidations to publicly held corporations; (3) that the requirement be eliminated that the stockholders of the acquired corporation end up with at least 20 percent of the participating stock of the acquiring corporation and in this respect to retain instead the substance of present law; (4) that tax-free merger or consolidation of a publicly held corporation, if that concept is retained, be permitted with another corporation which it controls by ownership of more than 50 percent of the stock; and (5) that the tax in the case of preferred-stock bailouts be imposed at the stockholder level and not on the corporation.

Thank you for your attention.

The CHAIRMAN. Thank you very much.

Mr. Seidman——

STATEMENT OF J. S. SEIDMAN, AMERICAN INSTITUTE OF ACCOUNTANTS

Mr. SEIDMAN. My name is J. S. Seidman. I appear as general chairman of the Committee on Federal Taxation of the American Institute of Accountants. I am accompanied by our subcommittee chairmen, Wallace M. Jensen, Leslie Mills, and J. P. Goedert.

The American Institute of Accountants is the national organization of certified public accountants, with a membership of over 23,000. The institute appreciates your willingness to hear it.

Our own tax committee, composed of over 30 CPA's from all over the country, and whose life's work is taxes, has been engaged in intensive study of H. R. 8300 since the bill was released a month ago. But we can hardly lay claim to understanding all its provisions, no less mastering them. That is particularly true of the area from which business draws so much of its daily lifeblood—corporate and partnership organizations, distributions, liquidations, and reorganizations.

The fact that we, who should be well informed, find ourselves reeling is significant. It leads to our first suggestion: Hold off the appli-

cation of these provisions at least until 1955, or 90 days after the bill is enacted, whichever is later.

Effective date for corporate and partnership provisions: Having waited 73 years for a thorough overhauling of our tax statutes, it is not asking too much to indulge a few more months. No revenue gain or loss is attributed to the corporate and partnership provisions. On the other hand, look how much good can be accomplished by holding off:

(1) It will give everybody a better opportunity to become acquainted with the rules of the game before getting on the ball field. This is as it should be, if injury or chaos is to be avoided. At best, the bill is not likely to be enacted before June. Assuming that the Senate does not rubberstamp the House bill and vice versa, taxpayers have no way of knowing yet what to count on. To drastically change the rules in the middle of the fourth inning, not only for the rest of the game but also for the innings already played, is hardly likely to sit well, either for the game, the players, or the rulemakers. No; it is far better to let the game be completed and apply the new rules the next time around.

(2) We can tell you that there are all sorts of "bugs" in the present provisions of the bill. We have just concluded what, to us, was a very delightful and constructive screening with Mr. Stam and his colleagues, of 213 changes we are recommending to you—in extension of this testimony—in the income-tax part of the bill. Over 90 apply to the corporation and partnership sections. I think it is fair to say that your technical experts felt that many of these recommendations merit consideration.

(3) From the time the bill is passed to the end of the year everyone concerned will have some opportunity not only to prepare for the new rules but also to appraise them. We have a feeling that the respite will prove a godsend in bringing to light and paving the way for advance correction of things that might otherwise provoke incalculable mischief in the daily affairs of business. At the very least, it will parole those who have already been caught in the trap and those yet to be trapped, and whose only crime is that they did not have a decent chance to know or be advised about the new, drastically changed and complex code.

Loopholes: The bill attacks loopholes on a broad front. That is commendable. Loopholes impair taxpayer morale and enable one taxpayer to get out from under the intended share of his tax burden, and palm it off on the rest. Loopholes sometimes mount to a point where they come back to roost at the doorstep of Congress, as illustrated by the special hearings necessitated in 1937 tax avoidance.

Every effort should be exerted to squelch loopholes before they rear their ugly heads. We fear that in the process of closing some doors, this bill unwittingly opens many others. We are sure we have not uncovered them all, but our recommendations that we are filing with you, refer to over 25 loopholes cutting clear across the bill. I will mention a few here:

(1) Under the spin-off provisions, section 353, the floodgates will open pretty wide. From 1923 to 1951, spin-offs were fully taxed. In 1951, limited exemption was accorded them. Now, it will be possible to segregate tax-free investments, real estate, and even cash, into a

separate company, and, by exercising 10 years' patience, get the cash and the other items into the stockholders' hands as a capital gain instead of an ordinary dividend.

(2) The right to a deduction for premium on bonds with early call dates has developed into a nasty loophole. But the solution in the bill, section 171, is like attacking a battleship with a B-B gun. All the bill does is to set up a 3-year barrier. That is hardly a deterrent to those hellbent for tax saving. We suggest that bond premiums be spread from the date the bond is bought to the date of maturity. If a bond is actually called before maturity, the part of the premium not yet deducted can then be allowed in full. That accords with good accounting. We think it makes for good taxes.

(3) The dividend credit—which we favor—can lend itself to abuse, section 34. A taxpayer with short-term profits will find it to his advantage to buy stock just before the dividend is paid, and sell it right afterward. This will enable him to reduce the tax on his short-term gains by the dividend credit. A possible solution is to condition the credit on a prescribed holding period before and after the stock goes ex-dividend.

(4) A capital loss can become a regular loss, and vice versa, under the way the foreclosure provisions, section 1035, are treated in the bill. For example, suppose $20,000 is owing the taxpayer for the sale of merchandise. He forecloses on securities that he holds as collateral. The securities are worth $19,000 at the time. Two years later, the securities have declined in value to $8,000, and he then sells out. Under the bill, he gets a $12,000 ordinary loss because the account receivable was from a merchandise transaction. Obviously, however, his loss on the account receivable was only $1,000 and the other $11,000 came from speculating in the securities.

(5) Subordinated debt issued to corporate insiders is treated in the bill as stock, and interest on it is not deductible, section 275. Redemption of this type of debt can, therefore, be a dividend. But look how easy it is to get around it: Subordinated debt is issued to the insider as a dividend. Since the debt is loooked upon as stock, that would be a nontaxable stock dividend. The insider then sells the debt to an outsider. That gives capital gain to the insider. In the hands of the outsider, the subordinated debt becomes real debt. The interest is then deductible to the corporation. The retirement of the debt is no longer a dividend, and everybody is happy but the Treasury.

Taxing the wrong taxpayer: In shooting at some loopholes, the bill has put the wrong taxpayer in the line of fire. Here are some illustrations of what we mean:

(1) The death sentence is given to the "bailout" of redemption of preferred stock issued as a dividend, through an 85-percent tax on the corporation, section 309. The punishment doesn't fit the crime. What should be aimed at is to tax the insider, as a dividend, for the amount he gets out of the company through the redemption. To tax the corporation makes the minority stockholders pay through the nose for something that they didn't participate in, and have no control over.

(2) If a partner retires, and under the partnership agreement he continues to have an interest in the income of the firm, payments to him from the partnership profits for the ensuing 5 years are, under the bill, taxable to him and not taxable to the continuing partners, section 336 (a). So far so good. However, payments after the 5-year

period are not taxable to the retiring partner but are taxable to the continuing partners. So far, not so good. The underlying inference is that after 5 years the retiring partner is getting a gift from the continuing partners. There may possibly be some room to impute gift if we are dealing with a family partnership, but among strangers, dealing at arm's length, letting one partner go scot free and taxing his income to other partners, just flies in the face of the facts.

(3) One of the many unfortunate and costly loopholes in the existing law is the traffic made possible in loss companies. Whatever else may become the effective date of the pending bill, this loophole should be closed immediately. The mechanics sought to do so in the bill is to amputate the net loss carryforward on a pro rata basis to the extent that there has been a shift in stockholdings of more than 50 percent. Again, the perfectly innocent continuing minority stockholder is called upon to bear the brunt of a transaction over which he has absolutely no control. Incidentally, the loophole closing does not go far enough, in that only the net loss of previous years is extinguished. The net loss of the current year is not touched and, therefore, continues to make valuable traffic.

The vanishing basis: In income-tax law, the word basis is generally a substitute for the word cost. The bill properly speaks of adjusted basis, substituted basis, and apportioned basis. But it also introduced a bit of legerdemain that I will call the vanishing basis. As a result, honest-to-goodness cost incurred in acquiring an asset goes up the flue. To that extent, what is taxed as income in really capital. That is not sound. Some examples may be helpful.

(1) Suppose a stockholder owns common stock costing him $100 and preferred stock costing him $200. The preferred stock is redeemed by the company for $200 under circumstances that make the whole $200 taxable as a dividend, section 302 (b). What happens to the $200 cost of the preferred stock? Under the bill, it just disappears. It should really be added to the taxpayer's cost of common stock. No provision is made for this.

(2) The same thing can happen in a corporate liquidation. Suppose a 100-percent stockholder paid $100 for all the stock of a company. The only asset of the company is inventory that cost the company $75 but is worth $100. The company liquidates. Under the bill the stockholder takes the inventory over at $75, its cost to the company. However, he is not allowed any loss. That leaves his other $25 of cost suspended in midair with no place to go or be used.

(3) Take the situation where Company A spinsoff Company B. The sole stockholder of Company A then splits the cost of his stock in Company A to $100 for A and $50 for B. Within 10 years he cashes in on his stock in Company B, with the result that the sales proceeds are all taxed to him as a dividend, section 353 (b). The $50 cost of his stock in B disappears. A fair arrangement would permit him to add the $50 to his cost in Company A, or, if he no longer has Company A stock either, he should be permitted a capital loss of the $50.

Impact on fiscal years: The Internal Revenue Service, business groups, and our own accounting profession have been urging taxpayers to keep their accounts and make their tax returns on a natural business year, if this differs from the calendar year. However, no tax advantage or disadvantage should derive from the fortuitous circum-

stance of the date of closing the books. This principle is violated in the bill. Let me mention a few of the instances:

(1) The bill introduced a 2-year carryback on net losses compared with the present 1 year. If a company on a calendar-year basis has a loss in 1954, that loss can apply against its income in 1952. However, if the company is on a November 30 fiscal year, none of the loss during 11 months of 1954 can be applied against 1952. The 2-year carryback will apply only to losses starting after November 30, 1954.

The CHAIRMAN. Is that right?

Mr. SMITH. Yes.

Mr. SEIDMAN. This should be corrected. The pattern for correction is the one previous revenue acts have followed, namely, a pro rata computation under the old law and the new, based on the number of months in 1953 and in 1954.

(2) The same point arises in respect, among others, to the allowance or deferment of research and experimental expenses, section 174; the new deduction for organization expenses, section 248 (c); the new right to defer prepaid income, section 452; and the new allowance of reserves for estimated expenses, section 462.

The right of a business organization to start off with a fiscal year of its own free choice should not be impeded. The bill runs afoul of that principle in respect to partnerships in section 706 (b) (1). For the first time in tax history, it prescribes that a new partneship must get permission to use a fiscal year. The Internal Revenue Service has, after its abundant experience over the years, come to the conclusion that greater elasticity rather than less is desirable in connection with the use of fiscal years. It therefore has given all taxpayers, including partnerships, the right to change from calendar year to fiscal year by their own say-so under certain circumstances. The provision in the bill stifling the use of fiscal years for new partnerships is a throwback that we hope your committee will remove.

Accounting provisions: The bill makes great strides in the direction of putting business accounting and income tax accounting on the same wavelength. That is something we have urged upon the Congress for many years. We applaud H. R. 8300 for getting it underway. The transition will bring on some problems, both from a revenue standpoint, as well as the scope of reserves for estimated expenses. For that reason, there is included in our list of recommendations certain cautions and restraints during the gear-shifting period.

Other provisions: As previously mentioned, our recommendations for change No. 213. These cover almost the entire gamut of the income tax and administrative provisions. They include 5 on dividend credit, 6 on depreciation, 17 on accounting, 14 on capital gains and losses, 11 on consolidated returns, 13 on administration. I'll single out a few that may interest you here:

(1) The date of mailing a return should be considered as its filing date.

(2) Capital losses should, like operating losses, be allowed a 2-year carryback, in addition to the present 5-year carryforward.

(3) The maximum tax on long-term capital gains should be 25 percent of the net taxable income, and not 25 percent of the net long-term gains, where the ordinary deductions exceed the ordinary income. At present, the net ordinary deductions can go to waste.

(4) Where contributions in any year are in excess of the maximum deduction, the excess should be carried forward to future years.

(5) Partners' salaries should be reported as if received at the same time as their profits in the firm are deemed distributable to them.

(6) The declining balance method of depreciation should be allowable for all depreciable assets, old and new, original and secondhand, and whether acquired before or after December 31, 1953.

When H. R. 8300 first saw the light of day, I wrote to Congressman Reed on behalf of our committee and complimented him and his technical experts on their accomplishment. That still goes. I am happy to report to you that of the 51 recommendations we made to the Ways and Means Committee last year, over two-thirds were adopted in whole or in part. The fact that we now have 213 recommendations in connection with H. R. 8300 merely attests to the complexity and range of the problems embraced by the bill.

We do think that considering the tremendous importance of a bill of this sort, the Congress, and the technical people on both sides of the table, should have adequate opportunity to subject a bill to critical analysis before it is catapulted into law. We urge your committee to proceed in that way in this and future major tax legislation.

Our own committee will be glad to hold itself available for further sessions with your technical experts to any extent that they feel we can be of help.

Let me again express the gratitude of the American Institute of Accountants for giving us the opportunity to present our views, both to you and your technical experts.

Mr. Chairman, if you will permit, I would like to place in the record, in extension of my testimony, a complete list of our recommendations.

The CHAIRMAN. Thank you very much. It will be placed in the record.

(The recommendations referred to follow:)

RECOMMENDATIONS ON INCOME TAXES IN RESPECT TO H. R. 8300, COMMITTEE ON FEDERAL TAXATION, AMERICAN INSTITUTE OF ACCOUNTANTS, NEW YORK 16, N. Y.

1. Section 2 (b): Is there a loophole that permits an affluent father to support a married daughter whose husband is capable of supporting the daughter, but who refrains from doing so because of the greater advantage to the father, taxwise, in establishing head-of-the-family status where the daughter and husband do not file joint returns?

2. Section 34: Dividends from stock insurance companies subject to the regular corporate tax should be eligible for the dividend exclusion, credit, and deduction allowed on corporate dividends.

3. Section 34 (a) (1): For ease in administration and application, the dividend credit should be applied to dividends received after December 31, 1953, and the percentage credits in 1954 and 1955 should be scaled down accordingly.

4. Section 34 (e): A possible abuse of the dividend credit exists through the purchase of stock just before the dividend is paid and the sale immediately thereafter in order to use the credit as an offset to any short-term gain income that the taxpayer may have. A possible solution is to condition the credit upon a prescribed holding period before and after the stock goes ex-dividend.

5. Section 34 (e): Though not related to the credit, a similar tax saving device exists in going short the stock just before dividend payment, and covering right after. A possible solution is to treat the dividend on the short stock as part of the cost of the covering stock rather than as an ordinary deduction.

6. Section 34 (e): The dividend credit also sets up a tax-saving impetus in borrowing to buy stock. Assuming the interest deduction and dividend income offset each other, the taxpayer is ahead by the amount of the dividend credit.

7. Section 62 (2) (D): This provision, relating to trade or business expenses, should apply to all outside representatives of an employer rather than just salesmen.

8. Section 76: Discharge of indebtedness should not result in income greater than amount of solvency.

9. Section 76 (a) (1): This provision, relating to discharge of indebtedness, should include payment in poverty.

10. Section 76 (b): The treatment of discharge of indebtedness should not be conditioned upon how the creditor treated the item.

11. Section 101 (a): There should be an affirmative provision that exemption of life-insurance proceeds does not apply to an outside purchaser of the insurance policy.

12. Section 101 (b): In view of the intent to remove the restrictions in the 1939 code, this provision with respect to the $5,000 exclusion should be made effective in respect to deaths occurring after December 31, 1953.

13. Section 101 (b) (2): It should be made clear that the $5,000 payment is to be considered as a deduction by the employer.

14. Section 164 (d): Reference "real" property should be deleted throughout so that the apportionment will apply to any property taxes.

15. Section 164 (d) (1): The apportionment of taxes should apply not only to sales but also to other dispositions, such as exchanges.

16. Section 165 (e): The loss should be allowed in either the year of theft or the year of discovery. Otherwise the taxpayer may, as a result of the theft, find himself insolvent in the year of discovery.

17. Section 165 (g) (1): The deduction for worthlessness should be made independent of the possible workings of section 267 where the securities involved are those of a related taxpayer. (This correspondingly applies to section 166 (d) (1) (B).)

18. Section 166 (f): A foreclosure should be treated as a closed transaction with the fair market value of the property repossessed treated as a reduction of the amount of the debt.

19. Section 167 (b) (2): The proposed depreciation rules would entail complex schedules and computations of depreciation for those desiring the declining-balance method. Assets would have to be classified between those acquired before December 31, 1953, and those after. Those after would in turn have to be classified between original user and secondhand. It will also be necessary to identify construction before and after December 1953 and related cost. A practical approach is to permit the declining-balance method to the net balance of all depreciable assets at December 31, 1953, at double the normal life rates, and to all acquisitions thereafter.

20. Section 167 (b) (2): Attention is called to the fact that by reason of the elimination of the factor of salvage value in the computation of the declining-balance method, the resulting initial amount of depreciation may be considerably more than twice what is allowed under the straight-line method. The situation becomes accentuated in those cases where assets have a very high salvage value.

21. Section 167 (b) (3): The limitation of the amount of depreciation under other methods to the aggregate allowable under the declining-balance method should be removed. The limitation can, at a particular point of time, destroy the effectiveness of such an approved depreciation method as the unit of production. Furthermore, it is not clear whether the limitation embraces the restrictions of section 167 (c). If it does and if there is no construction or original user acquisition after December 31, 1953, nothing will be allowable to the user of a method other than the straight-line method.

22. Section 167 (c) (1): In any event, the declining balance method should apply to the entire construction, etc., if completed after December 31, 1953.

23. Section 167 (c) (2): Eliminate the original user concept. Where property is acquired after December 31, 1953, from a related taxpayer the acquisition date should be deemed the date of first acquisition by related taxpayers.

24. Section 167 (e): 1. The elimination of depreciation rate disputes by machanical arrangement such as the 10 percent margain test is unsatisfactory. The present policy, under the Commissioner's recent directive, is effectively solving, on an administrative basis, the dispute area concerning depreciation. It should be left that way.

2. As an alternative, if a differential must be provided by statute, a 25 percent differential rather than 10 percent would be nearer to the practical area of difference.

25. Section 170: Charitable contributions in kind should be treated as a sale or exchange at fair market value to avoid inordinate tax benefit or inequity. This should be made effective from the date of enactment of the new bill.

26. Section 170: Contributions in excess of prescribed limits should be allowed to be carried forward.

27. Section 171: The converse of the premium on tax-free bonds should apply to a discount. A taxpayer should be permitted to increase his basis by a proration of the discount to maturity. At present a capital-gains tax can be levied on what is really part of tax-free interest.

28. Section 171 (b): The 3-year call provision merely sets up another arbitrary criterion and does not deal effectively with the loophole. The premium should, in the first instance, be amortizable from date of acquisition of the bond to date of maturity. In the event of an actual call before maturity, the unamortized premium should be allowed as a deduction in that year.

29. Section 172: The effective date of the net-operating-loss provision will create a distortion for fiscal-year taxpayers. For example, companies on a November 30 fiscal year will not be able to apply the 2-year carryback in respect to its operations for the 11 months in 1954. This should be corrected in the same way as was recently done in the Technical Change Act in respect to 1947 and 1948 fiscal years, that is, to allow a pro rata computation under the 1939 and 1954 codes based on the number of months in 1953 and 1954. (This same principle should apply throughout the code. There should be no undue advantage or disadvantage in respect to taxpayers on a fiscal year. Some of the sections to which this applies are sections 174 (a) (2), 175 (d) (1), 248 (c), 267 (d), and 462.)

30. Section 172 (d) (5): The dividend and other deductions in part VIII and in section 922 should be permitted to stand in the loss year and the carryback and carryforward years.

31. Section 174 (b) (1): The parenthetical material in the last sentence, relating to benefits from research should be eliminated. There may never be benefits realized from the research, and establishing time or extent of abandonment may be impossible.

32. Section 174 (b) (2): It should be made clear what the status is of undeducted research and experimental expenditures of prior years.

33. Section 213 (b): Eliminate the separate limitation on medicine and drug costs. It sets up a difficult allocation and computation problem that is hardly worthwhile for the amounts involved.

34. Section 213 (d) (2): The limitation on the deduction of expenses of the last illness should be removed. The expenses of the last illness should be deductible for both income- and estate-tax purposes just as if the amount had been paid by the decedent.

35. Section 214 (a): The words "during such year" should be deleted. Otherwise there is an unnecessary complication for an expense of child care which is ordinarily on a cash basis.

36. Section 243: The deduction on intercorporate dividends should be 100 percent.

37. Section 243: Since in the case of dealers in securities stocks are part of their inventory, no dividend deduction or credit should be allowed except for dividends on stock held for investment account.

38. Section 248: The deduction for organizational expenditures should be mandatory rather than elective.

39. Section 248: This provision, relating to organizational expenses, should be expanded to include reorganization, registration, and stock-listing costs.

40. Section 267 (a) (2) (A): If the amount accrued is not paid within 2½ months after the close of the year of accrual, the deduction should nevertheless be allowed if the related party reports the item as income either in the year of accrual or the succeeding year.

41. Section 267 (b) (9): The bill should define what is meant by control of a charitable organization. The approach in section 503 (c) might provide a guide.

42. Section 267 (d): The basis for determining gain or loss to the transferee should be the same as the basis to the transferor. This should also apply to the holding period.

43. Section 272 (a): Eliminate the provision relating to certain administrative and other expenses in connection with timber cut. The accounting segregations and computations that will be involved are most difficult if not impossible.

Furthermore, it is not clear why all the expenses are deductible while the timber is standing and become nondeductible when the timber is cut.

44. Section 275: 1. This section, dealing with the disallowance of interest on certain debts and securities, should be eliminated.

2. In the alternative the section should be made effective only for issues after enactment. If the section is retained then regardless of the time of issue, the credits, deductions and exclusions of section 34 (a), 116, and 243 (a) should apply.

45. Section 302 (a): Where stock redeemed is treated as the distribution of a taxable dividend the basis of such stock should be added to the basis of any other stock owned by the person in that corporation. If there is no stock then a capital loss should be allowed in respect of the basis of the stock redeemed. Otherwise the basis completely vanishes. (This correspondingly applies to sec. 304.)

46. Section 302 (c): The 10-year period applicable to reacquisitions provided by this section should be changed to 5 years.

47. Section 302 (c) (2) (A): The parenthetical insert defining the type of interest in a corporation should be removed. It is unnecessarily restrictive. On the other hand, the word "interest" should be broadened to include the type of interest defined in sections 544 (a) (3) and 544 (b), namely, options and convertible securities.

48. Section 302 (c) (2) (B): The reopening of closed years in the event that redemption is later held to be a dividend should also be applied for changes in income caused by changes in basis calculations.

49. Section 302 (c) (2) (B): This provision, with respect to acquisition of an interest in the corporation should exclude reacquisitions through foreclosure. On the other hand, as recommended for section 302 (c) (2) (A), reacquisitions through options and convertible securities should be included.

50. Section 303 (b) (1) (B): The additional period of time within which redemption of stock to pay death taxes may take place should not be restricted to the period before the Tax Court but should include any court.

51. Section 304: An exception from treatment as a dividend should be provided for redemptions to pay estate tax under section 303.

52. Section 305 (b): It is not clear whether an exchange of bonds for stock would be tax free if part of the stock was to pay for interest in arrears.

53. 305 (c) (1) (A): 1. Since a straight stock dividend would have been nontaxable, a distribution in this form should be nontaxable.

2. In any event, limit the measure of the dividend to the excess of the fair market value of the dividend stock and the related nonparticipating stock after the distribution over the basis of the related nonparticipating stock before the distribution, but not in excess of the amount of arrearage of the amount of earnings or profits of the distributing corporation.

54. Section 305 (c) (1) (B): This provision with respect to distributions by corporations should be extended to cover options payable either in stock or "securities." Otherwise, an option to take stock or cash is taxable as a dividend, whereas the equivalent option to take stock or bonds is not taxable.

55. Section 306: The old rule on boot should be restored. It worked out a sound economic result. The proposed rule of first matching principle amount of securities against principal amount does not attain the same result.

56. Section 306 (b) (2): The gain or loss involved in a disproportionate distribution should be classified as a gain or loss resulting from a sale or exchange. (This correspondingly applies to section 306 (d) (2) (A) and (B).)

57. Section 306 (c) (2): Provision should be made for stock with no par, no stated value, and no call price. The amount the stock is entitled to upon liquidation could be the criterion. (This correspondingly applies to secs. 306 (c) (3) and 310 (c).)

58. Section 306 (d): This provision as to exchanges for securities, etc., is unrealistic if based on very minor retention of stock. As a minimum, the 1 percent rule in section 302 (a) (5) should be applied to distinguish the application of section 306 (d) from section 306 (b).

59. Section 307 (b) (1): As a further simplification, no allocation of basis should be required in connection with stock dividends under the 15 percent limitation.

60. Section 308 (b): The measure of imputed gain on LIFO inventories should be the assumed realization by the corporation of the fair market value of the inventory. Otherwise it may be difficult if not impossible to determine what the inventory would have been on a LIFO basis.

61. Section 308 (c): It should be specified that the gain or loss recognized to the distributing corporation is classified as a gain or loss resulting from a sale or exchange.

62. Section 309: The remedy for the "bail out" is to tax the person bailing out. To tax the corporation makes minority stockholders bear the brunt of the tax saving of a particular stockholder. Furthermore, the 85 percent tax is easily defeated by a sale of the stock to a proper buyer such as a subsidiary company of the stockholder, or a charity, or an insurance company that will hold the stock for the 10-year period. The net result is that the tax is likely to serve merely as a trap for the unwary. The remedy is to tax the "bail out" as ordinary income. The identification of the "bail out" can be along the lines prescribed in the bill: In no event should the "bail out" category attach to stock that had been originally issued for value or stock that had been previously taxed as a dividend.

63. Section 309 (a): The 10-year period provided by this section should be changed to 5 years. The 5-year period shall in any event apply to distributions prior to the effective date of the bill to accord with administrative practice.

64. Section 309 (a) (1): This provision as to redemption of nonparticipating stock should be deemed complied with not only by concurrent redemption but also an antecedent redemption of the related participating stock.

65. Section 309 (a) (2): Extend the provision so as to cover concurrent redemption of nonparticipating stock on which a preferred stock dividend had been issued.

66. Section 309 (a) (3): The 105-percent test should apply not only to "property" but also "securities" for which the redeemed stock was issued.

67. Section 309 (b): Is this provision, relating to redemptions of nonparticipating stock, intended to apply to a case where, in a section 352 or 353 transaction, nonparticipating stock is exchanged, tax free for participating stock, and the participating stock is later redeemed?

68. Section 309 (c): The provision as to date of issuance should apply only to nonparticipating stock issued after the effective date of the provision. If stock acquired before then is, after that date, exchanged for other stock in a nontaxable transaction, the stock acquired shall take the issue date of the stock given up.

69. Section 311 (b): There should be added to the 50-percent value requirement the additional requirement that there be ownership of more than 50 percent of the combined voting power of all classes of stock.

70. Section 311 (c): 1. A beneficiary should be deemed to own only his pro rata part of the interest of the trust or estate just as is done in the case of partnerships, and a contingent or future beneficiary should be deemed to own no part.

2. In any event, the sole test should be the interest in the income, and because of the difficulties of computation the actuarial test should be removed.

71. Section 312 (a) (1) (B): The separate segregation of the current year's earnings should be eliminated and the parenthetical provision should be made part of (A). The current-year test is a hangover from the undistributed profits tax that has long since been repealed.

72. Section 312 (c): 1. Instead of the word "securities," it would be more clarifying to use a word such as "indebtedness." The definition should include subdivisions (1), (2), and (3). The definition should affirmatively require that there be a fixed date or dates for the payment of principal.

2. In the alternative, if any distinction in this subchapter is continued in reference to publicly held corporations, subdivisions (1), (2), and (3) should not apply to such corporations.

73. Section 312 (c): Subdivisions (1), (2), and (3) should not apply to securities issued as a dividend. Otherwise there is a possible loophole in the tax-free distribution of a subordinated debt that the 25-percent stockholder then sells to an outsider. The selling stockholder would realize capital gain. In the hands of the buyer, the subordinated debt becomes regular debt with interest fully deductible and redemption free of dividend status.

74. Section 312 (d): Nonparticipating stock should be defined as stock that is limited in its interest both as to earnings and distribution of assets. Participating stock should be defined as "all other stock" to insure that there will always be a participating stock.

75. Section 312 (f): The definition of property should be extended to include open-account indebtedness. Otherwise that item is not provided for.

76. Section 331 (d) (2): Appreciated inventory should be dealt with as suggested for section 308 (b), namely, as if realized by the liquidating corporation. The provision as written is inequitable and unrealistic. What would be the

situation if the only asset of the corporation is appreciated inventory and the stockholders' basis is in excess of the basis of the inventory to the corporation? Does the differential vanish?

77. Section 331 (c) (1): Under section 165 (g) (3) a loss from the worthlessness of a stock or bond would be an ordinary loss. Under the workings of sections 331 (c) and 331 (c) (1) a capital loss would result. The two should be coordinated.

78. Section 332 (b) (1): For the purpose of determining personal holding company status, the imputed dividend should not constitute gross income.

79. Section 332 (b) (1): In the case of a corporate shareholder, it should be made clear that the 100-percent deduction is not in any way to be restricted by the amount of the net income, through section 246 (b).

80. Section 333 (c): A distribution of inventory assets should be the equivalent of realization by the distributing corporation on those assets at their fair market value. The receiving stockholder should compute gain or loss based on that value. (This proposal adopts the theory of section 751 in relation to partnerships.) The subsequent disposition of the inventory assets by the stockholder would give rise to capital or ordinary gain or loss dependent upon the status of the assets in the hands of the stockholder.

81. Section 334 (d): In the event that the recommendation in respect of section 333 (c) is not adopted, section 334 (d) should not apply to the amount allocable to stock acquired prior to the effective date of the provision by purchase from other than the corporation, nor should it apply to stock acquired by inheritance.

82. Section 336 (a) (2): If the business was in existence for less than 5 years, then the period of its existence should control. If this is not accepted then in determining the 5-year period there should be tacked on the period that a predecessor business was in existence if that business was acquired in a nontaxable transaction.

83. Section 336 (a) (2) (A): Instead of a requirement for separate books and records, it should suffice that the income of the terminated business should be determinable from the accounting records. (This correspondingly applies to sec. 353 (c) (2).)

84. Section 336 (a) (2) (C): Instead of the test of personal holding company income, the test in section 165 (g) (3) (B) should be applied. (This correspondingly applies to sections 353 (b) and 353 (c) (3).)

85. Section 336 (d) (3): Rights to income should be defined as limited to items earned but not yet includible because of the method of accounting followed by the taxpayer.

86. Section 336 (d) (4): The definition of "inventory assets" in connection with liquidations should be extended to include depletable property.

87. Section 351 (a): Under this provision it would be possible to make a nontaxable transfer of property to a controlled company for a demand note because of the way "securities" is defined in section 312 (e). Is that intended? Furthermore, there is no tie-in between sections 351 and 306 as to boot, or vice versa.

88. Section 353: Doesn't this section permit too wide a latitude for tax-free spinoffs? For example, a spinoff of tax-free investments, real estate, oil leases, etc., will not entail personal holding company income, and will therefore not come under the definition of an inactive corporation. There can be tax-free or capital-gain realization of what might otherwise appropriately be taxed as a dividend.

89. Section 353: Is it intended that the stock of a 5-year-old operating controlled subsidiary can be distributed tax free and the stockholders immediately sell that stock and realize capital gain?

90. Section 353: Is it intended that cash can be spun off through a newly created subsidiary and by waiting 10 years the dividend avoided?

91. Section 353: Doesn't this make possible the deliberate elimination of earnings and profits by investment in the stock of an active company and distributing that stock to the stockholders?

92. Section 353 (a): It is not clear whether the spinoff provision prevails over the liquidation provision of section 331 or the reorganization provision of section 359 (c), if, in the liquidation or reorganization a spinoff is also involved. Furthermore, if in connection with the liquidation, gain on the spinoff portion is recognized, it is not clear whether section 306 as to boot would be applicable.

93. Section 353 (a): The last sentence in this provision, covering distribution of stock or securities of a controlled corporation, seems to be in conflict with what is intended by the type of transaction covered in section 359 (d).

94. Section 353 (b): What happens to the basis of the stock of an inactive corporation where there is realization on that stock within 10 years after the spinoff? There should be an affirmative provision to avoid a vanishing basis.

95. Section 353 (b): It should be made clear that this provision attributing ordinary income to certain stock dispositions does not apply to outside purchasers of stock of inactive corporations.

96. Section 353 (b) (1): The time of receipt of the proceeds of sale should not control, but rather the time of sale. Otherwise a loophole is opened through a sale immediately after the spinoff with deferred payments not to commence until after the 10-year period.

97. Section 353 (b) (1) (B): The second and third subdivisions of this provision should also apply where basis is determined by reference to fair market value on the optional date instead of the date of death.

98. Section 353 (d): Is it intended that the stockholders be given an election whether to treat the distribution as taxable or nontaxable by the mere failure to file the agreement?

99. Section 354 (b): This provision relating to gain or loss on corporate acquisitions and separations, should be clarified as to whether in the case of a statutory consolidation the consideration can be other than stock. The stock limitation is now mentioned only in connection with mergers. It should also be clarified whether mergers are restricted to two companies while consolidations may involve two or more companies.

100. Section 355 (a): Only section 355 (a) (2) should be applied to property acquired after December 31, 1953. As section 355 (a) (1) now reads, property acquired in January and February of 1954 would be affected, and this is contrary to the effective date under section 391.

101. Section 355 (b): The reference to acquisition after December 31, 1953, should be eliminated. As it now reads, property acquired in January and February of 1954 would be affected, and this is contrary to the effective date under section 391.

102. Section 355 (b): The basis provision for stock acquired in corporate acquisitions and separations should be related to net assets of the corporation rather than to the gross assets in order to adjust for liabilities.

103. Section 355 (c) (1) (A): Instead of date of enactment substitute the effective date of the provision. (This correspondingly applies to sec. 355 (c) (2) (A).)

104. Section 356 (2): There should not be capital-gain status where the related asset was not a capital asset.

105. Section 357: Should this provision, relating to reincorporations, apply at all when the net effect of liquidation and reincorporation is the same as if there were a spinoff in the first instance?

106. Section 357: To prevent a loophole a reincorporation should be deemed to have taken place if the assets are acquired indirectly by the new corporation, such as by lease from the stockholders.

107. Section 357 (a): Provision should be made for either the recovery or the offset of the tax, if any, originally paid by the stockholder in connection with the liquidation. The statute of limitations should be extended for this purpose.

108. Section 359 (a): The distinction between publicly held companies and privately held companies should be eliminated and the same rules applied to both. (This correspondingly applies to all of subch. C and to sec. 532.)

109. Section 359 (b): Subdivision (2), embodying the 25-400-percent requirement, and the sentence immediately following it should be eliminated. (This correspondingly applies to sec. 359 (c).)

110. Section 359 (b): Shouldn't there be a limitation restricting the consideration solely to stock on a corporate acquisition of stock, just as is provided in section 359 (c)?

111. Section 381: It should be made clear that nothing in this section precludes its application to an insolvency reorganization under section 371.

112. Section 381 (a): It should be made clear that the carryovers apply in a series of successions.

113. Section 381 (a) (2): Corporate separations (sec. 359 (d)) should likewise be included in respect to items covered in section 381 (c) (4) through (12) and (15) and (16) subject to regulations to be prescribed by the Secretary or his delegate.

114. Section 381 (c): In addition to listing specific items, it should be provided that for all other purposes the successor stands in the shoes of the predecessor.

115. Section 381 (c) (1) (B): Since the loss on liquidation would be only

a capital loss, the corporation should have the election to forego the capital loss and have the complete carryover.

116. Section 381 (c) (1) (B): In order to avoid a possible double benefit where the investment in the subsidiary becomes worthless, the parent company should be entitled to either the loss or to the carryover but not both.

117. Section 381 (c) (16): Eliminate the last sentence relating to stock, etc., transferred, as the transaction there covered has no bearing on the income determination of the corporation.

118. Section 382: In order to effectively close the loophole dealt with, the tax effect of a change of stockownership should be the equivalent of the purchase of the assets of the corporation at the price paid for the stock and the creation of a new corporation by the purchaser.

119. Section 382 (a): The loss of the current year in which the change of stockownership occurs should likewise be disallowed on a pro rata basis. The manner of proration should be prescribed by regulations.

120. Section 382 (a): Eliminate the parenthetical reference to a publicly held corporation.

121. Section 382 (c): The test of the ownership by the 10 persons should be the same as the test in section 382 (a) (1), namely, the fair market value of the outstanding participating stock. In any event, the concept of percentage of stock requires clarification, particularly if there are two or more classes of participating stock outstanding.

122. Section 391 (a): In order to permit consummation in an orderly manner of transactions covered by subchapter C, the effective date should be 90 days after enactment or January 1, 1955, whichever is later.

123. Section 401 (b) (1) (C): It should be made clear whether or not separation from service embraces a change of status from an employee to a partner.

124. Section 403 (b): This provision should specify that accrued compensation of 1 year that is paid before the close of the next year of the employer shall not be considered a deferred arrangement.

125. Section 421: In order to permit the qualification of plans involving stock in closely held corporations, a formula should be provided which the taxpayer may elect to use for valuation of stock. Such a formula might be based on book value or a specified number of times earnings of a fixed number of years. The formula would apply solely for the purposes of qualification, and no inference would attach to the formula wherever else value determination is required. (This same principle can be used elsewhere in the statute where value is a factor in qualifying rather than in determining gain or loss.)

126. Section 441 (e): The 52–53-week-year election should be available to any taxpayer meeting the tests of section 441 (f), and not limited to corporations.

127. Section 441 (g): A taxpayer already on a fiscal year under the 1939 code should continue on that basis. The requirement about "books" should be "books or records" since many individuals have the necessary records for fiscal-year determination of income but do not keep formal books. In any event, fiscal-year reporting should be permitted by consent of the Secretary. Section 442 may not cover this because of the categorical requirements of section 441 (g).

128. Section 443 (b) (2) (C): Eliminate the elective feature of the tax computation on the change of annual accounting period. The rule should be absolute that the tax for the short period will always be the lower of the various ways of computing it.

129. Section 446 (d): It should be made clear that a different method of accounting may be used for personal affairs from the method used in the business affairs of the same taxpayer.

130. Section 452: Certain types of liabilities may have no definite termination date; for example, coupons and tickets. These liabilities should be permitted prepaid income treatment and the classification in (a) or (b) should be based on experience.

131. Section 453 (d): This provision, dealing with dispositions of installment obligations, should not be deemed to apply to transfers such as incorporations and reorganizations in which no gain or loss is recognized and which are not covered by section 381 (c) (8).

132. Section 461 (c): The word "real" should be deleted so that application of this provision as to accrual of taxes will be to all property taxes.

133. Section 461 (c): An election similar to that in section 462 (c) for estimated expenses should be provided for accrual of real property taxes. On a mandatory basis, unintentional damage may be done to taxpayers previously required by the Government to use the lien date. If the lien date for the 1954 tax is in 1955, section 461 (c) will result in no tax deduction for 1954.

134. Section 461 (c) (1): The first line should be changed to read as follows: "Where the deduction for taxes is computed under an accrual method of accounting, * * *" to cover a hybrid method of accounting under which taxes are accrued.

135. Section 461 (c) (2): Since not all taxpayers have been placed on the lien basis for deducting property taxes, the word "allowed" should be substituted for the word "allowable" in both sentences to make sure the deduction is not denied completely.

136. Section 462 (a): To avoid the impact on the revenues in the transitional year where there will be a deduction both for the actual expenses and the estimated expenses, and in order to avoid undue distortion of income, the addition to the reserve should be spread as a deduction over the transitional year and the 2 succeeding years.

137. Section 462 (a): Considering the departure that is involved from the previous rules, and pending the development of experience regarding the respective items, the application of the new rules as to the reasonable addition to reserve should be in the discretion of the Secretary or his delegate, just as has been the case heretofore with the addition to the reserve for bad debts.

138. Section 462 (d) (1): The definition of estimated expenses should be narrowed to permit the deduction of only those expenses related to the current year and prior years subsequent to election. Otherwise, as the provision now stands, it would seem that interest for all years to maturity would be currently deductible.

139. Section 462 (d) (1): The term "estimated expenses" should not be limited to "deductions" but should also include items of exclusions from gross income so as to cover costs of goods sold.

140. Section 472 (c): This condition as to financial reporting should be eliminated. It is the only part of the code that creates any interlink with financial reporting. There is no warrant for the provisions. (This also applies to sec. 472 (e) (2).)

141. Section 481: In the case of an involuntary change in accounting method, adjustments should be spread out in accordance with the principles of section 1311, etc., or over such lesser period of time as the Secretary or his delegate and the taxpayer may agree.

142. Section 482: Whenever this provision permitting the Secretary to allocate income or deductions is applied, there should be the automatic right and obligation in the other party to the transaction to pick up the effect of the adjustment and the statute of limitations should be deemed reopened for the purpose.

143. Section 510 (e): The effective date of this provision relating to employees' trusts should be the time of enactment of the code. (This correspondingly applies to secs. 511 and 512.)

144. Section 505: The effective date of sections 503, 504, and 505 should be the date of enactment of the new code. These sections deal with certain prohibited transactions, unreasonable accumulations, and allowable investments and impose such limitations, for the first time, in respect of employees' trusts. In general, the effective date of such provisions is March 1, 1954.

145. Section 505 (a): 1. The requirement for valuation of the assets of the employees' trust should be eliminated. It will magnify controversy and uncertainty in an area where a great deal can be at stake. The tests should be pivoted around the adjusted basis of the various items involved.

2. In any event the requirement for quarterly valuation is impractical. If there is to be any valuation at all, it should be only once a year at the close of the accounting period.

146. Section 505 (a): 1. The violation of this provision relating to allowable investments should not entail any more penalty than the taxability of the income from the prohibited investment.

2. In the alternative, the violation should have the same effect as engaging in a prohibited transaction by a charitable organization, namely, the denial of the exemption prospectively. Otherwise employers will face retroactive disallowance of contributions to the pension trust because of action by a trustee over whom the employer has no control.

147. Section 532 (b) (1): This provision relating to publicly held corporations, should be eliminated.

148. Section 534 (c): 30 days is not enough time for the preparation of the statement justifying an accumulation of earnings and profits. The period should be extended to at least 60 days.

149. Section 535 (b) (1): The 85-percent tax in section 309 should be allowed as a deduction in computing the tax on accumulated income.

150. Section 535 (b) (1): The same election in reference to the handling of taxes paid as distinguished from taxes accrued that is in section 545 (b) (1) should be made applicable to section 535 (b) (1).

151. Section 542 (b) (2) (A): The 3-year requirement should be the period of existence of the affiliated group if less than 3 years.

152. Section 545 (b) (1): The 85-percent tax in section 309 should be allowed as a deduction in computing the personal holding company tax.

153. Section 547: The former provision regarding consent dividends by personal holding companies should be restored and be made available to liquidated corporations as well as existing corporations.

154. Section 666 (a): Isn't there a loophole possible by an arrangement whereby a trust accumulates all of the income except the income for the last 5 years, and then distributes the accumulated income? There would be no push-back application to a situation of this sort.

155. Section 702 (c): Clarify the use of the word "gross" where it last appears so that it will carry out the intent expressed on page A222 of the Ways and Means Committee report and will not be inconsistent with the definition in section 61 (a) (13).

156. Section 704 (b): Provision should be made for the method of profit allocation among partners where a partner is guaranteed an amount of profit. The guaranty should be treated as a reduction of the amount of profit and the remainder used in determining the proration of classified items.

157. Section 704 (e) (2): To prevent a possible loophole, the requirement for allowance of compensation for services rendered to the partnership should embrace the services of all partners and not merely the donor.

158. Section 705: It should be made clear that a partner's basis at the time of the termination of the effectiveness of the 1939 code is the measuring amount for the partner's basis at the beginning of the effectiveness of the 1954 code.

159. Section 706: Page A225 of the Ways and Means Committee report mentions annualization of the partnership income for short periods. There is no provision in the code to this effect and any such provision would be inappropriate. Correction should be made of this through appropriate reference in the Senate Finance Committee report.

160. Section 706 (b) (1): 1. A new partnership should have the right to select a fiscal year of its own choice.

2. In any event, a partnership that with permission changed from the calendar year to a fiscal year late in 1953, should be permitted to remain on such fiscal year, even though the short taxable year began on or after January 1, 1954.

161. Section 707 (b): A sale or exchange of property between a partner and a partnership should not give rise to gain or loss. It should be treated as a contribution by the partner and withdrawal of cash from the partnership or vice versa. The extent of the interest of the partner in the transaction should be immaterial.

162. Section 707 (c): To avoid bunching of income or unwarranted flexibility respect to the timing of income, this provision, dealing with "salaries" of partners, should be eliminated. In the alternative, the imputed compensation should be reportable at the same time and as part of the distributive share of the partners' profits. Furthermore, it should be made clear whether the imputed compensation is to be treated as such for purposes of the withholding tax, unemployment-compensation tax, social-security tax, pension and profit-sharing plans, etc.

163. Section 731: The rule as to the effect of liquidation of a partner's interest should correspond to the rules applicable to the liquidation of a corporation. The partner's basis or the basis or the assets to the partnership, whichever is higher, should apply (with the partnership basis of the assets considered as their fair market value if that value is less than the partnership's basis).

164. Section 731 (a): Since, in order to determine whether distributions exceed the basis of the partner's interest, it will be necessary to include the pro rata share of the earnings, a difficult and impractical computation will arise in connection with a determination of basis during the year. To simplify matters, the approach should be the same as is followed in connection with the determination of earnings and profits of a corporation and their availability for dividend purposes, namely, the earnings for the entire year should be considered. If before the close of the year the interest of a partner terminates, then the point of measurement should be the earnings at the time of termination.

165. Section 734: The 1939 code provision as to the effect of a distribution of a partnership asset should be restored. It accorded with economic realities. The

present provision makes possible manipulation through the deliberate distribution of partnership property that has depreciated in value in order to get a markup for the partnership on property that has appreciated in value and is about to be sold. If the 1939 provision is restored, the problem of valuation and allocation that then arose can be obviated by using as the ratio the basis to the partnership of the assets distributed, compared with the basis of all assets of the partnership. (This will correspondingly affect secs. 732 and 733.)

166. Section 736 (a): 1. The limitations with reference to the number of years should be removed as the result it produces is completely unrealistic.

2. In any event, the limitations should not apply to a partnership where capital is not a material income-producing factor.

3. On the other hand, recognition should be accorded to the right of the partnership and the individual to enter into a contractual relationship after the retirement, as long as the status of the individual is other than as a partner.

167. Section 736 (a): If any payments are not to be deductible by the continuing partners, the payments should increase the basis of their interest in the partnership. Conversely, the amount received by the former partner should be considered as an addition to the sales price of his partnership interest.

168. Section 742: The exclusion under section 751 should be a reduction of the basis of a partner's interest or else there will be a double benefit. The increase in the distributive share of the partner's profit adds to his basis. Unless the exclusion serves as a reduction of the distributive share, it should serve as a reduction of the basis in the partnership. Another way of handling this adjustment is through section 751 (b) (1), where the exclusion is allowed. The exclusion could there specifically be labeled as a decrease in the partner's distributive share of the partnership profit.

169. Section 743 (c) (1): No further allocation of basis should be permitted to inventory. In addition, if the allocations are to be made in proportion to the adjusted bases of the assets, it will mean that there cannot be any allocation to goodwill and it will also mean a disproportionately low allocation to assets with a low base but a high market value. The criterion for allocation should therefore be in all instances fair market value of the assets involved.

170. Section 743 (d): There should be an election each year to adjust the basis of partnership property in respect to transfers that took place during that year.

171. Section 761 (a): It should be made clear that the ownership of real estate as tenants in common is not a partnership where the real estate is held for rental, investment, or sale.

172. Section 901: The foreign tax credit should be carried back and forward to prevent it from being lost completely in cases where the domestic parent has a loss in the year in which the foreign dividend is received.

173. Section 951 (a): The definition of a "branch" in a foreign country should be extended to include wholesale establishments. (This correspondingly applies to secs. 951 (b) (1) (A) and 923 (a) (3) (A) (ii).)

174. Section 1035: On a foreclosure the value of the property acquired in the foreclosure should be applied against the debt. The tax consequences as to the balance of the debt should be dependent upon the circumstances at the time. The status for capital asset purposes of the property acquired in the foreclosure should be dependent upon its own characteristics, just as if the property had been independently purchased by the taxpayer.

175. Section 1201: The alternative tax should not be in excess of 25 percent of the amount of the net taxable income. (This would correspond in a way to the restriction on the dividend credit to 85 percent of the net corporate taxable income.)

176. Section 1211 (b): Income from the discharge of indebtedness should be reduced by any capital loss incurred in connection with the liquidation of the indebtedness, as in the case of the sale of collateral against the indebtedness.

177. Section 1212: A 2-year carryback for capital losses should be allowed just as in the case of net operating losses.

178. Section 1221 (4): Clarification is needed as to the reference to section 1035. That section refers to the capital-gain section and the capital-gain section in turn refers to section 1035.

179. Section 1221 (4): The provision excluding notes and accounts receivable from the status of capital assets should be extended to exclude all accounts and notes receivable to the extent that their receipt did, or their collections would, depending on the method of accounting employed by the taxpayer, constitute an item of ordinary income.

180. Section 1231: Gain or loss on property used in the trade or business, etc., should be treated uniformly as ordinary income or loss.

181. Section 1232 (a) (1): To close the loophole on retirement of discount bonds during 1954, reference to January 1, 1955, should be changed to January 1, 1954.

182. Section 1232 (a) (2) (A): To shorten the period when the loophole on sale or exchange of discount bonds is possible, the reference to December 31, 1954, should be changed to February 28, 1954.

183. Section 1232 (a) (2) (A): Eliminate the complications that attend upon the ratio calculations. Instead, the entire original discount on the bond should be deemed recovered to the extent of the gain involved in the transaction. On the other hand, no ordinary income shall be applicable in any situation where the cost of the bond is in excess of the price to be collected at maturity or any earlier call date.

184. Section 1232 (b) (1): The reference to one-tenth of 1 percent of the redemption price at maturity should be changed to one-fifth of 1 percent in order to eliminate dealing with insignificant amounts.

185. Section 1232 (b) (1): In addition to the reference to the redemption price at maturity there should also be added reference to the earliest call price.

186. Section 1234: Page A279 of the Ways and Means Committee report indicates that a loss on an option to buy a residence would be deductible as a capital loss. Is that intended?

187. Section 1237: No inference of non-capital-asset status should attach to holdings of real property for less than 5 years. They should be dependent upon a showing of the facts. (This same principle should apply to sec. 1238.) In any event, both sections 1237 and 1238 should include corporations. If both these sections are to stand, the restriction on improvements should be eliminated.

188. Section 1238 (b) (1): If this section (as to real property subdivided for sale) stands, then the sale of the first five lots should be regarded as sales of capital assets, regardless of when the sale of the sixth lot taxes place.

189. Section 1501: The inclusion in the code of the previous regulations on consolidated returns is undesirable. It creates an inflexibility that does not now exist. It also means that in any change of the basic law, revision will have to be made, right then, in any related provision in the law affecting consolidated returns, whereas experience with the regulations has shown that it takes considerable time adequately to work this out.

190. Section 1501: The requirement that the consent of all members of an affiliate be obtained would prevent the filing of a consolidated return where a subsidiary which was at least 80 percent but less than 95 percent owned was sold prior to the time H. R. 8300 was introduced and where the common parent corporation at the time of sale failed to obtain consent of such subsidiary. This inequity should be removed.

191. Section 1505 (a) (2): The election to file consolidated returns should be available annually.

192. Section 1505 (a) (2): If no annual election as to consolidated returns is permitted, then the election should be made to apply to the taxable year affected by a change in law, irrespective of the filing of a prior year's return before or after the date the change is effected or enacted.

193. Section 1505 (a) (2): The word "substantially" should be eliminated since it is an unnecessary extension of the present regulations.

194. Section 1514 (a): The 2-percent additional surtax on income reported on a consolidated return should be eliminated.

195. Section 1524. The provision in parentheses in section 1524 (1) should also appear in section 1524 (2) with the same wording.

196. Section 1623: The consolidated-return requirement set forth in the last sentence should be eliminated so that the general limitation would also be inapplicable to an 80-percent owned subsidiary which filed separate returns for prior periods.

197. Section 1629: If an affiliated group is formed or augmented after enactment various deductions otherwise applicable are restricted. The restrictions on the utilization of deductions should be limited to those cases in which utilization would constitute an abuse of consolidated returns. The qualification immediately following subsection (2) (D) should be extended to subsection (1).

198. Section 1707 (c) (2): It should be made clear that the principles of section 334 (c) apply where the stock of a corporation is really acquired as a

mere step in a plan to acquire its assets and the corporation is liquidated forthwith. Since the liquidation of such a corporation might not be completed within 30 days, a reasonable period of time, such as 6 months, should be specified. Unless this were the case, it appears that the subsidiary would be required to join in making the consolidated return and that upon liquidation the basis of the property would be the same as it would be in the hands of the transferor.

199. Section 1708 (b): No adjustment of the opening inventory should be required in the first year a consolidated return is filed. As presently stated the rules permit either double taxation or double deduction which may not be adequately cured in the final consolidated return year.

200. Section 1732: The section as now written should be eliminated or it should be amended to permit allocation by agreement among the members of the consolidated group. It should be provided that, in the absence of such agreement, the allocation should be according to regulations to be prescribed by the Secretary or his delegate.

201. Section 6042: The requirements in section 147 (d) of the 1939 code for information returns on income payments to others should be restored. They should provide a valuable audit mechanism.

202. Section 6046: This section, relating to filing of reports by advisers as to foreign corporations, should be eliminated as experience has demonstrated its impracticability. At the very most the return should be required only if the formation or reorganization is consummated.

203. Section 6071: There are several provisions in the law that will apply to fiscal years that closed in 1954 before the date of enactment. In many of those cases returns for those fiscal years will have already been filed. Those taxpayers should be required to refile their returns at the same time as returns due by calendar year 1954 taxpayers. Refunds and deficiencies should bear no interest. Provision should be made for "quickie" refunds. In the alternative interest should be payable on deficiencies and refunds after a certain date. (This correspondingly applies to the various provisions of subtitle F, pt. V.)

204. Section 6073: The final estimate of individual income tax should be made by February 15 to enhance the prospect of final returns in the light of the fact that W-2's become available generally at January 31. (This correspondingly applies to secs. 6015 (f) and 6153 (a).)

205. Section 6073 (c): The restriction as to one amendment of a declaration between installment dates should be eliminated. (This correspondingly applies to the inference in sec. 6074 (b).)

206. Section 6075 (b): The due date for the gift-tax return should be April 15 to coordinate with the due date of individual income-tax returns.

207. Section 6081 (b): To be realistic, termination of extension of time for filing returns should require a return by not less than 20 days from the termination notice.

208. Section 6653 (a): The negligence penalty for intentional disregard of regulations should not be imposed if the taxpayer disagrees in good faith and attaches a statement of his position to the return.

209. Section 6654: The effective date as to additions for failure to pay estimated tax should not be before January 1, 1955, at least for tax years beginning after enactment, so as to avoid penalizing declarations already filed in good faith under existing law.

210. Section 6654: The amounts for failure to pay adequate estimated tax called "additions" should be called "interest" and thereby become deductible. (This correspondingly applies to sec. 6655.)

211. Section 6901 (d): The intent set forth on page A422 of the Ways and Means Committee report about extension of time to file a claim for refund by a transferee during the extended period arising out of overpayments by the transferor should be made clear in the statute.

212. Section 7502 (a): The date of mailing of a return should be treated as the date of filing. The exclusion of returns should be eliminated. It should also be made clear that this applies to Tax Court petitions.

213. Section 7851 (a) (1) (A): The provision that excludes from the operation of the 1954 code taxable years beginning after December 31, 1953, and ending prior to date of enactment, should be reexamined. It creates the possibility of getting out from under the loophole closeup during that period.

The CHAIRMAN. Mr. Reynolds, identify yourself to the reporter and make yourself comfortable.

STATEMENT OF L. E. REYNOLDS, VICE PRESIDENT AND TREASURER, THE CONNECTICUT LIGHT & POWER CO., BERLIN, CONN.

Mr. REYNOLDS. Yes, sir.

Mr. Chairman, my name is Lester E. Reynolds. I am a resident of West Hartford, Conn. I am presently employed as vice president and treasurer of the Connecticut Light & Power Co., in Berlin, Conn.

I am here to oppose, on behalf of our company, section 110 of H. R. 8300. That section relates to the tax consequences of a lease agreement in which the lessee has agreed to reimburse to the lessor the income tax assessed on the annual rental payments specified in the lease agreement.

In addition to this oral testimony, I have prepared a detailed written statement which I wish to have placed in the record.

The CHAIRMAN. It will be included in the record.

(Mr. Reynolds' prepared statement follows:)

STATEMENT OF L. E. REYNOLDS, VICE PRESIDENT AND TREASURER OF THE CONNECTICUT LIGHT & POWER CO., BERLIN, CONN., WITH RESPECT TO SECTION 110 OF H. R. 8300

The Connecticut Light & Power Co., of Berlin, Conn., is a public utility engaged in the manufacture, sale, and distribution of electricity and gas throughout a substantial part of the State of Connecticut and is submitting this written statement in addition to oral testimony by its vice president and treasurer in opposition to section 110 of H. R. 8300. That section relates to the tax consequences of a lease agreement in which the lessee has agreed to pay the lessor's income tax on the annual rental payments specified in the lease agreement.

Section 110 proposes a radical change in the practice which has been followed by the Treasury Department for at least 30 years with respect to income-tax payments made by lessees on behalf of lessors. The company's opposition is primarily based upon the fact that section 110 imposes a tremendous new burden upon lessees who are operating under leasing contracts entered into many years ago. These lease contracts, some of which were entered into prior to enactment of the 16th amendment, run for 99 years or even 999 years, and their terms cannot be changed in order to avoid the disastrous effects which section 110 will have.

The Connecticut Light & Power Co. is currently operating part of their property as lessee under a 999-year lease entered into in 1906, which provides that the lessor corporation is entitled to a fixed annual rental after payment of all taxes and expenses imposed upon the lessor with respect to such rental.

Under this lease agreement, this company, as lessee, is obligated to pay the Federal income taxes imposed upon the lessor with respect to the annual rental. The Federal income tax so imposed on this rental payment and paid by the lessee has, over a long period of years, been considered by the Commissioner of Internal Revenue as additional taxable income to the lessor (letter of instruction issued in 1923 by Commissioner to all branches of the Bureau). That result, in turn, requires the lessee to pay an additional or second income tax for the lessor, but this second reimbursement of tax has, prior to 1952, never been considered as taxable income to the lessor.

Within the past 2 years a change in the policy of the Treasury Department with respect to the tax treatment of the income tax payments made under such long-term lease agreements has created very serious problems for lessees.

By proposing section 110 of H. R. 8300, the Ways and Means Committee of the House has apparently intended to correct the current confusion and to fix the tax consequences of such lease arrangements to both the lessor and the lessee. However, section 110, inadvertently perhaps, removes almost none of the inequities and absurdities of the present Treasury Department rule and in addition denies to lessees the right to deduct very substantial amounts which constitute ordinary and necessary business expenses.

In these circumstances, it is respectfully submitted that the Congress reject the formula of section 110 and should write into H. R. 8300 the practice and policy followed by the Treasury Department for at least 30 years prior to 1952.

Prior to 1952, it had been the consistent practice and policy of the Treasury Department for at least 30 years to include in the taxable income of the lessor the rental income plus the tax paid by the lessee on account of the rental, but not to include the next, or second, step (being the tax on tax) into the lessor's income. This latter reimbursement by the lessee to lessor was considered as a simple reimbursement of expense and not taxable income. As a part of that long-standing practice and policy, the Treasury Department recognized the right of the lessee to deduct as an ordinary and necessary business expense—

(1) The annual rental,

(2) The income tax paid by the lessee on account of the annual rental, and

(3) The second income tax paid by the lessee on account of the first income tax payment.

This may be illustrated as follows:

Rental paid by lessee	$100,000
Income tax on lessor at 52 percent	52,000
Income tax on such tax	27,040
Total cost of lease to lessee all deductible as an ordinary and necessary business expense	179,040

The lessor, using this example, was required to report, for income-tax purposes, only $152,000, on which a tax of $79,040 would be paid. The lessee was entitled to deduct, as a business expense, the total of $179,040, consisting of the rental plus all taxes of the lessor, so that the lessee's net cost of rental and tax would be $179,040 minus $93,100, or the amount of $85,940.

In 1952, the Treasury Department adopted a new policy which, in general, requires the pyramiding of the taxes on income taxes into the lessor's income, and allows the lessee, as a business-expense deduction, all such taxes. Under this method, the income taxes to be paid by the lessee on behalf of the lessor, including each successive tax on tax in the example cited, reach the absurd amount of 108 percent of the stipulated annual rental as shown in the following schedule:

Rental paid by lessee	$100,000
Tax on tax on tax, etc., at 52 percent	108,333
Total cost of lease to lessee	208,333

Under this method the entire $208,333 is includible in the lessor's taxable income and the same amount is deductible by the lessee as a business expense. The net cost of the lease to the lessee after this deduction is $100,000 as against $85,940 under the method followed by the Service for 30 years prior to 1952, as shown below:

Total cost of lease deductible by lessee	$208,333
Tax at 52 percent	108,333
Net cost of lease	100,000

More significant, assume the lessee has a net operating loss and thereby loses the benefit of the deduction of the $208,333. It is easy to see that in these circumstances lessees may be pyramided into bankruptcy.

The unequal and absurd results under the pyramiding system are also apparent when the lessor and the lessee fall into different corporate tax brackets, as will be illustrated hereinafter.

Pyramiding is also cumbersome, difficult, and costly to administer. This administrative burden falls on the Treasury Department and the lessor and lessee-taxpayer as well. In computing the lessor's pyramided income taxes, it is necessary either to go through a series of laborious mathematical computations, or to use an algebraic formula, which, as already noted, most unrealistically attributes income to the lessor in an amount more than double the specified rental.

The pyramiding system produces such patently absurd and detrimental results that apparently even the Treasury Department is willing to abandon it. Section 110 has apparently be designed to eliminate it, but the section is a kind of Trojan horse for it writes into law virtually all the adverse effects of pyramiding under the guise of eliminating them.

Section 110 proposes an entirely new rule with respect to the income-tax treatment of the tax payments made by lessees on behalf of lessors. The section pro-

poses, with respect to leases executed prior to January 1, 1954, to exclude from the gross income of lessors the amount of income-tax payments made by lessees on behalf of lessors. It also proposes to deny to lessees any tax deduction on account of such income-tax payments.

It is immediately apparent that section 110, as now written, violates consistent and long-established tax accounting principles by denying lessees a deduction for an ordinary and necessary business expense. The provision approved by the House committee is that the lessor be required to report as income the annual rental but not the tax on the rental, and that although the lessee pays or reimburses to the lessor the amount of such tax, the lessee is not to be allowed to deduct the tax as an item of business expense. The result is, using the figures of the previous examples, that the lessee will be entitled to deduct less than two-thirds of the actual cost of the lease:

Rental paid by lessee	$100,000
Tax paid by lessee for lessor	52,000
Total cost of lease contract to lessee	152,000
Allowable deduction to lessee	100,000

Thus, the lessee will pay out $152,000 as the total cost of the lease, and by deducting $100,000, will reduce his taxes by $52,000, making the net cost of the lease $100,000, exactly the same as under the pyramiding system.

There are other inequities of the pyramiding system which are perpetuated by section 110. One of the worst of these is the harsh result where the lessor corporation is in the 52 percent income tax bracket and the lessee corporation is in the 30 percent tax bracket.

In order to make clear the adverse effect of both the pyramiding system and section 110, let us assume a lease agreement entered into while the Treasury Department's pre-1952 practice was in effect. The rental is fixed at $100,000 after payment of lessor's taxes. Further assume that the lessee's income is $200,000 before deducting the costs of the lease. The lessee's net income after taxes will be as follows:

Lessee's income before deducting cost of lease	$200,000
Lease rental	100,000
Income taxes paid for lessor:	
Tax of lessor at 52 percent	52,000
Tax on tax of lessor at 52 percent	27,040
Total cost of lease to lessee all deductible	179,040
Taxable income of lessee	20,960
Income tax of lessee at 30 percent	6,288
Net income of lessee after taxes	14,672

Compare the foregoing result, which, under the pre-1952 Treasury practice, was anticipated at the time the lease agreement was entered into, with the results both under section 110 and pyramiding:

	Sec. 110		Pyramiding	
Lessee's income before deducting cost of lease		$200,000		$200,000
Lease rental	$100,000		$100,000	
Income taxes paid for lessor	52,000		108,333	
Total cost of lease to lessee	152,000		208,333	
Amount deductible by lessee		100,000		208,333
Taxable income of lessee		100,000		[1] 8,333
Income tax of lessee		46,500		None
Total		53,500		
Less: Income tax paid for lessor, not deductible		52,000		
Net income of lessee after taxes		1,500		[1] 8,333

[1] Loss.

It will be readily seen that the pyramiding method converts a lessee-taxpayer with net income after taxes into one with a net loss. Section 110 unrealistically increases the tax bracket of the lessee-taxpayer from 30 percent to 52 percent and at the same time reduces what is at best a small net income to a nominal figure.

Section 110 also denies to the lessee the deduction of a legitimate ordinary and necessary business expense. The Ways and Means Committee announced that the purpose of the new bill is "to bring the income-tax provisions of the code into harmony with accepted accounting principles." The proposed treatment of the lessor-lessee relations above referred to completely violates this purpose, as there is no recognized accounting principle which deprives a taxpayer of a deduction for an ordinary and necessary business expense incurred in the operation of income-producing property.

Moreover, the theory of section 110 appears to be incorrect in that it is made applicable only to leases entered into prior to January 1, 1954. Most long-term leases were executed even prior to imposition of any Federal income taxes. Leases executed after passage of the income-tax amendment have been made in the light of the tax treatment accorded to such leases by the Treasury prior to 1952. Generally speaking, the long-term leases falling into these two classes are not subject to change, so taxpayers are prevented from correcting by amendment the inequities which section 110 will produce. It is, therefore, suggested that if any such rule is to be written into the law, the section should be made applicable only to leases executed after the enactment of the statute. This will place all taxpayers on notice that a change has been made in the tax treatment of leases providing for the payment of income taxes and will permit them to contract accordingly.

However, the fact that the Treasury Department is attempting to impose the absurd rule of pyramiding taxes into income with respect to existing leases, after having followed a different and more reasonable practice for at least 30 years, indicates the need for enactment of a uniform rule both for preexisting and future lease agreements.

Our proposal is that Congress write into H. R. 8300 the long-standing pre-1952 rule of the Treasury Department. It is the most logical and equitable policy from the standpoint of taxpayers and, from the standpoint of revenue administration, is workable and easy to administer. It is also submitted that that policy presently has the sanction of the courts. The question was presented to the United States Supreme Court in 1929 in two cases: *Old Colony Trust Company* v. *Commissioner* (279 U. S. 716); and *United States* v. *Boston & Maine R. R. Company* (279 U. S. 732). The Boston & Maine case relates to the same kind of lease agreement as that held by the Connecticut Light and Power Co. under which the lessee has agreed to assume the income taxes of the lessor. The Old Colony case, involving the same principle, was concerned with an agreement by an employer to pay an employee a sufficient sum to give him annually X dollars after income taxes. The taxpayers contended in both those cases that the payment by the lessee and employer of the lessor's, or employee's, income taxes did not constitute additional taxable income to the lessor or employee. The taxpayers argued that if the tax payments constituted additional income, each such payment would create further taxable income ad infinitum, resulting in an absurdity which Congress could not have contemplated.

In its brief the Government assured the Supreme Court that since 1923 the Bureau practice was to add only the original tax to taxable income, and that it had never treated the additional or second tax as income. As evidence that this was the established practice of the Treasury Department, there was attached to the Government's brief in the cases cited above a letter of instructions issued in 1923 to all branches of the Bureau by Internal Revenue Commissioner Blair, setting forth the method to be followed in computing the taxable income of the lessor, as follows:

"The lessor corporation at the close of its taxable year should without taking into account the amount of income and profits taxes paid in its behalf by the lessee corporation determine what its gross income and net income are, then compute the amounts of income and profits taxes properly assessable against a similar amount of income, accrue upon its books additional gross income in an amount equal to the taxes so computed, and include such amount in its return as additional gross income. The amount of income and profits taxes assessable against the lessor corporation is to be computed on the amount of net income as shown in that return."

This was an unequivocal representation by the Government to the Supreme Court that it was its consistent practice in instances where a lessee was obligated to pay the taxes of a lessor to consider as additional income to the lessor only the initial tax computed upon the net income of the lessor without taking into account the amount of the additional taxes paid by the lessee for the lessor.

The Government also stated to the Supreme Court in the cases cited above:

"We think that in a case where the parties have placed themselves in such a position that extreme hardship will follow the literal application of a principle, the Treasury Department is not fairly to be censored if it fails to apply its theory literally in order to avoid absurd consequences."

The Supreme Court endorsed the practice and policy of the Treasury Department by stating in the Boston & Maine case that "* * * it should be added that neither before nor since 1923 has any algebraic formula been used by the Bureau in computing taxes" (279 U. S. 732 at 736).

It was not until 1952 that the Treasury Department made any change in that practice and policy. In all intervening years, the Congress took no action to require pyramiding. In these circumstances, that practice and policy must be deemed to have the force and effect of law.

Yet, on March 12, 1952, the Commissioner issued mimeograph No. 6779 reversing the long-established prior practice, and holding that where a lessor receives an annual net return after income taxes and other expenses, "the lessor is deemed to have received as rental not only the stipulated rental but in addition thereto all Federal income taxes paid by the lessee to or for the account of the lessor."

Subsequently, on October 14, 1952, the Commissioner issued IR mimeograph 53 providing that mimeograph 6779 would be applied only with respect to taxable years beginning on and after January 1, 1952.

Application of this mimeograph requires the imposition of a tax upon a tax to the point of infinity, and would produce the absurd result which the taxpayers questioned in the Old Colony and Boston & Maine cases, and which the Treasury Department stated to the Supreme Court was contrary to its policy.

By reason of present high income tax rates, the principle of pyramiding is not only economically unsound because it distorts income but approaches confiscation.

The proposed rule of section 110 of H. R. 8300 is even less satisfactory than the pyramiding system. It not only produces some of the same distortions but also denies the lessee the deduction of a legitimate business expense.

The fact that it is made applicable to lease agreements entered into prior to January 1, 1954, and not to prospective lease agreements is unreasonable and illogical. The effect of section 110, as presently drafted, is wholly contrary to the long-standing practice of the Treasury Department not to apply change of policy retroactively. This is particularly true where the taxpayer in his business transactions has complied with the previously existing policy and practice of the Treasury Department. It is difficult to understand why a new rule should be adopted for leases entered into many years ago at a time either when there were no Federal income taxes or the pre-1952 Treasury practice was so well established as to have the force and effect of law. Presumably, under section 110 as now proposed, lease agreements entered into on or after January 1, 1954, will be subject to the absurd pyramiding rule, although if it should be established in litigation that the pyramiding policy of the Treasury Department is illegal, they would then be subject to the Treasury's pre-1952 rule, which is fair and reasonable.

It is submitted that the Congress should adopt one rule with respect to all lease agreements past or future, and that that rule should embrace the long-standing pre-1952 Treasury practice and policy.

Mr. Reynolds. Section 110 proposes a radical change in the practice which has been followed by the Treasury Department for at least 30 years with respect to income-tax payments made by lessees on behalf of lessors. Our opposition is primarily based upon the fact that section 110 imposes a tremendous new burden upon lessees who are operating under lease agreements entered into many years ago. These lease contracts, some of which were entered into prior to the enactment of the 16th amendment, run for 99 years, or even 999 years, and their terms cannot be changed in order to avoid the disastrous effects which section 110 will have.

My company is currently operating as lessee under a 999-year lease entered into in 1906, which provides that the lessor corporation is entitled to a fixed annual rental after payment of all taxes imposed upon the lessor with respect to such rental.

Under this lease agreement, my company, as lessee, is obligated to pay the Federal income taxes imposed upon the lessor with respect to the annual rental. The Federal income tax so imposed upon this rental payment and paid by the lessee has, over a long period of years, been considered by the Commissioner of Internal Revenue, as additional taxable income to the lessor. That result, in turn, requires the lessee to pay an additional or second income tax for the lessor, that being a tax on the tax, but this second reimbursement of tax has, prior to 1952, never been considered as taxable income to the lessor. Prior to 1952, it has been the consistent practice and policy of the Treasury Department for at least 30 years, and sanctioned by the courts, to include in the taxable income of the lessor the rental income plus the tax paid by the lessee on account of the rental, but not to include the next or second step, being the tax on tax, in the lessor's income.

This latter reimbursement by the lessee to the lessor was considered as a simple reimbursement of expense and not taxable income. It might be illustrated by the fact that I walk uptown and buy a dozen pencils for $1 to be used in my work. When I come back on the job, the company reimburses me for the $1 spent. Certainly, that isn't income to me; but, obviously, it is an expense to my company.

As part of that longstanding practice, the Treasury Department allowed the lessee to deduct as an ordinary and necessary business expense (1) the annual rental; (2) the first income tax paid by the lessee on account of the annual rental; and (3) the second income tax reimbursement by the lessee on account of the first income-tax payment.

That was a wholly fair and satisfactory tax policy, inasmuch as the lessee was allowed a tax deduction for all of the taxes which were required to be paid for the benefit of the lessor.

In 1952, after 30 years of following the above-described practice, the Treasury Department adopted a new policy. That new policy requires the pyramiding of taxes on income taxes into the lessor's income to the point of infinity. Under this method, the income taxes paid by the lessee must include each successive income tax on income tax. As pointed out in my detailed written statement, at the current corporate tax rate of 52 percent, the income taxes to be paid by lessee on behalf of the lessor reach the absurd amount of 108 percent of the stipulated annual rental.

Although the Treasury Department under its new policy allows the lessee to deduct all the taxes paid with respect to the lessor's rental income, it nevertheless results in a tremendously greater burden upon the lessee than the former policy. Furthermore, if the lessee operates over a period of several years with annual net operating losses, the benefit of the deduction is entirely lost and the lessee may be quickly pyramided into bankruptcy.

In addition, when the lessor and the lessee fall into different corporate tax brackets, this pyramiding system produces unequal and harsh results in the case of a small corporate lessee, whose tax rate is 30 percent.

The pyramiding system produces such patently absurd and detrimental results that apparently even the Treasury Department is willing to abandon it. Presumably section 110 has been designed for that purpose but, inadvertently or designedly, it writes into law virtually all the adverse effects of pyramiding, under the guise of eliminating them.

Section 110 proposes an entirely new rule for leases executed prior to January 1, 1954. The section provides for the exclusion from the gross income of lessors, the amount of all the income tax payments made by lessees. At the same time, it proposes to deny to lessees any tax deduction on account of such income tax payments. It is immediately apparent that section 110 violates consistent and long-established tax accounting principles because it denies lessees a deduction for an ordinary and necessary business expense.

The result is, as pointed out by example in my written statement, lessees will be entitled to deduct for tax purposes less than two-thirds of the actual cost of the stipulated rental. Section 110 also perpetuates the extremely harsh result of the pyramiding system where the lessee corporation is in the 30 percent tax bracket and the lessor corporation is in the 52 percent tax bracket. Under the longstanding pre-1952 Treasury practice, a lessee may have earned a net taxable income of approximately $20,000. When the pyramiding system is applied, that same taxpayer will have an annual operating loss of several thousand dollars. Under section 110, the $15,000 net income after taxes is reduced to $1,500. Whereas, in most cases, the lease agreements cannot be broken, the lessee has no choice but bankruptcy.

Finally the theory of section 110 appears to be unsound in that it is made applicable only to leases entered into prior to January 1, 1954. Most long-term leases to which the section will apply were executed even prior to the enactment of the Federal income tax laws. Leases executed after the passage of the income tax amendment will have been made in the light of the longstanding pre-1952 Treasury practice.

Generally speaking, all of these long-term leases are not subject to change. Taxpayers are, therefore, prevented from correcting the inequities which section 110 will produce. This is retroactivity of the worst sort. If the rule set forth in section 110 is to be adopted at all, it should be made applicable only to leases executed after its enactment.

As section 110 now stands, it prescribes no law whatever for leases executed in the future. Will the Treasury Department apply the rule of pyramiding or its pre-1952 practice, or will it try to make use of the rule of section 110 for future leases? Nobody knows.

This situation indicates the need for a uniform rule both for preexisting and prospective lease agreements.

My proposal is that Congress write into H. R. 8300 the longstanding pre-1952 rule of the Treasury Department. From the standpoint of taxpayers it is the most fair and equitable policy and from the standpoint of revenue administration it is workable and simple to administer. Lessors and lessees with lease agreements which were entered into before 1913 have been able to operate satisfactorily under that longstanding rule. Leases executed between 1923 and 1952 have been based upon that rule. It avoids the extreme and unfair results of both the pyramiding system, and section 110. It provides a rea-

sonable uniform rule which can be applied both to previously executed and future lease agreements.

I take this opportunity to thank the chairman and the committee for the privilege of appearing in this matter and to request that careful consideration be given our suggestion that section 110 be replaced by the former longstanding, court-sanctioned Treasury Department practice and policy.

The CHAIRMAN. Thank you very much.

I am reading from a digest of suggestions having to do with this bill, put out by the joint committee staff. It says:

A suggested solution to the problem is to exclude such taxes from the lessor railroad's income and deny the lessee the right to deduct as rental any taxes it pays the lessor railroad. This would be similar to the present treatment of the Excess Profits Tax Act.

Mr. REYNOLDS. That is exactly what 110 is doing now. I would oppose that, sir.

The CHAIRMAN. Thank you very much.

(The following letter was subsequently supplied for the record:)

THE CONNECTICUT LIGHT & POWER CO.,
Berlin, Conn., April 28, 1954.

Hon. EUGENE D. MILLIKIN,
United States Senate, Washington 25, D. C.

DEAR SIR: As you know, I have had an opportunity to make some minor corrections in my oral testimony before the Senate Committee on Finance and have already returned the data to your chief clerk, Mrs. Springer.

In going over this oral testimony I have had an opportunity to digest a little more the question you asked me upon the completion of my testimony, when you referred to a digest of suggestions put out by the joint committee staff, and, as the record indicates, I opposed these suggestions. There is detailed below further information on this particular point which I am submitting to you for your information and for whatever use you may wish to make of it. I know that the committee hearings are closed and it may not be possible to get this into the record, but I am more interested in having you have the benefit of our thinking as far as this particular point is concerned.

Our point, as you know, is that section 110 denies to lessees any deduction for income taxs paid on behalf of the lessor, even though the lessee is bound to irrevocable contract to reimburse the lessor for all such taxes. The economic result under section 110, when applied to our company as a lessee under a 999-year lease, is virtually the same as the so-called pyramiding system. Both section 110 and pyramiding are inequitable and add tremendously to the cost of our lease. The long-established and consistent Treasury Department practice of including in the lessor's taxable income only the lessee's first income-tax reimbursement on the rental and of allowing the lessee to deduct the total taxes paid on behalf of the lessor is satisfactory to our company, and at the hearing before your committee I proposed that section 110 be rewritten to embrace in the code this long-established Treasury practice and policy. In that connection I want to call to your attention several facts relating to the origin of section 110. These facts have been brought to my attention since I testified.

The rule proposed by section 110— i. e., exclusion from the lessor's income of the income tax paid by lessee on account of lessor's receipt of the rental and the disallowance of the tax payment as an expense deduction of the lessee—originated with the railroad industry.

APRIL 23, 1954.

It was proposed to the Ways and Means Committee as a rule to be applied solely to railroad leases. The committee apparently adopted the proposal, but, instead of confining it to railroads alone, has applied it generally to all leases executed prior to January 1, 1954. The report of the Committee on Ways and Means (at p. A38) states that section 110 of H. R. 8300 adopts for income-tax purposes a rule applied in the excess-profits tax under section 101 of the Excess Profits Tax Act of 1950 (sec. 433 (a) (1) (K) of the 1939 code).

During my brief appearance before your committee, you referred to the provisions of the Excess Profits Tax Act of 1950 and inquired whether this would not answer the problem. The provisions of the Excess Profits Tax Act of 1950 referred to in the report of the Committee on Ways and Means with respect to H. R. 8300, and also referred to by you, have no application to the problem facing my company under the proposed provisions of section 110 of H. R. 8300. The aforesaid provisions of the Excess Profits Tax Act of 1950 were adopted to cover a situation peculiar to an excess-profits tax with which H. R. 8300 is not concerned.

The reason for the rule in the 1950 act, as explained in the report of the Committee on Finance, United States Senate, Excess Profits Tax, 1950 (at p. 15), was to prevent the imposition of the excess-profits tax on the amount of tax borne by the lessee on behalf of the lessor, which would thereby have increased the amount of the lease expense to the lessee. Relief from the imposition of a tax at excess-profits tax rates was intended and nothing more.

The Excess Profits Tax Act of 1950 provided the disallowance of the tax borne by the lessee as a deduction in computing the lessee's excess-profits net income for purposes of the the excess-profits tax only (sec. 433 (a) (1) (K)); however, the same adjustment was made in the lessee's income for the base-period years to determine the lessee's excess-profits credit (sec. 433 (b) (11)). Thus, the resulting increase in the excess-profits credit substantially compensated a lessee for the disallowance of the deduction in the taxable year for purposes of computing the excess-profits tax. This is not true of the normal tax and surtax imposed by H. R. 8300, for there is no reciprocal benefit derived from the denial to the lessee of the deduction of an ordinary and necessary business expense.

Aside from the excess-profits tax origin of the proposed new rule, my information is that most lessees and lessors of railroad properties are parent and subsidiary corporations. It is obvious that where the lessor and lessee are part of the same corporate family the problem of section 110 is of little importance. However, where the corporations are not related, the loss of the deduction of the tax reimbursement expense assumes very serious proportions. A rule of this kind, advocated on account of the peculiar problems of the railroad industry, should not be applied generally.

To the best of my knowledge, there is no precedent in the entire history and development of the income-tax law and business accounting principles which would deny to a taxpayer an annually recurring out-of-pocket payment which is an ordinary and necessary expense of doing business. Yet that would be the result if section 110 of H. R. 8300 is adopted in its present form.

Again, Senator, thank you very much for the courtesies extended to me. I certainly appreciate your cooperation.

Very truly yours,

L. E. Reynolds,
Vice President and Treasurer.

The Chairman. Mr. Gillet.

STATEMENT OF JAMES M. GILLET, VICTOR CHEMICAL WORKS, CHICAGO, ILL.

Mr. Gillet. My name is James M. Gillet. I am assistant to the president of Victor Chemical Works, Chicago, Ill.

Victor Chemical Works, Mr. Chairman, is a chemical manufacturing firm that has plants in Montana, California, Illinois, Tennessee, Florida, and Pennsylvania. Most of our operations are connected with the production of phosphates, starting with phosphate rock and continuing through to the production of some 150 chemicals that are used in practically every industry in the country.

I appear before you in connection with a request to clarify section 613 of the code. Since the committee has given the opportunity to discuss these clarifications, this seemed the time to do it. The technical staff of the committee is familiar with that matter and they have

a copy of the brief which I would like to have permission to file for the record.

The CHAIRMAN. You want to put it in the record or file it?

Mr. GILLET. I will put it in the record.

(The statement referred to follows:)

VICTOR CHEMICAL WORKS,
Chicago, Ill., April 12, 1954.

Subject: Internal Revenue Code of 1954, Section 613 (c) (4).

The CHAIRMAN,
Committee on Finance, United States Senate,
Washington, D. C.

DEAR SIR: As miners of phosphate rock and manufacturers of phosphorus, we respectfully ask the inclusion in section 613, subparagraph (c) (4) (E) of the words, "and the sintering and nodulizing of phosphate rock." The purpose of this amendment would be to show these processes are ordinary treatment processes required to bring phosphate rock to the state of usable raw material for the manufacture of phosphorus.

Phosphate rock mined in the United States differs in the method of mining, the character and purity of the mineral, and the uses to which various fractions and grades of mineral are put. Some rock is high in phosphorus content, and some is low; rock used for some purposes undergoes somewhat different treatment than the rock destined for other uses. Most of the rock of the quality used for the production of elemental phosphorus is in such a physical form that it must be treated by sintering or nodulizing to make it usable as a raw furnace feed for the electric furnace. These processes are considered by the industry to be "ordinary treatment processes" within the meaning of the Internal Revenue Code. This fact is not specifically set forth in the code, however, and it thus becomes a problem for administrative determination, which can lead to confusion and possibly to unequal treatment of various taxpayers.

The taxpayer now has no assurance that his tax return will be accepted as correct by the next Treasury engineer who audits it, nor that he may not some day be served with a deficiency notice because of the reversal of presently accepted interpretations by some new Commissioner of Internal Revenue.

We ask for no new benefit for the phosphate mine operators who nodulize, or sinter, rock for electric furnace feed. We ask only that the law be made specific in this matter in order that the taxpayer and the Treasury Department may have the same understanding of the intent of Congress.

A brief, discussing the matter in detail, is attached for your information.

Yours very truly,

JAMES M. GILLET,
Assistant to the President.

BRIEF OF VICTOR CHEMICAL WORKS

It is respectfully requested that section 613 (c) (4) (E) of the proposed Internal Revenue Code of 1954 be amended as follows: Subsection (4) (E), after the words "burning of magnesite", add the words "and the sintering and nodulizing of phosphate rock".

The sole purpose of the amendment is to clarify the meaning of the term "ordinary treatment process" as applied to phosphate rock in determining percentage depletion, so that the miner of phosphate rock may have a definite basis for determining his proper tax.

Phosphate rock is a mineral being mined in the States of Florida, Tennessee, Montana, Idaho, Wyoming, and Utah. It is the source of all phosphorous for foods, animal foods, plant foods, and industrial purposes. It is utilized in three general processes: first, by drying, grinding, and application to the soil as a plant food; second, by treatment with acids and other chemicals (wet processing) for the production of soluble plant foods and industrial chemicals; and third, by smelting in an electric furnace to liberate elemental phosphorous which is in turn converted to agricultural, industrial, and food chemicals. The first two general uses require rock of high phosphorous content and relatively free from impurities. This type of rock is mined and prepared by the ordinary treatment processes including washing, beneficiating, and drying of the rock as taken from the ground.

The electric-furnace process requires phosphate rock which is in either a small

lump form or which has been agglomerated by sintering or equivalent treatment. The supply of rock which is naturally in the form of small lumps is extremely limited, and is sufficient to supply the needs of only a small percentage of the phosphorous-producing industry. Eighty percent or more of the phosphate rock used in electric furnaces is so finely divided that it is not usable as a raw material until it is agglomerated by sintering to convert the fine particles into lumps.

For economical sintering the rock must have a relatively low melting temperature, which requires the presence of impurities, such as silica and alumina in quantities which would be objectionable if the rock were used for wet process treatment or as fertilizer. Such rock which is unsuitable for wet processing is of value only as furnace feed, and then only after sintering or equivalent agglomerating treatment.

In former years there was no mining of this low-grade phosphate rock except that incidental to the mining of high-analysis rock for wet process and fertilizer use, when it was sometimes unavoidably obtained as overburden or as refuse from the principal mining operations. With the advent of the phosphorous furnace processes, however, the material became of value for furnace use. With the dwindling of supplies of high-grade rock, the mining of low-analysis rock is now being carried on intentionally and in increasing amounts. Deposits which were formerly considered worthless are now of economic value. The development of the furnace process using low-grade rock has thus served to conserve the increased supply of high-grade rock. It has added greatly to the income of private landowners and to the revenue of the United States Government in the form of royalties from the mining of phosphate deposits formerly considered worthless, on private and public lands.

The operation of an electric furnace requires a burden sufficiently porous to permit the escape of phosphorous gases and the proper movement of the burden into the melting zone. These low-analysis phosphates, which are naturally in finely divided form, cannot be used in the furnaces until they have been sintered. It is obvious, therefore, that the sintering step applied to phosphate rock for furnace use is an "ordinary treatment process" within the meaning of the Internal Revenue Code.

"Ordinary treatment processes" as applied to phosphate rock are not specifically defined in the present law nor in the proposed revision. Since no formal ruling of the Commissioner of Internal Revenue has issued on the subject and further, since such a ruling, if issued would always be subject to reversal, it is earnestly requested that the code be amended to put an end to the uncertainty and to permit the taxpayer to know he has made a correct calculation of percentage depletion.

Percentage depletion in the case of furnace-grade rock has, in the past, been calculated generally on the assumption that sintering is properly an ordinary treatment process, and taxes have been paid upon this basis; it is believed, therefore, that the amendment requested would not affect the revenue of the Government. It would, however, remove uncertainty as to the intent of Congress and would provide an adequately defined basis for the calculation of percentage depletion.

Mr. GILLET. Section 613 refers to percentage depletion. Subsection C defines the gross income from the properties on which that percentage depletion is figured, and under that section there is a definition of the term, "mining," which says that mining includes "not merely the extraction of ores and minerals from the ground, but also the ordinary-treatment processes normally applied by mineowners and operators in order to obtain the commercially marketable mineral product or products."

It is this matter of ordinary treatment processes that has never been defined for phosphate rock.

Later on in the section, these ordinary treatment processes are specified for certain of the minerals, but they are not in the case of phosphate rock, and that leaves that matter a matter for administrative determination, with the possibility that the present feeling of the Treasury Department may be reversed at any moment, and some future administrator may reverse something that has previously been

done. The taxpayer never knows when his income tax is filed, whether he is filing it on the correct basis or not.

We have discussed this with some of the Treasury people and they think we are right. Others may not think so.

The CHAIRMAN. Have you discussed it with our staff?

Mr. GILLET. We have discussed it with the staff, yes, sir.

The matter that I am referring to principally is the sintering of phosphate rock. Phosphate rock, as you know, is mined in Florida and Tennessee, Colorado, Montana, Idaho and a good deal of it is made in the manufacture of elemental phosphorus. In order to use this rock in the production of phosphorus it is necessary that it be in lump form. The powdered, low-grade phosphate rocks, unless they are made into lump form, will not function in the furnace.

Originally most of the phosphorus was produced from high-grade rock which was mined as pebbles or as plate in Tennessee, but since the growth of the phosphate industry the supply of the lump rock is not enough for the industry.

It has been necessary for us to go to the use of low-grade rocks, which, incidentally, have no other use at all, except in the production of phosphorus and to treat those rocks by sintering, in order to make big particles out of little ones.

This is a sample of phosphate rock as it comes out of a mine we have in Montana. That mine was opened up originally for the purpose of getting fertilizer-grade rock. The owners found that they could not sell the rock because it was of such low quality. We were able to buy it and by sintering the product, converting that fine material into this type we find we can use it successfully in the furnace.

The income-tax returns are being filed now on the basis that sintering is an ordinary treatment process. It is not one of those processes which is banned in certain parts of the act, and therefore it would not make any change in the revenue that the Government receives. By specifying, though, that sintering isn't an ordinary treatment process for phosphate rock we believe we can avoid possible difficulties later on with the Treasury Department which would be of benefit to the Treasury as well as to us.

The CHAIRMAN. Is it a common practice to sinter that rock, by other companies?

Mr. GILLET. It is, yes, sir.

The CHAIRMAN. It is a general commercial practice?

Mr. GILLET. Those who make phosphorus, yes, sir.

We would request, then, that subsection E—that is the last item in section 613—be amended by addition of the words "by the sintering and nodulizing of phosphate rock."

Some people say they are sintered and others say nodulized, but it is the same thing.

The CHAIRMAN. What is the sintering process?

Mr. GILLET. As we apply it, it consists of putting the powdered rock into a kiln, a rotary kiln where it is heated by a gas flame from natural gas, or byproduct gas, or powdered coal. As it passes down through the kiln it warms up and gradually gets sticky. When it reaches the bottom of the kiln it is hot enough for these small particles to stick together. Those are discharged onto a moving grate where they are treated with a blast of air to cool them and they are then

ready to put on the stockpile for use as a raw material in the production of phosphorus. There is no chemical change involved and it is merely a physical operation.

This amendment to the act, if it can be put in, would greatly simplify our problems in reporting our tax returns.

The CHAIRMAN. Thank you very much, indeed.

Mr. Williamson.

STATEMENT OF JOHN C. WILLIAMSON, NATIONAL ASSOCIATION OF REAL ESTATE BOARDS, WASHINGTON, D. C.

Mr. WILLIAMSON. Mr. Chairman, my name is John Williamson. I am secretary counsel for the Realtors' Washington Committee, National Association of Real Estate Boards. I have here a statement I would like to insert for the record. It covers four points, one relating to capital gains treatment of gain derived from sale of real estate held by real-estate dealers for investment. Another relating to depreciation, and a third relating to tax exemption of income placed in a retirement fund by self-employed persons, and the fourth relating to accrual of real property taxes.

Because of the importance of the capital gains section which is section 1237, I would like to devote the principal portion of my time to that section and read a brief summary of that part of the statement relating to capital gains.

The CHAIRMAN. The statement will be includedd in the record.

Go ahead.

(The statement referred to follows:)

STATEMENT OF JOHN C. WILLIAMSON, SECRETARY-COUNSEL, REALTORS' WASHINGTON COMMITTEE OF THE NATIONAL ASSOCIATION OF REAL ESTATE BOARDS WITH RESPECT TO H. R. 8300, INTERNAL REVENUE CODE OF 1954

CAPITAL GAINS TREATMENT FOR DEALERS IN REAL ESTATE

Mr. Chairman and members of the committee, I am John C. Williamson, secretary-counsel of the Realtors' Washington Committee of the National Association of Real Estate Boards. This committee is the legislative committee of the National Association of Real Estate Boards. Our association consists of more than 51,500 realtors and realtor firms which include more than 300,000 persons actively engaged in the business of selling real estate as well as all other phases of the real-estate industry. These realtors and realtor firms are members of 1,151 local real estate boards in all 48 States.

Section 1237 of H. R. 8300, the pending Internal Revenue Code of 1954, prescribes rules under which an unincorporated dealer in real estate will be recognized to have an investment in real property and, upon sale or exchange, to have any loss and that part of any gain in excess of 5 percent of the selling price subject to the general provisions of subchapter P of the new code, relating to capital gains and losses.

Section 1237 seems to be responsive to the suggestions received by the staff of the Joint Committee on Internal Revenue Taxation from the survey[1] conducted by the staff prior to the general revenue revision hearings before the Committee on Ways and Means and to the apparently convincing testimony presented at the hearings that existing law, at least in its administration, is discriminatory against investments in real estate.[2] The criticism expressed may, perhaps, be briefly summarized as follows:

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[1] Preliminary Digest of Suggestions for Internal Revenue Revision, prepared by the staff of the Joint Committee on Internal Revenue Taxation, April 21, 1953, pp. 89-90.

[2] Hearings, pt. 2, 1013-1015, 1028-1032, 1038, 1061-1063, 1115-1124, 1164-1167.

(1) While dealers in other types of property, including dealers in securities,[3] may make investments in property like that which they hold for sale or for use in their business, dealers in real estate are subjected to an ever-increasing burden of administrative controversy with the Internal Revenue Service and litigation in the courts to establish their claim to capital gain treatment for real property held by them for investment.[4]

(2) Taxpayers engaged in another trade, business, or profession who may never have been in the business of buying or selling real estate and who may have held a tract for a long term of years during which the value of the property gradually increased, may find it advisable in liquidating their investment to sell it in smaller parcels with the hazard of being charged by the examining internal revenue agent with engaging in the real estate business and receiving gain fully taxable as ordinary income.[5]

Both problems arise out of the difficulties in determining under existing law and Treasury Regulations whether real estate sold by the taxpayer was a bona fide investment or was property held primarily for sale to customers in the ordinary course of his trade or business. The regulations (Regulations 118, sec. 39, 117 (a)-1) have accentuated the first problem by giving the case of a dealer in real estate as an example of a taxpayer which may be in realization of "gain or loss upon the sale or exchange of land primarily for sale to customers in the ordinary course of his business." This language has doubtless led some internal revenue agents to the erroneous conclusion that a dealer in real estate can never simultaneously be an investor in real estate. The courts have held to the contrary, but the heavy volume of litigation continues. There are now pending in the Tax Court alone approximately 35 docketed cases[6] in which the issue is whether real property sold by the taxpayer was a capital asset.

Section 1237 of the bill obviously represents an earnest effort to study and evaluate the impact of the existing discrimination against investment in real property. The report of the Committee on Ways and Means stresses the divergence in treatment between securities investments by dealers in securities and real-estate investments by dealers in real estate.[7] Section 1236 of the bill, however (relating to dealers in securities), which corresponds to section 117 (n) of the existing code, is in sharp contrast with section 1237. Section 1236 recognizes that a dealer in securities can invest, subject to requirements of clear identification as an investment on his records, in securities and can obtain capital-gain treatment if he keeps the investment for more than 6 months.

A dealer in real estate, however, under section 1237 must not only clearly identify real property as held by him for investment, but must hold it for more than 5 years—10 times as long as other investments must be held to receive capital-gain treatment. It may be suggested that investment in real estate is different, yet a dealer in real estate who forms a corporation to hold title to his property would be subject only to the 6-month holding period upon the sale of the stock in the corporation. Moreover, even under present law, taxpayers have been repeatedly successful in establishing their right to capital-gain treatment in cases in which the holding period was less than 5 years.[8]

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[3] Sec. 117 (n) of the Internal Revenue Code of 1939.

[4] See statement of Hon. Edgar W. Hiestand, hearings before Committee on Ways and Means on general revenue revision (1953), pp. 1013–1014; John C. Williamson, counsel, Realtors' Washington Committee, pp. 1164–1167. Examples of court decisions in which real-estate dealers have been forced to litigation to establish their right to capital-gain treatment of investments in real property are the following: *Nelson A. Farry et ux.* (13 T. C. 8 (1949)); *R. H. Hutchinson* (8 T. C. M. 507 (1949)); *S. Franklyn Woodcock* (9 T. C. M. 981 (1950)); *Malouf et al.* v. *Riddell* (52–1 U. S. T. C., par. 9296 (D. C., S. D. Calif., 1952)); *Walter R. Crabtree* (20 T. C. No. 120 (1953)); *Gabriel Leeh* (12 T. C. M. 256 (1953)); *Victory Housing No. 2, Inc.*, v. *Commissioner* (205 F. 2d 371 (C. A. 10, 1953)). In the Crabtree case, supra, Judge Rice observed: "The evidence is clear in this case that the nature and extent of petitioner's business puts him in the dual role of both a dealer and an investor in real estate."

[5] See statement, Hugh M. Bennett, hearings, Committee on Ways and Means, pp. 1115–1124.

[6] Commerce Clearing House Tax Court Reporter, Petitions Index, p. 7004.

[7] H. Rept. No. 1337, p. 84.

[8] Nelson A. Farry, 13 T. C. 8 (1949), Acq. 1950–1 C. B. 2. (In 1944 taxpayer sold 19 of his rental properties, 17 of which were held for 2 years or less, yet the court held on the evidence that he was entitled to capital-gain treatment although a dealer in respect of other real estate); *S. Franklyn Woodcock*, 9 T. C. M. 981 (1950). (Property purchased by a real-estate dealer for rental but held approximately 8 months was held taxable as capital gain.)

A further requirement under section 1237 is that no substantial improvement may have been made during the period it was held by the taxpayer. Such a prohibition would place a premium upon slothfulness and irresponsibility in the ownership and maintenance of large tracts of real property and discourage additional capital investment over a long period of time when such improvements can be made at greatest civic and economic advantage. For example, an investor in real estate may wish to embark upon a program of clearing, leveling, or drainage in a period of declining prices. Or such an investor may find it desirable to install a sewerage system at a time when a municipality is extending its sewer lines. Or, without effort on his part, a new State highway or paved road might be constructed across his land. Section 1237 (b) (2) would appear to prohibit such improvements, however, if the benefit of section 1237 (a) is to be obtained.

Section 1237 is inapplicable to investments by incorporated dealers in real property. It is difficult to understand this exclusion of corporations, since corporations and other taxpayers are generally accorded similar treatment with respect to gains and losses from the sale or exchange of capital assets, or from the sale or exchange of property used in the trade or business. This is true both under existing law and under H. R. 8300. Moreover, the most closely comparable provision with section 1237 is section 1236, relating to dealers in securities, which contains no prohibition against corporations. The corporate exclusion is perhaps less justified in cases of dealers in real property than in the case of dealers in securities, for the corporate form is especially adaptable to long-range investment in relatively large tracts of real estate. This is true because of the amount of capital frequently required both for acquisition of such an investment and for the payment of local real-estate taxes and other charges pending utilization of the property.

Other provisions of section 1237 which concern real-estate dealers are the following:

1. Even though all the restrictive requirements of section 1237 (b) are satisfied to demonstrate beyond a shadow of doubt that real property of a real-estate dealer is a bona fide investment, he can never receive capital-gain treatment for that part of the gain which is 5 percent of the selling price. If property is a capital asset, the entire amount of the gain or loss should be capital gain or loss. Furthermore, the 5-percent rule seems hardly to conform with a program of simplification.

2. If a dealer in real estate, in order to fortify his position that real property is held by him for investment under present law, has identified the property as held for investment, it is not clear whether such identification, even though accomplished long before consideration began on the current revenue revision, might subject him to the limitations of section 1237.

Although real-estate dealers with investments in real estate are appreciative of the time which has already been devoted to their request for fair and equitable tax treatment, we believe that section 1237 of the bill would create many new problems without actually solving the problems under existing law. While the burdens of potential controversy and litigation are now very substantial, they are at least balanced, if not outweighed, by those which are presented by section 1237. The best solution, in our opinion, if taxation of gains and losses from real-estate investments comparable with treatment of gains and losses from investments by dealers in other property is to be attained, is a flat holding period of 6 months. If the enactment of such a provision cannot be favorably considered by your committee, we urge that section 1237 be deleted from the bill in order that the entire subject may be given further study by the staffs of the joint committee and the Treasury Department, with further opportunity for consultation with the taxpayers so vitally affected.

If the committee should conclude, nevertheless, that some legislation in the pattern of section 1237 is desirable, we respectfully submit the attached draft of amendments to make clear that the section does not adversely affect the rights of real-estate dealers now available to them. It is our considered opinion that section 1237, if enacted in its present form, would increase the uncertainties in the tax treatment which real-estate dealers now are experiencing, would accentuate the discrimination against bona fide investments in real estate by real-estate dealers under existing law, and would not only fail to correct any existing inequity in the law but would go far toward compounding and aggravating the existing one.

PROPOSED AMENDMENTS TO SECTION 1237 OF H. R. 8300

(New language is italicized and language deleted is in brackets)

1. Amend subsection (b) (1) to read as follows:

"(b) REQUIREMENTS WITH RESPECT TO THE PROPERTY. * * *

* * * * * * *

Subsection (a) shall apply to real property if—

"(1) *After the date of enactment of this act, but* before the expiration of the 30th day after the date of its acquisition or before the expiration of the 90th day after the date of enactment of this title, whichever is the later, *the taxpayer has elected to have the gain taxed in accordance with the provisions of this section and* such real property has been clearly identified (*such election and identification to be made* in the manner prescribed by the Secretary or his delegate or, in the absence thereof, in the taxpayer's records) as real property held for investment; and"

2. Add as subsection (f) the following:

"(f) EFFECT OF FAILURE TO ELECT AND IDENTIFY. *In case of the sale or exchange of property as to which the taxpayer has not made the election and identification prescribed by the provisions of subsection (b) (1), none of the provisions of this section shall apply to the determination of taxable gain or deductible loss.*"

3. Redesignate subsection (f) as subsection (g) and amend it to read as follows:

"(g) EFFECTIVE DATE. This section shall apply only with respect to sales of property occuring after [March 15, 1954] *the date of enactment of this Act.*"

CHANGE IN TAX DEPRECIATION RATES

Section 167 provides for a liberalization of depreciation policy with respect to both the estimate of the useful life of property and the method of allocating the depreciable cost over the years of service. We believe that the application of the double-rate declining-balance depreciation method on property constructed after December 31, 1953, on new property acquired by the taxpayers after that date, will provide a fair measure of incentive for the replacement generally of obsolete structures which will inure to the benefit of the economy.

TREATMENT OF USED REAL ESTATE

While we appreciate the motivations which limit the application of the double-rate declining-balance formula to new construction, we respectfully submit that the exception of used real estate from this formula is most unfortunate and fails to take fully into account the peculiar characteristics of real estate, which over the period of its long useful life changes hands several times, and the continual necessity for maintenance of the property over its useful life by its successive owners—a degree of maintenance which is not comparable to that of machinery and equipment because of the latter's much shorter life.

Our association estimates that at least 80 percent of existing income property, rental, commercial, and industrial, was acquired by its present holders as used property. The denial of the double-rate declining-balance depreciation method to used real estate represents therefore a substantial discrimination.

From our study of the House report on the general tax revision bill we conclude that the principal basis for the exclusion of used real estate is the desire to minimize transitional revenue losses but still obtain maximum incentive effort; hence, the impropriety of permitting the doubling of the remaining life straight-line rate on such acquisitions. While we recognize to a degree the valid reasoning behind the exclusion of used real estate, we nevertheless believe that the remedy is altogether too harsh. Why not permit the declining balance depreciation, at the option of the subsequent purchaser, at twice the full-life straight-line rate (the rate computed on the sum of the expired life and remaining life)? We believe that this meets the principal objections to the inclusion of used buildings and used rental property, yet provides the incentive to maintenance of the property which is at least equally if not more important to our economy as is the stimulus for new construction, the avowed purpose of the House-approved change which we believe falls short of its target.

LIBERALIZED DEPRECIATION METHODS AS AN AID TO SLUM CLEARANCE

The committee is aware of the housing message of the President early this year which underscored the tremendous problem faced by the cities of our

country in eliminating slums and preventing the spread of blight and urban decay which are having telling effect on the health, morals, and safety of millions of our people. Millions of dollars have been expended by Federal, city, and State governments on this program, yet, according to the President's Advisory Committee on Housing Policies and Programs, it will take at least 200 years to do the job at the present rate. New methods, new techniques, new incentives, and broader vision are required to cope with this problem, and we note with satisfaction that the President in his housing message and the Congress in the housing bill now pending in the Senate are preparing to meet to a substantial degree this growing challenge.

Our association, too, in its build America better program is reaching down into the neighborhoods of our cities to meet the problem of slum prevention and neighborhood conservation with such tools as may be brought to bear against this problem by State and local governments and civic groups.

The President's Advisory Committee made one recommendation similar to one that is part of our build America better program, which we believe will materially assist in bringing about the demolition of slum dwellings. The Advisory Committee (p. 125) said:

"Under present rules when an obsolete property is demolished, the residual value ascribed to the building and the cost of demolition is considered to be part of land value and cannot be depreciated for tax purposes. This policy obviously deters the removal of obsolete structures."

Recommendation No. 14 (b) of the President's committee is as follows:

"Code enforcement should be employed to the fullest extent possible to achieve without compensation, compulsory demolition of dwellings unfit for human habitation and too far gone to be rehabilitated. This opportunity would be enhanced if, in the event of such demolition, *the residual value ascribed to the building and the cost of demolition were, for tax purposes, allowed as depreciation instead of being added to land value.*" [Emphasis supplied.]

We recommend therefore the approval of an amendment to the proposed bill as follows:

"SEC. —. Amortization deduction for demolished structures. Every person, at his election, shall be entitled to a deduction with respect to the amortization of the residual appraised value of any structure demolished within an urban renewal area so certified as such by the Administrator of the Housing and Home Finance Agency, plus the cost of demolition of such structure, based on a period of 60 months. The 60-month period shall begin as to any such demolished structure, with the month following the month in which the facility was demolished."

LIBERALIZED DEPRECIATION ALLOWANCES AS AN AID TO URBAN RENEWAL

The problem of replacing blighted or obsolete structures is as important to the renewal of our urban areas as is the demolition of the structures themselves.

The Blueprint for Neighborhood Conservation, which is the working manual of our Build America Better Council, recognizes the problem in the following recommendation which appears on page 24 of the manual:

"In order to encourage maximum investment in new construction and capital improvement of existing structures in conservation programs, it is proposed that Federal revenue laws be amended to provide that when a neighborhood conservation area is legally created, thereafter the total cost of any new capital improvement made or erected in such an area may be depreciated for income-tax purposes, at the option of the taxpayer, at a rate of not to exceed 20 percent in any 1 year."

We wish to emphasize that the spread of urban decay and urban blight, while basically a local problem, has reached such grave proportions that the Federal Government since 1949 has found it necessary to assume the greater part (two-thirds) of the financial cost involved. The pending housing bill reemphasizes and redirects this program and outlines the basis for deeper commitments which will inevitably increase Federal financial participation.

The question properly arises as to the extent of future Federal involvement in programs which are essentially local in character, and our association as well as the Congress has from time to time earnestly set itself to the task of devising means whereby the local responsibility might be increased and the Federal responsibility decreased.

We seriously doubt that a formula could readily be devised to completely eliminate the Federal Government's role in this problem. However, we see in a change in the tax structure relating to depreciation the basis for an incentive

toward accomplishing the goal of urban renewal with a resultant diminished impact on the Federal Treasury. We propose that the emergency of spreading urban decay be met with emergency methods and we cite the precedent of "amortization deduction of emergency facilities" under the present law as an example of an effective approach to meeting an emergency such as the one we describe herein.

We recommend therefore that the pending tax revision bill be amended so as to provide a more rapid depreciation deduction of new capital improvements constructed in an urban renewal area, certified as such by the Administrator of the HHFA, based on a period of 60 months. We are confident that the approval of such an amendment would provide such a stimulant toward renewal of our communities that ultimately the Federal Government will be spared the necessity of spending untold billions in assisting the localities to meet this problem—as would be required by the continued utilization of existing methods. A proposed draft of such an amendment follows:

"SEC. —. Amortization Deduction.—General Rule.—Every person, at his election, shall be entitled to a deduction with respect to the amortization of the adjusted basis (for determining gain) of any dwelling, building, facility (including machinery and equipment), or of any part thereof, the construction, erection, or installation of which was completed after December 31, 1953, within an urban renewal area so certified as such by the Administrator of the Housing and Home Finance Agency, based on a period of sixty months. The amortization deduction above provided with respect to any month shall be in lieu of the deduction with respect to such structure for such month provided by section 167, relating to exhaustion, wear and tear, and obsolescence. The sixty-month period shall begin as to any such structure, at the election of the taxpayer, with the month following the month in which the facility was completed, or with the succeeding taxable year."

TAX EXEMPTION OF INCOME PLACED IN A RETIREMENT FUND

As an industry of generally self-employed persons we are rightfully concerned with the effect of the high level of progressive income taxes which makes it exceedingly difficult for such persons to plan properly for old age, possible retirement, or to provide for the welfare of dependents in the event of death.

We seek here the removal of an inequity in our tax structure which is discriminatory against the self-employed. Other sections of the Internal Revenue Code provide for tax benefits which operate to encourage corporation pension plans. Approximately 20,000 such approved plans are now in existence covering an estimated 10 million employees and executives. Participants in these plans under the code are not required to include their employers' contributions in their taxable income until pension payments are received. Contributions by employers are deductible from taxable income in the year made. There is no comparable legislation for the self-employed.

We urge that the committee give favorable consideration to the individual retirement plan set forth in the bill, H. R. 10, introduced in the House of Representatives by Mr. Jenkins of Ohio on January 3, 1953. Because the staff of the joint committee is familiar with the language of the bill I will not unduly burden the record of these hearings by making the proposed amendment a part of this statement excpet to review briefly its principal points which are as follows:

1. Any qualified individual may exclude from his gross income in any taxable year, subject to certain limitations, that portion of his earned income that he has contributed to a restricted retirement fund to be managed by a trustee or paid to a life insurance company as premiums under a restricted retirement annuity contract.

2. A "qualified individual" is defined as one not eligible to participate in a pension or profit sharing plan, qualified under section 501 of the proposed revision, or established by a governmental or charitable employer. It thus covers employees of corporations or partnerships which have no qualified pension fund. Even if eligible for pension benefits under a qualified plan, if an individual is also self-employed and more than 75 percent of his earned income results from that self-employment he is a qualified individual.

3. The amount deductible in each year cannot exceed 10 percent of his earned income or $7,500, whichever is less, except as set forth in the following special rule. The aggregate amount excludable is limited to $150,000.

4. (Special rule.) In the case of a qualified individual who before January 1, 1953, had reached his 55th birthday, the amount excludable shall be increased

by 1 percent of the taxpayer's earned income or $750, which ever is the lesser, multiplied by the number of full years in excess of 55 determined as of January 1, 1953, but not in excess of 20.

5. The bill provides for carryover to succeeding years any amount by which the authorized exclusion exceeds the amount actually paid during any taxable year.

6. Upon reaching 65 years of age or prior thereto in the event of permanent disability the taxpayer has the option of withdrawing the accumulated fund in annual, quarterly, or monthly installments, or by the purchase from an insurance company of one or more single premium annuity contracts, or in a lump sum. If the taxpayer elects to receive the sum on an installment basis he pays ordinary income tax rates on the amount received. If he elects to take his entire interest in the fund in a lump-sum payment—after accumulation for more than 5 years—he may treat the distribution as a long-term capital gain.

The principles of this amendment are in conformity with the following statement of President Eisenhower in his message to the Congress:

"There are over 10 million workers who cannot take advantage of these tax-relief provisions now offered to corporations and their employees. They include owners of small businesses, doctors, lawyers, architects, accountants, farmers, artists, singers, writers—independent people of every kind and description but who are not regularly employed by a corporation. I think something ought to be done to help these people to help themselves by allowing a reasonable tax deduction for money put aside by them for their savings. This would encourage and assist them to provide their own funds for old age and retirement."

In behalf of the National Association of Real Estate Boards we strongly urge that the general tax revision bill be amended by incorporating the principles of this retirement plan.

ACCRUAL OF REAL-PROPERTY TAXES

Section 461 (c) changes the rules for the accrual of real property taxes. Under present law, real-property taxes accrue on the date on which such taxes become a lien under local law. Under section 461 (c) of the bill, real-property taxes must be accrued ratably in each month of the year to which the tax applied.

Although the future effects of this provision may be desirable, as presently drafted it would produce a substantial distortion of taxable income for many real-property owners in the transition year.

To illustrate, in Pennsylvania, Virginia, Wisconsin, and numerous other States, real-property taxes for each year become a lien under local law on January 1 of such year. Under existing law, taxpayers accrue the full year's taxes on that date, regardless of their accounting period. Under section 461 (c) (2), in the transition year, fiscal year taxpayers may be deprived of as much as eleven-twelfths of the deduction of real-property taxes to which they would normally be entitled. Thus, a Pennsylvania or Virginia taxpayer on a January 31 fiscal year beginning February 1, 1954, could deduct only 1 month's real-property taxes on his return for the 12-month period ending January 31, 1955.

This section creates similar problems in New York and other States where taxes become a lien in the year preceding the year for which imposed. I understand these situations have been the subject of comment by other witnesses before the committee.

Whatever plan of accrual of real-property taxes is used, there is no justification for denying property owners the full year's deductions for real-property taxes in the transition year. If permitted to remain in the bill, section 461 (c) (2) would cause severe and undue hardship to many real-property owners. If it were eliminated from the bill, it would not result in tax avoidance, for no taxpayer will receive more than 1 year's deduction in any 12-month period.

Section 461 (c) is not a loophole-closing provision, but is designed to bring tax accounting into harmony with generally accepted accounting principles. As such, it is obviously misconceived in its present form, since it imposes substantive burdens far greater than the technical benefits it is designed to accomplish.

We recommend, therefore, that section 461 (c) (2) be deleted from the bill, since it would limit the deduction of taxes previously accrued. If this limitation is not deleted, we urge most strongly that the provision be made elective rather than mandatory.

Mr. WILLIAMSON. 1237 of the bill obviously designed as a relief provision to meet the criticism made by witnesses in the House hear-

ings concerning the uncertainty of the application of the capital-gains provisions of existing law to the sale of investment real estate by real-estate dealers.

We feel that the section as drafted will not reduce the area of uncertainty but, on the contrary, will increase that area and will therefore increase the volume of litigation in this field. The complaints of the witnesses in the House hearings related primarily to two situations where the present law has produced an irritatingly large volume of litigation. Namely, (1) the case of a dealer in real estate who carries real estate as stock in trade, buying and holding it for sale to customers as a business, but who buys other real estate as an investment. While dealers in other types of property, notably security dealers, may earmark such an investment and get capital-gains treatment when the investment is liquidated, the real-estate dealer is finding it increasingly difficult to do so because of the attitude of the internal revenue service.

(2) Then there is the case of the man who is engaged in some other trade, business, or profession, who has invested his savings in real estate. When it comes to the point of liquidating his investment, if he finds it more advisable to sell the land in smaller parcels he is branded by the revenue agent as a dealer and his gains are claimed to be taxable as ordinary income. This taxpayer usually must resort to expensive litigation to get his rights recognized. If he held a large block of corporate stock, however, and sold it in small lots to avoid depressing the market price, his right to capital-gains treatment would not be questioned.

For the reasons set out in detail in our written statement, section 1237, while apparently intended to help taxpayers in these two classes, does not do the job. In summary these reasons are:

(1) While statements in the committee report indicated that if a taxpayer does not elect to come under the new provision, his rights under existing laws will not be impaired. The statutory language does not make this clear. In fact, in the committee report on pages 82–84 the House Ways and Means Committee cites two cases as an example of how a dealer under existing law can still qualify for capital-gains treatments.

The two cases are the Carrol and the Weinman Realty cases as examples of how a dealer under existing law could still get capital-gains treatment on property that he held for investment.

In reading those two cases the court emphasized the fact that the taxpayers were not dealers or brokers in real estate. That gives some basis for our anxiety that this section 1237, although it is intended to relieve an inequity, actually removes what benefits a dealer might obtain from existing law.

(2) If prior to the introduction of this bill in the House the taxpayer recorded the intention to hold property for investment, he has no choice but is made subject to the restrictions of a provision which was not in existence when he made that book entry.

(3) Without explanation or any rational justification that we can see, the new section does not apply to dealers who do business in corporate form. No such distinction appears in the section covering security dealers.

(4) Section 1237 provides that the making of substantial improvements, a term which the bill does not even attempt to define, will change the markets of investment property to that of stock in trade. If the

taxpayer replaces a leaky roof or installs an elevator, or air-conditioning equipment in rental property, he loses his right to claim that the property is held for investment. The same result follows if he is holding undeveloped land for investment and he clears, levels, or drains it.

(5) The holding period is extended from the 6 months applicable to other types of property, to 5 years, a tenfold increase.

(6) Even if the taxpayer meets all the restrictive qualification of section 1237 he gets only a part of the relief to which he is entitled. Under existing law on the sale of an investment all gain is taxable under the capital-gains provision, under section 1237, 5 percent of the sales price, less selling expense, if any, is automatically taxed by this bill as ordinary income.

(7) The section will result in a windfall for the 1 taxpayer who is clearly not entitled to relief, a dealer who has carried property for 5 years as stock in trade without making any improvements. He may now make a designation on his books, which is clearly contrary to the facts—that is, investment property—and convert ordinary income into capital gain.

For these reasons we urge: (1) That the holding period be reduced from 5 years to 6 months as is the case with other capital assets. (2) If, however, the committee cannot agree to this proposal we suggest that section 1237 be deleted from the bill and the whole subject matter be given further study. (3) Should the committee insist that legislation on this subject be included in the bill, we strongly urge that section 1237 be amended, at the very least, to make clear that the taxpayer who does not deliberately elect to subject himself to the burdensome conditions of this section will have his rights under existing law preserved. The form of amendments to accomplish this are attached to our written statement filed herein.

Now, Mr. Chairman, I cannot overemphasize the importance of our contention that this section although designed to remove an inequity, actually aggravates the existing one.

The Wall Street Journal on April 14 in its tax report column, in discussing this 1237 headlines it as follows:

Capital Gains Rules for Real Estate Dealers Would Be Stiffer.

You can imagine what repercussions that has had in our industry because originally the section was put in the bill to relieve an inequity and the House report states clearly that the real-estate dealer is getting something here that he doesn't have under existing law.

The CHAIRMAN. Has the staff considered that?

Mr. SMITH. We have gone into it with him.

Mr. WILLIAMSON. We have had consultations with the staff.

I would like to discuss 461 (c), regarding accrual of real-property taxes. This section changes the rule for the accrual of real-property taxes. Under present law real-property taxes accrue on the date of which such taxes become a lien under local law.

Under section 461 (c) of the bill real-property taxes must be accrued ratably in each month of the year to which the tax applies. Although the future effects of this provision may be desirable as presently drafted it would produce a substantial distortion of taxable income for many real property owners in the transition year.

To illustrate, in Pennsylvania, Virginia, Wisconsin, and numerous other States, real-property taxes for each year become a lien under local law on January 1 of such year. Under existing law, taxpayers accrue the full year's taxes on that date, regardless of their accounting period.

Under section 461 (c) (2) in the transition year, fiscal year taxpayers may have been deprived of as much as eleven-twelfths of the deduction of real-property taxes to which they would normally be entitled. Thus, a Pennsylvania or Virginia taxpayer, on a January 31 fiscal year, beginning February 1, 1954, could deduct only 1 month's real-property taxes upon his return for the 12-month period ending January 31, 1955.

Now, we recommend that section 461 (c) (2) be deleted from the bill since it would limit the deduction of taxes previously accrued. If this limitation is not deleted we urge most strongly that the provision be made elective rather than mandatory.

Mr. Chairman, this came to our attention within the last week and I have not had the opportunity to consult with the staff, although I understand that other witnesses have discussed the difficulty raised by this particular section.

Mr. SMITH. That is right.

Mr. WILLIAMSON. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you all very much for coming.

We will meet at 10:30 in the morning.

(By direction of the chairman, the following is made a part of the record:)

STATEMENT ON H. R. 8300 BY THE LAKE SUPERIOR IRON ORE ASSOCIATION

The Lake Superior Iron Ore Association represents most of the producers of iron ore from Minnesota, Michigan, and Wisconsin. These States normally produce about 80 percent of the iron ore consumed by the blast furnaces and steel plants of this country.

The members of this association consider that the proposed revision of the Internal Revenue Code is a substantial improvement over the existing code. We have not had an opportunity to consider all phases of this entire bill, but have concentrated our attention on those provisions of particular interest to the iron-ore industry. Later experience with provisions of the bill may indicate the need for further change and there should be a willingness to make such changes when the need becomes evident.

We urge that you consider the following amendments to certain provisions of H. R. 8300 which are confined to some of the problems of particular importance to the iron-ore mining industry.

1. DEFINITION OF PROPERTY

Under section 614 (b) (1) provision is made for election to aggregate separate interests for purposes of computing percentage depletion. Such an election should be permitted both for purposes of percentage depletion and for purposes of cost depletion.

The rule as stated permits but one aggregation within a single operating unit. It should be made clear that a separate right of election exists in respect to each operating unit. Also, it may be desirable to form more than one aggregate within a single operating unit and we urge that the taxpayer should be permitted to elect to form one or more aggregations of mineral interest within each operating unit.

Section 614 (b) (2) relating to the manner of his election appears to subject the taxpayer to unreasonable restrictions. In the interest of simplified administration we believe that once the taxpayer has established his property aggregate by making an election, he should continue to recognize that aggregation so long as conditions which dictated the election remained unchanged.

However, the taxpayer should be permitted a new election when changing circumstances demand a defferent aggregation. Among the changes which would permit a reconsideration of the properties included within a particular aggregate are the following:

(*a*) Where additional properties are acquired or previously owned properties are disposed of which could reasonably affect the makeup of the aggregate.

(*b*) Where properties which had not yet reached the production stage at the time of election were included in an aggregate but where, after reaching the production stage, additional fact become established which indicate that such property should not reasonably constitute part of such aggregate; or if not previously included in an aggregate that such property should be included in an aggregate.

(*c*) Other material changes in the circumstances which might dictate a different aggregation of properties than was indicated at the time that the original election was made.

If the taxpayer is permitted to make the same aggregation both for cost and percentage depletion purposes the provisions relating to allocation of depletion allowances included under section 614 (b) (4) and the last sentence of section 613 (a) appear to be superfluous.

2. PERCENTAGE DEPLETION OF WASTE PILES

Section 613 (c) (3) and section 381 (c) should be clarified to state the right of an acquiring corporation to take percentage depletion upon the extraction of ores or minerals from the waste or residue of prior mining in the case of a taxfree reorganization. Similar clarification is needed with respect to extension and renewal of leases where both the deposit of the waste or residue and the extraction do not occur within the period covered by one lease instrument.

3. DEPRECIATION

We understand that it was the intent to allow mining companies the right to also use the methods of depreciation provided under section 167. We request that subsection (h) be revised to clearly state that mining companies will be allowed to determine depreciation under the methods provided in section 167 as well as those contained in section 611.

4. ADVANCE MINIMUM ROYALTIES

No reference is made to H. R. 8300 to advance minimum royalties. Under regulation 118, section 39.23 (m)-10, the taxpayer is bound by an election in the first taxable year ending on or after December 31, 1939, in which such amounts are paid or accrued as to the treatment of minimum royalties in subsequent years. National security demands sufficient reserves of iron ore to insure an adequate supply of raw materials. If we are to maintain full capacity steel production in the event of emergency, this requires the maintenance of large reserves of iron ore which in turn means material increases in the payment of advance mineral royalties. The taxpayer therefor should be permitted an election with respect to advance minimum royalties which will permit the taxpayer to deduct such costs for any mineral property in the year paid or accrued or to defer the deduction to the year in which the mineral product in respect to which the advanced royalties were paid is sold.

We recommend that a taxpayer be permitted to make a new election with respect to advance minimum royalties for each mineral property in which he owns interest during the taxable year 1954. For properties acquired after January 1, 1954, election should be made in the tax return filed for the year of acquisition.

5. EXPLORATION EXPENDITURES

We have recommended in the past and feel strongly that both the present revenue law and H. R. 8300 do not give adequate recognition to the cost of present day exploration. Most easily discovered mineral deposits—especially those of iron ore—have been found and from now on the expenses of exploration will greatly exceed those of the past. If the necessary reserves of iron ore are to be maintained, exploration must be encouraged. Section 615 allows as a deduction only $75,000 a year for 4 years for each taxpayer. This amount does not begin to cover cost of iron-ore explorations for deep underground mines or large

deposits of low-grade iron ore. Previous statements before the Ways and Means Committee have emphasized the importance of encouraging iron-ore exploration and we feel that the maintenance of adequate iron-ore reserves has enough national significance that we should bring the matter to your attention. We therefore urge the removal of the $75,000 annual and the 4-year limitation, in order to permit expenditures incurred in prospecting to be deducted as an expense either in the year incurred or at the taxpayer's election, deferred and written off against resulting ore, or deducted when there is no reasonable expectation of resulting production.

Respectfully submitted.

FRANKLIN G. PARDEE, *President.*

APRIL 19, 1954.

Re H. R. 8300

To the Chairman and Members of the Committee on Finance,
United States Senate, Washington, D. C.

GENTLEMEN: The undersigned respectfully submit herewith our views on the tax on corporations improperly accumulating surplus, and ask that this statement be included in the record of hearings by your committee.

Sections 531 to 536 of H. R. 8300 levy a tax on corporations improperly accumulating surplus. There sections correspond to section 102 of existing law. The tax is a penalty tax levied upon all the undistributed earnings for a taxable year if the corporation was formed or availed of to avoid income tax on its shareholders by permitting earnings and profits to accumulate instead of being paid out in dividends.

Several amendments are incorporated in the new bill in order to minimize the inherent threat of this tax where funds are accumulated for legitimate business purposes, to exempt publicly held companies and small corporations. The amendments are generally helpful, but they do not remove all of the inequities of section 102.

Publicly held corporations

The bill exempts a publicly held corporation from this tax. A publicly held corporation is defined as one whose outstanding stock is held by more than 1,500 persons with not more than 10 percent of the total voting power or total value of all outstanding stock owned by any one individual. For the purpose of the 10-percent test, stock owned by an individual's relatives, partners, etc., will be attributed to the individual. In order to obtain the exemption, proof must be submitted in accordance with regulations to be issued.

The purpose of this provision is to exempt corporations which could not be used by a limited group to avoid tax by nonpayment of dividends. It seems doubtful, however, whether many widely held companies will be able to obtain the necessary information to satisfy the 10-percent test. If a corporation's shares are traded in actively, there may be a large number registered in the names of brokers. Similarly, many shares are held in custody accounts by banks and brokerage houses and registered in the name of the custodian. As a general rule the custodian will not disclose the name of the owner in such cases. Accordingly, a corporation whose shares are widely held may be unable to prove the identity of the owners of more than 10 percent of its stock.

Since it is the directors who determine a corporation's dividend policy, there would seem to be adequate protection if the 10-percent test were applied only to directors. A corporation can obtain the facts from its directors as to their stock ownership. If further protection is needed to prevent the use of dummy directors by a closely held company, it is suggested that 25 percent ownership by stockholders other than directors would be an adequate test.

All undistributed earnings are taxed

The penalty nature of the tax is emphasized by its imposition on an all-or-nothing basis. A corporation must show that every dollar of undistributed earnings was accumulated for a legitimate business purpose. If it fails, the entire amount is subject to the tax, even though the major portion may not be subject to any question. As a result the tax may equal a penalty of nearly 100 percent of the part of the accumulated earnings found to be unreasonable. It would seem more equitable to allow a deduction for that part of the accumulation found to be necessary for business reasons.

Burden of proof

The bill shifts the burden of proof to the Secretary or his delegate if the taxpayer has filed a statement of the grounds (together with facts sufficient to apprise the Secretary of the basis thereof) on which the taxpayer relies to show that earnings were not accumulated beyond the reasonable needs of the business. The burden of proof is shifted only with respect to the grounds set forth in the statement.

This is an entirely proper procedural change in the case of a penalty tax. The burden of proof has been on the Government in cases where a fraud penalty is asserted ever since the Revenue Act of 1928.

Burden of proof—effective date

The bill provides that the new rule shall apply only to cases involving taxable years beginning after December 31, 1953, where a notice of deficiency is mailed more than 90 days after the date of enactment of the title. This is an unwarranted restriction since the change affects only procedure, not substantive law. Perpetuating the existing rule in cases involving prior years, whether now pending or initiated in the future, may produce results which the Ways and Means Committee found undesirable in several instances.

The new rule should be made effective in every case where no trial before the Tax Court has been held before enactment of the bill. There is precedent for such treatment in the effective date provided by the Revenue Act of 1928 for shifting the burden of proof in fraud cases to the Commissioner (Revenue Act of 1928, sec. 601, amending sec. 907 (a) of the Revenue Act of 1924).

Prior to the enactment of the Revenue Act of 1928, the burden of proof in all cases before the Board of Tax Appeals (except in respect of new matter pleaded by the Commissioner) was upon the taxpayer. (See *Louis Ginsburg*, 18 B. T. A. 417.) The 1928 act changed this rule by providing:

"In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, *where no hearing has been held before the enactment of the Revenue Act of 1928*, the burden of proof in respect of such issue shall be upon the Commissioner." [Emphasis supplied.]

Your committee stated:

"This change will affect proceedings in which hearings are held (by the Board of Tax Appeals) after the date of the enactment of the new act, even though the petition was filed prior thereto." (Report of Senate Finance Committee (70th Cong., 1st sess., S. Rept. 960) p. 38.)

The reasons given in the report of the Ways and Means Committee for shifting the burden of proof in cases involving the accumulated-earnings tax emphasize the desirability of applying the new procedure to pending cases. The committee found indications that deficiencies have been asserted in many cases which were not adequately screened or analyzed. Taxpayers have been put to substantial expense and effort in proving their cases. Complaints by taxpayers that this tax is used as a threat by revenue agents to induce settlements on other issues appear to have a connection with the imposition of the burden of proof on the taxpayer. Finally, the report stated:

"It also appears probable that many small taxpayers may have yielded to a proposed deficiency because of the expense and difficulty of litigating their case under the present rules" (p. 52).

Many cases may be pending in which imposition of the burden of proof on the taxpayer will produce such results. Despite the best efforts of the Commissioner, new cases will probably arise for years prior to 1954 in which taxpayers are penalized because of this procedural handicap. It seems indefensible to refuse this relief in pending cases, unless it would create administrative problems. It is worthy of note, however, that no such problems prevented immediate application of the same procedural change in 1928 as to fraud cases.

No administrative problems should be encountered by shifting the burden of proof in cases heard by the Tax Court after the bill is enacted. In cases where no deficiency notice has been issued, the Commissioner would merely be required to follow the new procedure. If a deficiency notice has already been issued, the taxpayer could be permitted to include the statement referred to in section 534 (c) of the bill in its original petition to the Tax Court, or by amendment thereto if the original petition has already been filed. If the case has been adequately considered before the deficiency notice was issued, the Government should already have sufficient facts to assume the burden of proof, or have no difficulty in obtaining the necessary additional information from the taxpayer's statement.

Subsidiary corporations

It is not clear under the new provisions whether a subsidiary (as defined in sec. 330 (h) of the new bill) would be considered liable for the tax because its retention of earnings avoided the income tax with respect to its corporate shareholder. To eliminate this uncertainty the phrase "with respect to its shareholders or the shareholders of any other corporation" in section 532 (a) should be amended to read: "with respect to its individual shareholders or the individual shareholders of any other corporation."

Respectfully submitted.

VINCENT H. MALONEY,
Attorney at Law, New York, N. Y.
THOMAS J. GREEN,
C. P. A., New York, N. Y.

LANCASTER, PA., *April 19, 1954.*

Senator EUGENE D. MILLIKIN,
Chairman, Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: From June 1918 to June 1920 I was a field auditor in the Construction Division of the United States Army. From July 1920 to October 1940 I was an internal revenue agent, Field Auditor Division, Philadelphia, Pa., and from November 1940 to the present time I have been practicing as a certified public accountant and Federal and State tax consultant, with a Pennsylvania State certificate, at Lancaster, Pa. I have a very lucrative accounting and tax clientele.

On several occasions, I have taken the privilege of making tax suggestions when new laws and changes in the Federal tax laws have been under consideration by Congress. Because of my above-mentioned occupations, I believe that I have acquired some knowledge and experience that might be helpful to you lawmakers. Since you are now considering the House bill and changes in the Federal tax laws, I wish to submit the enclosed suggestions for your careful consideration for what they are worth to you and your committee members. I sincerely hope that the suggestions might be of some benefit to you in connection with the final writing of the changes to the Federal tax laws.

I will be glad to be of any service to you and your committee at any time.

Very truly yours,

PAUL L. MILTENBERGER,
Certified Public Accountant.

SUGGESTIONS SUBMITTED BY PAUL L. MILTENBERGER, C. P. A. OF PENNSYLVANIA, LANCASTER, PA.

Federal tax laws should provide for the following:

1. Written receipts for all cash expenditures for everything bought; all services rendered by any person or persons and for every other kind of cash expenditure to be given by the seller to the purchaser and the party rendering the services to the party receiving the services; and to the party paying by the party receiving for all other cash expenditures.

Why?—Cash expenditures for merchandise and other things bought and for services rendered are so great, and are the principal means of evasion of Federal income taxes, that no deduction for cash expenditures should be allowed without a proper receipt for the expenditure. Likewise, cash sales under the counter without receipt for same gives the seller the cash which is generally not accounted for as income, and the cost of the sales are deducted generally as an expense because same are most always paid by check to evidence the deductibility of costs, and the seller then gets a double benefit for tax purposes. Sales are not reported as income, and costs are deducted as an expense. Such transactions occur every day, especially in the large cities like New York, Chicago, and practically every other place. Many persons have regular employment where social security and withholding taxes are collected by the employer, and then the persons work on other employment where no taxes are collected and reported because the employee and employer do not account for same. The latter and exemptions claimed which taxpayers are not entitled to are principal tax evasions by individuals.

2. Personal exemptions for Federal income tax of $600 for each person should not be increased as a general increase for all taxpayers. However, if it becomes

necessary to make some kind of compromise, I would suggest that taxpayers having a tax liability of $40 or less be given an additional deduction for the Federal income tax of the tax liability due which would be the equivalent of giving the taxpayer 20 percent on $100 or 20 percent on any taxable amount of income under $100; if the personal tax liability is $80 or less, they should be given a credit against their tax liability of the $40 and any additional amount of the extra $40 or less that the lawmakers would see fit to give such taxpayers. This, in effect, would give the low-income taxpayer the benefit of the equivalent of the additional $100 or $200 exemption in accordance with the tax liability and would not apply to higher income taxpayers where the Federal income tax liability exceeds the $80. This provision would eliminate tax liabilities to a very large percentage of low-income taxpayers, and would overcome the argument of not giving anything to the taxpayers with low incomes.

3. Double taxation: The House bill provided for relief from double taxation on cash dividends received by persons owning stocks in corporations from which they receive the dividend during any taxable year. The House provisions do give some relief in regards to the double taxation. It is suggested that corporations be allowed to convert preference stocks used and outstanding into some form of convertible debentures on an equal par value exchange of preference stock for debenture bonds with the same rate of interest as was paid in cash dividends on the preference stock. This conversion feature should be a nontaxable exchange to the preference stockholder who would receive the debenture bonds or other form of indebtedness at the time of the exchange, and any tax liability should be deferred on account of the exchange until the debenture bonds were sold at which time a capital gain or loss would be determined. The debenture bonds should be given the right to be converted into common stock of the corporations at different times at different rates of exchange for same. No gain or loss should be recognized at the time of exchange of the debenture bonds into the common stock of the corporation until such time as the stockholder would sell the common stock and establish a capital gain or loss.

The corporation, by having the debenture bonds with a fixed rate of interest instead of preference stock with a fixed rate of dividend, would get a deduction of the interest for Federal income-tax purposes, and the recipient of the interest by a debenture bondholder would pay the Federal income tax on same, thus relieving the double taxation feature that is now in existence on cash dividends received from preference stock. It would appear that if such provisions were put in the law the debenture bonds could be treated on the statements of the corporations as part of their capital investments which would impair the financial status of the corporation for credit purposes. The relief of the double taxation on cash dividends received on common stocks would then be a help to persons holding same, and provisions could apply even to exchange of common stock for debenture bonds or other form of indebtedness without incurring any Federal income-tax liability at the time of the exchange. The application of the relief of double taxation to the individual persons owning this stock instead of some form of relief to the corporation paying out the cash dividends is not very workable. It would seem that it would be much better to provide for the relief on the part of the corporation instead of on the part of the individuals. This has been a very debatable question for a number of years, and any relief given to the corporations or the individuals receiving dividends is very acceptable.

4. Taxation of present nontaxable trusts, foundations, cooperatives, and all other exempt organizations: It is suggested that all present nontaxable organizations be taxed at a fixed rate of Federal income tax on all income received by them in order to relieve the staggering taxation at the present time on other taxpayers. The amount of wealth owned by foundations, trusts, and all other allowable nontaxable organizations has become so enormous, and the income from the wealth held by these nontaxable organizations has become so great that it seems advisable to tax at least the income of these nontaxable organizations at some rate of taxation because they are getting the same protection on their wealth as other taxpayers. Hence, it does not seem fair to burden the other taxpayers with the full amount of the responsibility and allow the nontaxable organizations to go tax free.

As an example, the Hershey Estates at Hershey, Pa., created by Milton Hershey about 1917 or 1918 was one of the first nontaxable organizations set up in the United States. The purpose of the creation of the Hershey Estate is very commendable because of the good which comes from same to the orphan boys who are taken care of through the creation of the estate. Mr. Hershey turned over about 80 percent of the common stock of the Hershey Chocolate Co., which

he owned, to the Hershey Estates at the time of the creation of the trust, and additional wealth has been turned over to the trust since that time together with all the income from the trust from the creation of same. By Mr. Hershey turning over this wealth to the Hershey Estates, the Government lost the Federal income tax on same from the beginning of the trust up to the present day. The wealth controlled by the Hershey Estates at the present time is very considerable. In reality, Mr Hershey did not give this to the Hershey Estates, but all other tax payers who are burdened with the additional tax liability on account of same are the real creators of any nontaxable organization. The same is true also in regards to the Rockefeller Foundation, the Mellon Foundation, the Carnegie Foundation, the Ford Foundation, and all other nontaxable foundations and trusts and forms of nontaxable organizations allowed to come into existence under the present Federal income and estate tax laws. The purposes of these nontaxable organizations are not questioned, but since all the wealth and income of these nontaxable organizations have the same protection of the United States Government as the wealth and income of other taxpayers, it certainly would seem fair and equitable for the United States Government to get some revenue from the income of these nontaxable organizations.

Any other suggestions can be made on request from you and your committee.

PACIFIC PALISADES, CALIF., *April 14, 1954.*

Re section 1235, H. R. 8300 (sales of patents by an inventor)

SENATE FINANCE COMMITTEE,
Washington, D. C.

GENTLEMEN: The Internal Revenue Code of 1954 as approved by the House of Representatives contains a provision relating to the sale of patents by an inventor which it is believed should be reviewed by your committee. The House report provides in effect in section 1235 that capital-gain treatment shall be allowed inventors where patents are sold under contracts which provide that the period of productivity, use, or disposition is not more than 5 years and if the payments are completed within 5 years (except for late payments resulting from failure of the buyer to meet the contract terms).

If it is intended to apply this provision to contracts already in effect in addition to those entered into after a certain date in 1954, it is believed that the use of a 5-year period will deny capital-gain treatment to a great many of the contracts which have been negotiated. Since a patent has a life of 17 years it has been customary to base the period over which the purchaser has the exclusive right to make, use, and sell the invention at or near the remaining life of the patent. It is suggested that if your committee feels that a 5-year restriction is an equitable requirement for new contracts entered into after a certain date in 1954 that it not apply this restriction to contracts already in effect. Many inventors have entered into contracts prior to 1954 relying on court decisions holding that payments received under contracts which sold the patent to the purchaser or which gave him the exclusive right to make use and sell the invention are a return of capital irrespective of the period of years over which the payments are received and irrespective of the indefiniteness of the period of years.

It is suggested that language similar to the following be inserted in section 1235 if the 5-year restriction on contracts entered into after a certain date in 1954 is retained: "Payments received from contracts entered into prior to ——— 1954 will not be affected by this section unless (1) received under contracts having their inception prior to that date which have had their sales price dependent upon more than 17 years of productivity, use, or disposition, and unless the payments are to be completed in more than 17 years, except for late payments resulting from the failure of the buyer to meet the contract terms, or (2) unless the contract is based on an indefinite number of years."

Where a contract has been based upon a period of 17 years or less it would seem to be equitable to allow capital-gain treatment on payments received under that contract if it was entered into on a date preceding 1954 or at least prior to 1953 before considerations thereon were held by the House Ways and Means Committee. If the 5-year provision is retained for new contracts, then the old contracts should at least have a 5-year period for continued capital-gain treatment on the proceeds of their sale. You might also wish to consider an equitable treatment for contracts based on an indefinite number of years.

Yours very truly,

HARRY A. WARDENBURG.

STATEMENT OF EUGENE F. BOGAN, WASHINGTON, D. C., ON H. R. 8300, SUBCHAPTER J, ESTATES, TRUSTS, ETC., SUBPART E, GRANTORS AND OTHERS TREATED AS SUBSTANIAL OWNERS, SECTION 674, POWER TO CONTROL BENEFICIAL ENJOYMENT

The purpose of this statement is point out the necessity of clarifying amendment in section 674 of the bill. This section sets out certain tax rules applicable to the grantor of a trust and in subsections (b) and (c) describe certain "excepted powers."

With respect to these powers, subsections (b) and (c) each contain the following clause: "A power does not fall within the powers described in this paragraph if any person is enabled to add to the class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children."

The wording of this clause is subject to serious problems of construction, particularly in connection with its use of the word "enabled." The thought intended to be expressed here is undoubtedly the word "power," and it would seem that the word should be used. For instance, in a case where the trust beneficiaries could include spouses of income beneficiaries, it might be argued with some force that a beneficiary was "enabled" to add to the beneficiaries by the act of marriage—bringing the spouse into the group of beneficiaries. It was hardly intended to condemn the trust for such reason, and the language should be clarified. The special exception for "after-born or after-adopted children" would emphasize the possibility of absurd results from the use of the word "enabled."

Also, as to the use of the phrase "class of beneficiaries," this is a term very difficult of construction because of uncertainty as to what the word "class" means. If, perchance, a trust has two groups of beneficiaries, it may have two "classes," or one "group" and one "class," or just simply "beneficiaries," etc.

The text used in the bill is very evidently taken from an obsolete draft of concurrent proposals of the American Bar Association and the American Law Institute. Both organizations have recast the phrasing of this clause to clarify it as follows:

"A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children."

It is respectfully suggested that this clause in section 674 (b) (5) and section 674 (c) be recast in the form suggested above.

AMERICAN AGGREGATES CORP.,
Greenville, Ohio, April 13, 1954.

Hon. EUGENE D. MILLIKIN,
United States Senator, Washington, D. C.

DEAR SENATOR MILLIKIN: This letter is concerned with the revenue bill which passed the House of Representatives and which is now being considered by the Senate Finance Committee. We have previously written in regard to the same subject to Hon. William M. McCulloch, United States Congressman from our 4th Congressional District.

Our corporation is engaged primarily in the mining and processing of sand and gravel with operations located within the States of Ohio, Indiana, and Michigan. We are actively identified with the National Sand & Gravel Association, 1325 E Street NW., Washington 4, D. C., of which Mr. Vincent P. Ahearn is executive secretary.

The pending revenue bill continues the existing percentage depletion rate of 5 percent on sand and gravel. However, it provides for a percentage depletion rate of 15 percent on so-called chemical and metallurgical limestone and, according to the House Ways and Means Committee report, this 15 percent rate applies to all such limestone "regardless of the use to which such minerals are put." In short, limestone so classified will receive the 15 percent rate even if it is used as construction materials in competition with sand and gravel.

We vigorously protest this unjust discrimination against the sand and gravel industry and respectfully petition the Senate Finance Committee to eliminate such discrimination for the following reasons, namely:

(1) Approximately 80 percent of the total crushed stone production of the country is limestone. Throughout the area we operate, limestone quarries produce flux rock and agricultural limestone. These same quarries produce crushed limestone and limestone sand for use as construction materials in competition

with processed sand and gravel. It is our understanding that under the pending revenue bill the foregoing crushed limestone and limestone sand used for construction purposes would be entitled to a percentage depletion rate of 15 percent in comparison with a percetnage depletion rate of 5 percent for sand and gravel. Our competitive experience indicates that this would provide a depletion allowance of from 15 to 20 cents per ton for crushed limestone and limestone sand as against our own corporation's depletion allowance of about 5 cents per ton for sand and gravel. This obvious inequity cannot be justified from any consideration and it will gravely jeopardize the competitive relationship that has existed for half a century between the crushed limestone industry and the sand and gravel industry. Tax legislation should not be utilized to distort historical competitive relationships among industries servicing the same general markets.

(2) We sincerely believe in the principle of percentage depletion as applied to industries dealing in wasting assets. We recognize that the basic purpose of this principle is to encourage such industries to explore for and to bring into production natural resources in their varied forms so as to maintain essential productive capacity at a high level in an expanding economy. It is our studied conclusion, however, based upon knowledge of crushed limestone operations within the States of Ohio, Indiana, and Michigan that the 15 percent percentage depletion rate for chemical and metallurgical limestone, under present conditions, is excessive. We are convinced the total depletion allowance computed at such rate for any given stone deposit will substantially exceed the total of (*a*) the cost of such deposit, (*b*) the cost of exploring for another deposit, and (*c*) the cost of such second deposit. We submit that this result does violence to the principle of percentage depletion.

(3) The pending revenue bill as passed by the House of Representatives and as interpreted by the report of the House Ways and Means Committee creates an impossible administration problem with respect to percentage depletion for the Internal Revenue Service. The "end use" conception as applied to limestone is done away with. The record will show that this test was never too effective, and I personally do not believe that the Senate Finance Committee can write an understandable and self-executing definition of "chemical and metallurgical limestone" which will simplify the problem. If this is to be the approach, then the Internal Revenue Service will be forced to man itself with a multitude of expert chemists to analyze each of the countless quarries throughout the Nation and test chemically the innumerable chemical variations of the rock strata of each quarry. This is manifestly too stupendous a task for any governmental agency to undertake.

CONCLUSION

Summarizing the foregoing:

(1) The proposed percentage depletion provision in the pending revenue bill as applied to the crushed limestone industry is grossly unfair to and discriminatory against the sand and gravel industry.

(2) A 15 percent percentage depletion rate for any limestone deposit is excessive and does violence to the principle of percentage depletion.

(3) The statutory establishment of different percentage depletion rates for limestone, upon the standards either of end use or of chemical constituents, creates an impossible administration problem and will inevitably result in protracted and costly litigation. It simply can't be done effectively.

RECOMMENDATION

It is our recommendation that this difficult problem be resolved by providing a percentage depletion rate of 10 percent for crushed stone of whatever chemical content and for sand and gravel. We are reliably informed that this solution would receive the endorsement of the great body of crushed stone producers throughout the Nation. The present 5 percent rate for the sand and gravel industry is not adequate. Moreover, the costs of exploring for sand and gravel deposits are no less than like costs for stone deposits and the prices paid per acre for sand and gravel deposits are equal, if not greater, than prices paid for stone deposits. Consequently, there exists no justification whatsoever for Congress to apply the principle of percentage depletion in such manner as to discriminate against the sand and gravel industry. We respectfully urge that our recommendation be given careful consideration by the Senate Finance Committee.

Sincerely yours,

WM. EDWARD HOLE,
President.

THE BLOCH BROS. TOBACCO CO.,
Wheeling, W. Va., April 12, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee, Washington, D. C.

DEAR SENATOR MILLIKIN: For several years, I have been chairman of the Internal Revenue Service committee of the Associated Tobacco Manufacturers, and during that time have been working with the Alcohol and Tobacco Tax Division of the Internal Revenue Service for simplification of the law and regulations relative to the tobacco industry.

While the administrative officers were always receptive to suggestions, it seemed impossible to get any results, as everything had to go through so many "channels" that they imposed a practical road block to improvement.

In August of last year, the opportunity was offered to present views of interested parties with respect to the amendment of the Internal Revenue Code, and I took the opportunity to testify before the Ways and Means Committee with respect to the tobacco section. The committee was quite receptive to the suggesions made, and referred the matter back to the Internal Revenue Service where our association and other interested parties had many opportunities to discuss the proposed changes which have now been incorporated in chapter 52 of the proposed Internal Revenue Code of 1954 (H. R. 8300) now before your committee.

The cooperation of the Internal Revenue Service and the tobacco industry has been so fine and I believe so helpful that chapter 52, as presented, has had, so far as I know, no opposition, and I am hopeful that it will be approved and adopted by the Senate Finance Committee.

The New York City Bar Association is reported as having requested the deletion, from the proposed code, of subchapter C of chapter 1 dealing with corporate distributions and adjustments.

Even if that subchapter should be deleted or modified or the old code relating to such matters should be reenacted, our committee and association are very definitely and very strongly of the opinion that chapter 52 should be adopted at this time.

This chapter completely revolutionizes the method of collecting tax on tobacco products and calls for many changes in administration which will require some time for the industry to prepare for carrying out. As presently written, the chapter contemplates that all tobacco taxes will, beginning January 1, 1955, be payable on the basis of periodical returns instead of by the purchase of stamps to be affixed to the individual packages.

For these reasons particularly, we are hopeful that your committee will recommend the adoption of chapter 52 at this session of the Congress.

Sincerely yours,

ROBERT LEE BOYD.
Vice President.

SPRINGFIELD, ILL., *April 13, 1954.*

Hon. EUGENE D. MILLIKIN,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR MILLIKIN: I wish to vehemently protest against one of the proposed provisions of the 1954 tax revision bill.

Under current law (§ 2 (b) (1)) of the Internal Revenue Code, the proceeds of a life-insurance policy taken out by a qualifying trust—pension or profit sharing—upon the life of an employee and paid by reason of the employee's death are not taxable income to the employee, his estate or beneficiaries.

I do not have the section number as proposed in the 1954 tax revision bill but I do know that the income tax exemption of life-insurance proceeds paid by reason of an employee's death is to no longer apply to the proceeds of insurance contracts purchased by a qualifying employee trust except in the case of group term-insurance contracts. They are taxable income subject to the tax privileges of lump-sum payments and of the $5,000 death benefits.

This provision violates the very letter and spirit of the viewpoint of each Congress ever since 1918. It eliminates what has always been a great boon to the little man. Through the medium of life insurance purchased either by himself or by qualifying pension trusts or profit sharing trusts, the average man has been able in the past to pass along direly needed money to his wife and children without the imposition of income tax costs.

If the proposed provision is enacted by Congress, with its attendant drastic income tax impact to employees, the end results could well be for practical purposes a death knell to pension plans and profit sharing plans established by smaller companies.

And in that connection, may I point out that the proposed provision is definitely inequitable, unfair, and unjust to the smaller employer and to the little men employed by smaller enterprises, because it operates in favor of the larger corporations whose employees in number are sufficient to permit group term life coverage, the proceeds of which continue to be tax-exempt. In other words, the larger corporations are financially capable and have enough employees to buy group term life insurance (the proceeds of which are tax-exempt) but there are literally hundreds of thousands of smaller businesses who do not have enough employees in number to qualify under the group term plan, and which businesses do not have enough money to make for attractiveness in buying group term insurance.

To reemphasize, the provision definitely is in direct conflict with the American way of life because it operates in favor of the larger corporations, because it eliminates a method by which employees may now leave badly needed cash to their families, and I not only hope but I sincerely urge that you will do all you can to eliminate this proposed provision from the act now under consideration by Congress.

Will you please write to me at your convenience telling me your views and what you have done or propose to do about this unjust situation?

Sincerely yours,

FRANK C. TOOMBS,
Tax Analyst.

FIRST MERCHANTS NATIONAL BANK & TRUST CO.,
LaFayette, Ind., April 13, 1954.

Mrs. ELIZABETH SPRINGER,
Clerk of Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MADAM: As a trust officer of a small midwestern banking institution I wish you would convey my feeling to the committee with respect to the proposal which will limit trustees of pension funds to investing no more than 5 percent in securities in any one company.

We are now serving as trustee for four small pension trusts (including our own bank) and have been using mostly Government bonds and conservative first mortgages as the principal investment medium at this time. Limiting the investment on a mortgage to 5 percent of the principal of the trust will work a serious hardship on us in the management of these trusts and I presume the same will be true for many of the smaller trust departments around the country.

It is respectfully requested that the committee seriously consider eliminating this feature from the new tax bill.

Yours very truly,

J. G. LISTE, *Trust Officer.*

WARD, REA & SHAW,
CERTIFIED PUBLIC ACCOUNTANTS,
Meridian, Miss., April 6, 1954.

Hon. JOHN C. STENNIS,
United States Senator, Senate Office Building,
Washington, D. C.

MY DEAR SENATOR STENNIS: The partners of F. W. Williams State Agency, Mississippi representatives for over 50 years of the United States Fidelity & Guaranty Co., have organized a corporation, Underwriter's Service Corp., for the purpose of erecting an office building in Meridian which is intended principally for the use of United States Fidelity & Guaranty Co., although part of the proposed space will be available for rent to the public.

In view of the fact that a part of the space proposed to be rented to United States Fidelity & Guaranty Co. will be occupied by the partnership, F. W. Williams State Agency, the members of which partnership are also stockholders in the corporation which will own the building, a question arose as to whether the rents paid by United States Fidelity & Guaranty Co. to the building corporation for that part of the space which will be occupied by the F. W. Williams State Agency would constitute personal holding company income within the meaning of section 502(f) of the existing Internal Revenue Code.

If these rents were held to be personal holding company income, this corporation would be subject to the penalty surtax of 75 percent of that part of its net income which is not paid out in dividends which would make it impossible for the building to be built, inasmuch as it will be financed in large part with borrowed funds, and it is expected that repayment will be made from rental income.

After studying carefully the legislative history of section 502(f), we and counsel for the company concluded that the law was not intended to apply to transactions of this nature, and accordingly we requested a ruling of the Internal Revenue Service as to their opinion of the application of the law to this fact situation. This ruling was requested in November 1953, and because of the apparent novelty of the question, even though several conferences have been held in various offices of the Internal Revenue Service, no conclusion has been reached. I believe that it is a fair statement to say that each officer of the Internal Revenue Service who has discussed the case with us has agreed that it was not the intent of the Congress that the existing law touch such transactions as ours, but they take the position that it is possible that the law does touch our transaction even though it was not intended to do so.

The House of Representatives has now passed H. R. 8300, a bill to revise the internal revenue laws of the United States, and in section 543 (a) (6) has, we believe, undertaken to correct the apparent misapplication of section 502 (f) of the existing Internal Revenue Code. The legislative history of the proposed new code section makes it entirely clear to us that the House of Representatives desires specifically to prevent the application of the personal holding company income concept to legitimate business transactions such as ours unquestionably is.

When the House of Representatives passed this act, we requested our Washington counsel to discuss the changes therein contained with the officers of the Internal Revenue Service to see if they now agreed that the proposed new code, if enacted, would clarify the law as to our particular situation. Doubt apparently still exists in the minds of the officers of the Internal Revenue Service as to whether even the proposed law could apply to such a transaction as we contemplate.

We therefore wish to suggest to the Senate Finance Committee an amendment to section 543 (a) (6) of H. R. 8300 for the sole purpose of clarifying the application of the section to legitimate business contracts such as we propose. Please understand that all we desire to do is have the law so clarified as to express what we and the officers of the Internal Revenue Service with whom we have discussed the law believe definitely to be the intent of the Congress as now expressed. We do not seek a special treatment for Underwriter's Service Corp. or its stockholders; we seek merely to have the intent of the Congress clarified in order that the doubt in the minds of administrative officers may be removed.

The prohibitive tax which would result to the corporation if the personal holding company statutes are permitted to apply will prevent the erection of this building in Meridian. As you know the economy of this area needs all of the constructive expenditures it can get at this time.

Your cooperation in this matter will be most deeply appreciated.

Yours very truly,

THOMAS R. WARD.

UNITED CEREBRAL PALSY ASSOCIATION OF CONNECTICUT, INC.,
Bridgeport, Conn., April 12, 1954.

Hon. PRESCOTT BUSH,
United States Senate, Washington, D. C.

DEAR SENATOR BUSH: With reference to your letter of April 9, you are correct in interpreting my request of April 7 concerning H. R. 8300. Regarding section 214 of this general tax revision bill, I recommend, most earnestly, that the age limit of 16 for physically or mentally handicapped children be raised to 21. Child-care expenses for children falling into these categories go far beyond any established estimate for nonhandicapped youngsters and cannot be measured by the same chronological yardstick of dependency.

Your bringing this matter to the attention of Senator Millikin, chairman of the Finance Committee, will be appreciated.

Sincerely,

HERBERT M. GOLDMAN, *President.*

OKLAHOMA CITY, OKLA., *April 15, 1954.*

SENATE FINANCE COMMITTEE,
Internal Revenue Code Division,
Senate Office Building, Washington, D. C.

DEAR SIRS: Because of a statement I noticed in a weekly report from Prentice-Hall, to the effect that written questions about the proposed Internal Revenue Code would be considered by your committee, I am addressing this communication to you. It deals with the meaning of section 501 of the proposed code as it affects profit-sharing trusts. This question has arisen in my mind as to a specific case under consideration and I do not find an answer to the question in the new code.

A corporation has created a profit-sharing trust, contributing a certain portion of its net earnings. Its annual contributions are allocated to their employees on a point system, involving both years of service and compensation for the preceding year; in other words, an employee receiving $5,000 with an employment record of 8 years, would be given 50 points for his compensation and 1 point for each year of service, for a total of 58 points. An employee receiving $4,000 with 4 years' service would get 44 points for the purpose of allocation of annual contributions. Under section 501 (4) (B) this presents no problem as to the allocation of the annual contributions, but assuming an employee terminates his employment and a portion of his previously allocated funds in the profit-sharing trust are reallocated among the remaining employees, there is a possibility that such reallocation might violate the requirement of this section of the proposed code, reading as follows:

"All of the amounts arising from forfeitures on termination of service * * * (must be) * * * allocated in such a manner that the allocated amounts do not bear a higher ratio to compensation for any covered employee than for any other covered employee whose compensation is lower * * *"

It would seem that even though the agreement was not designed to favor higher paid employees as to such reallocated funds resulting from termination of employment, in effect a $5,000 employee with 6 years of service would receive a slightly larger percentage than a $4,000 employee with 5 years of service. Of course, it might well work the other way since a $4,000 employee with 6 years of service would receive more percentagewise than a $5,000 employee with 4 years of service.

I do not believe that it was the intent of the draftsman of this statute to require the reallocation of forfeitures on one formula and the allocation of annual contributions on another formula so long as the former formula for allocation of annual contributions was acceptable. The difficulty presented is largely mechanical but of considerable nuisance value.

Another question arises in reference to the same section under the definition of "compensation." The term "compensation" is stated to mean:

"The basic or regular rate of compensation or total compensation if amounts other than the basic or regular rate of compensation are determined under a definite formula."

In the same specific case, a question is raised as to what is meant by "compensation determined under a definite formula." In this particular concern, there are a number of outside salesmen engaged in selling expensive, heavy road machinery and equipment. They are compensated with a basic salary plus a commission on the sales in excess of that salary. Within the past few years with a basic salary of $6,000 a year, the commission paid to these salesmen under a definite schedule has varied from $2,000 to $11,000 per year. They participate in the profit-sharing plan only to the extent of their basic salary. I can find nothing in the act which with certainty determines whether or not such commissions are "compensation determined under a definite formula." It is almost impossible to guess in any one year what the total of such commission for any particular salesman would amount to and thereby determine whether he is a key employee or whether or not his participation must be based upon total compensation, including commissions, or whether it can be limited to participation based upon his salary.

The foregoing questions are applicable to an existing profit-sharing trust but have come to my attention in considering a proposed profit-sharing trust under much the same questions. I hope that your committee can perhaps clarify this section of the proposed code so that some of us may move with more certainty as to what the law means.

Yours truly,

O. D. ELLISON.

THE CLEVELAND PATENT LAW ASSOCIATION,
April 14, 1954.

The Honorable EUGENE D. MILLIKIN,
Chairman, the Senate Finance Committee,
United States Senate, Washington, D. C.

SIR: This is to inform you that the Cleveland Patent Law Association at a regular meeting held April 13, 1954, after considering the proposed revisions of the tax revision bill, H. R. 8300 insofar as it pertains to patents, passed the following resolution:

"*Be it resolved:* That the Cleveland Patent Law Association approves the substitute section 1235 of the tax revision bill, H. R. 8300 proposed by the National Patent Council and recommends inclusion in H. R. 8300 the provisions of H. R. 7646 (percentage depletion allowance for patents)."

Very truly yours,

HENRY KOZAK,
Secretary-Treasurer.

CAPITAL CO.,
San Francisco, April 7, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
The United States Senate, Washington 25, D. C.

DEAR SENATOR MILLIKIN: On December 30, 1953, Great Lakes Carbon Corp. and Capital Co. purchased, for approximately $8 million, all of the capital stock of Palos Verdes Corp., a real estate corporation whose principal assets consist of approximately 6,800 acres of land on the Palos Verdes Peninsula, Los Angeles, Calif.

Great Lakes Carbon Corp. is engaged in the business of mining diatomaceous earth and processing it for industrial filter aids. The 6,800 acres include a substantial deposit of diatomaceous earth, of approximately 800 acres, located near the great lakes plant, at Palos Verdes. That corporation made efforts to purchase the deposit from Palos Verdes Corp., but the stockholders refused to sell. They did, however, agree to sell all of the stock in the corporation so that the deposit could be acquired.

Capital Co. is a real estate company, and was brought into the transaction because of its real estate experience and the desire of the Great Lakes Carbon Corp. to dispose of all of the real estate, other than the diatomaceous earth deposit, as promptly as possible. It was proposed to dissolve Palos Verdes Corp. and liquidate it in a taxable liquidation, under the provisions of the Internal Revenue Code now in effect. This would mean that the stockholder corporations would surrender their stock and receive the assets at their fair market value, which would presumably equal the price paid for the stock—$8 million.

The provisions of H. R. 8300, however, not only defeat this proposed plan, but involve the stockholders in a tremendous financial loss.

Palos Verdes Corp. has a very low tax basis for the 6,800 acres of real estate (about $1 million) which were acquired many years ago. This real estate constitutes appreciated inventory, under the provisions of section 336 (e) of H. R. 8300, and, therefore, the stockholder corporations will be required to take over the same $1 million basis as their tax basis for the real estate upon liquidation. Furthermore, the real estate remains inventory. Thus, if the stockholders were to sell the real estate for the same sum paid for the stock, to wit $8 million, they nevertheless would be taxed on the $7 million profit at 52 percent tax rate—which would actually constitute a tax levy on their capital investment in the stock.

This harsh and inequitable result is attributable solely to the proposed law, which by its terms is made applicable to all such distributions after March 1, 1954 (sec. 391 (d)), and which deprives Great Lakes Carbon Corp. and Capital Co. of the basis to which they were entitled under the law in effect in December 1953, when the purchase of the stock was consummated, in reliance upon such existing law.

The purpose of the proposed statute is to prevent appreciated inventory assets being transferred in such a manner that a stockholder could realize the appreciation as capital gain and pay merely a capital gain tax in lieu of the normal tax which would have been chargeable thereon had the subsidiary corporation sold it. This purpose is commendable but the law can and should be so composed that it will not deprive the taxpayer of a tax-free return of his capital. This can be accomplished by change in the proposed law in either one of two ways:

1. Section 391 (a) can be amended by changing the effective date March 1, 1954 to 60 days after enactment of this act, thus excluding from the new provisions any distribution made under a plan of liquidation adopted within 60 days after enactment of the law; or

2. Section 336 (d), defining inventory assets, could be amended to add to both subparagraphs (1) and (2) thereof the words "and not held over 3 years." This would carry out the principle now incorporated in section 117 (m) of the 1939 code relating to collapsible corporations, excluding from inventory assets any property held over 3 years, and would bring the proposed section 336 (d) in conformance with the present provisions.

The suggested amendment of section 336 (d) will not only carry out the presently existing principle, but it will alleviate the difficulty now imposed by the proposed section. Under the 1939 code provisions (section 117 (m)), the penalty for use of collapsible corporations as a means of avoiding tax is imposed upon the person who is trying to avoid the tax. Under the proposed law, in H. R. 8300, the penalty is not imposed upon that person but is imposed upon the person dealing with him. It is respectfully submitted that this is a fundamentally unsound form of taxing statute. In other words, the statute is in effect: if you deal with a person who is seeking a certain tax advantage we will give him the advantage, but we will penalize you, even though you entered into a bona fide, legitimate transaction. Such a provision compels a taxpayer to pry into the affairs of another taxpayer and to determine the validity of that taxpayer's intent for tax situations, and upon failure to do so, or even if misinformed, he would suffer a penalty. If there is to be any penalty, it should be imposed upon the person getting the tax advantage, as now provided for in the 1939 code, and not upon another taxpayer acting in good faith and executing a transaction in the ordinary course of his business.

On this broad premise, the proposed provisions for reduction of the basis in the hands of a purchaser are objectionable and should be eliminated.

The suggestion herein contained for amendment of section 391 (a) gives some relief and is the least that should be done to correct the objectionable provisions.

It is respectfully requested that the inequities mentioned above and the suggested changes in the proposed law be given careful consideration.

Respectfully yours,

HARRY M. CLELLAND, *President.*

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Chicago 3, Ill., April 14, 1954.

Re H. R. 8300

Hon. EUGENE D. MILLIKIN,
Chairman, Finance Committee, United States Senate,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR MILLIKIN: As chairman of the board of governors of the National Association of Securities Dealers, Inc., for the year 1954, I am writing to you with respect to H. R. 8300. In so doing, I speak on behalf of the 3,008 members of this association, all of whom are registered brokers and dealers with the United States Securities and Exchange Commission.

I will comment upon three aspects of the bill pending before your committee as adopted by the House of Representatives:

(1) It is our considered judgment that the provisions of the bill as adopted by the House of Representatives, relating to double taxation of dividends, should be adopted by the Senate's Finance Committee and by the United States Senate. It is our belief that these provisions do not represent preferential treatment for investors or for the securities business, but represent a change in the law which has long been needed, and is in the interest of fair and equitable treatment to all taxpayers, regardless of the size of their individual income. It is also our belief that these provisions will, if adopted, be of material assistance to the maintenance of a healthy and strong economy in this country.

(2) We also wish to suggest to you and your committee that there be reconsideration of the provisions in the present law relating to the length of the required holding period for purposes of capital gains taxation. It is our considered opinion that a reduction in the length of the holding period would have the following results:

(a) More readily permit and encourage investors whose holdings show a profit to dispose of those holdings and reinvest their capital in other productive enterprises.

(b) It would encourage a more rapid turnover of investors holdings when a gain may be realized which would have the twofold result of increased revenues to the Treasury and a more fluid market for securities.

(c) It would, through the encouragement of liquidation to realize a profit, provide sources for equity capital in the United States which are, in the opinion of industry and the securities business, urgently needed in order to assure continued expansion of industrial production and full employment in this country. It is the belief and studied opinion of the group which I represent that a change in the holding period to 3 months would be in the public interest not only for the reasons stated but also would provide additional tax revenues to aid in the balancing of the necessarily tremendous governmental budget.

(3) I also feel that it is important to call to your attention the fact that many of our members have communicated with us with respect to the impact of provisions set forth in section 359 of the bill as passed by the House of Representatives relating to mergers of corporations. These provisions have been the cause of considerable concern because, it is my understanding, it was not known that changes in the law with respect to mergers were contemplated in this bill and the full impact thereof is not understood, as yet, by business men, accountants, tax attorneys, bankers and investment bankers.

It would appear, and this opinion has been expressed by many, that to alter the concept of tax-free mergers in the manner proposed will have its principal effect on small business corporations, placing them in a very disadvangtageous competitive position. For instance, small corporations which may need to merge in order better to meet competition of the larger and stronger companies; or closely held family corporations where the owners do not or cannot sell and thus have serious difficulties in meeting the problems of carrying on and building up their business under present conditions except through a merger and exchange of stock which will give them access to the capital markets. To place a tax penalty on such mergers would be especially serious, in its effect on small business, in the event of a downturn in business and the much stronger competition which would then be present.

There are many instances in the past in which the tax-free merger has been helpful to the economy of the Nation, and we urgently suggest that the present law be continued as it is, with the interpretations thereof unaffected, until this situation, all of the legal and economic aspects thereof, and business conditions generally have been closely surveyed by, not only the committees of the Congress but also by representatives of the various business groups of the Nation, all, we believe, in the public interest.

I would very much appreciate it if the foregoing letter could be inserted in the record before your committee in its consideration of H. R. 8300.

Respectfully yours,

EDWARD C. GEORGE, *Chairman.*

THE RUBBER MANUFACTURERS ASSOCIATION, INC.,
New York 22, N. Y., April 14, 1954.

Hon. EUGENE D. MILLIKIN,
Senate Office Building, Washington, D. C.

SIR: Several companies in the rubber manufacturing industry maintain through wholly owned subsidiary corporations plantations in foreign lands for the production of natural rubber.

Section 923 of H. R. 8300 provides for a credit against tax equal to 14 percent of certain types of income earned abroad. Subsection 3 of section 923 identifies this income as dividends from a foreign corporation if such income "has been derived to the extent of at least 90 percent from the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business situated within a foreign country."

The report of the Committee on Ways and Means, House Report No. 1337, states in explanation of this particular section that, and we quote:

"The recital in section 923 of 'factory, mine, oil or gas well, public utility facility, or retail establishment' is not meant to be exhaustive. 'Other like place of

business' may include, for example, the operation of a bank or an air transportation business."

It is, therefore, to be assumed that it was the intent of Congress to include an establishment such as a rubber plantation which is incorporated in a foreign country for the purpose of producing an essential raw material.

In order that American-owned foreign plantations be clearly enunciated as being part of the inclusions of section 923, it is suggested that section 923 (a) (3) (ii) be amended to include a specific mention of rubber plantations.

Natural rubber is a strategic material, and the plantations owned by rubber manufacturing companies played an important part in supplying natural rubber to the United States at a time during World War II when rubber was an extremely essential material for our war production. Natural rubber is required by our American economy in peacetime as well for many products for which synthetic rubber is not suitable.

Section 923 (a) (3) (iii), which attaches a qualification to the credit allowance on the foreign income in paragraph (ii), would seem not to restrict plantation income. This reads as follows:

"(iii) does not consist of more than 25 percent of gross income derived from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States."

We again refer to the report of the Committee on Ways and Means, House Report 1337, in which it is stated:

"The requirement [as contained in paragraph (iii)] that, in order for earnings and profits to qualify for preferred dividend purposes, not more than 25 percent of the gross income of the foreign corporation for the year must be derived from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States, is confined to manufacturing."

This indicates that it was the intent of Congress that such raw materials as oil and rubber were not considered to be limited by the 25-percent restriction of gross income derived from the sale of articles of such foreign corporations and intended for use, consumption, or sale in the United States. Although the House report seems clear on this point, we suggest that clarification be included in paragraph (iii) to embrace rubber and any necessary processing in its preparation for market.

One last point, section 923 (a) (3) (A) (ii) specifically mentions retail establishment. By reference to the House Ways and Means Committee Report 1337, it is apparent that a wholesale business is excluded from the benefits of this section as follows:

"For purpose of the qualifying requirements in the preceding two paragraphs, trade or business is specifically defined so as to exclude (with one exception): (1) the operation of an establishment engaged principally in the purchase or sale of goods or merchandise, or (2) the maintenance of an office, or employment of an agent, to import or to facilitate the importation of goods or merchandise. However, operation of a retail sales establishment abroad does constitute an eligible trade or business."

It is our industry's feeling that income derived from a wholesale business should not be excluded from the benefits of section 923, and we respectfully request your consideration for enlarging the scope of this section to include a wholesale business.

In summary, it is our industry's position that section 923 should be clarified in the first two points and amended in the third, as follows:

(1) Rubber plantations should be specifically mentioned as one of the forms of business entitled to the relief extended therein:

(2) That the section should show the 25-percent limitation is not applicable to a raw material such as rubber and its necessary processing in preparation for market:

(3) That the benefits of the section should be applicable to wholesale business as well as retail business.

We deeply appreciate the opportunity of presenting our industry's views to you with respect to section 923 of H. R. 8300.

Respectfully submitteed.

C. W. HALLIGAN,
Chairman, Rubber Manufacturers Association Tax Committee.

C. I. T. FINANCIAL CORP.,
New York, N. Y., April 15, 1954.

Re section 6323 of H. R. 8300 proposed Revenue Code of 1954

Hon. EUGENE MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SIR: The writer and several of his associates are members of committees of the section of corporation banking and business law of the American Bar Association, and as such are concerned generally with the problems of commercial and financial law. As attorneys for C. I. T. Financial Corp., and its affiliated companies, we are also concerned with a sound development of the law in these fields of financing which contribute to much of the commerce and capital investment of our economy.

We are concerned with the changes in existing law proposed to be made by section 6323 of H. R. 8300, the Revenue Code of 1954, because we fear that the proposed changes might render uncertain the relative priorities between Federal tax liens and the lien of an extender of credit to such an extent as to affect adversely the supply of credit in business loan transactions.

1. One principal subject of concern is the addition in proposed section 6323 (c) of a provision not found in the present comparable provision in section 3672 of the present Internal Revenue Code. The new provision is to the effect that the Federal tax lien shall be valid without filing of notice thereof, against a mortgagee, pledgee, or purchaser who had notice or knowledge of the existence of such lien at the time the mortgage, pledge or purchase was made. This contrasts with present section 3672, which protects the mortgagee, pledgee, or purchaser until notice of the lien is duly filed, without exception. The impact of the proposed change cannot be fully understood without also noticing that under section 6322 of the proposed code, the lien arises when the assessment is made, and under section 6203, the assessment is made by recording the liability of the taxpayer in the Office of the Secretary or his delegate. Under these provisions, the lien could arise by a mere mechanical recording of the liability as soon as the return is filed, and it would appear at least arguable that the lien arises when the return is filed even before the tax is payable. Since everyone is presumably charged with knowledge of the law, and since this would be particularly true of persons in financial occupations, it might well be contended that all such persons had "notice" of the existence of the lien, even before the taxes were payable. Such persons, therefore, would always lose the protection of the requirement that notice of the tax lien be filed, because they would be charged with notice even though notice was never filed under the provisions of section 6323 (c). So long as such interpretation remained a possibility under the statute, every lender or purchaser would face the danger of losing his priority to a Government claim of lien for all taxes, whether or not yet due, as to which a return had been filed up to the date of the loan or purchase.

We believe that this proposed change in the bill is a serious mistake, and that section 6323 (c) should be amended before passage so as to eliminate therefrom any provision that the tax lien can prevail against a mortgagee, pledgee, or purchaser unless notice of the tax lien is filed before the mortgage, pledge, or purchase. In other words, clause 1 of proposed section 6323 (c) should be deleted, and conforming language changes made in the other clauses.

2. The present section 3672 fails to extend expressly the protective advantage of filed notice of the tax lien to persons who do not fit exactly into the categories of mortgagee, pledgee, purchaser. There has been litigation involving the question whether section 3672 should be construed to apply to forms of contractual liens or security interests in all respects comparable to a mortgage or pledge, but not falling technically within those concepts. This problem becomes more acute because the State of Pennsylvania has now enacted the Uniform Commercial Code effective July 1, 1954, in which the old nomenclature of mortgage and pledge and other names of contractual liens are replaced by the single designation of "security interest." The Uniform Commercial Code has been proposed for enactment in several other States, and has been approved by the American Law Institute, the National Conference of Commissioners of Uniform State Laws, and the American Bar Association. It would seem that now is the time to take account of this developing change in terminology. We therefore suggest that section 6323 (a) should be amended by adding after the word "pledgee" the words "holder of a perfected lien or security interest."

Very truly yours,

MELBOURNE BERGERMAN.

DRINKER BITTLE & REATH,
Philadelphia 3, April 14, 1954.

Re Section 6323, H. R. 8300

Hon. EUGENE MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR MILLIKIN: As counsel for a number of banking institutions in Philadelphia, I have been studying section 6323 of H. R. 8300, and have been corresponding about it with some of the members of the American Bar Association in other States, who have been likewise thinking about it, and particularly with J. Francis Ireton, Esq., of Baltimore. Pennsylvania has recently adopted the Uniform Commercial Code, which becomes effective July 1, 1954. This eliminates the distinctions between the various types of security instruments, such as chattel mortagages and conditional sale contracts, and substitutes a single system for using personal property as collateral security for debts and other obligations. It provides that the lender or other secured party shall have a security interest in such property, irrespective of whether he is a pledgee, a conditional seller, a chattel mortgagee, etc.

The Uniform Commercial Code is under consideration in a number of States. In addition, the Uniform Trust Receipts Act is in effect in about 30 States, and it likewise uses the term "security interest" instead of the older terminology.

Under these circumstances it is extremely important to all lending institutions, and particularly to banks and finance companies, that after they have entered into a loan transaction with a customer their status shall not be jeopardized by a later tax lien in favor of the Federal Government. If they felt that they were subjected to such a risk they would undoubtedly greatly curtail the loans they were willing to make and this would have a serious effect upon business in general and smaller business in particular. I therefore urge that section 6323 (a) in its present form be amended by including the holder of a perfected lien or security interest among those persons as to whom the lien imposed by section 6321 shall not be valid until notice has been filed in the appropriate office. The precise language of such an amendment has been submitted to your committee by several previous writers and it is therefore unnecessary for me to repeat it in full in this letter.

In addition, section 6323 (c) provides that the lien imposed by section 6321 shall be valid without filing as against any mortgagee, pledgee, purchaser, or or judgment creditor if he had notice or knowledge of the existence of the lien at the time a mortgage, pledge, or purchase was made. This change would introduce a new and unfortunate element into the problem of tax liens and would promote much confusion and uncertainty. It likewise would be a deterrent to lending.

At the present time a lender who is about to make a secured loan to a customer can find out with complete certainty, by examining the records in a nearby filing office (in Pennsylvania, the office of the prothonotary of the court of common pleas of the county in which the property is located) whether or not a notice of tax lien has been filed. He knows that if the record discloses no such notice he can safely make his loan to the customer without worrying about the latter's tax situation. But lenders today are large organizations with many offices located throughout large cities, and sometimes throughout several counties or even an entire State. It is perfectly possible that a lending officer of a bank might examine the record and determine to make the loan on the basis of what he found; and then might subsequently discover that although no filing had occurred, some other officer, in some other branch of the bank, had what amounted to either notice or knowledge of the existence of a lien. The present law provides an objective and certain test which any lending officer can apply; the new provision would promote uncertainty and leave him subject to serious risk. I therefore join in strongly urging that section 6323 (c) (1) be deleted from the bill, and that the remaining subparagraphs be revised accordingly.

Finally, I notice that section 163 of the bill provides for a deduction for finance charges paid, not to exceed 6 percent of the average unpaid balance under the contract during the taxable year. The object which this provision seems to achieve is laudable. However, certain of the language which is used throws some doubt on the important distinction which has heretofore existed between the time sale price of an article sold on credit and interest which is charged for money borrowed. It is essential that this distinction be preserved

and I urge that the language of section 163 be changed for this purpose, in the manner which has already been recommended to you by counsel for the National Commercial Finance Conference, Inc., and others who have written to your committee on the subject.

Very truly yours,

CARL W. FUNK.

WEIL, GOTSHAL & MANGES,
New York 17, N. Y., April 12, 1954.

Hon. WALTER GEORGE,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR GEORGE: I noticed in the papers in the last few days an invitation to submit written statements in connection with changes in the proposed revenue bill. I should like to take this opportunity to bring to your attention an inequity relating to individuals on a calendar-year basis who are members of a partnership on a fiscal-year basis. I have already been in touch with Senator Long about this problem, and, in addition, brought the problem to the attention of Collin F. Stam, chief of staff of the Joint Committee on Internal Revenue. Unfortunately, my communication with Mr. Stam was too late to have any impact on the bill as it passed the House of Representatives.

If an individual on a calendar-year basis severs his membership in a fiscal-year partnership, the consequence is that he is required to report more than 12 months of income in 1 year. To take the most extreme case, suppose such an individual severs his connection on December 31, 1954. For 1954 that individual will have to report 23 months of income for Federal income-tax purposes, as follows:

(a) His distributive share of the partnership income for the 12 months ended January 31, 1954. You will realize that for tax purposes he is deemed to have received all of his income on January 31, 1954, although as a practical matter he probably received a substantial part of it by way of drawing over the previous 12 months.

(b) His distributive share of the partnership income for the 11-month period, February 1, 1954, to December 31, 1954.

Needless to say, with the graduated surtax rates, the burden upon the individual in such a situation is quite heavy. Nor is this a situation that is unlikely to arise. Almost any person who leaves a fiscal year partnership to take a salaried position will face this problem. Even if he leaves the partnership prior to December 31, he still will have 23 months of income, since he will have to report his salary for the period from the date he left the partnership to the end of the calendar year in addition to the items mentioned above.

The only possible way to hedge against such a situation is for the individual to adopt a fiscal year himself which coincides with the fiscal year of the partnership. Leaving aside any question of the consent of the Commissioner to such a change, the individual then runs afoul of the provisions of section 47(c) of the Internal Revenue Code (sec. 443(b) of the proposed Internal Revenue Code of 1954). This section provides that, in the event of such a change, the income for the short year must be annualized—that is, the income for the short year must be multiplied by 12, the tax computed, and the result divided by 12.

The result of this annualization requirement can be quite harsh. Assume an individual on a calendar-year basis is a member of a partnership having a fiscal year ending January 31. The individual decides to change to a January 31 fiscal year. As a result, he is required to file a return for the short year, namely, January 1 to January 31, 1954, and to annualize this income. Let us further assume that the individual's sole income was his distributive share of partnership income for its fiscal year ending January 31, 1954, that this amounted to $15,000 after deductions and exemptions, and that the individual was married but had no children. His tax for the short period would be computed as follows:

(*a*) Income	$15,000
(*b*) Annualized ($15,000×12)	180,000
(*c*) Tax on $180,000	117,240
(*d*) Tax payable (1/12 of (*c*))	9,770

For a person to have to pay a tax of $9,770 on a net income of $15,000 is to put it mildly a heavy burden.

Section 47(c) (2) purports to provide some relief by allowing a taxpayer in such a situation to recompute his tax after a period of 12 months from the begin-

ning of the short period and then take a pro rata amount of that tax (i. e., that proportion which the net income for the short period bears to the net income for the 12-month period).

Let us assume that the individual taxpayer described above continues as a partner and has no other income than that derived from the partnership. His income will, therefore, remain at $15,000 for the 12-month period January 1 to December 31, 1954, since the next partnership distribution date will be January 31, 1955. At the end of 1954, he may then compute his tax on the basis of $15,000, which will amount to $3,620, and obtain a refund of $6,150.

The difficulty with the relief provisions of section 47(c) (2) is that one needs to have the cash to finance the change of taxable year. It seems strange indeed that the practical availability of a provision of this kind should be dependent upon the financial condition of the taxpayer. I do not believe that such a situation fits into the basic philosophy upon which our tax laws are predicated.

The argument may be made that the individual in the siuation described had a year free of tax when he was originally made a partner. The fact is, however, that he merely postpones his liability to tax; he was not relieved of a year's taxes. Eventually those taxes have to be paid, and, as the law stands now, at higher surtax rates.

I suspect that, in enacting section 47 (c), Congress never considered the impact of annualization on an individual who derived his principal income from a partnership. In all probability Congress had in mind the situation of an individual who received his taxable income fairly ratably over the year and inserted section 47 (c) (2) to cover situations where occasionally a slight variation might arise.

The inequitable situation which I have described can, I believe, be taken care of by the addition of a clause at the end of section 443 (b) (1), reading as follows: "*Provided, however*, That if the net income for the short period includes the distributable share of the net income of a partnership for a taxable year ending within the short period, then, for the purposes of this subsection (1) but not for the purposes of subsection (2), there shall be included in the net income for the short period only that proportion of the distributable share of the net income of the partnership as the number of months in the short period bears to 12."

I respectfully urge that consideration be given to the problem I have described and that a provision along the lines above suggested be inserted in the proposed Internal Revenue Code of 1954. I should also appreciate it if this letter were made a part of the record of the hearings before the Senate Finance Committee.

I shall, of course, be pleased at any time to furnish additional information and discuss the matter with you or the staff of your committee.

Sincerely,

THEODORE TANNENWALD, Jr.

NATIONAL ACADEMY OF SCIENCES,
Washington 25, D. C., April 16, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Committee on Finance,
United States Senate, Washington 25, D. C.

MY DEAR SENATOR MILLIKIN: The attention of the National Academy of Sciences has been drawn to section 117 of H. R. 8300, now pending before your committee, which deals with the exemption of scholarships and fellowships from tax liability. We are disturbed by the phraseology of section 117 although we are in full sympathy with the intention that is evident therein of establishing objective criteria by which the tax liability of scholarships and fellowships can be determined.

As president of the National Academy of Sciences I feel that it is my duty to submit our views in this matter for your consideration because, as you know, the purposes for which the Academy was founded in 1863 by act of Congress, approved by President Lincoln, include the furthering of science and also the providing of advice to the Federal Government in scientific matters.

If section 117 in the measure as it passed the House should be approved by the Senate and enacted into law we are convinced that it would run serious risk of jeopardizing the varied program of fellowships that was inaugurated soon after World War I and that for more than 30 years has provided a substantial part of the advanced training of our young and talented men and women for leadership in science and technology. It would endanger similar programs in other fields as well which contribute much to the encouragement and support of the intellectual and artistic development of the Nation.

In particular, a large proportion of postdoctoral fellowships and others where the holder is not a candidate for a degree, which have previously been generally exempt from tax, would be taxed under subsection (b) (2) of section 117, which provides that such grants shall be taxed if they amount to 75 percent or more of the recipient's salary or earned income for the 12-month period preceding the grant. A great many fellowships are awarded to individuals who, having just received the doctorate or other degree, have had only a very small previous earned income, or none at all.

To the end that proper fellowship programs can be continued on an undiminished scale without injury to the Government, and with great benefit to the advancement of the arts and sciences, medicine and technology, we are exploring possible amendments to section 117. In this effort we are working closely with other organizations, public and private, that are concerned with similar programs, and with officials of the Treasury Department. We plan also to consult with members of the staff of the Joint Committee on Internal Revenue Taxation. I have every expectation that together we shall succeed in arriving at proposed phraseology that will carry out the spirit of section 117 in protecting the interests of the Government and that will at the same time give adequate protection to fellowships as a vital part of our pattern of advanced academic training.

I earnestly and respectfully recommend this matter to your attention in your consideration of the bill that is before you. I should be happy to appear before the committee in this connection if the committee should desire that I do so.

Yours sincerely,

DETLEV W. BRONK, *President.*

CHICAGO 2, ILL., *April 15, 1954.*

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee, Senate Office Building, Washington, D. C.

HONORABLE SIR: The purpose of this letter is to voice my objection to sections 275 and 312 (c) and (d) of the proposed Internal Revenue Code of 1954 (H. R. 8300) which sections would, in effect, disallow as a deduction interest on corporation indebtedness if the obligations are held by persons owning 25 percent or more of the corporation's stock, and if the obligation is subordinated to the claims of other creditors.

I am attorney for, and a stockholder of, Citizens Loan Corp., a small family corporation. Such a provision will result in a real hardship to this corporation, and to other small corporations, whose stockholders must lend money to the corporation on a subordinated basis so that the company may maintain its line of credit at banks and other lending institutions.

To distinguish between the stockholder-lender, and the nonstockholder-lender, in disallowing or allowing the deductibility of interest on subordinate notes, or bonds, is an arbitrary and capricious classification.

The financial programs of many companies have, for years, been founded upon this kind of financing from stockholders, and the deductibility of interest paid on such subordinated obligations has been long established.

To upset such a long-standing practice will do incalculable harm to small family corporations and will remove much of the incentive to expand their operations.

I urge you to oppose these sections most vigorously.

If this provision remains in the bill, it should be amended so that interest would be disallowed as a deduction only in those cases where the corporation is undercapitalized with an abnormal amount of debt in relation to a nominal amount of capital. This change could be accomplished by providing that no interest would be deductible with respect to subordinated obligations held by persons who own 25 percent or more of the common stock. If the total principal amount of subordinated obligations held by such stockholders exceeds 75 percent, or 66⅔ percent, of the net worth (capital and surplus) of the issuing corporations, this would mean that the net worth must be at least 133 percent, or 150 percent, of the total principal amount of subordinated obligations held by such stockholders; otherwise, no deduction would be allowed for the interest thereon. This change would prevent any interest deduction in all cases of this kind unless the stockholders have a substantial stock equity in the business.

Such a provision would penalize the undercapitalized, or "thin" corporations, but it would not be a burden to most of the small family corporations who must

obtain some of their financing from stockholders on a subordinated obligation basis.

Your attention to this letter will be greatly appreciated.

Yours very truly,

JOHN A. BREEN,
Attorney at Law.

THE NORTHWESTERN MUTUAL LIFE INSURANCE CO.,
Chattanooga 2, Tenn., April 15, 1954.

Senator EUGENE D. MILLIKIN,
Washington, D. C.

DEAR SENATOR MILLIKIN: In the April 2 Prentice-Hall pension and profit-sharing report, the following statement was made regarding the proposed Internal Revenue Code of 1954:

"Remember, the Finance Committee hasn't hesitated to rewrite House revenue bills in the past. Headed by Senator Eugene D. Milliken (Republican, Colorado), a capable, down-to-earth taxman, it also includes such respected minority members as Senators Walter F. George (Democrat, Georgia) and Harry F. Byrd (Democrat, Virginia). Since the House acted, inequities, inconsistencies, and provisions calling for greater refinement have become apparent in the bill. Senator Millikin and his colleagues can be counted on to try to iron these out."

I am writing you in regard to one of the proposals for qualification of an employee's exempt pension, stock bonus, or profit-sharing trust. This provision is a so-called 30-percent stockholder limitation which states "A plan is considered to discriminate in favor of stockholders if more than 30 percent of the funds are used for stockholder benefits. For this purpose, an employee is considered to be a stockholder if he owns 10 percent or more of the company's stock (including stock held by close relatives)."

In my opinion, if the 30-percent stockholder limitation becomes a part of the new law, it will just about kill the pension business for the small corporation just as it did when the 30-percent stockholder limitation was made a part of the regulations. This portion of the regulations was finally declared to be illegal and the pension business for the small corporation boomed immediately thereafter.

Within the past 6 months I have made calculations on about 7 pension trust proposals. It is interesting to know that not a single case would have qualified without reducing the benefits to be received by the stockholder group. In the usual small closely held corporation, the stockholder group is usually of a higher age and the amount of basic compensation is larger than the average employee group. Even with 1 so-called stockholder, the benefits usually have to be reduced to comply with a 30-percent rule and if there is more than 1 stockholder, the benefits to be received by them are often less than the amount received under the formula by a high-paid employee drawing considerably less basic compensation.

When it is necessary to drastically reduce the benefits to be received by the stockholder group, it materially limits the desirability of such a plan for a closely held corporation. When a plan is not adopted, this necessarily has the effect that the employees will not receive any benefits.

I certainly hope that your committee is giving adequate consideration to the limitations the proposed law would have on future pension plans for small corporation—and are attempting to have this provision eliminated or materially modified.

Sincerely yours,

JULIAN D. WALTER, *District Agent.*

STATEMENT OF THE LIMITED PRICE VARIETY STORES ASSOCIATION PRESENTED BY CHESTER M. EDELMANN, CHAIRMAN, COMMITTEE ON TAXATION, RECOMMENDING CHANGES IN H. R. 8300

The Limited Price Variety Stores Association is composed of members operating approximately 8,500 variety stores (so-called 5 and 10 cent to $1 stores) in all 48 States and the District of Columbia, doing an annual volume of approximately $2.5 billion.

At the outset credit must be given to those who devoted considerable time and effort in drafting the proposed Internal Revenue Code of 1954. In the pressures

under which everyone worked, unintentional errors and numerous instances of inconsistencies and inequities were bound to occur, and in the desire to meet a deadline, certain provisions were not given adequate attention.

There is much that is good and worthwhile in the proposed bill, but our association feels that it must call to your attention a few important, desirable changes on behalf of retailers. Since hundreds of experts were engaged nearly a year in this stupendous task, it is obvious that a small committee could barely scratch the surface in the few weeks that the proposed bill has been available to the public. Consequently, failure to mention any other section of the bill is not to be construed as approval of such sections. Our committee will continue its work and if other major changes are deemed necessary, it will appreciate the opportunity to submit these to the appropriate congressional and Treasury staffs and committees.

RECOMMENDATIONS

1. Effective date of act

Tax practitioners, lawyers, and accountants have not had sufficient time to study the many technical changes made in H. R. 8300. Certainly business executives have even less comprehension of how the technical changes may affect pending or contemplated business transactions. Consequently, it is recommended that all such changes be effective January 1, 1955, or 90 days after enactment at the earliest. Business has a right to have a reasonable time to change from long-established tax principles to new ones no matter how desirable and equitable such changes may appear.

2. Section 6016, declaration of estimated income tax by corporations should be eliminated

There are approximately 3 million retailers of merchandise or services in the United States. Chain Store Age estimates that 93.5 percent of retail stores are operated by independents and only 6.5 percent by chains.

Much of the retail business is unusual in that it is highly seasonal, with the largest amount of business transacted in the fourth or Christmas quarter of the year. In many instances, substantially the entire year's profit is made in the fourth quarter—and this may be further localized in the month of December. Retail trade in December is dependent to a large degree on favorable weather—which is beyond man's knowledge or control.

Most retailers, including many large ones, take inventory only once a year, at which time and only at such time are profits reasonably determined. Most retailers affected by this section are modest-sized and do not have the facilities or trained personnel to make the estimates required by this section.

In addition, it is customary in the retail business to accumulate peak inventories and incur peak indebtedness beginning in September and extending until mid-December. It is a well-known fact that even the largest retail companies customarily rely on seasonal bank financing to carry these peak inventories until sales are made in December. If the stronger companies are compelled to seek additional financing during the September-December period, it is at once apparent what the effect of prepayment of income tax would have on the smaller retailer. It will mean more borrowing by such companies—if they can get such credit—with additional deductions for interest charges.

As a matter of fact, the Treasury will actually lose in net receipts under the proposed plan. Let us see the effect on the Treasury for each $1 million borrowed by corporations in order to prepay their taxes. If such sum is borrowed for 4 months at say 5 percent—the corporations will pay $16,667 in interest which at 52 percent will reduce income tax revenues by $8,667. The Treasury can borrow $1 million on 91-day bills at approximately 1 percent rate at a cost of about $2,500.

It is true that section 6655 softens the effect of an erroneous estimate of tax due, but these escape provisions do not reduce the need for money to invest in inventories for the pre-Christmas period.

The present code is fair, effective, and reasonable to administer. Beginning with 1954 income the entire income-tax liability is required to be paid in two equal installments within 5½ months after the close of the taxable year.

3. Subchapter, corporate distributions and adjustments

This highly technical subchapter contains a great deal that is good. However, some parts such as sections 309, 311, 359, and 382, to mention a few, are inequitable and discriminate against the smaller corporation. Most retailers are small corporations.

Retailing is a matter of personal skill and management. Many persons have built up successful businesses and because of age or health merged their businesses in a tax-free exchange with a larger one, continuing their life's efforts in the form of an investment in the merged corporation.

Section 359 now makes such normal business transactions in the retail field virtually impossible. This discrimination against smaller corporations has no place in American life, and certainly has no proper place in American tax law.

Subchapter C is probably the most important in the entire code. Drastic changes are proposed. Businessmen and tax experts have not had adequate time to fully understand the provisions. The entire subchapter should be eliminated and should be enacted next year after sufficient study by congressional committees and business and tax experts.

4. Section 167, depreciation

This section is a step in the right direction, but by no means can be considered unduly liberal. The section, under certain circumstances, allows new property, acquired after December 31, 1953, to be fully depreciated over a shorter period of time than previously permitted. However, in the average case it will take from 15 to 25 years to ascertain whether or not the taxpayer actually benefited from such accelerated depreciation.

Several minor suggestions are offered:

(*a*) The declining balance method is too complicated for retailers who are mainly small business. Any sound method of depreciation should be permitted, even if at the end of a particular year the accumulated depreciation is higher than the amount permitted under the declining balance method.

An example of another appropriate method that has been brought to our committee's attention is the sum-of-the-digits method, and, while it is more complicated than the straight-line method, it is more desirable for retailers than the declining balance method.

(*b*) Subsection (3) (1) is more likely to result in disputes than to settle them. The 10 percent differential in useful life is too narrow. Technological advances made in machinery and equipment in the last 10 years make it more and more difficult for management, their engineers and accountants to accurately determine the useful life of property. The differential should be increased to at least 25 percent to make this subsection achieve its intended results of eliminating disputes. It would be better to remove this subsection than to permit it to remain in its present form.

(*c*) Retailers generally are not equipped to maintain the detailed terminal writeoff records required by the declining balance method. Some provision should be made for writing off the undepreciated balance at the end of its estimated useful life (even though the property may still be in use) or for a minimum annual allowance (while the property is still in use) of not less than one-half the rate that would have been used on a straight-line basis. In addition, there should be a terminal writeoff whenever the remaining balance is less than 5 percent of cost, but in no event more than the annual allowance on a straight-line basis.

(*d*) Where property is completed and first used after December 31, 1953, the declining or other approved method of depreciation should be applicable to the entire cost, even though some part of its was incurred prior to January 1, 1954.

5. Section 472, Lifo inventories

We recommend that section 472 be amended to permit valuing Lifo inventories at the lower of cost or market

Erroneous Treasury rulings prevented many retailers from adopting this method in the early forties. Some adopted the method as a result of the decision in the Hutzler Bros. case. Such taxpayers are now required to value their inventories at cost which may be and which from all indications may continue to be above market value, which is contrary to sound accounting practices.

Retailers are in business to distribute at the lowest possible cost the products of farms and factories. Retailers are merchants, not speculators. They should not be made to speculate on the proper time to adopt Lifo.

With prices stabilized in the past year to a greater degree than at any time since 1950, revenue considerations would be an unimportant factor in adopting this provision at this time.

Retailers have the right to use the lower of cost or market on the first-in first-out (Fifo) method. It is only fair and equitable that it apply as well to the Lifo method.

Only a relatively few large retailers have adopted the Lifo method. Small retailers cannot take the risk of guessing at price trends. If the proposed amendment is adopted, the Lifo method would be available to practically all retailers on an equal basis.

6. Section 461, accrual of real-estate taxes

This section attempts to make clear the year or years in which real estate taxes should be deducted, by relating the year or years of deduction to the period covered by the tax. This concept is approved, but touches on only a small area of the problem.

There has been a tremendous amount of litigation with respect to accrual dates of personal property, license, franchise, and other taxes that are related to a definite period of time. The section should be amended to include all taxes that are related to a definite period, which will be deductible pro rata over such period.

Since the transition is mandatory, the effect will be generally that taxpayers who have deducted 1954 taxes in their 1953 returns (those taxes that legally accrued in 1953 and which are under present law deductible in 1953) will get no deduction until 1955 for a similar tax. Consequently there will be 1 year, 1954, in which no deduction, or only partial deduction, will be allowed. This situation ought to be corrected by allowing the 1954 tax to be deducted in 1954. If this were permitted, only 1 year's tax would be deductible in any 1 year and it is difficult to see how the Government's interest would be adversely affected.

7. Section 462, reserves for estimated expenses

This section follows sound accounting principles used even in the smaller business. It is approved in principle.

However, the beneficial effects of this section ought not be lost through faulty interpretation of its effect in any transition year. The section should make it clear that in a transition year, the reserve for estimated expenses for any future period will be allowed in that year in addition to similar expenses or losses actually incurred in that year—not the higher of two amounts.

8. Sections 505–514, investment and taxable income of pension trusts

Relatively few of our members are affected by the above sections. However, we do recognize the problem and we are informed that other trade associations have members similarly affected.

Since real estate, in which are located efficiently operated retail stores, is becoming more and more attractive as an investment for pension trusts, we, of course, condemn any legislation, such as section 505, that unduly limits this trend. In addition, we believe that income received by a pension trust from such real estate should be entirely tax exempt to such trust, even though the real estate may be subject to a mortgage indebtedness.

We generally endorse the views of those individuals and companies or associations who have filed statements protesting these sections with your committee.

9. Sections 531–536, improper accumulation of surplus

These sections discriminate against the so-called closed corporation. Only a negligible number of retailers would qualify as publicly held corporations as defined in section 532 (c). As a matter of fact, according to information of the Securities and Exchange Commission, there are only 250 retail companies listed on all exchanges, some of which might not even qualify as a publicly held corporation.

The tax is levied on all undistributed earnings of the taxable year. It is possible that even in a situation where the imposition of the tax is justified, that some of the retained earnings might be reasonably needed in the taxpayer's business. Consequently the tax ought to apply only to that portion of the undistributed earnings that is unreasonably accumulated.

The accumulated earnings of $30,000 provided by section 535 (c) (1) is generally inadequate. It may be too much for some corporations and insufficient as to others. Since it is difficult to relate the amount to capital, or earnings, it is recommended that the credit be increased to $100,000.

The burden of proof requirement of section 534 is inadequate as far as the small taxpayer is concerned. Although section 534 (c) may transfer this burden to the Secretary of the Treasury, the taxpayer can do this only by filing with the Secretary a statement setting forth his grounds together with facts sufficient

to apprise the Secretary of the basis of the taxpayer's case. In effect, the taxpayer is placed under an undue burden, and may not realize that failure to furnish the Secretary with such a statement puts the burden of proof on him.

The small taxpayer ought to be better protected. The burden of proof should never be on him in a section 531 tax.

Several witnesses, appearing for the American Retail Federation of which the Limited Price Variety Stores Association is a part, have presented more detailed testimony on some of the above points. We endorse this testimony and also that of the National Retail Dry Goods Association concerning the use of cost or market for valuing inventories under the Lifo method.

Thank you for the opportunity to submit these views.

DUER, STRONG & WHITEHEAD,
New York 5, April 20, 1954.

Re section 170 (b) (1) (C), H. R. 8300, unlimited deduction for charitable contributions.

Hon. EUGENE D. MILLIKIN,
United States Senate, Washington, D. C.

DEAR MR. CHAIRMAN: We propose adding to the language of section 170 (b) (1) (C) of H. R. 8300 the italicized paragraph below.

Section 170 (b) (1) (C), 1954 Revenue Code:

"(C) Unlimited Deduction for Certain Individuals.—The limitation in subparagraph (B) shall not apply in the case of an individual if, in the taxable year and in 9 of the 10 preceding taxable years, the amount of the charitable contributions, plus the amount of income tax (determined without regard to chapter 2, relating the tax on self-employment income) paid during such year in respect of such year or preceding taxable years, exceeds 90 percent of the taxpayer's taxable income for such year, computed without regard to—

"(i) this section,

"(ii) section 151 (allowance of deductions for personal exemptions), and

"(iii) any net operating loss carryback to the taxable year under section 172.

This subparagraph shall also apply in the determination of tax liabilities for years beginning after December 31, 1943, and prior to January 1, 1954, if in the one year of the qualifying period in which such percent did not exceed 90, the amount of such contributions plus the amount of such taxes paid during such year exceeded 90 percent of the taxpayer's taxable income as reported in his income tax return filed for such year computed without regard to (i), (ii) and (iii) referred to in this subparagraph."

REASON FOR PROPOSED ADDITIONAL WORDS

To remove the injustice where the 10-year qualification period is interrupted in a single year owing to adjustment of net income under retroactive provisions of a revenue act enacted subsequent to the filing of the return, thereby increasing the income reported in the return and reducing the percent of contributions and taxes paid to slightly less than 90 percent.

Respectfully submitted.

DUER, STRONG & WHITEHEAD.

STATEMENT ON BEHALF OF AMERICAN TRANSIT ASSOCIATION IN SUPPORT OF AMENDMENT OF SECTION 247 OF H. R. 8300, BY HARLEY L. SWIFT, PAST PRESIDENT AND CHAIRMAN OF POLICY COMMITTEE ON TAXES

The American Transit Association is a voluntary trade association. Its membership is comprised of companies operating motor buses, streetcars, trolley coaches, and rapid transit facilities, or various combinations thereof, in urban and suburban areas in all parts of the United States. The operating member companies include privately owned and operated and publicly owned and operated companies which annually transport more than 80 percent of the transit passengers carried in the United States. About 14 billion passengers were carried by the transit industry last year. Approximately 81,000 passenger vehicles of all types were owned by the industry as of December 31 of last year.

Except for a relatively few publicly owned and operated transit systems, the rates of fare as well as the quantity and quality of the service rendered by local transit operators are strictly regulated either by a State, public utility commission, or by the municipality or municipalities in which the service is rendered. In a few cases the operations are such as to bring them within the jurisdiction of the Interstate Commerce Commission also.

The definition of the term "public utility" found in paragraph (b) (1) of section 247 of H. R. 8300 (sec. 26 (h) of the present Internal Revenue Code adopted in 1939) does not cover corporations engaged in furnishing local transit service, although it does cover most other types of public utilities. We believe the omission of transit companies is due to inadvertence at the time this section was enacted. However, continued failure to accord transit companies the same rights and privileges accorded to the other public utilities specifically mentioned in this section is unjust and discriminatory.

There are transit companies with outstanding preferred stock which meets the requirements outlined in paragraph (b) (2) of section 247 of H. R. 8300 (sec. 26 (h) of the present Internal Revenue Code adopted in 1939).

We respectfully suggest that paragraph (b) (1) of section 247 of H. R. 8300 be amended by inserting the words "in the local transportation of persons by rapid transit vehicles, streetcars, trolley coaches or motor buses" after the words "telephone service".

Because of financial difficulties throughout the industry and the reorganizations which have followed, only a limited number of transit companies would benefit, from the relief we seek and the loss in revenue to the Federal Government would be relatively small. However, removal of this inequity would prove extremely helpful to the affected companies now confronted with a continuing decline in riding and constantly rising labor and material costs.

We sincerely hope that this committee, after due consideration, will report a bill containing the amendment we have suggested, removing the inequity which now exists.

MOMSEN & FREEMAN,
New York 5, N. Y., April 9, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Finance Committee of the United States Senate,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: I have read with considerable interest the sections of the proposed revision of the Internal Revenue Code (H. R. 8300, 83d Cong.), relating to income derived from foreign sources, and the right to deferment as to income of foreign branches. As attorneys, specializing in the field of international operations, we are especially interested in the provisions of sections 923 and 951. I have a number of suggestions to make with respect to the aforementioned sections, which I believe merit the serious consideration of the Senate Finance Committee.

I. Section 923

Under section 923, a tax credit of 27 percent is allowed to domestic corporations as to income derived from sources within a foreign country, either in the form of profits resulting from branch operations, or dividends from a foreign corporation. There appears to be an exclusion from this benefit with respect to such income where "import-wholesale" and "branch sales office" operations are carried on in a foreign country, or an office is maintained abroad to facilitate the importation of merchandise.

This exclusion would appear to be discriminatory and unreasonable. Many American firms maintain branches abroad or subsidiary foreign corporations for the purpose of doing business in foreign countries, such operations involving an investment of capital, the importation of goods and merchandise from the United States and their sale to or through wholesalers, jobbers and distributors. These firms are doing business in the foreign countries, and are subjecting themselves to foreign taxes and all the risks incident to the conduct of a trade or business in a foreign country. The exclusion of this type of operation is unwarranted. The same risks and foreign tax liabilities are assumed as in the case of retail operations, now included in section 923, and furthermore, the "import-wholesale" and "branch sales office" operations are most important to the promotion of the foreign trade and commerce of the United States.

It would appear to me that the Senate Finance Committee should consider the following as possible amendments to section 923:

(*a*) Replace section 923 (a) (3) II with the following:

"Has been derived to the extent of at least 90 percent from the active conduct of a trade or business within a foreign country."

(*b*) Eliminate section 923 (b) (1), in view of its restricted character.

II. Section 951

The same criticism that I have made with respect to section 923 would apply also to section 951, and since the benefits under section 951 are closely related to section 923, it would be necessary to make a similar change in section 951.

Accordingly, I would suggest the following amendments to section 951:

(*a*) Eliminate from section 951 (a) that part of the paragraph reading as follows:

"Through a factory, mine, oil or gas well, public utility facility, retail establishment or other like place of business situated within a foreign country."

(*b*) Eliminate section 951 (b) (1) in view of its restrictive character.

I believe that there is a further case of apparent discrimination with respect to section 951 (c) (2), which excludes from the right to deferment of income, a domestic corporation which claims Western Hemisphere trade corporation status. If a domestic corporation claiming such status is doing business in a foreign country through a registered branch, the income from such branch operation also should be entitled to the right of deferment. In this connection, I believe that section 951 (c) (2) should be eliminated.

The above suggestions are in the interest of American business and in accordance with the intention and desire of the administration to foster foreign trade and investments abroad.

In support of, and as further clarification of the views expressed in this letter, I enclose, herewith, a copy of an article entitled "Serious Defects in Proposed United States Tax Legislation Affecting Income from Overseas Operations" which I have written and which will appear in the April 19 issue of Export Trade and Shipper magazine.

I consider the suggestions I have made to be of vital importance, and if you believe that they should be developed before the entire committee, and you deem my presence advisable I would be glad to go to Washington to present my views.

Very sincerely yours,

JOSEPH S. CARDINALE,
Counselor at Law.

SERIOUS DEFECTS IN PROPOSED UNITED STATES TAX LEGISLATION AFFECTING INCOME FROM OVERSEAS OPERATIONS

(By Joseph S. Cardinale, attorney and counselor at law, New York City)

Legislation now pending before Congress, revising the Internal Revenue Code, proposes the granting of a 27 percent tax credit with respect to income derived from foreign sources, either through a foreign subsidiary corporation or a foreign branch, and the right of deferment as to income of foreign branches. The legislation in question has been approved by the House of Representatives and is now being considered by the Senate Finance Committee.

Undoubtedly, there can be no objection to the purpose and general scope of the proposal, other than the customary and repeated complaint that the United States Government tax policy, with respect to foreign investments, does not go as far as is desired and necessary, that is, the elimination of double taxation, by recognition of the principle of taxation of foreign income at the source. At best, there is only a partial recognition of this principle in the pending legislation, and although somewhat limited in scope, none of the less welcome, for it indicates the continued desire of the Government to extend more favorable tax treatment to income from overseas operations, and it is a step in the right direction.

However, a careful examination of the proposed legislation reveals serious defects which should be brought to the immediate attention of the Senate Finance Committee, and in this connection, the active support of American business interests is essential in order that its voice be heard and corrective steps be taken. For this purpose, an analysis of the proposed section 923 (business income from foreign sources), and section 951 (income which may be deferred) are presented herewith:

I. SECTION 923

(A) A tax credit of 27 percent of the combined normal and surtax is allowed as to income derived from sources within a foreign country with respect to—

(1) Income from foreign branches of a domestic corporation, when such income is the result of the active conduct of a trade or business, through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business, situated within a foreign country (also see sec. 951 A).

(2) Compensation resulting from the rendition of technical, engineering, scientific, or like services.

(3) Dividends from a foreign corporation—

(*a*) Derived at least 95 percent from sources without the United States:

(*b*) Derived at least 90 percent from the active conduct of a trade or business, through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business, situated in a foreign country, and

(*c*) Which does not consist of more than 25 percent of gross income from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States.

(*d*) It is further required that the domestic corporation, either alone or in association with not more than 3 other domestic corporations, own more than 50 percent of the voting stock of the foreign corporation; or

(*e*) That the domestic corporation own not less than 10 percent of the voting stock of the foreign corporation, and that the trade or business of such domestic corportation be related to the trade or business of the foreign corporation, by reason of the rendition of technical, engineering, scientific, or like services or assistance, incident to the trade or business of the foreign corporation.

(4) Interest from a foreign corporation, if during the year in which such interest is paid, the recipient domestic corporation fulfills one of the requirements set forth in 3d and 3e above.

(B) In defining the term "trade or business" as used above, section 923 provides that it does not include an establishment engaged principally in the purchase or sale (other than at retail) of goods or merchandise, or the maintenance of an office or agent, other than a retail establishment, to import or facilitate the importation of goods or merchandise.

(C) Excluded from this particular 27 percent tax credit are Western Hemisphere trade corporations and other special types of corporations already receiving special tax treatment.

The general principle on which the proposed section premises the 27 percent tax credit appears to be the maintenance abroad of an establishment or the rendering of services, or investment in a foreign country. Furthermore, the particular tax credit is granted without limitation as to the area of operation or investment, and regardless of whether a registered branch or a foreign subsidiary method of operation is used. In this respect, the proposed section is an improvement on the present section 109 relating to Western Hemisphere trade corporations, in that the benefit is extended to foreign corporations, thus permitting American business to select the form or method of operation desired, as contrasted with the provision of section 109 restricting the benefits only to operations through a domestic corporation, and consequently, excluding income from a foreign corporation.

However, there is a serious defect in the proposed section 923, which is in fact discriminatory and unreasonable, and which should be brought to the attention of the Senate Finance Committee immediately. As presently worded, section 923 specifically excludes "import-wholesale" and "branch sales office" operations, either through a foreign branch or through a foreign corporation. This exclusion is arbitrary and strikes at the very core of the methods of operation available to American firms for doing business in foreign countries.

Numerous American companies have established and will continue to set up operations in foreign countries, either through a registered branch or a foreign corporation, for the purpose of importing or facilitating the importation of goods and merchandise from the United States and their sale within the foreign country, directly or through wholesalers, jobbers, and distributors. For this purpose an office must be maintained in the foreign country, a staff employed, storage facilities set up, and furthermore, capital must be allocated to the foreign branch operation.

The "import-wholesale" and "branch sales office" type of operation are most essential to the fostering and promotion of United States foreign trade and in addition, it is often a necessary preliminary step to expanded operation and

investment in foreign country. Before substantial investments in overseas manufacturing facilities can be made, a market must be developed and maintained, and the product well established. These types of operation, either through a registered branch or a foreign corporation, are an essential and vital factor in the trade and investment policy of the United States and should be placed on an equal plane with any other type of operation now covered by the proposed section 923.

In this respect, the "import-wholesale" and "branch sales office" type of operation are of greater importance and more worthy candidates for receiving the 27 percent tax credit than a foreign retail establishment. The present exclusion in section 923 is discriminatory and without valid reason, and furthermore, is injurious to the foreign trade and investment policy of the United States and should be eliminated immediately.

II. SECTION 951

(A) Income may be deferred in the case of a domestic corporation which operates a branch in a foreign country and is engaged in the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business, if such branch has derived—

(1) 95 percent or more of its income from sources without the United States;

(2) 90 percent or more of its income from the active conduct of a trade or business; and

(3) Not more than 25 percent of its gross income results from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States.

(B) In defining the term "trade or business," section 951, as in the case of section 923, states that "trade or business" does not include the operation of an establishment engaged principally in the purchase or sale "other than at retail" of goods or merchandise, or the maintenance of an office or agent "other than a retail establishment to import or facilitate the importation of goods or merchandise.

(C) Excluded from the above right to deferment of income are the Western Hemisphere Trade Corporation and other special types of corporations already receiving special tax treatment under presently existing sections of the Internal Revenue Code.

No reference is made to foreign corporations in section 951, in view of the fact that foreign corporation income is not subject to United States taxes, income therefrom to the American stockholders being taxed only at such time as a dividend is declared and paid by the foreign corporation.

Again, as in the case of section 923, previously discussed, there is a serious defect which is in fact discriminatory and unreasonable. The objection is in connection with the definition of the term "trade or business," which being identical with the provision in section 923, results in an exclusion of the import-wholesale and branch sales office type of operation, and, consequently, income to a domestic corporation from a foreign branch which engages in or facilitates the importation of goods and merchandise and the sale thereof in the foreign countries, directly or through wholesalers, distributors, and jobbers, is excluded from the right of deferment of income. Apparently, sections 923 and 951 are at least consistent, in that they contain the same definition for the term "trade or business."

The effect is an exclusion which is detrimental to the interests of American business and the foreign trade and investment policy of the Nation. There is, certainly, no objection to including retail establishments, but on the other hand a stronger case can be made out for extending the benefits to import-wholesale and branch office sales operations in that these are essential to the development and expansion of overseas markets and eventually lead to substantial investment abroad. The inclusion of the aforementioned types of operations would be wholly consistent with the apparent purpose of sections 923 and 951; that is, the maintenance of an establishment abroad which involves an investment and the actual conduct of a trade or business in the foreign country.

There is an additional serious defect in section 951 which results in the exclusion of a domestic corporation, which claims Western Hemisphere Trade Corporation status, from the right to deferment of income from sources within a foreign country. This effect is to permit deferment with respect to income from foreign branch operations in general, but to specifically exclude from this right, income from foreign branches of a Western Hemisphere Trade Corporation. This exclusion, again, is arbitrary and injurious to the interests of American firms maintaining branches abroad.

An examination of the report of the Ways and Means Committee of the House of Representatives, approving the revision of the Internal Revenue Code (H. R. 8300) and in particular sections 923 and 951, reveals that the committee has adopted the policy that preferential tax treatment is to be restricted to enterprises engaged in the conduct of a business involving a significant investment or economic activity abroad. These phrases, "significant investment abroad" and "significant economic activity abroad," apparently provide the reason for the exclusion of import-wholsale and branch sales office operations from the benefits of sections 923 and 951. Even assuming the reasonableness and logic of this criteria requiring a "signficant investment abroad" or "significant economic activity abroad," there still would be no valid reason for excluding the import-wholesale and branch sales office types of operation, since undoubtedly a significant investment and economic activity abroad are involved in the form of capital, either allocated to the branch operation or invested in the foreign corporation, maintenance of office space, staff, and storage facilities, etc.

If the basis for granting the benefits of sections 923 and 951 is that set forth in the report of the House Ways and Means Committee, then it is reasonable to take the position that the import-wholesale and branch sales office types of operation, whether through a registered branch or a foreign corporation, is entirely consistent with such policy and should be included.

The aforementioned exclusion in sections 923 and 951 are of serious concern to American business interests doing business abroad, and it is urgent that appropriate measures be taken to impress upon the Senate Finance Committee the immediate need for amendment of sections 923 and 951, so as to include import-wholesale and branch sales office operations, whether conducted through a branch or a foreign corporation, and at the same time to revise section 951 so as not to exclude domestic corporations, which claim Western Hemisphere Trade Corporation status, from the right to deferment of income from branches abroad.

STATEMENT OF CAPITAL FINANCE CORP., COLUMBUS, OHIO, ON EFFECT OF SECTIONS 275 AND 312 (A) AND (T) OF H. R. 8300 ON FINANCING PROBLEMS OF SMALL BUSINESS AND PROPOSED REVISIONS NECESSARY TO CURE INEQUITIES

Part IX, section 275 of the Revenue Code of 1954, H. R. 8300, disallows a deduction from gross income for interest paid with respect to certain securities which are defined in section 312 (d) and further defined in section 312 (e) (1).

This disallowance is an attempt by law to establish a new criterion for deductibility of interest on subordinated obligations which conflicts with criteria established as a result of much litigation, and which now appears to be a well-established framework within the limits of various court decisions.

These criteria, so established, are based upon the legal attributes of various classes of securities to determine whether they are, in fact, liability or equity securities and also require that they pass the business purpose test. Under part IX, section 275 as passed by the House, it is now proposed to add another test which is entirely unrelated to these critera. This test is that if a debt instrument is subordinated to "trade creditors generally" then the interest on such debt held by persons "who together own 25 percent or more of the participating stock" is not deductible.

Discrimination against small business.—This limitation is one further step in the statutory tax restrictions added to the problems of the small-business man. Large national concerns such as GMAC, CIT, Commercial Credit, etc., are able to sell senior securities at ratios of up to five times their outstanding equity capital. The smaller finance concerns in competition with these giants cannot possibly hope to secure senior credit at such ratios. It, therefore, becomes necessary for them to issue either additional equity capital or subordinated debt to secure increased senior debt. But if additional equity capital is issued, a high rate of return is necessary to market it. The resulting cost of providing a return on the equity capital after deducting income taxes from available earnings makes it necessary for such an operator to price himself out of competition with the giants because his gross income must be larger to absorb the increased cost of securing funds.

Present stockholders are by far the most logical sources of additional funds for any corporation, particularly the smaller corporation which does not have the benefit of national dissemination of information respecting investments in their companies.

Therefore, to add such a severe restriction as is provided by section 275 based on those who hold the securities will further restrict the ability of the smaller organization to finance in competition with large corporations.

Even though the corporation were successful in issuing securities to those not stockholders (and this would require constant vigilance) it is entirely possible that through no action on the part of the corporation individuals together owning 25 percent or more of the stock might acquire securities from a group of owners not owning such an amount of stock.

Discrimination against private ownership.—Such an extreme limitation based upon the principle of stock ownership is an added burden to the small corporation owned through capital stock ownership as compared to the rapidly increasing (both in number and size) cooperative and mutual financial organizations. The cooperative organizations receive a subsidy through exemption from any Federal taxation, both as to amounts paid to members and amounts retained within the cooperative corporation, so long as noncashable evidences of indebtedness for such amounts retained are issued to the members.

Suggested revision.—Present court precedents and case law provide a sufficient criteria for protecting the revenues of the Government against deductions claimed for pseudo debt securities which are, in fact, equity investments. The addition of the very severe and possibly crippling limitation imposed by sections 275 and 312 (d) as now drafted on financing policies of the smaller corporation is not necessary.

If the Treasury Department is actually at a disadvantage under the present status of the law on the subject a slight revision of section 312 (c) (1) will result in a fair restriction which will amply protect the revenue. The words "substantially all" should be substituted for "25 percent or more" so that section 312 (c) (1) would then read: "which in the case of obligations held by persons who together own substantially all of the participating stock is not subordinated to the claims of trade creditors generally."

The term "substantially all" has been used for a number of years in the revenue acts and its meaning has on numerous occasions been reviewed by the courts. In extending exemptions to the cooperative or mutual form of organization the term is used in H. R. 8300. See chapter 79, section 7701 (a) (19), Domestic Building and Loan Association—"The term 'domestic building and load association' means a domestic building and loan association *substantially all the business of which* is confined to making loans to members." [Italics supplied.]

The term "substantially all of the stock" is used as a limitation to the application of paragraph (2) section 359 of H. R. 8300.

In section 275 an ownership limitation is added to restrictions presently existing to determine if a normal business expense is deductible.

Ownership is not a proper test for interest deductibility except in those situations where ownership of stock and ownership of subordinated securities is so clearly related as to indicate the lack of arms length dealing.

Anything less than ownership among the stockholders of substantially the same proportions of participating stock and subordinated notes would indicate an arms length transaction.

Therefore, the substitution of "substantially all" in section 312 (c) for "25 percent or more," or the complete elimination of section 275, should be recommended by the Senate Finance Committee.

Prepared by,

G. ROBERT BECKER, CPA.

COLUMBUS, OHIO.

STATEMENT OF THOMAS J. GREEN, PARTNER, PEAT, MARWICK, MITCHELL & CO., C. P. A., NEW YORK CITY, ON DEFINITION OF NONBUSINESS BAD DEBTS

Subsection 166 (d) (2) of H. R. 8300 defines nonbusiness bad debts. The definition follows:

"(2) NONBUSINESS DEBT DEFINED. For purposes of paragraph (1), the term, 'nonbusiness debt' means a debt other than—

"(A) a debt created or acquired (as the case may be) in connection with a taxpayer's trade or business; or

"(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

On August 6, 1953, I appeared before the Ways and Means Committee of the House of Representatives and testified at length to urge that those debts which

arise in the course of a taxpayer's trade or business, or which represent loans or advances to business organizations in which the taxpayer has a financial interest either as an employee, stockholder, or creditor, be excluded from the definition of nonbusiness bad debts. As a result, the definition quoted above excludes "a debt created or acquired (as the case may be) in connection with a taxpayer's trade or business," which is gratifying and of immense importance to the great number of taxpayers who formerly were unable to deduct as business bad debts those debts not related to the taxpayer's trade or business at the time the debts became worthless.

As I testified before the Ways and Means Committee, however, a larger and more extensive inequity has existed because of the all-inclusive definition of nonbusines bad debts which was contained in subsection 23 (k) (4) of the Internal Revenue Code of 1939 and because of the narrow definition of "trade or business" adopted by the courts in connection with the defining of nonbusiness bad debts. An example cited before the Ways and Means Committee was the case of *Commissioner of Internal Revenue* v. *Weldon D. Smith*, decided April 10, 1953, by the United States Circuit Court of Appeals for the Second Circuit, reversing a decision of the Tax Court. Mr. Smith, who had many other business interests, became interested in a farm operated by a mother and three sons. The mother and her three sons needed someone to assume business management of the farm. Mr. Smith joined with them in forming a corporation of which he became treasurer and general manager in addition to being a 20-percent stockholder. The new corporation sustained operating loses and over the years Mr. Smith loaned it $38,220. The corporation filed a general assignment of its assets for the benefit of creditors, making its debt to Mr. Smith worthless.

The Tax Court found that over the years the taxpayer had invested in or loaned money to a number of businesses and also personally took part in their operations, and it held that under all the facts the $38,220 constituted a business bad debt which became worthless during the taxable year in which the corporation became bankrupt. The circuit court, in reversing the Tax Court, found that Mr. Smith was interested as an investor, manager, and creditor in a number of business enterprises. It said, however, "But since each of these activities separately does not constitute a business, we cannot see how a combination of them spread over various businesses can alter the result. Of course, if respondent were regularly engaged in lending money to business enterprises, bad-debt losses resulting therefrom would be incurred in his business. But respondent himself testified that he was never in the money-lending business, and the other evidence in the records supports this conclusion."

This is typical of the narrow requirement which has developed in order that a businessman, loaning money to his incorporated business, may claim a business bad debt. The requirement that he must show that he is in the business of loaning money deprives him of a bad-debt deduction for money advanced to his business and lost on the poor technicality that it is only his business entity which is engaged in a trade or business and he is simply an investor. This is true even though he serves as an officer of the corporation, devotes most, or all, of his time to conducting its business and has his entire wealth employed in the activity. For example, a group of small-business men, owning boats and engaging in the fishing business, may decide to incorporate the business so that the business will have limited liability because of the hazardous nature of the enterprise. The business will need only a certain permanent capital for investment in the boats and to finance operations. It would be nonsense to insist that the group also furnish permanent capital to cover possible losses from operations. If losses do occur, therefore, the group temporarily loans the corporation sufficient money to cover the losses. These isolated loans are not sufficient to establish that the group is in the business of loaning money, and if the corporation fails and is unable to repay the loans, the individuals are unable to claim their bad debt losses as business bad debts.

Unless the individuals have substantial capital gains (a rare coincidence) against which to offset the so-called nonbusiness bad debts which are considered as short-term capital losses, the individuals obtain only fractional tax benefit from the losses sustained. The corporation, having failed and having a history of losses for 2 or more years before failure in many such cases, is not able to carry back its net operating losses far enough to obtain any tax benefit. Thus, neither the individuals nor the corporation obtain a substantially usable deduction.

To relieve this inequitable burden which has been placed upon businessmen, I urged before the Ways and Means Committee that loans or advances to business organizations in which the taxpayer has a financial interest either as an em-

ployee, stockholder, or creditor be excluded from the definition of nonbusiness bad debts. In urging this exclusion it was not my purpose that all lenders to business organizations should be treated as having made loans which could be classified as "a debt created or acquired (as the case may be) in connection with a taxpayer's trade or business." It was not my purpose to provide that ordinary investors would be allowed business bad debt deductions. The Ways and Means Committee may have considered the second part of my suggestion of last summer to be too broad for its purpose so I therefore now urge that the definition of nonbusiness bad debt be made to specifically exclude only loans or advances to business organizations in which the taxpayer has a substantial financial interest either as a partner, employee or stockholder; and because of the difficulty of defining the word "substantial" that it be defined as meaning ownership of 10 percent or more of the debtor's issued and outstanding voting stock or other proprietary capital. What I urge could be accomplished by rewording subsection 166(d) (2) of H. R. 8300 to read somewhat as follows:

"(2) NONBUSINESS DEBT DEFINED. For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--

"(A) a debt created or acquired (as the case may be) in connection with a taxpayer's trade or business, or as a partner, employee, or stockholder of the debtor owning 10 percent or more of the debtor's issued and outstanding voting stock or other proprietary capital; or

"(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

I suggest the 10 percent ownership limitation as being sufficient to prevent mere investors with no substantial voting rights and active participation in the trade or business entity from obtaining uncontemplated advantage from the exclusion. Confined to those for whom the relief I urge is intended, the exclusion will do much to stimulate business. As it is, there is inadequate incentive for owners of businesses to make loans to enable the businesses to continue or resume after suffering losses and the inability to obtain adequate deductions for loans is contributing to business failures. The exclusion of ownership loans from the definition of nonbusiness bad debts would do much to sustain faith in the fairness of our taxing system.

Senate amendment of subsection 166 (d) (2) of H. R. 8300 as I have urged, would eliminate also the harsh treatment accorded owners of businesses who guarantee bank loans and are, through guarantees, required to pay business debts. An example is the substantial owner and principal officer of a corporation who must guarantee the corporation's notes to banks. When the corporation is unable to pay the banks the guarantor is required to make the payments. Such payments as guarantor after the corporation is dissolved so that he will have no right of subrogation are deductible as losses under subsection 23 (e) of the Internal Revenue Code of 1939 and presumably will be deductible as losses under section 165 of H. R. 8300 (*Greenspon*, 8 T. C. 431). However, the Supreme Court of the United States has ruled in *Spring City Foundry Co. v. Commissioner* (292 U. S. 182) that the provisions of law which deal with losses and the section which deals with bad debts are mutually exclusive, and that an amount properly deductible under one section may not be deducted under the other. When a guarantor pays under his guarantee for a solvent corporation he becomes a creditor of the corporation by right of subrogation and if the corporation is unable to repay him, he has a bad debt loss (*Leo L. Pollak and Virginia M. Pollak, husband and wife*, v. *Commissioner*, 20 T. C. 376). But what constitutes solvency has been hard to determine, as shown by the reversal of the Pollak decision by the Court of Appeals, for the Third Circuit (*Pollak* v. *Commissioner*, 209 F. 2d 57). This uncertainty deters businessmen from making guarantee payments while any possible right of subrogation could transform their losses into bad debt deductions which could be disallowed, and treated as short-term capital losses, because of a finding that the bad debts were nonbusiness bad debts. The credit of honest businessmen is being damaged and the orderly collection of bank loans is being interferred with by this unfortunate impact of a taxing statute and the interpretations which have been placed upon it. For this reason, also, the Senate amendment which I urge is most necessary.

THOMAS J. GREEN.

STATEMENT OF HAROLD P. MUELLER, L. J. MUELLER FURNACE CO., MILWAUKEE, WIS.

Gentlemen, my name is Harold P. Mueller. I am the president of L. J. Mueller Furnace Co., a Wisconsin corporation located in Milwaukee, Wis., engaged in the business of manufacturing and distributing home heating and air-condition-

ing and allied products. The company has been in existence for 97 years and distributes its products nationally through dealers, jobbers, distributors and utilities, and sells some of its products in foreign markets. The company is not publicly held. Its stock is owned by approximately 300 stockholders and is not listed on any exchange.

Beginning in the midsummer of 1953, negotiations were undertaken to merge the company's business with that of Worthington Corp., a much larger concern, which is the producer of pumps, steam turbines, air-conditioning equipment, to mention only a few of an extremely well-diversified line of industrial and consumer products. Such a merger was desirable from the point of view of Mueller because it would give to Mueller the experience, facilities, and resources of Worthington in the air-conditioning field, and it was desirable from the point of view of Worthington because Worthington is in need of the background, experience, and distribution facilities of Mueller in the home heating industry. It is well recognized that in the residential consumer market of the future, home heating and home air-conditioning are going to be more and more closely allied.

These negotiations culminated in a contract entered into February 4, 1954, between Mueller and Worthington under which Mueller was to sell its assets to Worthington in exchange for common stock of Worthington, whereupon Mueller was to dissolve and distribute the Worthington common stock pro rata to the Mueller stockholders.

On February 23, 1954, an opinion was received from the Commissioner of Internal Revenue to the effect that the agreement entered into on February 4 was a tax-free reorganization, and that no taxable gain or loss would be recognized, either to Mueller or its stockholders, upon consummation of the plan. A similar opinion was received from the Wisconsin Department of Taxation on February 25, 1954.

Under Wisconsin law the contract could not be binding upon Mueller until approved by a vote of two-thirds of the holders of Mueller's stock, and 20 days' notice of the meeting at which such vote is to be taken is required by Wisconsin law. The notice was given on March 1, 1954, and the meeting set for March 24, 1954. A two-thirds vote was assured because the holders of more than two-thirds of Mueller's stock signed the agreement on February 4, 1954.

In this state of affairs, the House of Representatives passed H. R. 8300 on March 18, in the week before the Mueller stockholders' meeting was scheduled to be held. Subchapter C of chapter 1 of subtitle A of the proposed code relates to corporate adjustments of this kind, and prior to the meeting our attorneys informed us that because of section 359 (c) of this subchapter, made retroactive to March 1, 1954, by section 391, the plan of reorganization to be submitted to the stockholders would not be tax-free. As a result, we have had to postpone the vote of our stockholders, and it is apparent that if these sections are passed in their present form, this transaction, so important to our company and to Milwaukee industry, and to the heating and air-conditioning industry in general, cannot and will not be consummated.

It is apparent, from the above recital of facts, that we have moved as rapidly as it was possible for us to move under legal and other requirements, and it does not seem at all fair or equitable that our transaction has been frustrated in this way by the threat of a law retroactive in nature, the effect of which, if enacted, will be to nullify tax rulings which have been obtained in good faith from the Commissioner of Internal Revenue.

It is our feeling that if section 359 and related sections are to pass in their present form, they should not be made retroactive in any sense and should not apply to transactions consummated during the rest of the year 1954. This may seem like a lot of time, but it is only fair to consider the length of time required to carry through corporate transactions of this sort.

We direct the attention of the committee to the fact that section 359 (c) introduces into the tax law a strange and novel discrimination against small business corporations in which the stock is not publicly held. Under this section such a corporation can no longer merge with a larger corporation in a tax-free transaction unless immediately after the transaction its stockholders own more than 25 percent of the stock of the acquiring corporation outstanding before the transfer. Literally, what this means is that unless the stockholders of such a small company acquire at least 20 percent of the participating stock of the acquiring company, it may no longer do what other small corporations have done for the last 25 years; that is, exchange assets for the stock of a larger company and have the imposition of tax on any gain deferred until such stock is sold. This limitation does not apply to corporations where the stock is publicly held.

We see the limitation as an unjustified discrimination against small businesses in which the stock is not publicly held. With respect to such businesses the rule denies nonrecognition of taxable gain solely upon the basis of the relative size of the corporations involved.

The basic purpose of the reorganization sections has always been to defer recognition of gain on an exchange of stock where the shareholder leaves his investment in at the risk of the business. This relative-size limitation imposed by section 359 (c) introduces an altogether foreign concept into the tax law and will surely have the effect of preventing many mergers and consolidations involving small business which are generally considered desirable and beneficial in the national economy.

We feel that these novel provisions should be very carefully considered in principle before they are enacted, and if they are enacted, they should not under any circumstances be applicable to any transaction completed in the year 1954.

Very truly yours,

HAROLD P. MUELLER.

Statement summary

The statement of Mr. H. P. Mueller, president of L. J. Mueller Furnace Co., Milwaukee, Wis., may be summarized briefly as follows:

1. The L. J. Mueller Furnace Co., Milwaukee, Wis., had in March 1954 almost completed a merger transaction with Worthington Corp., which had been declared tax-free under existing law in an opinion by the Commissioner of Internal Revenue. Under section 359 (c) and related sections of H. R. 8300, this transaction is not tax-free, and the transaction has been deferred and will not be consummated if the law is enacted in its present form.
2. It is unfair and inequitable to pass a law retroactive in nature which will subject to tax transactions which were in progress during the period in which the law was under consideration in Congress. The law should not be retroactive, and should not apply to any transactions consummated during the year 1954.
3. The law is unfair and discriminatory against the owners of small businesses where the stock is not publicly held, and introduces into business reorganization tax law a relative-size limitation concept which is foreign to the tax law, the implications of which should be very carefully considered before any action is finally taken along this line by the Congress.

NEW YORK, N. Y., *April 16, 1954.*

Re revision of revenue acts.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
The Capitol, Washington, D. C.

DEAR MR. CHAIRMAN: By letter dated April 13, 1954, I asked that you committee give consideration to what I believe will be a noncontroversial creation of authority for the establishment of a common trust fund under State authority so as to make available to individual fiduciaries and small banks opportunities for pooling investments so as to obtain the protection of principal and income which such pooling makes possible.

Since your committee may not have time available for me to appear before it in support of this idea, I respectfully request that you make my proposals in my letter of April 13, 1954, a part of the record of the hearings of your committee. In that way I trust there will be opportunity for the committee staff to consider the idea presented by me and to report upon it to your full committee after the hearings are finished. For the purpose of enabling your staff members to consider the matter, I am enclosing herewith three additional copies of my letter of April 13.

Respectfully,

JAMES A. DELEHANTY,
Attorney at Law.

NEW YORK, N. Y., *April 13, 1954.*

Re revision of revenue acts.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
The Capitol, Washington, D. C.

DEAR MR. CHAIRMAN: There is presently an opportunity for your committee to provide in the pending revision of the revenue acts for expansion of the idea of a common trust fund in an area which could be noncontroversial. By sections

169 and 170 of the Internal Revenue Code and by sections 39.169-1 to 39.169-5 of the regulations authority is given for the creation of a common trust fund to be maintained by a bank as a means of combined investment of funds held by that bank as trustee, executor, administrator, or guardian. Under existing law such a common fund is available only to the particular bank which creates it and uses it for investment of the fiduciary funds of that particular bank.

In New York State the larger banks have created common trust funds under the authority of the existing Revenue Code and regulations and are operating them not only with a saving in expense to themselves but with an assurance of safety of principal and income of the funds which are so invested.

Not all of the banks have created common trust funds chiefly because their trust departments are not large and the volume of business which would be available for such a common trust fund would be too small. The banks so situated have been considering over this and prior years the creation of a vehicle for pooling investments so as to enjoy the lower unit cost of such combined investment with the safety of income and principal which would result. It was ascertained that a large volume of fiduciary funds would be so invested if an appropriate vehicle were found.

Because the existing revenue act limits the benefit of the common trust fund idea to the single bank which creates it for the investment of funds which it either singly or with cofiduciaries holds as fiduciary, the smaller banks were compelled to resort to the device of organizing a regulated investment company. A bill establishing such a regulated investment company under the provisions of the banking law of the State of New York has just been signed by the Governor of New York. This provides that fiduciary funds held by banks may be pooled by participating in such a regulated investment company.

The most important group of fiduciaries—the individual executors, trustees, committees and guardians—are not provided for at all either in the existing common trust fund legislation or in the legislation just referred to as having been enacted in the State of New York. What is needed for their protection is authority for the creation of a general common trust fund which would enable the individual fiduciary to participate. Unless authority for the creation of such a general common trust fund is provided the individual fiduciary is left at the hazard of the economic conditions which the pooling of investments diminishes in large degree. The individual fiduciary is now left to his own devices in finding investments which are both safe and productive. He must take all the risks of business disturbances in the economy of the country when he makes any investment. Though he is the person most in need of the protection which a pool of investments would afford he has no place to go to secure the safety of the funds in his hands.

If authority for a general common trust fund is provided in the revision now under consideration by your committee and a common fund authorized for investment of fiduciary funds in the charge of individuals the large number of family trusts now under the management of family members or family friends will be able to enjoy that safety of investment and that reduction in cost of administration which results from the pooling of investments. In a disturbed economic era it is common experience that no individual fiduciary handling a small fund can adequately spread his investments so as to diminish the risk both of capital and of income. The volume of property in the hands of individual trustees and other fiduciaries is in the aggregate far greater than that in the hands of banks. Since experience has shown that the common trust fund idea is a very useful one I suggest respectfully that your committee should enlarge the trust fund scope so as to permit individual fiduciaries the same opportunities for pooling investments as are now extended to banks.

My interest in the problem is due to my experience in passing on the accounts of executors, trustees and guardians in the years 1933-48 while I was one of the surrogates in New York County, N. Y. During that period the country passed through a very serious industrial depression and also a period of inflation. The effects of each of these conditions upon the investments of trusts and estates were in some instances drastic in the extreme. The ill effects could have been avoided in large degree at least, had there been available a common pool into which fiduciaries generally could have put their fiduciary funds.

During the latter part of my service as surrogate in New York County I was chairman of the executive committee of the Surrogates' Association of the State of New York. I have continued my membership in that executive committee and in the association despite my retirement from the office of surrogate. The association is composed of the surrogates of all the counties in the State of New

York. I know that the association and its executive committee entertain the view expressed in this letter that legislation of the sort suggested would be highly useful in protecting estates and in reducing the costs of their administration. I write to ask that the subject of authorizing such a common trust fund as is here suggested be taken up by your committee during its current work in redrafting the revenue laws. I would welcome an opportunity to attend before the committee and to give it more in detail the information at my disposal which seems to me to justify this request for legislation.

Very truly yours,

JAMES A. DELEHANTY.

STATEMENT RE H. R. 8300, SECTION 37—CREDIT WITH RESPECT TO BUSINESS INCOME FROM FOREIGN SOURCES; SECTION 923—APPLICATION OF ABOVE CREDIT TO INCOME FROM TRADE OR BUSINESS FROM FOREIGN SOURCES; SECTION 951—FOREIGN SOURCE INCOME WHICH MAY BE DEFERRED

Gentlemen, I am general counsel for national Association of Direct Selling Companies, Winona, Minn., which association has a membership of 227 companies. A substantial number of these companies as well as a substantial number of other direct selling companies which are not members of this association, have sources of income from trade or business in foreign countries, and hence have an interest in the benefits which may come from the legislative subject matter covered in the aforementioned sections of H. R. 8300, which is now before your committee.

Some of these interested companies have income from wholly owned foreign subsidiaries. Some own and operate branches in foreign countries. Others have sources of foreign income from retail sales direct to the consumer without other contact with the consumer than a salesperson taking consumer orders on the account of the United States company.

Direct selling traditionally and overwhelmingly, in number of companies, is a retail operation.

Typically it has the local incidents which pertain in the case of local retailing both in the United States and in the operation of the United States companies in foreign countries.

I understand that the concept of this legislation is to deny benefits under the three sections which have been referred to, to United States exporters and foreign import agencies. As contrasted to this, the foreign trade and business of the United States companies in direct selling is typically to effectuate sales at retail within the scope of the United States selling company's operations.

Typically direct selling is, where foreign trade and business in foreign countries is concerned, an integrated operation all the way through to the retail sale without the intervening of outside concerns such as importers, exporters, export agencies, or foreign wholesalers.

I have been informed that there may be some question in the minds of the committee as to whether or not the trade or business of direct selling companies consists of sales at retail, and that because of this misconception there may be a chance for statutory interpretations which are to the contrary.

Where the right to the benefits of this legislation is dependent upon its retail sales concept, there is no intention in this statement to request benefits which are not within such concept.

Neither is there any request or suggestion in this statement that there be a change made in this legislation in respect to the limitations now appearing in the bill.

It is respectfully suggested, however, (1) that the committee report on the bill contain mention of the fact that foreign trade or business in the direct selling field is to be considered as sales at retail where the operations are within the scope of facts set forth in this statement, or (2) that the bill be amended to define "sales at retail" in such manner as to include retail sales in direct selling which fall within the description given in this statement.

Respectfully submitted.

NATIONAL ASSOCIATION OF DIRECT SELLING COMPANIES,
By J. M. GEORGE, *General Counsel.*

SATTERLEE, WARFIELD & STEPHENS,
New York, N. Y., April 7, 1954.

Re recommendations for changes in H. R. 8300—Internal Revenue Code of 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR MR. MILLIKIN: Sections 302 and 311—Basis of redeemed stock where attribution of ownership:

This section deals with the tax treatment to a stockholder of distributions in redemption of stock. If the distribution is in complete redemption of all of the stock held by a stockholder, distribution is treated as a payment in exchange for the stock with the result that the stockholder will have capital gain or capital loss. However, in determining the ownership of the stock, section 311 dealing with attribution of ownership is made applicable.

If all of the stock of a particular stockholder is redeemed, such redemption will not qualify in certain cases for capital gains treatment, if under section 311 the holdings of another stockholder are attributed to the stockholder whose shares were redeemed. In such case, the redemption proceeds would be taxed as a dividend under section 301 without regard to the adjusted basis of such stock. The result is that the stockholder whose stock was redeemed has not been allowed a recovery of his investment.

Some provision should be made for the tax-free recovery of the investment referred to. Since the stockholder in question owns no other shares in the corporation which made the distribution, his unrecovered cost should be attributed to the related stockholder whose ownership was attributed under section 311.

For example, corporation A owns all the stock of corporation B. A and B own all the stock of corporation X. B's adjusted basis for the stock of X owned by it is $100,000. Corporation X redeems its shares owned by B and distributes in connection therewith $150,000. The shares of X owned by A are not redeemed. Under sections 302 and 311, the distribution of $150,000 to B is treated as a dividend under section 301. H. R. 8300 as it now stands is silent as to the treatment of the adjusted basis of B of $100,000.

It is recommended that the bill make some provision for carrying over the $100,000 adjusted basis in the hands of corporation B to corporation A. If this is not done, a future tax might be incurred upon a distribution which is in part, at least, merely a return of capital.

The same situation exists where all the stock of a certain individual is redeemed, but other shares of the same corporation are owned by members of his family.

Sections 359 and 311—A majority-owned subsidiary of a publicly held corporation should also be considered as a publicly held corporation:

Section 359 (a) which defines a publicly held corporation, provides that the attribution of ownership rules of section 311 are applicable. Insofar as a parent-subsidiary relationship is concerned, section 311 does not permit any attribution of ownership of the stock of the subsidiary to a stockholder of the parent corporation, except to such stockholder owning more than 50 percent of the stock of the parent (sec. 311 (b)).

It is submitted that section 311 (b) is too restricted in its scope. Attribution of ownership of the stock of the subsidiary should be permitted as to all of the stockholders of the parent, irrespective of the percentage of stock owned in the parent corporation. In other words, if the parent corporation has 1,000 shareholders, the subsidiary should also be considered as having 1,000 stockholders for the purpose of determining whether the subsidiary is a publicly held corporation under section 359 (a).

This recommendation would be in line with the constructive ownership rules applied for determining whether a corporation is a personal holding company. (See sec. 544 (a) (1), under which it is provided that stock owned by a corporation is considered to be owned proportionately by its stockholders.)

Briefly, it should be permissible to look through to the individual shareholders of a parent corporation.

Very truly yours,

PAUL EDGAR SWARTS.

SATTERLEE, WARFIELD & STEPHENS,
New York, N. Y., April 8, 1954.

Re recommendations for changes in H. R. 8300, Internal Revenue Code of 1954: Section 34—Credit for dividends received from insurance companies; Section 246—Deductions from dividends received from insurance companies

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Washington, D. C.

DEAR SENATOR: Under section 34 (c) (1), the credit allowed to individuals for dividends received and under 246 (a) (1), the deduction allowed to corporations of 85 percent of dividends received, is denied as to dividends received from insurance companies.

It is respectfully submitted that this provision will seriously affect the entire insurance industry and place an unjust burden upon not only the insurance companies but also upon their shareholders, both corporate and individual.

Specifically, this discrimination against dividends paid by insurance companies would have the following adverse effects:

1. It will depress the market value of insurance company stocks. Corporate shareholders, by reason of this penalty which would increase the effective rate on dividends from 4.5 percent or 7.8 percent to 52 percent, would be forced to sell their holdings on the market. The effect of such liquidation upon individual shareholders is evident. Not only will the individual shareholders suffer a present loss of value, but the long-term effect on the market will also be adverse because of the permanent withdrawal of corporate investors from the market. Individual shareholders, of course, will also switch from insurance company stocks to other companies. This will have a further unsettling effect on the market.

2. It will force insurance company groups to reorganize. Such groups could not possibly operate profitably if intercompany dividends are taxed at 52 percent. They would be compelled to merge or to dispose of their intercompany holdings to the detriment of their investors. For example, under the laws of the State of Ohio, a company is limited as to the lines of insurance it can write and consequently it is necessary to have separate companies to permit a group to write multiple lines of insurance. Such groups, of course, could not be merged; they would be forced to sell. Furthermore, even where State law permits a single company to write more than one line of insurance, a large number of groups of separate companies have been formed with intercompany holdings.

3. It will discourage the formation of new insurance companies. Corporate and other investors certainly cannot be expected to make investments, the income from which will be subject to the tax penalty imposed by these new provisions.

4. It will restrict the growth and expansion of existing insurance companies. Such companies, like other corporations, must look to corporate investors for a large share of their additional capital. Insurance companies, particularly the smaller companies, must have additional equity capital to support the acceptance of new business. The public's demand for insurance coverage in all types of insurance—life, fire, casuality, etc.—requires the companies to add continuously to their capital. The new provision will hamper the ability of the insurance companies to meet the increasing needs of the public.

5. It will tend to reduce dividend payments by insurance companies. Because of the removal of corporate investors as a source of new capital and the consequent depression in the market for insurance company stocks, the companies will be forced to accumulate a larger portion of their earnings and thus lower their dividend payments to stockholders.

6. It will have an adverse effect upon the tax revenue. For the reasons noted above, corporate shareholders will be compelled to dispose of their insurance company holdings, and a lesser proportion of earnings will be distributed to the remaining individual shareholders.

There is no sound reason for this discrimination against the insurance industry and its shareholders. As to insurance companies other than life, the extra tax burden imposed upon their shareholders cannot be justified on the ground that such burden is an offset against income not taxed to the companies, for the companies described are subject to tax on their entire income at the regular rate of 52 percent.

As to life companies, it is true that they are taxed in a different manner and at a lower rate than ordinary corporations. But this was approved by your com-

mittee and adopted by Congress many years ago and merely gave recognition to the public service feature of life-insurance companies.

It is urged that it would be unwise for Congress to depart from the long-established policy of exempting 85 percent of dividends received by corporate stockholders by now denying such exemption to stockholders of insurance companies (life, fire, casualty, etc.). To do so would be to single out and discriminate against insurance companies and would impose an unfair and unbearable burden upon them and their stockholders. Therefore, it is recommended that paragraph (1) of subsection (a) of section 246 be stricken from H. R. 8300.

For reasons given above with respect to dividends received by corporate stockholders of insurance companies, it is also recommended that individual taxpayers be allowed the dividends received credit of 5 percent, and later of 10 percent, on dividends received from insurance companies in the same manner as dividends received from ordinary business corporations, and that paragraph (1) of subsection (c) of section 34 be stricken from H. R. 8300.

Very truly yours,

PAUL EDGAR SWARTZ.

PAUL WEISS, RIFKIND, WHARTON & GARRISON,
New York N. Y., April 8, 1954.

Re Internal Revenue Code of 1954, section 353 (c)

Hon. EUGENE D. MILLIKEN,
Chairman, Committee on Finance, United States Senate,
Washington 25, D. C.

MY DEAR SENATOR MILLIKIN: In connection with the proposed Internal Revenue Code of 1954, I should like to direct your attention to a provision relating to corporate organizations, acquisitions, and separations which operates in a manner that I think cannot have been intended by the House Committee on Ways and Means.

The provision I have in mind is in section 353 (c) of the proposed code, which defines the term "inactive corporation." Paragraph (3) of subsection (c) brings within the definition of inactive corporation a corporation 10 percent or more of whose gross income each year, over a 5-year period, is personal holding company income. Where such corporations have been subsidiaries of other corporations, they are deemed potential tax avoidance vehicles when their stock or securities are distributed to shareholders by the parent corporations. Their stockholders accordingly are severely penalized thereafter in a number of ways upon distributions, sales and exchanges.

This provision, apparently by inadvertence, has been drafted in a manner which makes it apply to many bona fide operating businesses, for it automatically brings within the definition of "inactive corporation" many business corporations simply because of the inherent nature of their business income. I have in mind such financial organizations as banks, life-insurance companies, surety companies, personal finance companies, loan or investment organizations, factoring concerns, etc. Such companies have been expressly excluded from the category of personal holding companies under existing law. This exclusion would be continued in section 542 (c) of the new proposed code. However, by making the test of section 353 (c) turn entirely upon the receipt of 10 percent or more of personal holding company income, such businesses would inevitably become "inactive corporations" since more than 10 percent of the gross income of all such businesses arises from receipt of interest, which is personal holding company income.

The dangers posed by the proposed 353 (c) to such businesses are clearly very serious. It would mean that these companies and their shareholders would be penalized should the parent corporation enter into any one of several common corporate rearrangements involving the distribution of stock or securities of subsidiaries to their shareholders, even though such subsidiaries are at all times engaged only in the ordinary and usual financing and investing activities for which such companies are formed.

It seems to me that this situation must have arisen simply from oversight. It can be readily corrected by simply adding to the definition of inactive corporation in section 353 (c) language to provide that in no event should the term apply to insurance and financial corporations excluded from the personal holding company definition by section 542 (c) (2), (3), (4), (6), (7), (8) and (9), of the 1954 code. There is enclosed a proposed draft of an amendment to this effect.

I should appreciate very much your consideration of this matter and your submission of it to Mr. Stam for study, if you believe it has merit. I shall, of course, be glad to submit any additional information that might be helpful or otherwise be of any assistance possible.

Very truly yours,

ADRIAN W. DEWIND.

PROPOSED AMENDMENT TO SECTION 353 (c) TO ELIMINATE ITS APPLICATION TO BANKS, LIFE-INSURANCE COMPANIES, SURETY COMPANIES, AND OTHER FINANCIAL CORPORATIONS

Subparagraph (3) of section 353 (c) (relating to inactive corporations) is hereby amended to read as follows:

"(3) 90 pjercent or more of the gross income of such business for each year of such 5-year period was other than personal holding company income as defined in section 543 or such business is held by a corporation defined in section 542 (c), (2), (3), (4), (6), (7), (8), and (9)."

PAUL WEISS, RIFKIND, WHARTON & GARRISON,
New York 22, N. Y., April 14, 1954.

HON. EUGENE D. MILLIKIN,
Chairman, Committee on Finance,
United States Senate, Washington 25, D. C.

MY DEAR SENATOR MILLIKIN: I am writing to suggest the desirability of eliminating from the proposed Internal Revenue Code of 1954 the provision in section 453 (c) and a related provision in section 481 (d). A detailed memorandum relating to this proposal is enclosed.

Under existing law, an accrual basis taxpayer who makes sales of merchandise on the installment plan and who desires to change to the installment method of accounting is subject to a severe tax penalty in the form of a double inclusion of gross income from installment accounts receivable outstanding at the time of the change in the method of accounting.

Briefly stated, this penalty arises from the fact that installment accounts previously accrued under the accrual method of accounting are again required to be included in computing gross income when they are collected after the change to the installment method of reporting. Since the deductible expenses of the previously accrued sales are not available a second time as deductions, the second reporting of the installment receivables results in a tax on gross income which may be easily several times the net profit on the sales involved. While as long as sales are maintained at the same or higher levels, the contemporaneous deduction of the expenses of later sales will tend to defer the effect of the penalty tax on earlier sales, the time will inevitably come when a decline in sales and a consequent decline in expenses will bring the full impact of the penalty tax. The effect is that taxpayers are effectively prevented from making a desirable and wise change in accounting method.

One of our clients, Field Enterprises, Inc., whose educational division publishes and sells the children's encyclopedias known as World Book and Childcraft, is an example of a taxpayer adversely affected by the existing law. Encyclopedias are largely sold on the installment plan and, accordingly, Field Enterprises is heavily involved in installment accounts receivable. At present these receivables total between $12 million and $15 million at any given time. A change of accounting method under existing law would present the company with an ultimate tax penalty substantially in excess of $4 million, under existing tax rates. This, of course, absolutely prevents any change in accounting method. The result is that as the sales of the encyclopedias increase the cash position of the company steadily worsens, because of the fact that income taxes must be paid upon the added sales long prior to the collection of the installment payments.

Under section 453 (c) of the proposed 1954 code, a provision has been inserted which is apparently designed to give relief to taxpayers from the penalty tax under existing law. However, the relief offered is at best partial and in some cases will amount to no relief at all. The reason for this is that under the proposed section 453 (c) the double inclusion in gross income would be continued, as under existing law, but with a credit against the second tax. This credit, however, it limited to the tax on the installment items paid in the earlier

year of accrual. The difficulty with this credit is that the tax in the earlier year was only a tax on net income, whereas the second time the installment items are included, the gross amount is taken into income unreduced by deductible expenses. Accordingly, the tax credit will be much less than the penalty tax, and the relief provision is entirely inadequate.

There is no apparent reason for continuing to exact this penalty. Under section 481 of the proposed code, it is expressly provided that in the case of every other change in accounting method, the Secretary is to establish rules to prevent double inclusion of items in gross income and the allowance of double deductions. Thus, a change from the accrual basis to the cash basis of accounting would not be subject to any penalty tax; yet this change in method is very similar to a change to the installment method. Such other changes in accounting method as the adoption of the LIFO inventory method, the declining balance method of depreciation or any other accounting method which results in the deferment of income, would be free of penalty. The only apparent reason for continuing any part of the penalty is that in a continuing business the expenses of future sales may result in deferring the impact of the penalty, thus making it less apparent. Since, however, the full impact will ultimately be felt, this appears to be no ground upon which to single out this particular change of accounting method for imposition of a penalty. Moreover, since the penalty tax will tend to have its effect in a period in which sales and related expenses decline, the timing of the imposition of the penalty could hardly be worse.

In view of the foregoing, I most respectfully urge that most serious consideration be given to eliminating section 453 (c) and the related section 481 (d). This change would apply to taxpayers shifting to the installment method of accounting precisely the same treatment that is accorded to every other change in accounting method under section 481. Moreover, any taxpayer making such a change would not become entitled to any deferment of income that is not enjoyed by a taxpayer who has been on the installment method of accounting from the beginning. There is, therefore, no special privilege granted to a taxpayer who now makes the change.

It may be observed that this change would not cost the Government any revenue, since it is to be very much doubted that any taxpayer would ever subject himself to the existing penalty tax. In fact, most taxpayers are able to get around the penalty provisions simply by selling their accounts receivable prior to making the change to the installment method. This has precisely the same effect as the change in the law here proposed. It is only in those cases in which a taxpayer is so heavily involved in installment sales that a sale of installment receivables could only be made at a sizable loss, that the penalty provision can have any effect. In such instances, of course, no change in accounting method is made and so the Government never collects the penalty tax anyhow. This simply results in continuing an unwarranted and discriminatory burden upon taxpayers who should be allowed the benefits of the installment method of reporting that are available to other taxpayers similarly situated.

I should appreciate very much your consideration of this matter. I shall, of course, be glad to submit any additional information that might be helpful or otherwise be of any assistance possible.

Very truly yours,

ADRIAN W. DEWIND.

CHANGES FROM THE ACCRUAL TO THE INSTALLMENT METHOD OF REPORTING INCOME—INADEQUACY OF RELIEF PROPOSED IN INTERNAL REVENUE CODE OF 1954

The Internal Revenue Code of 1954, as passed by the House of Representatives, contains a relief provision [1] for taxpayers who wish to change from the accrual method of accounting to the installment method.

Dealers often wish to change from the accrual to the installment method when their installment sales are increasing rapidly. Continued use of the accrual methods, which requires the payment of income tax upon profits from the increasing sales before the sales proceeds are received, tends to burden and restrict the growth of the business. Since this burden is not shared by competitors using the installment method of reporting income, the taxpayer using the accrual method can obtain equality of treatment only by changing to the installment method.

[1] Sec. 453 (c).

However, existing law exacts a double or penalty tax for the privilege of making the change, which is frequently so severe that it prohibits the change entirely. Present law requires the taxpayer who changes from the accrual to the installment method to include, in computing taxable income, all installment payments subsequently received on account of sales made before the change, even though the income from those sales had previously been fully included in the taxpayer's income under the accrual method.

As an example, assume that a taxpayer using the accrual method has accrued and reported $1 million of gross profit from installment sales, payment for which has not yet been received from its customers. If the taxpayer changes to the installment method of reporting, it must again include the $1 million of gross profit in income as payments are received. If the taxpayer is a corporation, and a 52 percent tax rate is assumed, the taxpayer must pay a penalty tax of $520,000 for the privilege of changing accounting method. If the business is being conducted as a partnership or sole proprietorship, the penalty tax may be even higher.

The excess amount subject to tax under this penalty provision is not merely the net profit inhering in the installment accounts on the books at the time of the change. The effect of the penalty provision is to include the gross profit from these accounts in income twice even though the selling and administrative expenses attributable to those accounts are deducted only once. This means that the original tax plus the penalty tax can amount to several times the entire net profit from the installment sales involved. As tax rates have increased over the years, this has become more and more often the case. The penalty causes a permanent overstatement of the taxpayer's net income by an amount equal to the gross profit attributable to the accounts receivable at the time of the change. In the example given in the preceding paragraph, the taxpayer must, in one year or another, overstate its net income permanently by $1 million.

The penalty is particularly severe in those types of businesses which have a high gross profit ratio, and heavy selling and administrative expenses. Assume, for example, that a taxpayer whose income statement (expressed as a percentage of net sales) is as shown below, desires to change from the accrual to the installment method:

	Percent
Net sales	100
Cost of goods sold	20
Gross profit	80
Selling and administrative expenses	65
Net profit	15

Assume also that there are $1,250,000 of installment receivables at the time of the change. These receivables represent a gross profit of $1 million, but a net profit of only $187,500. The original tax, assuming the taxpayer to be a corporation and the rate of tax to be 52 percent, on the net profit of $187,500 would be $97,500. The penalty tax on the gross profit of $1 million would be $520,000. The combined taxes of $617,500 would be over 3 times the $187,500 net profit before taxes.

The Internal Revenue Code of 1954 as passed by the House purports to eliminate the penalty or double tax. Under the House bill the gross profit inhering in the receivables on the books at the time of the change from the accrual to the installment method will continue to be included in income twice—first in the year of accrual and secondly in the year of collection. But the House bill provides that the tax imposed for the year of collection shall be adjusted downward by an amount which equals the lesser of the following:

(1) The proportionate part of the tax in the year of accrual which is attributable to the doubly taxed gross profit, and

(2) The proportionate part of the tax in the year of collection which is attributable to the doubly taxed gross profit.

By its very nature, the provision in the House bill will fail to eliminate the inequity at which it is aimed. As stated above, the nature of the penalty is a permanent overstatement of taxable income in an amount equal to the gross profit represented by the receivables on the books at the time of the change. But the House bill would alleviate this penalty only by the amount of tax on the net profit from those receivables. For instance, in the above example in which the original and penalty taxes on a net profit of $187,500 amount to $617,500, the relief provided by the House bill could not exceed the original

tax of $97,500. The remaining tax of $520,000 would still be almost 3 times the net profit.

What is worse is that there will be many situations in which the House provision will provide still less adequate relief, or even no relief at all, from the penalty exacted by the present law.

The following example illustrates a case in which the House provision would provide no relief whatever. Assume that a taxpayer enters into business on January 1, 1953, and subsequently on January 1, 1957, sells or otherwise disposes of the business. During his period of operations the taxpayer earned a gross profit of $6 million and had expenses of $5 million thus netting $1 million before taxes. Assume also that the year-by-year distribution of the taxpayer's gross profit computed under the accrual basis, his gross profit computed under the installment basis, and his expense deductions were as follows:

	1953	1954	1955	1956	1957
Gross profit (accrual basis)	$800,000	$2,000,000	$1,600,000	$1,600,000	0
Gross profit (installment basis)	400,000	1,400,000	1,800,000	1,600,000	$800,000
Expense deductions	1,400,000	1,400,000	1,100,000	1,100,000	0

NOTE.—The table is prepared on the assumption that the selling price is collected ½ in the year of sale and ½ in the succeeding year. The $800,000 profit uncollected as of Jan. 1, 1957, becomes taxable in the year in which the taxpayer disposes of the business. The expense deductions are, as is usual with a new business, proportionately heavier in the initial year than in later years.

The exhibit attached at the end of this memorandum shows a computation of the taxable income of this taxpayer on the assumption that he continuously reported income on the installment basis. It also shows three sets of computations based on the assumption that he reported income on the accrual basis for 1953 and 1954, and then switched to the installment basis. These last three computations show taxable income: (1) Under present law, (2) under the proposal in the House bill, and (3) under a proposal to be advanced below, which would eliminate the double inclusion of gross profit inhering in the receivables on the taxpayer's books at the time of the change in accounting method. The results of the attached computations are compared below:

	1953	1954	1955	1956	1957	Aggregate taxable income
(1) Installment method	0	0	0	$200,000	$800,000	$1,000,000
Accrual method for 1953 and 1954—installment method for 1955-57.						
(2) Present law	0	0	$700,000	500,000	800,000	2,000,000
(3) House bill	0	0	700,000	500,000	800,000	2,000,000
(4) Proposal advanced below	0	0	0	200,000	800,000	1,000,000

In the above example, the House bill affords no relief. It will continue to exact a full tax upon $2 million, which is twice the amount of the taxpayer's true income. The relief provided by the bill fails in this case because the income-tax liability of the taxpayer for the year at the close of which the change from the accrual to the installment method was made was wiped out by the carry-forward from the taxpayer's initial loss year. This situation will not be infrequent where the taxpayer who seeks to change from the accrual to the installment method has not been in business long. The House bill will also give little or no relief where there is little or no income-tax liability for the year immediately following the change in accounting method. This may result from any of a number of unforeseen causes. For example, sales may unexpectedly decline or overhead unexpectedly increase. Or a corporation one of whose branches has had installment sales may sustain unexpected losses in another branch of its business. These and other situations in which the House bill affords little relief or no relief whatever are just as deserving as those in which the bill gives greater relief.

In every type of change in accounting method other than the change from the accrual to the installment method, the House bill [1] permits a complete adjustment

[1] Sec. 481.

in order to insure that every item of gross income or deduction is taken into account once and only once. Under this general provision governing all other types of accounting changes, items of income which were included in gross income prior to the change will not be again included thereafter. There is no good reason why the change from the accrual to the installment method should be excluded from the general provision and given inadequate, and in many cases no, relief.

It is realized that the change from the accrual to the installment method of accounting may permit some temporary deferment of income as compared to a continued use of the accrual method. However, insofar as there is any temporary deferment, this is inherent in the installment method; the deferment arises merely from the use of the installment method and not from the fact that the taxpayer adopted the installment method after previously using the accrual method. By authorizing the use of the installment method, Congress has determined that this temporary deferment represents desirable tax policy, since it enables the taxpayer to pay the tax on his profits when those profits are received by him in the form of cash. Moreover, any initial deferment under the installment method will subsequently be offset by a continuation of heavy tax payments when the volume of installment sales declines or when the taxpayer sells or liquidates the business.

Temporary deferment of income is also permitted by the present law in some situations and is authorized by the House bill in still others. Examples of this are the use of the cash method of accounting; the first-out inventory method; the reserve method for bad debts; reserves permitted by the House bill; and the declining-balance depreciation method authorized by the House bill. No penalty is exacted from a taxpayer who switches to any of these methods. A temporary deferment of income clearly can never justify a severe penalty, since the Government will collect a full measure of tax. And the Government would collect a full tax where the installment method of accounting is used, even though the penalty exacted by present law for a change to that method from the accrual method, and only partially ameliorated by the House bill, is eliminated entirely. Indeed, this is the one case in which the Government is assured of an ultimate tax on all income, for there are special provisions designed to prevent taxpayers from escaping tax on installment obligations.[3]

It is believed, therefore, that section 453 (c) and its companion provision, section 481 (d), should be stricken from the House bill, thus permitting changes from the accrual to the installment method of accounting to be treated under the more general and equitable provisions of section 481. Profits once included in income under the accrual method would then not be included a second time after the taxpayer switched to the installment method. All changes in accounting methods would then be treated fairly and consistently.

EXHIBIT.—*Computation of taxable income*

A. UNDER CONSISTENT USE OF INSTALLMENT METHOD

	1953	1954	1955	1956	1957
Gross profit	$400,000	$1,400,000	$1,800,000	$1,600,000	$800,000
Expense deductions	1,400,000	1,400,000	1,100,000	1,100,000	0
Balance	(1,000,000)	0	700,000	500,000	800,000
Loss carryover	0	1,000,000	1,000,000	300,000	0
Taxable income (loss)	(1,000,000)	(1,000,000)	(300,000)	200,000	800,000

B. UNDER SWITCH FROM ACCRUAL TO INSTALLMENT METHOD AT END OF 1954, PRESENT LAW

Gross profit	$800,000	$2,000,000	$1,800,000	$1,600,000	$800,000
Expense deductions	1,400,000	1,400,000	1,100,000	1,100,000	0
Balance	(600,000)	600,000	700,000	500,000	800,000
Loss carryover	0	600,000	0	0	0
Taxable income (loss)	(600,000)	0	700,000	500,000	800,000

[3] Sec. 44 (d) of present law; sec. 453 (d) of the House bill.

C. UNDER SWITCH FROM ACCRUAL TO INSTALLMENT METHOD AT END OF 1954
HOUSE BILL

(Same in every respect as B; no benefit whatever obtained.)

D. UNDER SWITCH FROM ACCRUAL TO INSTALLMENT METHOD AT END OF 1954,
PROPOSAL ADVANCED HEREIN

Gross profit	$800,000	$2,000,000	[1] $800,000	$1,600,000	$800,000
Expense deductions	1,400,000	1,400,000	1,100,000	1,100,000	0
Balance	(600,000)	600,000	(300,000)	500,000	800,000
Loss carryover	0	600,000	0	300,000	0
Taxable income (loss)	(600,000)	0	(300,000)	200,000	800,000

[1] The $1 million profit which had been accrued in 1954 is eliminated.

NOTE.—Parentheses denote loss.

MEMORANDUM OF PROPOSED AMENDMENT OF SECTION 851 (A) OF H. R. 8300,
REGULATED INVESTMENT COMPANIES

I. Introduction

Provisions of both the present Internal Revenue Code and H. R. 8300 deny to personal holding companies the right to qualify as regulated investment companies with the advantages that follow from such qualification. There is no apparent historical or logical reason for this discrimination against personal holding companies. Investment counselors and other investment concerns, which rightfully should be treated as true investment companies, are compelled thereby to operate in a cumbersome, expensive fashion, which impedes and discourages trading and diversification, solely because of the representation among their stockholders of family client-groups. We believe this discrimination should be eliminated. From a drafting standpoint, the amendment can be accomplished by a very simple change as set out below.

II. Statement of proposed amendment

Section 851 (a) (subch. M) of H. R. 8300 should be amended to permit a personal holding company (as defined in sec. 542 of H. R. 8300) to qualify as a regulated investment company.

This amendment would be accomplished by deleting from the third line of section 851 (a) the parenthetical phrase "(other than a personal holding company as defined in sec. 542)."

III. Legislative history of pertinent regulated investment company provisions

The parenthetical phrase referred to above appears in the provisions of section 361 (a) of the present Internal Revenue Code.

It has appeared in this provision of the present code since its enactment in 1939 and appeared in the Revenue Acts of 1936 and 1938.

There is no indication in the legislative history as to why an exception was made excluding personal holding companies from the benefits of the regulated investment company provisions. On the contrary, it would appear that the reasons which prompted the enactment of the provisions covering regulated investment companies, apply as well in the case of closely held groups as in the case of larger organizations. Prior to the enactment of these provisions, so-called investment companies were treated as trusts, when organized as pure conduits. Some fear developed, however, that they might be taxed as corporations because of the features of centralized management, transferable interests, etc. It was primarily to eliminate this possibility that these provisions were first enacted to insure treatment of these investment companies as mere conduits. (See statement of John Sherman Myers, Hearings Before Senate Finance Committee on the Revenue Act of 1936, p. 776.) This basis for enacting these provisions contains no grounds on which a distinction can be made between closely held and more widely held companies.

It may be presumed that the draftsmen had in mind that the benefits of the regulated investment company provisions should only be available to companies which are more than mere "incorporated pocketbooks." But, if this is the case, the assurance that regulated investment companies would have some public character is amply provided by the requirement of the code that they be "at all times during the taxable years * * * registered under the Investment Company Act of 1940 * * *" as discussed more fully below.

It appears, therefore, to be clear that there is no reason apparent in the legislative history why this exception for personal holding companies should not be deleted from the code. It further appears from the legislative history that the underlying reasons for the enactment of the regulated investment company provisions apply as well to companies in the category of personal holding companies as to those which are more widely held.

IV. Provisions of the present Internal Revenue Code and H. R. 8300 deny the benefits of treatment as a regulated investment company to many investment counselors and other investment concerns because of the representation among their stockholders of family client groups. The operations of these concerns are thereby impeded and desirable diversification and freedom of trading is greatly hampered

Firms acting as investment counselors or investment trusts have grown in many instances from handling the investments of family client groups and have gradually added clients independent from such family groups until their clientele represents a substantial, diversified aggregation.

In many cases, however, more than 50 percent of the investments involved continue to be held or managed for no more than 5 family client groups thus bringing the entire operation within the ambit of the personal holding company provisions if the corporate form is adopted.

Because of this situation, it has not been feasible to employ the corporate form, even though all income is distributed currently, because of the applicability of corporate taxes. As a consequence, these firms have been required to establish separate accounts for each client with individual investments held for each account. The burden of administrative detail is not only expensive and onerous, but, in addition, it has very substantially hampered diversification and has made trading cumbersome and uncertain. The present situation thus operates to restrict these two objectives which have been commonly regarded as desirable. These problems are eliminated for qualifying companies by the regulated investment company provisions which permit all investments to be held in a common fund with certificates of interest issued against the fund as a whole. Substantially the same advantages are accorded to banks under the provisions permitting the existence of common trust funds.

We believe that the type of investment firms referred to above should rightfully be treated in the same way as other investment trusts and should be accorded no lesser advantage than that given to banks. The character of their business and operations do not differ in any way from the usual investment trust; the problems to which the regulated investment company provisions would apply are the same in both instances.

We submit that there are no factors with respect to personal holding companies of the type which could qualify as regulated investment companies (if the law were changed as here suggested) on which the advantages of the regulated investment company provisions should be denied to these personal holding companies. We deal with this point in the section next below.

V. The proposed change would not restrict the personal holding company provisions. On the contrary, these provisions would still apply and only a true investment type of personal holding company could, in fact, qualify as a regulated investment company

We do not propose any change in the personal holding company provisions. They would continue to apply so that any failure to distribute earnings would result in a penalty tax and the other safeguards of the personal holding company provisions would remain applicable.

Nor would the proposed change confer any benefit, on a wide basis, on personal holding companies of the pure holding company type. Such pure holding companies could not, in any event, meet the diversification requirements for qualification under the regulated investment company provisions.

The only type of personal holding company which could qualify as a regulated investment company, if the proposed change were made, would be one which had diversified investments, which currently distributed at least 90 percent of its net income, and which derived its income at least 90 percent from stocks and bonds (through dividends, interest, or gains). It is precisely this type of investment firm, which so closely follows the usual investment firm pattern, which would be benefited from the change. All other personal holding companies would be unaffected by the change.

There are, thus, no unfavorable consequences, in the personal holding company field, which can be perceived as a result of the proposed change.

VI. The proposed change would, of course, leave unaffected the requirement that a regulated investment company be registered throughout the taxable year under the Investment Act of 1940, thereby assuring the protection of the interest of the public and of the shareholder in such companies

In the event the change here proposed were made, a personal holding company would, in order to qualify as a regulated investment company, be required to be registered under the Investment Act of 1940, as amended. It would, thus, be required to have 100 or more stockholders, or to make its stock the subject of a public offering.

This requirement, thus, would continue to provide the most logical means of protecting the interests of the public and of the shareholders in regulated investment companies. Personal holding companies, qualifying as regulated investment companies, would, thus, be forced to meet the requirements of annual reporting imposed by the Securities and Exchange Commission. It would also be made certain that such companies would have some public character, as assured by the requirement of at least 100 stockholders, or that they submit to the rigorous requirements of a stock registration under the Securities Acts of 1933 and 1934.

Accordingly, the change proposed here could only result in subjecting personal holding companies, qualifying as regulated investment companies, to means of insuring the protection of the interests of the public and of the shareholders, beyond the devices employed in the personal holding company provisions.

VII. Conclusions and recommendations

A. Exclusion of personal holding companies from qualification as regulated investment companies has resulted in the denial to many true investment firms of the benefits of these provisions. An unwarranted discrimination is thus worked between such firms, on the one hand, and other investment concerns and banks (for whom special provisions are made) on the other.

B. This discrimination hampers the operations of many investment firms and substantially impedes diversification and trading.

C. Extension of the regulated investment company provisions to personal holding companies is a desirable and logical step to eliminate these disadvantages and discriminations and to accord to true investment firms the benefits of these provisions.

D. This change would not disturb the present personal holding company provisions and would not affect in any way the true holding company which could not qualify as a regulated investment company in any event.

E. The interests of the public and of the shareholders would be adequately protected by the requirement of registration under the Investment Act of 1940.

Recommendation.—It is respectfully recommended that section 851 (a) of H. R. 8300 be amended to delete the parenthetical phrase "(other than a personal holding company as defined in sec. 542)."

GEORGE E. CLEARY.
GEORGE STINSON.

NEW YORK, N. Y., *April 22, 1954.*

(Whereupon, at 1:20 p. m., the committee adjourned to reconvene at 10:30 a. m., Tuesday, April 20, 1954.)

THE INTERNAL REVENUE CODE OF 1954

TUESDAY, APRIL 20, 1954

United States Senate,
Committee on Finance,
Washington, D. C.

The committee met, pursuant to recess, in room 312, Senate Office Building, at 10:40 a. m., Senator Eugene D. Millikin (chairman) presiding.

Present: Senators Millikin and Martin.

The Chairman. The meeting will come to order, please.

Mr. Ralph W. Button. Be seated and make yourself comfortable, Mr. Button, and identify yourself to the reporter.

STATEMENT OF RALPH W. BUTTON, MEMBER, TAXATION AND FISCAL POLICY COMMITTEE, AMERICAN RETAIL FEDERATION

Mr. Button. I am Ralph W. Button, assistant secretary of Allied Stores Corp. I appear before you today as a member of the taxation and fiscal policy committee of the American Retail Federation. The American Retail Federation is a federation of 26 national retail trade associations and 34 statewide associations of retailers, representing in all more than 600,000 retail outlets. A list of participating member associations is attached to this statement.

We have limited our oral testimony to sections 461 (c) relating to the accrual of real property taxes and sections 6016, 6154, and 6655 relating to the declaration of estimated income by corporations. We are concerned with other provisions of H. R. 8300 which we have set out in our more detailed brief accompanying this statement.

There are approximately 25 States which specify January 1 as the date real property taxes become a liability. The period covered by this property tax is the calendar year. Taxpayers who file their income-tax returns for a fiscal year ending in 1955 will be permitted to deduct only a portion of their 1955 real-property taxes. Thus, retailers operating on a fiscal year ending January 31, 1955, will be allowed to deduct one-twelfth of their 1955 real-property taxes. This means that their taxable net income will be increased by eleven-twelfths of the real property tax expense by reason of the special rules set out in section 461 (c) (2).

I have applied this section to a specific retailer operating in Massachusetts. Under the present law, his tax liability is $42,900 or an effective rate of 46.1 percent. The disallowance of his real property tax expense in January 31, 1955, all other factors being equal, his tax liability will be increased to $69,500 or an effective tax rate of 74.6 percent on the same accounting net income. The disallowance thus costing him $26,000.

The CHAIRMAN. Is that what the staff figures?

Mr. SMITH. This problem has been brought to our attention and it is being studied.

Mr. BUTTON. Does that mean——

The CHAIRMAN. He won't tell us what it means. He has indicated enough that it will make it clear to you that the subject is being carefully considered. That is not a guaranty that you are going to get anything.

Mr. BUTTON. I would like to continue, sir, because I think there are other statistical figures which point up the problem.

I have made the same calculation for six other retailers operating in other States and I will cut my comments short. The total increase in income taxes for these 6 retailers amounts to $785,200.

So section 461 (c) is known as a sleeper, and now that I know you are considering it, I will continue.

The result reached by the application of section 461 (c) to actual situations surely points up the need for careful consideration and study of all of the provisions of H. R. 8300.

The declaration and estimation of income taxes by corporations present serious financial and administrative problems, particularly for retailers.

The House committee report indicates that out of 425,000 corporations, 35,000 corporations have been singled out for this special tax treatment. These 35,000 corporations were selected for the stated reason that they account for 90 percent of the corporation income-tax liabilities.

The House committee report does not indicate the kinds of companies in their 35,000 figure. What is the economic status, the financial status of these companies? Will the enactment of section 6016 and related sections create greater problems than the problems sought to be solved? These are some of the questions that need to be answered before these sections are enacted into law. The House committee report indicates that consideration has been given to only one part of the problem.

In this connection, I call your attention to an article appearing in the New York World-Telegram and Sun—and a copy is attached—which shows that 25 corporations showed a net profit of $4.3 billion in 1953. A rough estimate of the corporation income-tax liability on this amount of income is $2.2 billion, which I estimate is approximately 10 percent of all corporation income taxes.

If 11,400 of this group of 35,000 corporations accounts for one-tenth of the corporate income tax liability, is it not possible that a relatively few corporations account for a major part of the total tax liability? If this is true, how many thousands of corporations with tax liabilities of just over $50,000 are classified into this group, and what is the impact of this section on them?

We must measure the adequacy of the solution proposed by section 6016, and so forth, against a true statement of financial ability of all the 35,000 corporations mentioned.

Retailers, particularly, will have difficulty meeting the financial and administrative requirements of section 6016 and related sections.

The average retailer produces more than half of his annual profits, the range being 48 percent to 80 percent, during the months of October,

November, and December. The retailer must purchase and pay for the merchandise to be sold during this 3-month period in the months of September, October, and November. These are months of heavy cash outlay. Cash resources are usually insufficient to meet these requirements, necessitating borrowing.

The enactment of section 6016 and the related sections will cause a further strain on his resources. It really means further borrowing to pay in advance a tax on income that may not yet have been earned.

The first declaration of estimated income tax is due to be filed on the 15th day of the 9th month. This filing date is wholly unrealistic. A taxpayer is given exactly 15 days from the close of an 8-month period to resolve the complexities that enter into the determination of net income in this modern world.

Physical inventories play an important role in determining net income. These inventories are taken only twice a year at the most. True income can only be determined when the status of the inventory is known.

Retailers using the LIFO method have an added problem. LIFO inventory valuations are based on retail price indexes. These indexes are published by the Bureau of Labor Statistics twice a year, namely, March and September as of January 15 and July 15. No formula has yet been devised to measure the effect of unknown price changes for the intervening months.

Retailers reporting their profit on the gross profit method require further calculations to determine their net income.

Administrative problems are further aggravated. Two more returns are added to the long list of tax returns now required to be filed by retailers. These extra returns will increase administrative costs not only for the taxpayer but for the Government as well.

The corporation income tax was scheduled to be reduced to 47 percent on March 31, 1954. This decrease is now to be postponed for 1 year. Instead of getting the decrease as originaly scheduled, the favored 35,000 corporations are required to pay out a greater amount in corporation income taxes within a 12-month period for the next few years than is now required under present law and more than is to be extracted from the other 390,000 corporations.

Eight percent of all the corporations are singled out for this special tax treatment solely on the basis of their net income. It seems to me that this is an extension of the principle that bigness per se is evil. I am a firm believer in democratic principles and that their principles should be applied to all groups without fear or favor. The application of section 6016 to 8 percent of the corporations violates my sense of fair play, justness, and equity.

We are not unmindful of the sound objectives of H. R. 8300. It does much to clarify and simplify our existing Internal Revenue Code provisions. There are areas in this bill which we believe are not in the best interest of our national economy. We particularly urge that action on subchapter C relating to corporate distributions and adjustments be postponed until adequate consideration can be given to the very complex rules set forth therein.

We specifically recommend:

(*a*) That section 461 (c) relating to accrual of real property taxes be amended to provide that a taxpayer may continue his present method of deducting real property taxes.

(b) That sections 6016, 6154, and 6655 relating to the declaration of estimated income tax by corporations be deleted completely.

Thank you, sir.

The CHAIRMAN. Thank you very much.

(The statements of Mr. Button, with attachments, follow:)

STATEMENT OF RALPH W. BUTTON OF AMERICAN RETAIL FEDERATION

I am Ralph W. Button, assistant secretary of Allied Stores Corp. I appear before you today as a member of the taxation and fiscal policy committee of the American Retail Federation. The American Retail Federation is a federation of 26 national retail trade associations and 34 statewide associations of retailers, representing in all more than 600,000 retail outlets.

A list of participating member associations is attached to this statement.

We have limited our oral testimony to sections 461 (c) relating to the accrual of real property taxes and sections 6016, 6154, and 6655 relating to the declaration of estimated income by corporations. We are concerned with other provisions of H. R. 8300 which we have set out in our more detailed brief accompanying this statement.

We believe that section 461 (c) was designed to bring tax accounting more in line with good accounting practice. In actual operation, section 461 (c) for the first year it is effective will cost taxpayers many millions of dollars.

There are approximately 25 States which specify January 1 as the date real property taxes become a liability. The period covered by this property tax is the calendar year. Taxpayers who file their income tax returns for a fiscal year ending in 1955 will be permitted to deduct only a portion of their 1955 real property taxes. Thus, retailers operating on a fiscal year ending January 31, 1955, will be allowed to deduct 1/12 of their 1955 real property taxes. This means that their taxable net income will be increased by 11/12 of the real property tax expense by reason of the special rules set out in section 461 (c)–(2).

I have applied this section to a specific retailer operating in Massachusetts. Under the present law, his tax liability is $42,900 or an effective rate of 46.1 percent. The disallowance of his real property tax expense in January 31, 1955, all other factors being equal, his tax liability will be increased to $69,500 or an effective tax rate of 74.6 percent on the same accounting net income, the disallowance thus costing him $26,600.

I have made this same calculation for six other retailers operating in the States of Pennsylvania, North Carolina, Massachusetts, and Michigan. The total increase in income taxes by reason of section 461 (c) for these six retailers amounts to $785,200.

It is obvious from the foregoing that the loss sustained by taxpayers throughout the country will reach staggering proportions.

In everyday tax parlance, section 461 (c) is known as a sleeper. I am certain that Congress never intended that this statutory change in accounting methods should result in the loss of millions of dollars and I am confident that this committee will correct the inequity thus created.

The result reached by the application of section 461 (c) to actual situations surely points up the need for careful consideration and study of all the provisions of H. R. 8300.

The declaration and estimation of income taxes by corporations present serious financial and administrative problems particularly for retailers.

The House committee report indicates that out of 425,000 corporations, 35,000 corporations have been singled out for this special tax treatment. These 35,000 corporations were selected for the stated reason that they account for 90 percent of the corporation income-tax liabilities.

The House committee report does not indicate the kinds of companies in their 35,000 figure. What is the economic status, the financial status of these companies? Will the enactment of section 6016 and related sections create greater problems than the problems sought to be solved? These are some of the questions that need to be answered before these sections are enacted into law. The House committee report indicates that consideration has been given to only one part of the problem.

In this connection, I call to your attention an article appearing in the New York World-Telegram and Sun (a copy is attached) which shows that 25 corporations showed a net profit in 1953 of $4.8 billion. A rough estimate of the

corporation income tax liability on this amount of income is $2.2 billion which I estimate is approximately 10 percent of all corporation income taxes.

If 1/1400 of this group of 35,000 corporations accounts for 1/10 of the corporate income tax liability, is it not possible that a relatively few corporations account for the major part of the total tax liability? If this is true, how many thousands of corporations with tax liabilities of just over $50,000 are classified into this group and what is the impact of this section on them?

We must measure the adequacy of the solution proposed by section 6016, etc. against a true statement of financial ability of all the 35,000 corporations mentioned.

Retailers, particularly, will have difficulty meeting the financial and administrative requirements of section 6016 and related sections.

The average retailer produces more than half of his annual profits, the range being 48 to 80 percent, during the months of October, November, and December. The retailer must purchase and pay for the merchandise to be sold during this 3-month period in the months of September, October, and November. These are months of heavy cash outlay. Cash resources are usually insufficient to meet these requirements necessitating borrowing.

The enactment of section 6016 and the related sections will cause a further strain on his resources. It really means further borrowing to pay in advance a tax on income that may not yet have been earned.

The first declaration of estimated income tax is due to be filed on the 15th day of the ninth month. This filing date is wholly unrealistic. A taxpayer is given exactly 15 days from the close of an 8-month period to resolve the complexities that enter into the determination of net income in this modern world.

Physical inventories play an important role in determining net income. These inventories are taken only twice a year at the most. True income can only be determined when the status of the inventory is known.

Retailers using the LIFO method have an added problem. LIFO inventory valuations are based on retail-price indexes. These indexes are published by the Bureau of Labor Statistics twice a year, namely, March and September as of January 15 and July 15. No formula has yet been devised to measure the effect of unknown price changes for the intervening months.

Retailers reporting their profit on the gross-profit method require further calculations to determine their net income.

Administrative problems are further aggravated. Two more returns are added to the long list of tax returns now required to be field by retailers. These extra returns will increase administrative costs not only for the taxpayer but for the Government as well.

The corporation income tax was scheduled to be reduced to 47 percent on March 31, 1954. This decrease is now to be postponed for 1 year. Instead of getting the decrease as originally scheduled, the favored 35,000 corporations are required to pay out a greater amount in corporation income taxes within a 12-month period for the next few years than is now required under present law and more than is to be extracted from the other 390,000 corporations.

Eight percent of all the corporations are singled out for this special tax treatment solely on the basis of their net income. It seems to me that this is an extension of the principle that bigness per se is evil. I am a firm believer in democratic principles and that these principles should be applied to all groups without fear or favor. The application of section 6016 to 8 percent of the corporations violates my sense of fair play, justness, and equity.

We are not unmindful of the sound objectives of H. R. 8300. It does much to clarify and simplify our existing Internal Revenue Code provisions. There are areas in this bill which we believe are not in the best interest of our national economy. We particularly urge that action on subchapter C relating to corporate distributions and adjustments be postponed until adequate consideration can be given to the very complex rules set forth therein.

We specifically recommend:

(*a*) That section 461 (c) relating to accrual of real property taxes be amended to provide that a taxpayer may continue his present method of deducting real-property taxes.

(*b*) That sections 6016, 6154, and 6655 relating to the declaration of estimated income tax by corporations be deleted completely.

SUPPLEMENTAL STATEMENT OF RALPH W. BUTTON OF AMERICAN RETAIL FEDERATION

I am Ralph W. Button, assistant secretary, Allied Stores Corp. I appear before you today as a member of the taxation and fiscal policy committee of the American Retail Federation. The American Retail Federation is a federation of 28 national retail trade associations and 34 statewide associations of retailers, representing in all more than 600,000 retail outlets. (A list of participating member associations is attached to this statement.)

H. R. 8300 makes sweeping changes in many provisions of the Internal Revenue Code. Some of these changes are good but there are many areas in this bill which will, if passed in their present form, work great hardships on a multitude of taxpayers, large and small alike.

Great pressure is being exerted to get H. R. 8300 passed. Taxpayers have not had adequate time to study and test all of the provisions of this bill to actual situations. Subchapter C, alone, relating to corporate distributions and adjustments changes the rules of many years' standing. This chapter is very complex, it introduces new terms, new phrases, new tests, and changes the very concept of corporate reorganizations.

Section 461 (c) relating to accrual of real property taxes is a brand new provision. The application of this provision will increase income tax payments by many millions of dollars.

Section 6016 and related sections 6154 and 6655 extend the declaration of estimated income tax to an estimated 35,000 corporations.

H. R. 8300, according to published reports, is designed to clarify and simplify existing code provisions, eliminate inequities, create incentives for business and effect some tax relief for individuals. While H. R. 8300 accomplished some of its aims and goals, it also creates inequities, retards and restricts certain expansions, and will cause economic dislocations in some classes of industry.

SUBCHAPTER C—CORPORATE DISTRIBUTIONS AND LIQUIDATIONS

Subchapter C relating to corporate distributions and adjustments for all practical purposes eliminates the tax free character of the acquisition by one corporation by issuance of its voting stock for all or substantially all of the stock or assets of another corporation. Such an acquisition was a tax free reorganization under the provisions of section 112 (b) (3) and (4) of the Internal Revenue Code of 1939.

The owners of a small retail establishment desiring to sell their business because of age or illness of its management will find it very difficult, if not impossible, to find a buyer who will be able to pay cash for their business. Buyers can be found where the purchase price is paid in stock of the buyer.

I have in mind just such a situation. The owners want to sell their business for the very reasons I have mentioned. The owners prefer to sell for cash but have been unable to find a buyer. Another retail organization is interested in acquiring this business for a part of its voting stock. Under present law, this transaction could be accomplished without incurring a present tax. The tax would be postponed until the selling stockholders converted their stock into cash.

However, under H. R. 8300, this type of transaction would be taxable since the selling stockholders would not own 25 percent of the acquiring corporation's stock.

If the selling stockholders accept stock in exchange for their assets or stock in this transaction, they would be compelled to sell some of the stock so acquired in order to obtain cash with which to pay the tax imposed.

When a publicly owned corporation issues its stock in acquisition of another corporation, the SEC requires the selling stockholders to sign an agreement to the effect that the stock so acquired is to be held for investment and not for resale in order that the publicly held corporation may register its stock under the Securities Exchange Act of 1934 rather than the Securities Act of 1933. Thus, a selling stockholder acquiring this stock with the knowledge that he would be forced to sell a part of it would be violating the Securities Exchange Act of 1934.

Another factor involved in this proposed transaction is the necessity of the buyer to spend between $250,000 and $500,000 for renovating and rehabilitating the physical plant.

H. R. 8300 will probably kill this transaction with the probable result that the additional money to rehabilitate the property will not be spent and might

result in the owners liquidating and closing the business. If such should happen, 100 or so employees would be thrown out of work.

I know from my own experience that a number of acquisitions effected in the past under 112 (b) (3) and 112 (b) (4) would not now be effected. I can also say from my own experience that such acquisitions have resulted in the economic improvement to the community in which the retail establishment is located and to the employees employed therein.

Thus, it is subchapter C of H. R. 8300 places an economic brake on corporate expansions to the detriment of economy of the country as a whole.

We recommend that action on subchapter C of chapter 1, subtitle A, be deferred to permit more time for analysis of the economic effects and for the drafting of modifications necessary to accomplish its purposes. If deferment is not feasible then we recommend that the effective date be changed from March 1 to a date 6 months after the adoption of H. R. 8300.

SECTION 461 (C) ACCRUAL OF REAL-PROPERTY TAXES

The House Ways and Means Committee's report explains section 461 (c) as follows:

"Under present law a deduction for the payment of local property taxes accrues upon the date when the amount and liability for the tax become fixed. In many jurisdictions, the amount and liability for a property tax for the calendar year 1955 would be fixed on a date late in 1954 and, under court decisions, is deductible for accrual basis taxpayers only at that time.

"The bill provides that an accrual basis taxpayer may in the future accrue a real property tax ratably over the period for which the property tax is imposed."

A reading of the foregoing gives the impression that the objective sought to be accomplished is most desirable. The language of the second quoted paragraph seems to indicate that a taxpayer has a choice of either changing his method of accruing real property taxes in conformance with section 461 (c) or continuing his present method. Section 461 (c) of H. R. 8300, in fact, makes the change in accounting method mandatory and an accrual basis taxpayer has no choice.

Continuing the House committee's explanation of this section, the report says, "Special rules are provided to cover the transitional problems which may arise as a result of the change."

A taxpayer, reading newspaper accounts of H. R. 8300 has been lulled into the belief that H. R. 8300 is designed to eliminate inequities found in the present law, to clarify existing provisions and, in fact, effect some tax reductions in certain areas.

It is true that H. R. 8300 does fulfill some of its objectives but what will the taxpayer's reaction be when he discovers some months from now that H. R. 8300 for the first year of its operation has actually increased his income taxes.

Section 461 (c) for the first year will actually cost taxpayers, large and small, many millions of dollars. I cannot estimate the total cost to taxpayers but I can factually show what the cost will be to individual retailers.

Let us take a small retailer operating in the State of Massachusetts. Massachusetts is one of approximately 25 States which specifies January 1 as the date real property taxes become a liability. The period covered by this property tax is the calendar year. This retailer keeps his books and records and files his Federal income-tax return on a fiscal-year basis, namely, January 31.

Let us apply section 461 (c) to this taxpayer. For the year ended January 31, 1954, the Federal income-tax return of this retailer will show the following:

Net sales Jan. 31, 1954	$1,800,000
Real property taxes covering the calendar year 1954 accruing on Jan. 1 under Massachusetts statutes but required to be deducted by present Federal laws on Jan. 31, 1954	$30,000
Net profit for the year Jan. 31, 1954	$93,000
Federal income-tax liability	$42,900
Effective tax rate on accounting net income (percent)	46.1

Under section 461 (c), this same retailer, all factors being equal, at January 31, 1955, would show the same result for purposes of reporting to owners of the business, creditors, etc.

But, for Federal income-tax purposes, his return for January 31, 1955, applying section 461 (c) would show the following results:

Net sales	$1,800,000
Real property taxes 1/12 of the real property taxes for the period beginning Jan. 1, 1955 (1/12 of 56,000) allowed as a deduction under the special-rules section, 461 (c) (2)	$4,700
Net profit for accounting purposes as shown above	$93,000
Add real property taxes disallowed under the special rules (56,000—4,700)	$51,300
Taxable net profit under sec. 461 (c)	$144,300
Federal income-tax liability	$69,500
Effective tax rate on accounting net income (percent)	74.7

Thus, this retailer's income taxes for the fiscal year ended January 31, 1955, will be increased by $26,600 or an increase in the effective tax rate of 28.6 percent.

The following short table summarizes the effect of the application of section 461 (c) on retailers operating in other States. This summary is by no means complete. It is submitted as an indication of the cumulative effect of section 461 (c).

State in which each retailer operates	Effective tax rate on accounting net income before disallowance of real property taxes	Amount of real property taxes disallowed	Effective tax rate on accounting net income after disallowance of real property taxes	Additional income taxes payable on disallowed real property taxes
Pennsylvania	49.4	$13,400	52.7	$6,900
Do	48.7	6,500	50.7	3,400
North Carolina	50.2	22,400	51.0	11,700
Massachusetts	51.9	1,385,000	70.3	720,200
Do	49.5	26,300	55.8	13,700
Michigan	5[illegible].2	56,400	55.4	29,300
Total		1,510,000		785,200

The total additional income taxes payable by all six retailers set out above is $811,800.

It is important to remember that the disallowance of real property taxes as provided in section 461 (c) (2) is forever lost. It is not a disallowance in one year recoverable in another; it is gone.

I have shown the increased income-tax costs of only six retailers. What then is the total cost of all taxpayers?

The House committee report is completely silent as to the effect of the application of section 461 (c). I believe that if the House committee was aware of the foregoing results, it would have provided for the continuance of taxpayers present accounting and reporting methods.

In everyday tax parlance, section 461 (c) is known as a sleeper. I am convinced that Congress never intended the results portrayed, and I am confident that this committee will correct the situation.

The end result reached by application of section 461 (c) surely points up the need for careful consideration and study of all the provisions of H. R. 8300.

We recommend that section 461 (c) relating to accrual of real property taxes be amended to provide that a taxpayer may continue his present reporting method of deducting real property taxes.

SECTIONS 6016, 6154, AND 6655—DECLARATION OF ESTIMATED INCOME BY CORPORATIONS

The declaration and estimation of income taxes by corporations present serious financial and administrative problems particularly for retailers.

The House committee report indicates that out of 425,000 corporations, 35,000 corporations have been singled out for this special tax treatment. These 35,000 corporations were selected for the stated reason that they account for 90 percent of the corporation income-tax liabilities.

The House committe report does not indicate the kinds of companies in their 35,000 figure. What is the economic status, the financial status of these companies? Will the enactment of sections 6016 and related sections create greater problems than the problems sought to be solved? These are some of the questions that need to be answered before these sections are enacted into law. The House committee report indicates that consideration has been given to only one part of the problem.

In this connection, I call to your attention an article appearing in the New York World-Telegram and Sun (a copy is attached) which shows that 25 corporations showed a net profit in 1953 of $4.3 billion. A rough estimate of the corporation income-tax liability on this amount of income is $2.2 billion which I estimate is approximately 10 percent of all corporation income taxes.

If one fourteen-hundredths of this group of 35,000 corporations accounts for one-tenth of the corporate income-tax liability, is it not possible that a relatively few corporations account for the major part of the total tax liability? If this is true, how many thousands of corporations with tax liabilities of just over $50,000 are classified into this group and what is the impact of this section on them?

We must measure the adequacy of the solution proposed by section 6016, etc., against a true statement of financial ability of all the 35,000 corporations mentioned. I find no indication that consideration has been given to the economic effect on business.

Retailers, particularly, will have difficulty meeting the financial and administrative requirements of section 6016 and related sections.

The average retailer produces more than half of his annual profits, the range being 48 to 80 percent, during the months of October, November, and December. The retailer must purchase and pay for the merchandise to be sold during this 3-month period in the months of September, October, and November. These are months of heavy cash outlay. Cash resources are usually insufficient to meet these requirements necessitating borrowing.

The enactment of section 6016 and the related sections will cause a further strain on his resources. It really means further borrowing to pay in advance a tax on income that may not yet have been earned.

The first declaration of estimated income tax is due to be filed on the 15th day of the 9th month. This filing date is wholly unrealistic. A taxpayer is given exactly 15 days from the close of an 8-month period to resolve the complexities that enter into the determination of net income in this modern world.

Physical inventories play an important role in determining net income. These inventories are taken only twice a year at the most. True income can only be determined when the status of the inventory is known.

Retailers using the LIFO method have an added problem. LIFO inventory valuations are based on retail price indexes. These indexes are published by the Bureau of Labor Statistics twice a year, namely, March and September as of January 15 and July 15. No formula has yet been devised to measure the effect of unknown price changes for the intervening months.

Retailers reporting their profit on the gross profit method require further calculations to determine their net income.

Administrative problems are further aggravated. Two more returns are added to the long list of tax returns now required to be filed by retailers. These extra returns will increase administrative costs not only for the taxpayer but for the Government as well.

The corporation income tax was scheduled to be reduced to 47 percent on March 31, 1954. This decrease is now to be postponed for 1 year. Instead of getting the decrease as originally scheduled, the favored 35,000 corporations are required to pay out a greater amount in corporation income taxes within a 12-month period for the next few years than is now required under present law and more than is to be extracted from the other 390,000 corporations.

Eight percent of all the corporations are singled out for this special tax treatment solely on the basis of their net income. It seems to me that this is an extension of the principle that bigness per se is evil. I am a firm believer in democratic principles and that these principles should be applied to all groups without fear or favor. The application of section 6016 to 8 percent of the corporations violates my sense of fair play, justness, equity, and morality.

We recommend that sections 6016, 6154, and 6655 be completely deleted from H. R. 8300.

CONCLUSION

We are not unmindful of the sound objectives of H. R. 8300. It does much to clarify and simplify other existing Internal Revenue Code provisions. There are, however, areas in this bill which require additional study and analysis to determine the economic impact of the changes proposed.

Consideration of this bill under conditions of haste and pressure can and may result in creating situations that could outweight the good sought to be accomplished. We urge upon you the need for careful, deliberate study of H. R. 8300 lest we do greater harm than we do good.

We specifically recommend:

(*a*) That subchapter C relating to corporate distributions and adjustments be deferred to permit more time for study, testing, and to obtain an understanding of the very complex provisions relating to corporate reorganizations.

(*b*) That section 461 (c) relating to accrual of real-property taxes be amended to provide that a taxpayer may continue his present method of deducting real-property taxes.

(*c*) That sections 6016, 6154, and 6655, relating to the declaration of estimated income tax by corporations be deleted completely.

MEMBER ASSOCIATIONS AMERICAN RETAIL FEDERATION

National associations:
- American National Retail Jewelers Association
- American Retail Coal Association
- Association of Credit Apparel Stores, Inc.
- Institute of Distribution, Inc.
- Limited Price Variety Stores Association, Inc.
- Mail Order Association of America
- National Appliance and Radio-TV Dealers Association
- National Association of Chain Drug Stores
- National Association of Music Merchants, Inc.
- National Association of Retail Clothiers and Furnishers
- National Association of Retail Grocers
- National Association of Shoe Chain Stores
- National Foundation for Consumer Credit
- National Industrial Stores Association
- National Jewelers Association
- National Luggage Dealers Association
- National Retail Dry Goods Association
- National Retail Farm Equipment Association
- National Retail Furniture Association
- National Retail Hardware Association
- National Retail Tea and Coffee Merchants Association
- National Shoe Retailers Association
- National Sporting Goods Association
- National Stationery and Office Equipment Association
- Retail Paint and Wallpaper Distributors of America, Inc.

State associations:
- Arizona Federation of Retail Associations
- California Retailers Association
- Colorado Retailers Association
- Delaware Retailers' Council
- Florida State Retailers Association
- Georgia Mercantile Association
- Idaho Council of Retailers
- Illinois Federation of Retail Associations
- Associated Retailers of Indiana
- Associated Retailers of Iowa, Inc.
- Kentucky Merchants Association, Inc.
- Louisiana Retailers Association
- Maine Merchants Association, Inc.
- Maryland Council of Retail Merchants, Inc.
- Massachusetts Council of Retail Merchants
- Michigan Retailers Association
- Minnesota Retail Federation

MEMBER ASSOCIATIONS AMERICAN RETAIL FEDERATION—Continued

State associations—Continued
- Missouri Retailers Association
- Nevada Retail Merchants Association
- Retail Merchants Association of New Jersey
- New York State Council of Retail Merchants, Inc.
- North Carolina Merchants Association, Inc.
- Ohio State Council of Retail Merchants
- Oklahoma Retail Merchants Association
- Oregon State Retailers' Council
- Pennsylvania Retailers Association
- Rhode Island Retail Association
- Retail Merchants Association of South Dakota
- Retail Merchants Association of Tennessee
- Council of Texas Retailers Associations
- Utah Council of Retailers
- Virginia Retail Merchants Association, Inc.
- Associated Retailers of Washington
- West Virginia Retailers Association, Inc.

[From the New York World-Telegram and Sun, April 12, 1953]

TWENTY-FIVE BIGGEST MONEYMAKERS OF 1953

(By Joseph D'Aleo, financial writer)

With only three reporting lower profits, the 25 biggest moneymakers of 1953 increased their aggregate earnings 11 percent over 1952 to a record $4,303,108,000.

Most of the companies making up the list which is an exclusive tabulation in the World-Telegram and Sun, attained new record dollar profits. Exceptions included General Motors, which reported higher earnings although the total was still some $236 million behind the all-time record $834,044,000 of 1950; and Chrysler, Southern Pacific and Sinclair, all of which had lower net than in 1952.

Two newcomers appear this year. With this change the make-up of the list showed considerable shifting around from the ranking of the previous year. There was no change in the first four places—with GM, SONJ, ATT and Du Pont ruling in that order but United States Steel recovered to fifth place, where it was 2 years ago. In 1952 it dipped to ninth place due to the steel strike in that year.

New entries were Pacific Gas & Electric (the only gas and electric utility in the list) and International Paper. This is Pacific Gas' first time on the list but International Paper, now at the tail end, managed, in 1950, to place 24th. It was out of the running in 1951 and 1952.

The list comprises 9 oil firms, 3 railroads and 2 each for motor, chemical, utility, steel and electric equipment classifications. A nonferrous metal producer, a mail-order house and a paper producer round out the industry groupings.

For the 9 oil companies aggregate profit rose to $1,684 392,000, from $1,558,796,000 for the same companies in 1952 and $1,583,595,000 in 1951. High costs incident to the accelerated examination of undeveloped oil and gas leases, and comparison with a year when there was a special credit of $9,630,351 were factors for the reduced profit for Sinclair, the only one of the nine to show lower net than in 1952.

The list excludes Ford Motor Co. only because it is a closed corporation and, as such, does not report earnings publicly. It is believed to be a large enough earner to place in the first dozen corporations.

[Net profits, in thousands]

Company	1953		1952		1951		1950	
	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank
General Motors	$598,119	1	$558,721	1	$506,100	2	$834,044	1
Standard Oil (New Jersey)	552,826	2	519,981	2	528,461	1	408,223	2
American Telephone & Telegraph (Consolidated)	478,512	3	406,661	3	364,874	3	346,962	3
Du Pont	235,505	4	224,064	4	220,743	4	307,602	4
United States Steel	222,088	5	143,688	9	184,359	5	215,464	5
Texas Co	192,600	6	181,212	5	178,774	6	149,072	8
Standard Oil (California)	189,453	7	174,030	6	173,341	7	150,804	7
Socony-Vacuum	187,250	8	171,001	7	161,622	8	128,217	10
Gulf Oil	175,036	9	141,820	10	140,071	10	111,140	15
General Electric	165,728	10	151,719	8	138,116	11	173,424	6
Bethlehem	133,948	11	90,900	14	106,531	13	122,976	14
Standard Oil (Indiana)	124,826	12	119,081	11	148,097	9	123,581	13
Sears, Roebuck [1]	117,882	13	110,236	12	111,804	12	143,655	9
Shell Oil	115,406	14	90,873	15	97,020	15	91,185	16
Union Carbide	102,783	15	98,320	13	103,889	14	124,112	12
Kennecott	88,754	16	80,150	17	91,347	16	89,161	17
Santa Fe Ry	77,186	17	70,737	20	73,315	19	82,142	18
Phillips Petroleum	76,700	18	75,284	19	73,711	18	51,557	(2)
Chrysler	74,789	19	78,696	18	71,973	20	127,877	11
Westinghouse	74,322	20	68,581	22	64,578	22	77,923	19
Union Pacific	70,965	21	68,727	21	68,805	21	60,701	22
Sinclair	68,061	22	86,475	16	81,808	17	70,103	21
Southern Pacific	62,014	23	63,440	23	49,004	(2)	50,839	(2)
Pacific Gas & Electric	59,693	24	47,002	(2)	36,876	(2)	37,816	(2)
International Paper	58,542	25	52,126	(2)	56,819	(2)	60,647	24
Total	4,303,108	......	3,880,515	....	3,833,947	....	4,157,407	......

[1] 12 months ended Jan. 31.
[2] Out of running in that year.

STATES SPECIFYING JANUARY 1, OR A DATE WITHIN THE MONTH OF JANUARY, AS THE DATE REAL PROPERTY TAXES BECOME A LIABILITY

Arizona
Arkansas
Florida
Idaho
Kentucky
Louisiana
Maryland (Baltimore County)
Massachusetts
Michigan
Mississippi
Missouri
Nebraska
New Mexico
North Carolina
Ohio
Oklahoma
Oregon
Pennsylvania
South Carolina
Tennessee
Texas
Utah
Virginia
Washington
West Virginia

Section 461 (c) may be amended by adding a subsection (3) immediately following subsection (2). The wording of such subsection (3) may be stated as follows:

"(3) Irrespective of the rules provided in subsections (1) and (2) of this subsection (c), a taxpayer may continue his method of accounting for and reporting of real property taxes consistently employed by such taxpayer prior to the effective date of this subsection (c) and which method has been accepted or was required by the Commissioner of Internal Revenue."

The CHAIRMAN. Mr. Oates. Is Mr. Oates here? Mr. O'Brien.

STATEMENT OF W. BRICE O'BRIEN, ASSISTANT COUNSEL, NATIONAL COAL ASSOCIATION, ACCOMPANIED BY LOVELL H. PARKER, CHAIRMAN, TAX COMMITTEE

Mr. O'Brien. Mr. Chairman, my name is W. Brice O'Brien. I am assistant counsel of the National Coal Association, representing bituminous coal producers throughout the Nation. I am accompanied by Mr. Lovell H. Parker, chairman of the association's tax committee.

We feel that the tax-writing committees of Congress are to be congratulated for undertaking the tremendous and essential task of rewriting the Internal Revenue Code. It is inevitable, of course, that there will be some inequities arising out of the new language. It is hoped, however, that this committee will do their best to correct at this time any inequities which they may discover and will also study the actual operation of this new code so any undiscovered inequities may be corrected retroactively.

We are advocating, on behalf of the coal industry, four amendments to H. R. 8300—dealing with dust allaying and antifreeze treatment of coal, with the net operating loss deduction, with the definition of the "property" for depletion purposes, and with the net income upon which percentage depletion is based. However, because of time limitations, we will discuss here only the amendment dealing with dust allaying and antifreeze treatment of coal. We ask that our written statement, dealing in detail with all four recommendations, be made a part of the record of these hearings.

The Chairman. That will be done.

(The statement referred to follows Mr. O'Brien's testimony.)

Mr. O'Brien. In the decade beginning in 1930 dust-allaying treatment was developed on a broad scale to combat the alarming trend away from coal as a domestic fuel. This technique has been only partially successful, as evidenced by the fact that in the last 10 years the retail deliveries of bituminous coal have been cut almost in half. Nevertheless, if any part of the domestic market is to be retained, the coal which serves that market will have to be dust-treated. The industry is having an extremely difficult time selling coal to the householder even with dust treatment. If we must sell dusty coal, our job is utterly hopeless. Without dust-allaying treatment, it is practically impossible to sell coal for domestic heating purposes.

Section 114 (b) (4) (B) was added to the Internal Revenue Code in 1943. This section provides a definition of gross income from the property, upon which percentage depletion is based. This definition is carried over in subsection (c) of section 613 of H. R. 8300.

Under the definition, "gross income from the property" means the gross income from mining. The provision specifies that "mining" includes not merely the extraction of the ores or minerals from the ground but also the "ordinary treatment processes" normally applied in order to obtain the commercially marketable product or products. The provision further specifies that ordinary treatment processes include the following:

> In the case of coal—cleaning, breaking, sizing, and loading for shipment.

In *Black Mountain Corporation* v. *Commissioner* (21 T. C. No. 83), promulgated February 25, 1954, the Tax Court held—with Judge Arundell dissenting—that the application of a fine oil spray or mist

to coal for the purpose of allaying dust is not an ordinary treatment process within the meaning of the statute. The Tax Court held, therefore, that the gross income from the property upon which percentage depletion is based must be reduced by the amount of gross income from the dust-allaying treatment and that the net income from the property which also provides a limitation on percentage depletion must be reduced by any profit involved in the dust-allaying treatment.

This decision was promulgated too late for us to bring this matter to the attention of the Ways and Means Committee. We ask, therefore, that this committee amend subsection (c) (4) (A) of section 613 of H. R. 8300 to read as follows:

In the case of coal—cleaning, breaking, sizing, dust-allaying and antifreeze treatment, and loading for shipment.

The CHAIRMAN. Anti what?

Mr. O'BRIEN. Antifreeze.

The CHAIRMAN. Tell us about that.

Mr. O'BRIEN. When coal is shipped in the northern parts of the country during the winter months, it is necessary to use certain chemicals or other materials—I believe calcium chloride is the most common—when the coal is loaded on the car, to keep the coal from freezing in the car. Without such treatment in the cold months it would be very difficult to get the coal out of the car. It freezes I believe primarily in the corners of the car.

The CHAIRMAN. Is that a common practice?

Mr. O'BRIEN. It is.

The CHAIRMAN. What is the percentage of coal sold subjected to that practice?

Mr. O'BRIEN. It depends upon the weather at the time of shipment. If the weather is below freezing at the time of shipment, it is my understanding that all of the coal in that climate is treated for antifreeze. But coal shipped in the summertime, of course, is not so treated.

Unfortunately, I am unable to give you figures as to the percentage of the total production.

The CHAIRMAN. Well, is it a common practice?

Mr. O'BRIEN. It is, sir. It is universal.

The CHAIRMAN. All right.

Mr. O'BRIEN. With respect to the dust treatment, the Tax Court recognized, in the Black Mountain decision, the following important facts:

On the average, only 11 pounds of oil are applied to 2,000 pounds of coal, and the oil so applied does not add to the burning qualities of the coal in any measurable amount. In other words, the burning qualities of the coal are not beneficiated by the oil treatment. The purpose of the oil treatment is primarily and purely to allay the dust which would otherwise be so annoying to the householder.

The CHAIRMAN. What percentage of your coal is customarily subjected to that treatment?

Mr. O'BRIEN. In the last year for which figures were available—I believe that was 1949—some 41 million tons of coal were subjected to the dust-allaying treatment.

The CHAIRMAN. Out of a total of how much?

Mr. O'BRIEN. Out of a total of 465 million tons—approximately 9 percent.

The CHAIRMAN. You say it is about 9 percent?

Mr. O'BRIEN. Yes, sir. The point is, however, that that 9 percent of total production represents, as near as we can judge, somewhere over 90 percent of the coal which goes to the domestic home. Retail deliveries of coal in that year amounted to about 65 to 70 million tons. But retail deliveries include not only domestic coal, but includes also coal to the small industrials and to the hotels and large apartment houses.

Now, much of that coal it is not necessary to dust treat. It is necessary to dust treat over 90 percent of the coal which goes into the home.

Government figures aren't available as to the exact percentage of home coal which is dust treated. The reason for that is that there is no breakdown in the amount of retail deliveries between homes and these small industrials. Our sales people are convinced, however, that practically all coal that goes into the home is dust treated and must be dust treated in order to be sold.

The CHAIRMAN. Do you have any evidence of that in the House?

Mr. O'BRIEN. The only evidence on the point was opinion evidence which was presented to the Tax Court in the Black Mountain case in Chicago. They made no specific finding in their decision as to the percentage of domestic coal which is oil treated or dust treated. There is no available evidence other than opinion testimony of expert witnesses.

The CHAIRMAN. Is the treatment done by the mines or by the distributor?

Mr. O'BRIEN. The treatment is done at the mine. The Tax Court recognized that it is not feasible for this dust treatment to be done anywhere other than at the mine, before shipment. Early in the game, in the 1930's, when this treatment first developed, some retailers did try to apply their own dust treatment.

The CHAIRMAN. Is it a patented process?

Mr. O'BRIEN. There may have been some patents on it. I think there are no royalties being paid on the processes at the present time.

The CHAIRMAN. You are talking about patent royalties or royalties on coal?

Mr. O'BRIEN. I am speaking of patent royalties.

The CHAIRMAN. Have you got a definite position as to whether it is or is not patented?

Mr. O'BRIEN. I am sorry, sir, I do not have. I didn't go into that question. There are, however, numerous methods of applying dust treatment. Most of it is done through the application of a fine oil spray; some of it is done with calcium chloride.

The CHAIRMAN. What does that add to the cost of a ton of coal?

Mr. O'BRIEN. The ordinary charge runs between 10 and 15 cents a ton. In the Black Mountain case they charged 15 cents a ton on the average, and the Government used for its cost in that process merely the amount of oil. No figures were available, in the taxpayer's records, to show other costs which are attributable to the process, such as manpower, depreciation of equipment, or allocation of overhead. So the cost of oil amounted to approximately 13 cents a ton, leaving, in the Government's estimation, a profit of approximately 2 or 3 cents a ton out of the dust treatment process.

That is an important point, in our opinion, because we believe that if this decision is allowed to stand, the coal companies will then be forced to protect themselves by setting up their books with proper records to show how much of this overhead and depreciation is allocable to this proposition. Once they have done that, we believe that in the ordinary case—and we are so advised by our members—there will be no profit to the coal operator out of the dust-treatment process. So, therefore, the decision will not in the long run gain revenue for the Government.

The CHAIRMAN. Why does a man produce coal without making a profit?

Mr. O'BRIEN. Because he cannot sell it to the domestic market until it is so treated.

The CHAIRMAN. That is what you make a profit on, isn't it?

Mr. O'BRIEN. Perhaps I didn't make myself clear. My point is that there is no profit in the dust-treatment process. There may be a profit in the mining of the coal.

The CHAIRMAN. But you add that to the cost of the coal, don't you, when you sell it?

Mr. O'BRIEN. Yes, sir.

The CHAIRMAN. And that is what you make your profit on, isn't it, if you make a profit?

Mr. O'BRIEN. You make a profit on the price of the coal, yes, sir. The ordinary billing is perhaps——

The CHAIRMAN. I don't care about the billing. I am asking a very simple question: This is a cost of operation, is it not?

Mr. O'BRIEN. Yes, sir.

The CHAIRMAN. And you aim to make a profit on your cost of operation, don't you?

Mr. O'BRIEN. That is correct.

The CHAIRMAN. You are not throwing any part of your operation in free, are you?

Mr. O'BRIEN. No, sir.

The CHAIRMAN. No. Thank you.

Mr. O'BRIEN. We would like to point out further that if the decision is allowed to stand, in order to protect their depletion allowance, the operators will be put to considerable accounting expense, as I think I already stated, and in the long run proper accounting will show that the amount of profit involved only in the oil treatment is either nonexistent or extremely small. The oil-treatment process itself is applied not as a source of profit, but as a means of selling the coal, which does furnish the source of profit.

The CHAIRMAN. Well, unless you have a very peculiar type of business, you add up all of your costs and figure what profit you want to make on it, and that includes, I assume, all your dust-treating processes, doesn't it? Do you have some part of your operation where you merely figure on getting your money back, and no more?

Mr. O'BRIEN. In this case I believe that is correct, sir. At least we are so advised by our people.

We do have, as you know, Senator, a peculiar type of business in that unlike most businesses we can't figure our cost and add our profit and set the price. The coal industry today is forced to start with the price. The price has to be sufficiently low to sell the coal. They

work backwards on the proposition. The price is established by market, and if your cost can be kept within that price, you keep operating. Otherwise, you go under.

The CHAIRMAN. Well, do you, in figuring out what it costs you to run your coal-producing operation, disregard the cost of the oil treatment? Don't you figure that in?

Mr. O'BRIEN. It is computed in, yes, sir.

The CHAIRMAN. Well, of course. Unless you are in an awfully peculiar position, you don't omit any item of your cost, and you are trying to keep your head above water.

Mr. O'BRIEN. We did have many companies in that position last year and this year.

The CHAIRMAN. I have no doubt of that.

Mr. O'BRIEN. I think probably in our discussion——

The CHAIRMAN. I want to ask you another question: How usual is this in the business?

Mr. O'BRIEN. Only 9 percent of the total production is dust treated, approximately 9 percent or 10 percent. However, over 90 percent of coal which goes into homes is dust treated. Now, practically every mine of any size, practically everything but the gopher hole, has dust treatment equipment. They use that dust treatment equipment and process only for the coal which goes into the home.

I should correct that statement: In some cases they use it for other types of coal. I believe certain types of slack are dust treated, so it won't all blow away during shipment. But primarily it is used almost totally for coal which goes into the home.

The CHAIRMAN. A wagon mine wouldn't have any dust treatment, would it?

Mr. O'BRIEN. They wouldn't, and ordinarily they would sell to a mine which has a preparation plant, and it would then be dust treated in that preparation plant, if it were going into the home. But the wagon mine that is selling to a truck, that coal will not be dust treated, and the chances are 9 to 1 that it will not go into the home because of the fact that it is not dust treated.

Dr. Parker has reminded me that the average mine sells its industrial coal without dust treatment. And ordinarily they use the same price or a relative price. And where dust treatment is applied, they add an amount which, in their opinion, is sufficient to reimburse them for the expense involved in that oil treatment.

I would like to quote to you a paragraph or two from Judge Arundell's dissenting opinion in the Black Mountain case. I believe his opinion indicated a very clear and practical approach to the situation. He said, and I quote——

The CHAIRMAN. Could there be same feasible way of finding the cost where you have it, as against your other costs where you don't have it?

Mr. O'BRIEN. I think there is, sir. Not under the present record of most companies. The present bookkeeping records of most companies will show merely the cost of the oil which was used in the dust process.

If this decision is allowed to stand, however, I believe that within 2 or 3 years the records of most companies will show not only that oil cost but the depreciation cost of the equipment which is used in the process, and the allocation of the applicable manpower to that process,

and the allocation of general overboard expenses, on a proportionate basis.

Those are difficult allocations and perhaps beyond the ability of the bookkeeping departments of most small companies. The large companies, with expert accountants in their service, will be able to make those allocations.

The CHAIRMAN. What is the practical way of handling it?

Mr. O'BRIEN. We recommend amending the statute to include dust allaying treatment as an ordinary process. In that method the computation need never be made. As Mr. Parker points out, to handle it just as the statute now provides, you handle cleaning, breaking, sizing and loading for shipment.

The Chairman. This would not be interpreted as cleaning?

Mr. O'BRIEN. The majority of the Tax Court so concluded. Judge Arundell, in his dissenting opinion said that in his opinion it shouldn't make any difference whether the cleaning is done with water, which is the method accepted by the Bureau for cleaning, or whether it is done by the application of an oil spray.

In our opinion, there is no essential difference between cleaning with the application of water or cleaning with the application of an oil spray.

The CHAIRMAN. When you clean it with water, you get a better coal product, but you also clean it to allay dust, don't you?

Mr. O'BRIEN. That is correct, sir.

The CHAIRMAN. And you do much the same thing with oil?

Mr. O'BRIEN. That is correct, sir.

The difference apparently, in the opinion of the Tax Court, was that in coal you are applying only—that in the water process you are applying only water, but in this process you are applying an oil spray. And my own opinion is that perhaps they were under the impression, although they stated to the contrary in the decision, that in some way this is added for the purpose of making the coal burn better. It doesn't beneficiate the burning qualities at all. If so, the scientists have not been able to measure the extent to which it adds to the burning quality, it is so small.

The CHAIRMAN. Proceed.

Mr. O'BRIEN. In conclusion, I would like to read to you a couple of paragraphs from Judge Arundell's dissenting opinion. He said:

> There is no question that the oil treatment was a process applied by mine owners to obtain a commercially marketable products, but the majority have concluded that the oil treatment was not an ordinary treatment process normally applied by mine owners. This conclusion is based largely on statistics.
>
> Certainly the oil process was not unusual or extraordinary, for the amount of coal treated with oil or in a similar manner to allay the coal dust ran into millions and millions of tons a year, and a very large part of the bituminous coal which was used for heating homes was so treated. In fact, it is doubtful if there there would have been any considerable market for bituminous coal for home heating purposes if the coal had not been given this treatment. In a competitive economy, there are always new and better methods being used to accomplish the same end, and whether the coal was washed with water or oil to allay the coal dust should not be a determinative matter in the construction of this statute. * * *
>
> I would hold that the oil treatment was an ordinary process normally applied by mine owners in order to obtain a commercially marketable product within the meaning of the statute.

The CHAIRMAN. I hope the staff will give special attention to that and bring it to the attention of the committee.

Mr. SMITH. We will, Senator, and I hope Mr. OBrien will furnish us with statistical data relating to the amount of expense incurred.

The CHAIRMAN. It seems there is a very large gap in the figures here.

Mr. O'BRIEN. We will be glad to furnish that.

Thank you very much.

The CHAIRMAN. Thank you.

NATIONAL COAL ASSOCIATION,
Washington, D. C., April 22, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee, Senate Office Building,
Washington, D. C.

DEAR SENATOR MILLIKIN: On April 20 I testified before your committee and asked, on behalf of the bituminous coal industry, that subsection (c) (4) (A) of section 613 of H. R. 8300 be amended to include in the ordinary treatment process for coal, dust-allaying and antifreeze treatment.

You were kind enough to exhibit considerable interest in this matter, and suggested that additional statistics should be furnished for the use of the staff.

The attached document contains statistics on this matter for the years 1948-52, inclusive. Statistics are not available later than the year 1952.

I am furnishing copies of this material to the staff and to the clerk of your committee.

Your interest in this problem is deeply appreciated.

Respectfully submitted.

W. BRICE O'BRIEN,
Assistant Counsel.

Summary data on treatment of bituminous coal at mines for allaying dust in the United States, 1948-52, inclusive

Year	Grand total production (net tons) (1)	Net tons treated for allaying dust (2)	Percent of total production treated (3)	Retail dealer deliveries (4)	Tonnage treated expressed as percentage of retail dealer deliveries (5)	Estimated tonnage used for domestic heating purposes (6)	Tonnage treated expressed as percentage of domestic heating coal (7)
1948	599, 518, 229	50, 381, 696	8.4	89, 747, 000	56.1	71, 797, 600	70.2
1949	437, 868, 036	41, 774, 902	9.5	90, 299, 000	46.3	72, 239, 200	57.8
1950	516, 311, 053	54, 333, 871	10.5	86, 604, 000	62.7	69, 283, 200	78.4
1951	533, 664, 732	58, 597, 809	11.0	76, 531, 000	76.6	61, 224, 800	95.7
1952	466, 840, 782	51, 568, 276	11.0	68, 393, 000	75.4	54, 714, 400	94.2

SOURCE AND EXPLANATION

Cols. (1), (2), and (3) contained in Weekly Coal Report No. 1900, issued on April 16, 1954, by the U. S. Department of the Interior, Bureau of Mines.

Col. (4) obtained from U. S. Bureau of Mines publications.

Col. (5) computed—col. (2) divided by col. (4).

Col. (6) computed by taking 80 percent of col. (4). Retail dealer deliveries contain substantial tonnage which reaches markets other than domestic heating and apartment and small commercial heating, such as small industrials and other types of uses which do not necessarily require dust treatment. Census of housing figures for 1950 show the number of residences (including small apartment houses) heated by bituminous coal, and the average number of rooms per residence. Using this information, and the B. t. u. required per room as shown by a study published by Housing and Home Finance Agency, we have computed the tonnage used in 1950 for heating residences and small apartment houses at 50,990,163 tons, or 59 percent of retail dealer deliveries for that year. However, qualified industry members estimate that when the tonnage used for schools, hospitals, and small commercial space heating of the type which requires dust-treated coal is added to the tonnage used in residences, the total is approximately 80 percent of the total tonnage represented by retail dealer deliveries. The tonnage set forth in column (6) is, therefore, the best judgment of qualified members of the industry as to the amount of coal used for purposes which require dustless coal, including homes, hospitals, schools, and small commercial space heating.

Col. (7) computed—col. (6) divided into col. (2).

NOTE.—Dust treatment of coal is confined almost wholly to coal shipped to retail dealers. Practically no coal is sold by retail dealers for domestic use unless it is dusttreated. Testimony of expert witnesses, James R. Henderson and Joseph F. Bigane, Sr., on Mar. 8, 1953, before the Tax Court in *Black Mountain Corporation* v. *Commissioner*—transcript of trial, pp. 65-67 and pp. 80-81.

(The prepared statement of Mr. O'Brien follows:)

STATEMENT OF W. BRICE O'BRIEN, ASSISTANT COUNSEL, NATIONAL COAL ASSOCIATION, WASHINGTON, D. C.

Mr. Chairman and members of the committee, my name is W. Brice O'Brien. I am assistant counsel of the National Coal Association, representing bituminous coal producers throughout the Nation. I am accompanied by Mr. Lovell H. Parker, chairman of the association's tax committee.

We feel that the tax-writing committees of Congress are to be congratulated for undertaking the tremendous and essential task of rewriting the Internal Revenue Code. It is inevitable, of course, that there will be some inequities arising out of the new language. It is hoped, however, that this committee will do their best to correct at this time any inequities which they may discover and will also study the actual operation of this new code so any undiscovered inequities may be corrected retroactively.

We are advocating, on behalf of the coal industry, four amendments to H. R. 8300—dealing with dust-allaying and antifreeze treatment of coal, with the net operating loss deduction, with the definition of the property for depletion purposes, and with the net income upon which percentage depletion is based. However, because of time limitations, we will discuss here only the amendment dealing with dust-allaying and antifreeze treatment of coal. We ask that our written statement, dealing in detail with all four recommendations, be made a part of the record of these hearings.

DUST-ALLAYING AND ANTIFREEZE TREATMENT

In the decade beginning in 1930, dust-allaying treatment was developed on a broad scale to combat the alarming trend away from coal as a domestic fuel. This technique has been only partially successful, as evidenced by the fact that in the last 10 years the retail deliveries of bituminous coal have been cut almost in half. Nevertheless, if any part of the domestic market is to be retained, the coal which serves that market will have to be dust treated. The industry is having an extremely difficult time selling coal to the householder even with dust treatment. If we must sell dusty coal, our job is utterly hopeless. Without dust-allaying treatment, it is practically impossible to sell coal for domestic heating purposes.

Section 114 (b) (4) (B) was added to the Internal Revenue Code in 1943. This section provides a definition of gross income from the property, upon which percentage depletion is based. This definition is carried over in subsection (c) of section 613 of H. R. 8300.

Under the definition, "gross income from the property" means the gross income from mining. The provision specifies that "mining" includes not merely the extraction of the ores or minerals from the ground but also the "ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products." Subsection (c) (4) (A) of section 613 provides that the term "ordinary treatment processes" includes the following:

"In the case of coal—cleaning, breaking, sizing, and loading for shipment."

In *Black Mountain Corporation* v. *Commissioner* (21 T. C. No. 88), promulgated February 24, 1954, the Tax Court held (with Judge Arundell dissenting) that the application of a fine-oil spray or mist to coal for the purpose of allaying dust is not an ordinary treatment process within the meaning of the statute. The Tax Court held, therefore, that the gross income from the property upon which percentage depletion is based must be reduced by the amount of gross income from the dust-allaying treatment and that the net income from the property which also provides a limitation on percentage depletion must be reduced by any profit involved in the dust-allaying treatment.

This decision was promulgated too late for us to bring this matter to the attention of the Ways and Means Committee. We ask, therefore, that this committee amend subsection (c) (4) (A) of section 613 of H. R. 8300 to read as follows:

"In the case of coal—cleaning, breaking, sizing, dust-allaying and antifreeze treatment, and loading for shipment."

In its decision in the Black Mountain case the Tax Court recognized the following important facts:

On the average, only 11 pounds of oil are applied to 2,000 pounds of coal, and the oil so applied does not add to the burning qualities of the coal in any measurable amount. The oil spray is applied for the purpose of allaying dust for a normal storage period, and dust is also allayed by the use of calcium chloride and other materials. It is not feasible for anyone other than the mineowner or operator to apply the dust-allaying treatment. Dust-allaying treatment developed in efforts to meet the competition of oil and gas as a domestic heating fuel. In 1949 (last year for which figures were available) more than 41 million tons of bituminous coal were treated at the mines for allaying dust.

Apparently the Tax Court based its decision on the erroneous conception that there would be a market for such coal even if it were not dust treated. For practical purposes, this just isn't the case. The primary factor in the determination of whether coal will be dust treated is the available market. If the domestic heating market is its destination, the coal must be, and is, treated to allay dust. The majority of the Tax Court felt that the untreated coal could be sold to other markets. Unfortunately, in the coal industry today there are no alternative markets for surplus coal. Our markets have declined from 630 million tons in 1947 to 453 million tons in 1953. So far this year production is running more than 16 percent below that of last year. Under those circumstances, a market loss cannot easily be replaced.

For many years the industry considered, without question, that dust-allaying treatment was an ordinary treatment process. A few years ago, however, the Commissioner began to assert, in individual cases, the position that it was not included within the terms of the statute. Because the amount of tax liability in any one year was not large for any one taxpayer, no taxpayer took the matter to court prior to the Black Mountain case. However, the situation involves some tax liability (although a small one) for every coal producer, and this tax liability is a recurring matter. Moreover, if the decision is allowed to stand, every producer will be forced to protect himself by establishing accurate accounting records on the total cost of all items which enter into the dust-allaying treatment. In the Black Mountain case the Tax Court reduced the gross income by the amount charged because of dust treatment (about 15 cents per ton), and reduced the net income by the Government's interpretation of the "profit" involved, which was the amount charged minus the cost of the oil. If this decision stands, the taxpayer will be entitled to reduce the profit by the depreciation of equipment involved, by the manpower involved, and by the overhead applicable to this treatment. The net result will be that in most cases this decision eventually will have no effect on the revenue, but it will cause a substantially increased accounting cost and nuisance both to the Government and the taxpayer.

Indeed, it is theoretically possible that the Black Mountain decision might reduce tax liability. For dust treatment most companies charge only a few cents per ton, and in many cases the charge is not sufficient to cover the cost. If the Black Mountain decision is correct, then the net income should be increased by the amount of the loss where a loss results from dust treatment. Undoubtedly the Internal Revenue Service would seriously object to such a situation, but the possibility illustrates the type of annoying problems which may arise from the Black Mountain holding. Reduction of the gross income by the amount of the small charge involved will not produce any additional revenue, because under today's economic conditions few, if any, coal companies have sufficient earnings to measure their percentage depletion by gross income.

Judge Arundell's dissenting opinion in the Black Mountain case indicated a clear and practical approach to the situation. Part of his opinion is quoted here:

"There is no question that the oil treatment was a process applied by mineowners to obtain a commercially marketable product, but the majority have concluded that the oil treatment was not an ordinary treatment process normally applied by mineowners. This conclusion is based largely on statistics.

"Certainly the oil process was not unusual or extraordinary, for the amount of coal treated with oil or in a similar manner to allay the coal dust ran into millions and millions of tons a year, and a very large part of the bituminous coal which was used for heating homes was so treated. In fact, it is doubtful if there would have been any considerable market for bituminous coal for home heating purposes if the coal had not been given this treatment. In a competitive economy, there are always new and better methods being used to accomplish the same end, and whether the coal was washed with water or oil to allay the coal dust should not be a determinative matter in the construction of this statute * * *.

"I would hold that the oil treatment was an ordinary process normally applied by mineowners in order to obtain a commercially marketable product within the meaning of the statute."

In our suggested amendment we specify, in addition to dust-allaying treatment, antifreeze treatment. While this particular treatment has not been the subject of a decision as yet, it appears to fall within the same category as dust treatment. Depending on the climate at the time of shipment, it is often necessary to treat coal to prevent freezing during shipment. Like dust-allaying treatment, this antifreeze treatment involves only minor cost and is applied only when necessary. The industry has always regarded this as a part of the production of coal. However, in the face of the surprising decision on dust-allaying treatment, it appears necessary to obtain congressional protection on antifreeze treatment also.

NET OPERATING LOSS DEDUCTION

Section 172 of H. R. 8300 rewrites the net operating loss provisions of the 1939 code. In rewriting this provision, several major substantive changes have been made.

Under the present law the net operating loss must be reduced, both in the year in which the loss is sustained and in all years to which the loss is carried, by the excess of percentage depletion over cost depletion.

Section 172 of H. R. 8300 makes a change which has the effect of eliminating this double penalty insofar as it involves the first of the 7 years to which a net operating loss may be carried, although the double penalty is retained with respect to the other 6 years to which the loss may be carried. The reasons for this change are set forth in the Ways and Means Committee report at page 27, as follows:

"Your committee has also made changes in the method of computing the net operating loss deduction, in order to lessen the differences in tax treatment of firms with fluctuating and those with stable incomes. Under present law the loss is reduced for certain items with respect both to the loss year and the income year to which the loss is carried, before the loss can be offset against taxable income of the latter year. Thus under existing law taxpayers with loss carryovers are denied the use of tax benefits which are fully available to those with stable incomes."

This recognized inequity has been carried by section 172 to the extent that it involves the first year to which a loss may be carried, although it has not been corrected with respect to the other 6 years to which a loss may be carried. We feel the Congress should be commended for this step forward.

Unfortunately, however, subsection (e) of section 172 provides that:

"In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year. The preceding sentence shall apply with respect to all taxable years, whether they begin before, on, or after January 1, 1954."

It is, of course, true that subsection (e) merely writes into law a rule already laid down by the courts—*Reo Motors, Inc.* v. *Commissioner* (338 U. S. 442, 70 S. Ct. 283). However, the courts based their ruling on an interpretation of the intent of Congress, and on nothing else. There is no reason why Congress is not free to change that rule by statute.

Under subsection (e) of section 172 the partial correction of inequity accomplished by section 172, as outlined above, will not become effective until 1956. Losses sustained in 1954 may be carried back to 1952, and under subsection (e) the law of 1952 will govern—the double penalty will still be imposed. Losses sustained in 1955 may be carried back to 1953, and under the 1953 law the double penalty will still be imposed. Section 172 does not eliminate the double penalty for any years to which a loss may be carried except the earliest of such years, and therefore will not be of any benefit in this respect insofar as losses incurred in 1954 or 1955 are concerned.

In practically all other respects it is the obvious intent of Congress to make the changes accomplished in H. R. 8300 effective with respect to the taxable year 1954 and subsequent years. It is unreasonable to postpone until 1956 the application of a change which is recognized as the correction of an inequity.

We urge the committee to amend subsection (e) of section 172 to read as follows:

"LAW APPLICABLE TO COMPUTATIONS. In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year, except that a net operating loss sustained in any taxable year beginning after December 31, 1953 shall not be adjusted by the modifications set forth in subsection (d) hereof in the earliest of the 7 taxable years to which (by reason of par. (1) of subsec. (b) hereof) such loss may be carried. The preceding sentence shall apply with respect to all taxable years, whether they begin before, on, or after January 1, 1954."

In support of this amendment, we wish to point out that it will not affect the computation of excess profits taxes. Subsection (f) (3) of section 172 provides that excess profits net income shall be computed as if this section had not been enacted.

The coal industry has a particular stake in the amendment herein recommended. That stake arises because of the depressed condition of the industry and the depressing outlook for the industry. The loss of coal markets to imported residual oil, to domestic petroleum, and to natural gas are too well known and too well documented before various committees of Congress to require further substantiation here. It is enough to point out that in 1954 a substantial number of coal companies will suffer net operating losses. At least for the reasonably foreseeable future, no change in the economic outlook of the industry is in sight—the shrinkage of markets promises to continue for a number of years.

If the amendment advocated herein is adopted, it will have the effect of partially removing the recognized inequity involved with respect to losses sustained in 1954 and 1955, and thereby enabling some coal companies to remain above water for a little longer. If this amendment is not adopted, many coal companies will never receive any benefit from the change now contained in section 172 because as it stands this change has no application to losses sustained before 1956. Companies with a period of successive loss years beginning in 1954 (and it appears that there will be a number of coal companies in that category) may well be forced out of business before any benefit is received from section 172 unless it is made applicable to losses sustained in 1954.

DEFINITION OF THE PROPERTY

Section 614 of H. R. 8300 contains a definition of the property for the purpose of computing the depletion allowance. At present there is no such definition in the law, but regulations 118 provide such a definition in section 39.23 (m)-1 (i). In the regulations it is specified that "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 consistetly followed."

The lack of a statutory definition of the property has in the past occasioned considerable litigation, and therefore a sound definition appears to be desirable. Hower, section 614 in its present form appears to be seriously deficient in some respects.

The aggregation of interests permitted by existing regulations and decisions is in many cases applied for the purpose of cost, or unit, depletion as well as for the purpose of percentage depletion. In many cases a mining operation is composed of a large number of small tracts of land acquired at different times and from different sources. There are in existence a number of such mining operations which are composed of a number of tracts and which became operative so long ago that records are no longer available as to the cost basis of each and every individual interest therein. The number of such cases has been increased by the fact that under present law the operator has been permitted to aggregate such interests (provided such treatment was consistently followed) for both cost depletion and percentage depletion purposes.

After defining "property" as meaning each separate interest owned by the taxpayer in each mineral deposit in each separate tract, section 614 permits the taxpayer to aggregate such interests under specified conditions, "but only for the purpose of computing the percentage depletion allowance."

Even though the taxpayer may be computing his depletion allowance on the percentage basis, he must of course be able to determine his cost or unit depletion. If section 614 is enacted in its present form there will be a large number of taxpayers for whom it will be impossible to comply with the requirements of the section.

If the same aggregation is permitted for cost depletion purposes as is permitted for percentage depletion purposes this treatment will not impose insoluble problems were a portion of the aggregated property is disposed of. When such an event occurs, the taxpayer determines gain or loss by deduction of adjusted basis from the selling price. If the taxpayer's records do not permit him to establish an adjusted basis of the particular portion disposed of, then he simply fails to establish any reduction of the selling price in the determination of gain. The Government, therefore, will lose nothing by permitting the same aggregation for cost depletion purposes as is permitted for percentage depletion purposes.

In addition to the essential change in section 614 discussed herein, there are a number of desirable changes which we feel should be made in the statutory definition of the property. The taxpayer should be permitted to form more than one aggregation in a given operating unit where circumstances make it desirable to do so. The taxpayer should be permitted a new election as to aggregation of interests when there is a substantial change in holdings. Lessors should be permitted a reasonable aggregation of mineral interests. These matters are discussed in detail in exhibit A attached to the statement presented to this committee yesterday by Mr. Henry B. Fernald on behalf of the American Mining Congress. We have examined exhibit A to Mr. Fernald's statement and concur in the recommendations therein. We will not burden the record by repetition here of the reasons therein set forth.

DEFINITION OF NET INCOME FROM THE PROPERTY

When the percentage depletion provisions applying to coal and metal mining were first made a part of the revenue statutes in the Revenue Act of 1932 and reaffirmed in the Revenue Act of 1934, the definitions of "gross income from the property" and "net income from the property" upon which the allowable computations of percentage depletion were based, were left by Congress for inclusion in the regulations by the Commissioner of Internal Revenue.

The mine operators protested the definitions drafted by the Commissioner for inclusion in the regulations on the grounds that they did not express the clear intent of Congress. As a result, a group of mine operators and their representatives met with the officials of the Treasury Department late in December 1932 to discuss the matter. In this conference, it was agreed the definitions drafted by the Commissioner did not express the intent of Congress. However, as the regulations containing the definitions drafted by the Commissioner had, in the interim, been printed in bound form and been delivered to the Treasury Department and were ready for issuance, the Treasury representatives expressed reluctance to withdraw said regulations on the ground such a change could not be made and have the regulations issued in time for use in connection with the returns due to be filed March 15, 1933. To meet this situation, it was proposed that the regulations be issued as printed with the understanding the definitions would be interpreted and applied according to the meaning of the act as agreed to in that conference. The operators agreed to this procedure. The regulations were thus issued and the definitions were applied as agreed to up to about the latter part of 1938.

Beginning in about 1938 and progressively over subsequent years, the Commissioner of Internal Revenue made various changes in the interpretation and application of these definitions contained in the regulations, all detrimental to the mining operator entitled to an allowance as depletion. Some of these changes were covered by rulings issued by the Commissioner. However, in the main, the Commissioner merely took the position that his prior allowances had been contrary to the expressed wording of the regulations and the changes being made were for the purpose of complying with those regulations.

Since 1938 the Commissioner has progressively and gradually set up additional deductions not previously deemed deductions from gross income in determining net income from the property. Many of these deductions have no relation to the production from the particular property upon which the depletion is claimed. Since the law does not contain a definition of "net income from the property," but leaves the matter to the discretion of the Commissioner, the courts have generally upheld the Commissioner's determinations. For example, in *Sheridan Wyoming Coal Co.* (125 Fed. (2) 42), interest payments on outstanding bonds, bond discount, and expense of amortization of bonds, whether or not said bonds applied to the particular property upon which depletion was claimed, were held to be proper deductions from gross income in computing net income from the

property. There have been other equally vital decisions detrimental to the coal operator.

In the Revenue Act of 1942 the Congress, at the request of the mining industry, adopted a definition of "gross income from the property." However, no definition of "net income from the property" has been put into the law. In section 613 (a) of H. R. 8300 the phrase "net income from the property" has been replaced by the phrase "taxable income from the property." The report of the Committee on Ways and Means on H. R. 8300 states, at page A184, as follows:

"As used in section 613, the term 'taxable income from the property' means the same as 'net income from the property' in existing section 114 (b) (3), (4) (A), and no substantive change is intended by the change in language. In computing taxable income from the property it is intended that there be taken into account all deductible items (other than depletion) including such items as administrative and financial overhead expenditures and taxes which, under sound accounting principles, are attributable to extraction or processes treated as mining."

Thus, if H. R. 8300 is adopted in its present form it will confirm by law the reduction of the percentage depletion allowance which has come about over the years by the regulations promulgated by the Commissioner. We do not believe that those regulations express the intent of Congress when it enacted the percentage depletion provisions, and we hope they do not reflect the intent of Congress at this time. We therefore ask that in section 613 (a) the phrase "taxable income from the property" be replaced by the existing phrase, "net income from the property," and that a new subsection designated subsection (d) be added to section 613, reading as follows:

"(d) DEFINITION OF NET INCOME FROM THE PROPERTY. As used in this paragraph the term 'net income from the property' means the gross income from the minerals from the property, less the allowable deductions directly attributable to the mineral property upon which the depletion is claimed and the allowable deductions directly attributable to the processes described in paragraph (c) of this section insofar as they relate to the products of such property, including operating expenses, development costs properly charged to expense, depreciation, property taxes, losses sustained, etc., but excluding any allowance for depletion. Such expenses or deductions shall not include expenses or deductions attributable to, or arising out of expenditures on, other property or assets, irrespective of whether such property or assets are income producing or active. Deductions not attributable to, or arising out of, particular properties, processes or assets, such as general overhead, shall be fairly allocated to all properties, processes, and assets whether active or inactive. The term 'general overhead' as used herein shall be deemed to mean the overhead relating to the property but shall exclude deductions and expenses of financial overhead of the taxpayer such as interest, taxes based on or measured by income, capital stock taxes, and the like."

The proposed amendment merely provides, as we believe was originally intended by Congress, that expenditures which have no connection with the "net income from the property" should not be deducted from "gross income from the property" in arriving at such net income.

The principal items involved in our proposed definition are interest on indebtedness and taxes measured by income. Under present Bureau rulings, when the 50-percent depletion limitation on net income from the property applies (practically universally in the coal industry because of the industry's low margin of profit, if any), a coal company which is in debt receives substantially less depletion than a coal company under exactly similar conditions which is not in debt. On its face, this is not equitable between taxpayers.

Under present Bureau rulings, a coal company which is located in a State which imposes an income tax receives less depletion on its Federal return than another company which is identical in all respects except that it is located in a State where there is no State income tax. There seems to be no logical reason why this inequity should exist—no reason why the amount of the Federal depletion allowances should be dependent upon whether or not the State imposes an income tax.

Further, within the same State the amount of Federal depletion allowance may be dependent upon the form of ownership. Some States impose income taxes upon corporations but not upon individuals or partnerships. In such States two coal companies which are located in the same area and which are identical in

all respects except for the form of ownership will receive different Federal depletion allowances.

A majority of the States which provide percentage depletion for the natural resource industries pattern their provisions after the Federal laws and therefore require the deduction of Federal income taxes in determining the net income upon which depletion is based. In those States the determination of the Federal depletion allowance (which depends upon the amount of the State income tax), the State depletion allowance (which depends upon the amount of the Federal income tax), the Federal income tax (which depends upon the amount of the Federal depletion allowance), and the State income tax (which depends upon the amount of the State depletion allowance) involves the finding of four unknowns—an exercise in higher mathematics which is many times beyond the ability of many tax practitioners, much less the ability of the small taxpayer.

These inequities and complications would be eliminated if section 613 were amended in the manner set forth above—to provide, in substance, that expenditures which have no connection with the "gross income from the property" shall not be deducted from "gross income from the property" in arriving at the net income upon which depletion is based.

The CHAIRMAN. Mr. Roger Milliken. Sit down, Mr. Milliken and make yourself comfortable.

STATEMENT OF ROGER MILLIKEN, DIRECTOR, AMERICAN COTTON MANUFACTURERS INSTITUTE

Mr. MILLIKEN. Thank you.

Mr. Chairman, Senator Martin, my name is Roger Milliken. I am president of Deering, Milliken & Co., Inc., a textile concern, and director of the American Cotton Manufacturers Institute. I am appearing before you as spokesman for the latter organization, and I am going to discuss the subject of depreciation.

The American Machinists magazine says that the United States of America has the world's most backward depreciation policy. This was recognized by Congress in World War II, and in the Korean war, when necessity certificates were issued to stimulate the building of new productive capacity, and it is reaffirmed by the proposal in H. R. 8300 to substitute what is supposed to be a modern approach for this outmoded system.

The willingness of Congress to come to grips with this problem is most encouraging. Unfortunately, the provisions now contained in H. R. 8300 will not accomplish this objective. And this is most simply shown by means of a chart.

Under present law the system most commonly used is the straight-line depreciation. The specific rate varies with the assumed life of the capital asset, but for the machinery and equipment as a whole, the average is 6 percent a year, according to the Department of Commerce figures. Under this arrangement, therefore, the total cost of such an asset is charged off in 16⅔ years. And this is shown by our zero line here on the chart, with the years down below and the percentages on this side.

We show that under the normal methods used, the average asset in industry is charged off completely in 16⅔ years.

Now, even at present the taxpayer is allowed to use a declining-balance method, equal to 1½ times the straightline rate. This is shown by the shaded area—the advantages are shown by the shaded blue area, and the disadvantages are shown by the shaded red area. And you will see there is a slight advantage to the taxpayer in the earlier

years of using this declining-balance method, and a disadvantage in the later years.

Now, all that H. R. 8300 does is to liberalize this alternate provision, which very few companies use, because it is of no value, to 2 times the straight-line value, or 200 percent. And the dark blue shows the cumulative advantage of the 200-percent declining balance method, and the dark red shows the disadvantage of it.

You will see that at the peak of its advantage, a company electing to use it would only be approximately 11 percent better off than if he chose to use the 160-percent declining method, which he now has a right to use. And at the end of 16⅔ years, when the average asset in American industry would be completely charged off, the taxpayer electing the 200-percent declining-balance method would be 12 percent worse off than if he stayed with the old method.

The CHAIRMAN. You think the old method is better?

Mr. MILLIKIN. I think there is little to choose between them, sir—very little to choose.

Specifically, to prove this point, we introduce the evidence that Great Britain has for many years allowed 250 percent of the straight-line depreciation on declining-balance basis. In fact, this is the common method used by British taxpayers, and all informed men know of the almost complete condition of obsolescence of the British industry.

Instead, the Tax Committee, the directors, and the entire membership of the American Cotton Manufacturers Institute advocate a proposal which will permit taxpayers to elect to depreciate productive equipment as follows: Buildings, 10 years; machinery, 5 years; automobiles and short-lived personality, 2 years. There will be no restriction as to maximum life. This is basically the formula of the necessity certificate, except that our proposal limits depreciation on buildings to 10 percent per annum.

The CHAIRMAN. If you were allowed to do what you suggested, what would be the advantage to your type of business?

Mr. MILLIKEN. It would be the same as to all types of businesses, namely, it would return the cash that we invest in new assets to us faster, so that we would be willing to take more risks in purchasing new machinery than we have been able to do in the past.

The CHAIRMAN. Is your particular industry subject to revolutionary changes in machinery?

Mr. MILLIKEN. Yes, sir. About the same as any other industry in America. We are not particularly pleading this case for our industry, but for America as a whole. And we will only benefit to the extent that all of industry benefits, and our economy is stimulated.

The CHAIRMAN. It would take us too long to go to all the industries of the United States. I was wondering about your industry.

Mr. MILLIKEN. I have been in touch with a lot of presidents of corporations in our industry, and all of them have written me that they have projects on the drawing board which they would immediately go into, provided this method of depreciation were adopted, but that they do not feel that they can do so under the present proposal of H. R. 8300.

The CHAIRMAN. The reason I asked that is that it has been claimed frequently that in foreign countries we have equipped them with the newest and most modern machinery.

Mr. MILLIKEN. That is right, sir.

The CHAIRMAN. All right.

Mr. MILLIKEN. Wherever this proposal has been used it has worked. Here in the United States in World War II the necessity certificate allowing a 20-percent depreciation per annum was fantastically successful in getting business to make investments in productive capacity.

At the time of the Korean war the same depreciation incentive worked additional miracles in inducing companies to expand their capacity.

In pre-World War II Germany, Hitler's government used the same type of depreciation incentive and achieved in a few years, out of the ruins of inflation, a tremendous industrial machine. A team of specialists making a survey in Germany after the war reported that the average age of the German industrial equipment was considerably younger than that of existing equipment in the United States.

Today one reads a great deal about the tremendous recovery that Western Germany is making, and it is thus interesting to note that the German Government permits any company who had interference from the Nazis, or who had bombed-out facilities—and surely all of the German industry falls into one or two of those categories—to depreciate all productive assets acquired within Germany over a period of 2 years—a rate of 50 percent, contrasted with our proposal of 20 percent. I think it is thus safe to say that probably more than anything else this depreciation incentive is responsible for the miraculous recovery of Western Germany.

The CHAIRMAN. Of course, a lot of the machinery in Western Germany was, as you say, bombed out and partially destroyed. That is not completely analogous to a rather ancient piece of machinery that is still operating where you haven't been bombed.

Mr. MILLIKEN. We would be better off if ours was no longer in place, sir, and we had the new machnery in its place, as Germany does.

The CHAIRMAN. You are not advocating being bombed out?

Mr. MILLIKEN. No, sir.

Sweden has allowed a 1-year writeoff of all new assets and has enjoyed tremendous economic activity as a result.

Postwar Canada, which has seen an industrial growth which is percentagewise greater than that of the United States, has allowed new capital investment almost any rate of depreciation that was desired.

The CHAIRMAN. It has been suggested to me that under Hitler, true, they allowed a very fast depreciation, but they then proceeded to raise the rates so that they were worse off then they were before.

Mr. MILLIKEN. I hope we allow a fast rate, but don't raise the rates here, sir.

In addition, our research shows that Switzerland, Australia, New Zealand, India, and Holland, among others, also grant large depreciation incentives on acquisitions of new machinery.

We say that the examples cited above are positive proof of the desirable results of what can be accomplished by giving industry real depreciation incentives.

Now, we maintain that the Government will actually increase its revenue by granting these incentives, because they will serve to stimulate a substantial amount of new orders, which means more employment, more economic activity, more individual income that can be

taxed, and with the resultant upturn in the economy, greater industrial profits, of which the Government takes 50 percent.

In addition, on all new orders for plant and building that will be triggered by this proposal, we will demonstrate by this chart that the Government not only will not lose income but will come out ahead.

Assuming a $10 billion increase in capital expenditures to be stimulated by incentive depreciation; taxable corporate income would be increased by a 25 percent return made on the new expenditures—25 percent before taxes, which is 12½ percent after taxes—increasing it by $2.5 billion.

Total taxable corporate income would be decreased by the difference between the average Department of Commerce rate of 6 percent, and 20 percent. We have assumed that all companies would elect to go to the full 20 percent depreciation rate. I do not think that all would, but for the purposes of being conservative in this chart, we have used the full calculation. This would decrease taxable corporate income by $1.4 billion and subtracting that figure from $2.5 billion results in $1.1 billion net more corporate taxable income and assuming a tax rate of 50 percent, this would give the Government $550 million more tax revenue.

Now, in addition to that, Mr. Chairman, some companies would be supplying this $10 billion worth of additional capital expenditures. The Machine Tool Manufacturers Association tells us that those companies would make 18 percent on their sales before taxes. We say let's cut that figure down and say 10 percent before taxes. If they made 10 percent before taxes, this conservative figure—and applying again a 50 percent tax rate—would provide an additional $500 million worth of income to the Government, or a total, adding the two together, of $1,050 million additional income, provided $10 billion of increase in capital expenditures were stimulated.

Now, no one can categorically say that that exact amount would be stimulated per annum. But we have taken that figure because we find since 1950, in 4 years, the Department of Defense has granted certificates of necessity on $30 billion worth of productive facilities, which comes out to an average of $7.5 billion per year for the last 4 years. To that figure we are adding $2.5 billion, which is a very small figure to take care of all companies that would not be supplying items for the defense program, who would make those investments, provided they could see a way for getting their cash back quickly.

And the McGraw-Hill survey, in this week's Business Week magazine, shows that in answer to a questionnaire they sent out, 55 percent of all corporations queried said that they would increase their expenditures for capital assets, provided a real depreciation incentive was passed by the Congress.

The important thing to remember, always, when we talk about this matter of depreciation, is assuming the same rate of taxes, the Government can never lose money over the long run, because depreciation can only be taken once.

We think that it is thus demonstrable beyond a question of a doubt that the extra taxable income generated by this proposal, as outlined above, would many times more than offset the possible loss to the Government from increased depreciation taken by the companies that have already placed firm orders for new equipment, because a substan-

tial part of these orders already placed either carry necessity certificates or are orders for utility and telephone companies that would not change their depreciation rates.

Now, the American Cotton Manufacturers Institute believes it is essential to go beyond H. R. 8300 for other reasons: One is the necessity to provide jobs for our growing population and labor force. Currently our population is increasing at the rate of about 2.7 million persons a year, and we must be prepared to take care of an increase in our labor force of close to a million persons a year. That is a formidable assignment. Today in this country it requires, on the average an investment of between $12,000 and $15,000 for each worker. To take care of a million new workers each year, therefore, requires an annual investment—not just replacement—of about 12 to 15 billion dollars.

But if that new investment is not forthcoming, the youngsters cominto our labor force are not going to have jobs.

In addition, we today are in the midst of the greatest technological revolution in human history. Not a week passes without the discovery or invention of some new machine, or product, or production process. And every time this happens, some other machine, or product, or production process becomes obsolete and should be replaced. This replacement may be a matter of a few thousand dollars or it may amount to millions. In the aggregate, over the year, it comes to billions. That is, of course, the productive efficiency and progress, a cost which is returned to us many times over as consumers through a better standard of living.

Now, many of these new developments are made by small businesses, or are applicable to small businesses who have great difficulty today in finding the cash to take advantage of these developments as aggressively as they would like to. Our depreciation proposal would greatly ease this problem for small business and make it possible for them to compete more successfully with the larger concerns who have readier access to the capital markets.

The foregoing are compelling reasons for adopting an incentive depreciation policy, but a much greater consideration, in our opinion overriding all others, is the importance of making certain that America's capacity to produce efficiently and at low cost be maintained in case of war.

Although business has been investing enormous sums in plant and equipment, American plants are still not nearly as efficient as they could and should be. A simple way to show this is presented on chart 3, which gives the percentage of machine tools in American plants less than 10 years old.

In 1925, 56 percent of the machine tools in American industry were less than 10 years old. That percentage declined until 1940, when only 28 percent of our machine tools in American plants were less than 10 years old. Then came the war and the stimulation to industry of necessity certificates, and the figures soared to a point where we had 62 percent of all machine tools in American plants which were less than 10 years old. Now we are declining again. We are today at a point where only 45 percent of our machine tools—less than half—are less than 10 years od, and if the same line continues, we will be right back to where we were in 1940. And the Machine

Tool Association tells us that a machine tool available for installation today is at least on an average 30 percent more efficient than a machine tool that is 10 years old.

What this would mean if we went back to where we were in 1940 in the way of productive inefficiency, and the inability to maintain wages and employment, is too obvious to need discussion.

Now, while obsolescence has been growing in American plants, our Nation has poured billions of dollars into the productive rehabilitation of foreign countries. A substantial proportion of these billions has been used to provide foreign producers more modern factories and more efficient, up-to-date machine tools than many American producers now have.

We do not mean to infer that these foreign producers have simply been given these factories and machines as a gift. They have paid for them, just as American business stands willing to pay for more efficient factories and machines. The difference has been that whereas when an American business buys a new machine tool it will take, on the average, 16⅔ years to recoup this outlay through depreciation, these foreign businesses, however, have been permitted by their governments to charge off the entire cost in from 1 to 5 years.

At this point I would like to read a letter from Mr. Kenneth Wyatt, a brilliant copper engineer, to Mr. Bradley Dewey, the president of the Dewey Chemical Co. He writes:

> On Monday, January 11, 1954, the Cologne, Germany newspapers carried the story of the first visitors to see the new aluminum cable sheathing press of Felten & Guilleaume, with illustrations. They were Professor Dr. Conant, formerly of Harvard University and now United States High Commissioner to Germany, together with Dr. Vannevar Bush, formerly president of MIT.

He went on to say:

> This press they say costs 4⅓ million German marks, or something over $7 million. This represents the crowning achievement of this company, who are the first in the world to solve this problem. It will make possible reductions in the cost of power cables and an improvement in quality because lead is too heavy for many uses and also is not good where vibration takes place, as over bridges, and so forth. They have extra plant capacity in Carlswerk to supply some of these cables for the American Government from Europe. Further, they have a large number of orders for cable to be sheathed with aluminum and these orders specified that it should be put on with this giant press.
>
> Dr. Conant and Dr. Bush expressed themselves as being quite amazed at the size of this press and that this age-old problem of continuously sheathing cables with aluminum had at last been solved. They were amazed at the courage of the Felten & Guilleaume management to spend this tremendous sum of money, namely, over $1 million, on this new project and thus to lead the world in this development.

Mr. Wyatt goes on to say:

> I wish to point out that in Germany the law permits the company to write off all capital investments for machinery in 1 year.

And he closes:

> My friend, Howard Herrick, of E. W. Bliss Co., and others are hoping that Congress will make it easier for American corporations to take bold moves in new machinery by allowing a very high writeoff rate of depreciation.

This example illustrates that unless this Congress votes to adopt an incentive depreciation policy, American business will be placed in the position of being asked to compete with the industry of foreign countries with one hand tied behind its back—an intolerable position if we are to remain the bastion of freedom and free enterprise.

To sum up, we believe that our proposal for treatment of depreciation is urgently called for at this time because:

1. It will be a powerful influence in reversing the current business downtrend.

2. It will be a major factor in assuring jobs for young men and women as they join our labor force.

3. It will hasten the movement of new discoveries and inventions out of laboratories into our production lines and on to consumers.

4. It will help provide all aggressive small businesses with the cash to further their expansion.

5. It will assure a substantial increase in the volume of business investment, and thereby through assuring a higher business activity will tend to enhance rather than reduce Treasury revenue.

6. It will make it possible and provide an incentive for modernizing our productive plants and bringing our equipment up to date.

7. It will remove the restrictions that now make it almost impossible for us to equal the technological efficiency of foreign producers to whom this country has given great economic aid in recent years and against whom American manufacturers must compete for the markets of the world.

Finally, it is vital to our security in the face of constant threat of war that our industrial plant be the best in the world. This it cannot be in these days of heavy taxes unless adequate depreciation incentives are provided.

We therefore respectfully urge the adoption of our proposal. And I have here a draft of legislative language, which will carry out this proposal, and I ask permission to have it put in the record, if I may.

The CHAIRMAN. You may put it in the record.

(The proposed amendment referred to follows:)

PROPOSED AMENDMENT TO SECTION 167 OF H. R. 8300, SUBMITTED BY AMERICAN COTTON MANUFACTURERS INSTITUTE

After section 167 (b) (2) insert a new paragraph (3) reading as follows:

"(3) A taxpayer using the straight line method under (b) (1) above, and subject to the conditions of subsection (c) below, may elect a useful life for property as follows:

"(i) in the case of buildings, the useful life of the property shall be ten years;

"(ii) in the case of machinery and equipment, other than short-lived property as described in (iii) below, the useful life shall be five years;

"(iii) in the case of property which normally has a useful life of five years or less, such as automobiles, trucks, small tools and the like, the useful life of the property shall be two years.

"The taxpayer shall, in such manner as the Secretary shall prescribe, notify the Secretary of the period of useful life elected by him under this subsection with respect to each property, at the time his first return claiming such elected depreciation rates for each property is filed, and the period so determined shall be binding with respect to such property for all succeeding taxable years, unless the Secretary consents to a determination by the taxpayer of a different period of useful life with respect to such property."

Amend section 167 (b) (3) by changing the (3 to (4) and at the end of that subsection strike the period and insert in lieu thereof "or (3)".

The CHAIRMAN. You have discussed this with the staff, have you?

Mr. MILLIKEN. Earlier, sir. But a lot of the later information we have developed we have not had a chance to yet.

The CHAIRMAN. I suggest you get in touch with the staff, and bring the figures to their attention.

Mr. MILLIKEN. We will do that.

Senator MARTIN. In addition to the handicap of depreciation, you also have the handicap and complication that for foreign countries they have low wage rates.

Mr. MILLIKEN. Absolutely, yes, sir.

Thank you, sir.

The CHAIRMAN. Thank you.

(The charts accompanying Mr. Milliken's statement follow (see also p. 1430) :)

A $10 billion increase in capital expenditures, stimulated by incentive depreciation, affects taxable corporate income as follows:

1. Increases income by a 25-percent return on expenditures before taxes[1]	$2,500,000,000
2. Decreases income by the difference between present and proposed depreciation:	
Proposed depreciation 20 percent	2,000,000,000
Present depreciation 6 percent	600,000,000
	1,400,000,000
Net increase in corporate income	1,100,000,000

[1] After 6-percent depreciation.

The increased Federal revenue (assuming 50-percent rate) amounts to $550 million.

The CHAIRMAN. Mr. Cohen. Sit down and make yourself comfortable and identify yourself to the reporter.

STATEMENT OF BARRY S. COHEN, ATTORNEY, NEW YORK CITY

Mr. COHEN. My name is Barry S. Cohen. I am an attorney practicing in New York City, specializing in tax matters. I come here as one interested in the alleviation of tax inequity.

Last July I had the privilege of appearing before the Ways and Means Committee of the House of Representatives, in order to point up what I considered to be an inequity existing in the income tax laws and caused by section 113 (a) (5) of the Internal Revenue Code of 1939, now rewritten, supplemented, amended and appearing as section 1014 of H. R. 8300.

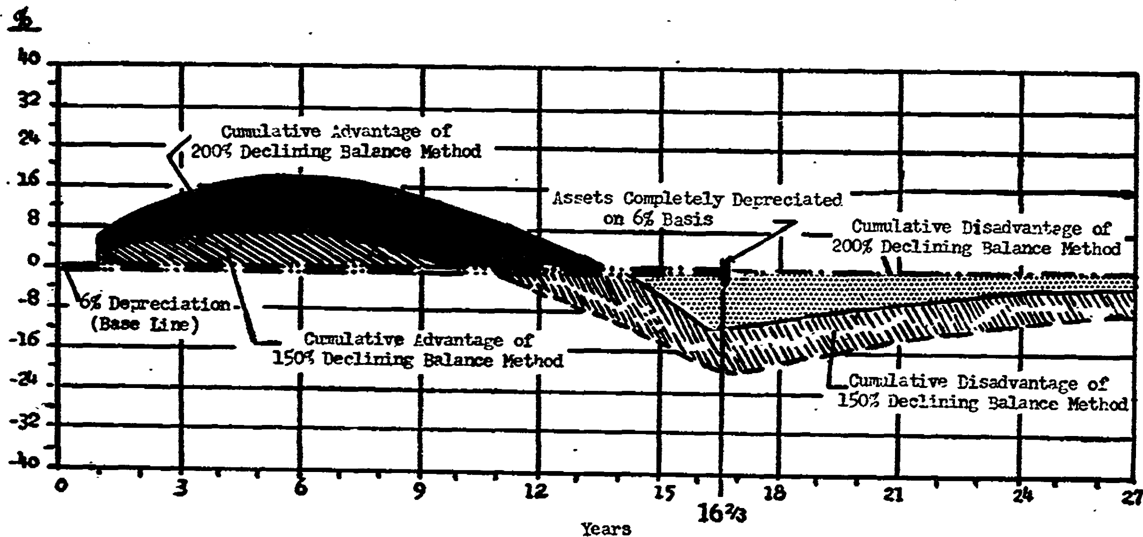
Briefly put, this inequity resulted from the fact that under the earlier law property transferred by a decedent received for subsequent income-tax purposes a change in basis under section 113 (a) (5), if it had been transferred in certain ways, but did not receive this change in basis if, fortuitously in many cases, the property had been transferred in other ways. Therefore, some types of transfers received a change in basis for subsequent depreciation and capital-gains purposes, while other types of transfers did not.

While providing for the change in basis, for example, for an outright transfer, such as the one exemplified when a man leaves property by will to his son, the section failed to accord the change in basis to property transferred in contemplation of death, and has been construed to deny the change in basis to property transferred via certain trusts, even though such other transfers or such trusts were of a nature such that the property had to be included in the gross estate of the transferor. In short, by covering one situation and failing to cover another, section 113 (a) (5) worked injustice and hardship.

CUMULATIVE ADVANTAGES AND DISADVANTAGES OF

200% and 150% DECLINING BALANCE METHOD OF DEPRECIATION vs. STRAIGHT LINE DEPRECIATION

(Assuming Dept. of Commerce Average Straight Line Depreciation of 6%)



In those cases where no change in basis was received even though the property was included or includible in the gross estate for Federal estate tax purposes, there was room under the 1939 code for a brand of double taxation to flourish. This double taxation, unnoticed by many, but flourishing nevertheless, stemmed from the fact that both an estate tax and an income tax would be levied on the same appreciation in value, since an estate tax was levied on the fair market value of the property as of the date of its owner's death but since when a subsequent income tax fell due (let's say, upon a sale) the decedent's heir would not get the benefit of a change in basis and would have to use the earlier and lower basis of the property, the transferor's basis.

I am happy to say that H. R. 8300, passed by the House of Representatives, showed an awareness of this problem. In fact, to a very great and helpful extent, section 1014 of H. R. 8300 has solved the problem by giving equal treatment to all transfers which are, in the words of the statute, "acquired from" or which are "passed from" a decedent. Because of this section, the income-tax law will be more appropriately correlated with the estate-tax law, and the existing double taxation on appreciated property will be eliminated.

Section 1014 of the revenue bill passed by the House, however, does not do quite enough. If section 1014 is left the way it now has been drafted, all will be well for the future, but all will not be well with the past. Why? Mainly because of the ancient rule of statutory construction which says that if A is explicitly covered by a statute, then B, C, D, and E must be excluded, because if B, C, D, and E were to be covered they too would have been explicitly spelled out. I think that is referred to as "Inclusio unius est exclusio alterius," in the old legal Latin.

Allow me to point out that section 113 (a) (5), which is to be changed, originated in the internal revenue laws of 1926. Bit by bit it has been expanded through the years, by the Revenue Acts of 1928, 1942, 1948, 1951 and, most recently, by the stop-gap measure, the Technical Changes Act of 1953. The Technical Changes Act of 1953, as a matter of fact, touched upon one of the most acute problems lurking in the old section 113 (a) (5). This committee, in reporting the Technical Changes Act to the Senate last summer, stated as follows in connection with this matter:

> Section 113 (a) (5) of existing law contains a provision to the effect that where the grantor retains the income from property in trust for his life, with power to revoke the trust, the basis of the property in the hands of the persons entitled to take the property under the terms of the trust insrument after the grantor's death shall, after such death, be the same as if the property had passed under a will executed on the day of the grantor's death. This results in the basis of the property in the hands of the recipients being its fair market value at the date of the grantor's death or, at the election of the executor, the value 1 year from the date of death. Your committee believes that this same rule should apply to situations where the grantor with a reserve life estate has the power to make any change in the enjoyment of the corpus of the trust through the power to alter, amend or terminate the trust. In both cases, the trust property is required to be included in the gross estate of the grantor for estate-tax purposes.

That was certainly true. The same rule should apply to the type of trust referred to by the committee. But that was, in effect, not enough. By grafting another amendatory clause into section 113 (a) (5) the Congress did little more than reraise the question of what

the statute was intended to cover. It was piecemeal kind of legislation, breeding uncertainty because, again, the Congress seemed to want to include in all similar trusts, though the language used by the statute did not appear to be that broad.

Now, as I say, the section contained in H. R. 8300 is to blanket the field, and it would seem to me it does explicitly blanket the field. However, it applies only prospectively. Making everything clear for the future, unfortunately, does not similarly make everything clear for the past.

To pursue the reference to trusts further, there have been cases in the past in which section 113 (a) (5) has been found to be replete with question marks. For example, in connection with trusts of the sort referred to in the committee report, the question has arisen, "Aren't the 'twin brothers' of these trusts covered? If X type of trust be subject to estate tax and get a change in basis under 113 (a) (5), isn't Y type of trust, which is also subject to estate tax and is essentially similar to X to get the same change in basis for income tax purposes?" The answer has been unclear.

I therefore recommend to the committee at this time that trusts be singled out specifically and it be made clear, perhaps merely by committee report, that the new law is clarifying; that the new law does not, in respect to the treatment of trusts at least, make substantive changes in the conditions under which 113 (a) (5) has applied in the past; and that last summer's amendment was also merely clarifying and worked no substantive change.

In the alternative, I recommend that if it be found, as I believe it will be, that very little revenue is involved in this sort of technical provision, that the committee see fit to clarify for all times the past law by reworking and broadening the language of subdivision (a) (3) of section 1014. This subdivision parallels the language put into section 113 (a) (5) last year. It should cover not only the many types of trusts it does specifically refer to, but all trusts where the retention of a power by either the decedent or one lacking a substantial adverse interest to the decedent causes the trust property to be included in the decedent's gross estate. Moreover, it should have applicability not merely in the case of decedents dying after December 31, 1951 (the date set forth for some reason unknown to me in (a) (3)) but in earlier cases as well. I recommend that such effective date might fairly be geared to one of the years in which Congress had earlier imperfectly attempted to broaden section 113 (a) (5)—to October 21, 1942, when the section was reviewed and it was geared for the first time with section 811 (j) of the estate tax law and thus explicitly and statutorily related to the estate tax law.

The CHAIRMAN. How about cases that have been closed?

Mr. COHEN. Well, what is involved here is not so much the estate tax as it is the subsequent sale of assets received by an heir or devisee or a trust beneficiary from trusts or from estates. Therefore, I doubt that there have been many cases which have been closed under the section. I doubt that it has been used much in the manner to which I refer at all.

However, I think that a closed case might well be left standing as closed. What we look for now is clarification of the law, and, as the

Senator knows, if you go up to court in March you have the benefit of the cases that have been decided in January and February, whereas had you gone to court in the previous December you wouldn't have had the benefits of the January and February decisions. The same should be true of legislative clarification. That sort of clarification of past law is what is suggested. I do not believe I come here today to recommend retroactive substantive changes. This is not quite that. This is a clarification of an uncertainty, one that has existed in the statute heretofore and which now could be solved either by an express declaration in the new section 1014, clarifying existing law in connection with such trusts or, by an explanation in the committee report

Thank you very much.

The CHAIRMAN. Thank you.

Mr. Goldstein, make yourself comfortable and identify yourself for the reporter.

STATEMENT OF MEYER M. GOLDSTEIN, PENSION PLANNING CO., NEW YORK

Mr. GOLDSTEIN. My name is Meyer Goldstein, of the Pension Planning Co. of New York. We are consultants and actuaries to many companies in the field of pension and profit-sharing plans.

I have a digest on the first three pages, and I would ask your permission to put the whole statement into the record.

The CHAIRMAN. It will be put in the record.

(The statement of Mr. Goldstein follows:)

TESTIMONY OF MEYER M. GOLDSTEIN ON PROPOSED INTERNAL REVENUE CODE OF 1954 PENSION AND PROFIT-SHARING PROVISIONS

My name is Meyer M. Goldstein. I am executive director of the Pension Planning Co., located at No. 260 Madison Avenue, New York, N. Y.

I. GENERAL STATEMENT

When I had the privilege of appearing before the Senate Finance Committee to testify on the pension and profit-sharing provisions which were proposed as parts of the then pending Revenue Act of 1942 there were but a relative handful of private pension systems in this country as compared to the large number now in existence. This evidences a tremendous growth which has progressively continued during the intervening years. There is no doubt that the encouragement given by the Congress through the tax treatment of employees and employees is, to a considerable extent, responsible for such growth, and I venture the prediction that the improvements that have been included in H. R. 8300 will even further accelerate this movement which is so important to the free enterprise system and the American way of life.

The draftsmen of the revenue revision bill performed a herculean task in selecting, deleting, compiling, and rearranging numerous sections in a limited period of time, and it is readily understandable that the resultant revenue bill submitted should contain certain inequities. My purpose is to point out some of these and to suggest possible remedies.

I shall attempt to relate my testimony primarily to those areas which I feel have not been fully clarified and to other areas which apparently favor one type of plan as against another. I trust that some of the features will be elaborated upon by others who will here testify. The matters which I shall endeavor to cover, and which are set forth in a written memorandum which I deem a privilege to submit to this committee, are indicated in the digest of contents which precedes this memorandum.

II. Grace Period Necessary for Transition From Present Law to New Code

In the opening general statement of the Committee on Ways and Means in its report on H. R. 8300 there appears the following:

"In general, the purpose of these changes has been to remove inequities, to end harassment of the taxpayer, and to reduce tax barriers to future expansion of production and employment."

I believe that this general purpose has been carried out to a considerable extent in this highly technical section of the code dealing with pension, stock bonus, and profit-sharing plans.

However, the new bill has created new inequities which will take time to clear up—both by changes in the code and by clarification in subsequent new regulations. Meanwhile, current progress in this field is being arrested. Already, taxpayers are saying, "Let's wait and see what happens to the new tax law before we install a new plan—or amend an existing one." Then, when the new tax law becomes a reality they will say, "Let's wait for the new regulations." When the new regulations come out they will say, "Let's study the new regulations and submit our proposed plans or proposed amendments to the Internal Revenue Service." The situation is an echo of the one which prevailed after the enactment of the Revenue Act of 1942 on October 21 of that year. Yet it was not until the summer of 1944 that the Commissioner of Internal Revenue began to pass upon the qualification of plans to any considerable extent. True, the present bill is intended to liberalize the rules for qualification, but taxpayers are averse to parting with their contributions before they have an assurance, by way of a written ruling, as to the qualification of the plan.

Thus, this creeping paralysis can extend over a transition period of years. This stagnation is unhealthy, undesirable, and unnecessary.

It should be observed that the pension and profit-sharing provisions of the code are unique because of the practice and tradition of doing nothing until the Internal Revenue Service issues a favorable ruling.

Recommendation No. 1: Grace period, with taxpayer's choice under present or new law during transition period

Therefore, my first recommendation is that the Congress permit a taxpayer his choice of qualifying his plan under the present code, or the new one for a period of not less than 1 year after the new code becomes effective, or at least until December 31, 1955. Under this proposal a taxpayer can install a new plan or amend an existing one under the present law with the assurance (except for the sections relating to allowable investments, prohibited transactions, and unrelated business income) that he does not need to worry about—or subsequently qualify—under the new code as long as his plan remains substantially unchanged after the end of the grace period, for example, December 31, 1955.

Then, meanwhile, if a taxpayer wants to qualify under the new code, if more favorable, he can proceed leisurely to seek an advance approval from the Internal Revenue Service. If the Internal Revenue Service delays such approvals (as I fear it might—pending new regulations)—the taxpayer will not be stagnated. He can still, in the meantime, get approval under the present tax law—and then subsequently amend if the new regulations, when issued, turn out to be more favorable.

This grace period will also allow the Internal Revenue Service more time to make the transition and train its staff to keep pace with the tremendous amount of additional approvals which it will be called upon to issue because of the new code.

This recommendation will, I believe, be a way of minimizing the chaos and stagnation that will exist during this transition period unless the Congress wants to defer making the entire pension and profit-sharing sections of H. R. 8300 operative until, say 1 year after new regulations are issued, based on the new code as adopted.

III. Employee Coverage Under Pension Plans are too Restrictive for Limited Classification Plans

Probably the area of H. R. 8300 which requires the most urgent correction, and about which I believe your committee will be deluged with requests for modification, is that which relates to employee coverage under a qualified plan such as (1) a plan for employees who are not subject to collective bargaining, or (2) a plan for salaried employees only.

A. AUTOMATIC 25 PERCENT (OR 50 PERCENT) CLASSIFICATION IS GENERALLY SATISFACTORY IF ALL REGULAR EMPLOYEES ARE ELIGIBLE

The employee coverage provisions are not all bad by any means. For instance, a tremendous improvement may be expected through the elimination of the high percentage requirements, the 70 and 80 percent provisions, of existing law for employee eligibility and participation. Also, great strides are being made toward a logical and feasible approach by doing away with the haphazard and purely discretionary means of determining whether a classification discriminates in favor of employees who are officers, shareholders, supervisors, or highly compensated. What is a discriminatory classification is a matter of opinion and opinions differ. Not only is there a wide divergence of opinion among the pension trust reviewers in the various field offices throughout the country but different views may be encountered in the same office.

A classification which is automatically acceptable is therefore desirable. The requirements for coverage of 25 percent of all regular [1] employees, or 50 percent if there are no more than 20 of such employees, are excellent and will take care of some cases.

B. FOR LIMITED CLASSIFICATION PLANS, THE 10-PERCENT KEYMAN RULE IS THE TROUBLE SPOT

However, the difficulty develops where an employer wants to qualify his plan under the proposed limited classifications of some of his employees which would make the plan subject to the new 10-percent keyman rule. This proposed 10-percent keyman rule is a new concept and is the greatest obstacle and, in fact, an insurmountable obstacle in many cases involving plans which are otherwise sound.

Thus we have an anomalous situation. The expressed intent of the Congress was to liberalize the pension provisions. Yet we find in this particular area that it is possible for companies to set up limited classification plans and obtain tax approval under the present tax law but which would be impossible of approval if the new bill becomes law.

The simplest solution, obviously, is to remove the 10-percent keyman rule entirely from the proposed law and merely spread the 25 percent (or 50 percent) coverage rule to all limited classification plans as well as to all broad coverage plans. However, such an extension of the 25 percent (or 50 percent) rule, without some restraints, could lead to abuses that could cause discredit on the whole pension movement. This development should be avoided at all costs. Consequently, I have endeavored to spell out the type of cases where the 10 percent rule needs to be eliminated, so that, in the balance of cases, the 10 percent rule, or perhaps the present integration rule, may be utilized.

On the surface, this 10-percent keyman limitation does not appear to be unduly harsh, but let us see what it means in concrete situations.

1. Companies with collective-bargaining units

Let us consider the case of a company which employs 2,000 full-time regular employees. All of the hourly rated employees, 1,800 in number, are already covered under a union-negotiated pension plan which is fully financed by company contributions. The company may desire to set up a plan for the 200 employees who are not subject to the collective-bargaining agreement. This is what it will be faced with:

No more than 20 of the participants in the plan for employees not in the collective-bargaining unit, that is, 10 percent of 200, may be key employees. Key employees are those whose total compensation places them in the highest paid 10 percent of the regular employees, up to a limit of 100 highest paid employees. Many of the non-collective-bargaining employees are frequently higher paid than the employees who are subject to collective bargaining with the result that, say, 100 of the 200 employees not subject to collective bargaining might rank among the highest paid 10 percent of all regular employees. However, only 20 of these 100 higher paid employees may be included in the plan for employees not subject to collective bargaining. Thus, this employer could not establish a practical pension system for his employees not subject to collective bargain-

[1] Regular employees are those who are employed for more than 20 hours a week, more than 5 months a year, and for more than a minimum period prescribed by the plan, not exceeding 5 years.

ing because 80 out of 100 of them must be left out of that plan. This innocent employer would find himself in this dilemma even though, in fact, he is willing and able to contribute to the cost of 2 pension plans, 1 for all his employees subject to collective bargaining and the other for all his employees who are not members of a collective-bargaining unit. The fact that the 1,800 employees' pension plan was being funded as a result of a collective-bargaining agreement would not in any way help this employer in the straitjacket established by an impractical 10-percent keyman tax test applied in a vacuum only for the employees not subject to collective bargaining. From the standpoint of tax deductions, the anomaly is that the plan for employees not subject to collective bargaining, might well require but a small fraction of the cost for both plans. This unsound situation could not develop under the present tax law. Hence, the 10-percent keyman rule must be eliminated, at least in situations of this type, if the pension movement is to continue to develop.

(a) *Recommendation No. 2—25 percent (or 50 percent) rule to apply to a plan for non-collective-bargaining employees if employees in collective-bargaining units have a pension plan.*—True, the employer may designate a trust, or two or more trusts, or trust or trusts and annuity plan or plans as constituting parts of a plan intended to qualify. This would be helpful if the plan for the employees subject to collective bargaining could be considered with the plan for the employees not so subject and both held to qualify on an overall basis, as meeting the 25 percent overall test even though the benefits of the two plans are different—which they usually are. It does not appear, however, that the present bill provides this relief. My second recommendation is that the code provide this relief, i. e., that both plans be held to qualify on an overall basis regardless of any divergence in benefits as between the two plans.

(b) *Recommendation No. 3—Present 70 percent and 80 percent rule to apply in a plan for non-collective-bargaining employees if collective-bargaining units do not have a pension plan.*—Another inequity of H. R. 8300 would be in a case where a company wants to establish a plan for its regular employees who are not subject to collective bargaining (e. g., salaried employees) but does not want to establish a plan for the balance of regular employees (e. g., hourly rated employees), who are subject to collective bargaining. The union can always demand a pension plan for those members of the collective-bargaining unit which it represents if and when it has exhausted direct wage and other working-condition demands, or when it becomes a top-priority demand at the bargaining table. In addition, most collective-bargaining agreements have a seniority clause which the union might be able to invoke as a deterrent to an employer dismissing long-service members without a pension plan.

Besides, it must be remembered that even though an employer is perfectly willing to have an identical plan for his employees who are subject to collective bargaining and for those not subject to collective bargaining there is the fact that some unions insist on having their own type of plan covering their union members only—often on an areawide, or industrywide basis. Consequently, it would be impractical in such a situation for an employer to negotiate a pension plan for his employees subject to collective bargaining that would be identical with his plan for the employees not subject to collective bargaining. Yet, unless he did this under H. R. 8300, it would be impossible for him to start with a plan for his employees not subject to collective bargaining alone without meeting the impractical 10 percent keyman test (unless there are at least 1,000 salaried employees not subject to collective bargaining).

My recommendation is that where an employer is subject to collective bargaining of some of his regular employees, even though these employees do not have a pension plan, the employer should be permitted to offer a plan to these employees who are not subject to collective bargaining. In such cases, the present tax-law rules as to coverage might be applied, i. e., the plan for employees not subject to collective bargaining may qualify if it covers at least 70 percent of all such regular employees or, if at least 70 percent of them are eligible, at least 80 percent of those who are eligible must participate in the plan.

Similarly, if some of the employer's salaried or hourly rated employees are members of a collective-bargaining unit, while others are not, the 70-percent and 80-percent coverage rules should apply as to these nonmember employees.

Recommendation No. 4—70-percent and 80-percent rule for salaried employees only plan where nonsalaried employees have no plan

Thus far, I have addressed myself solely to the critical situations where, for practical purposes, an employer would be prevented from establishing a plan for

his employees not subject to collective bargaining if he had some employees who are subject to collective bargaining.

However, there are other areas which I believe should be opened up to the possibility of establishing a limited classification plan, particularly salaried employees' classification, even though the nonsalaried, e. g., hourly employees, are not subject to collective bargaining.

Again the 10-percent keyman rule under H. R. 8300 makes such salaried plans hopeless except for very large companies which can cover 1,000 or more salaried employees. Thus, smaller companies could not establish a practical salaried-employees-only-classification type of plan if the 10-percent keyman rule becomes the law. This would discriminate against the small employer in his efforts to attract and hold desirable salaried employees. No such restriction applies under the present tax law. The remedy lies in eliminating the 10-percent keyman rule for the salaried-employees-only type of plans.

If the Congress continues—as I believe it should—the possibility of a salaried-only classification, it would mean that the Congress was reaffirming the policy of permitting companies to start first with a salaried-only-type plan and relying on the general impact of employer and employee relations to encourage these employers to ultimately broaden their plans to cover their nonsalaried employees instead of trying to force this issue through tax encouragement or tax penalty.

It is possible that there may develop some abuses. However, the fact that contributions or benefits have to be nondiscriminatory within the group covered in a salaried plan will be a restraint. In addition, the basic restraint will be the fact that, whatever benefits an employer provides for his salaried employees will make him vulnerable to similar request from the excluded nonsalaried employees. Fundamentally, if an employer's nonsalaried (hourly) employees are not subject to collective bargaining and he elects to give pensions to his salaried employees only, he may be treating employees unequally and causing probable friction among them. This would be poor employee relations and adversely affect plant efficiency and operation and this will be a constant reminder to an employer who establishes a salaried-only plan. This basic restraint will cause pension plans to expand and cover all regular employees with the Government merely providing the initial impetus by encouraging a company to start a plan, even if on a salaried-employees-only basis.

My recommendation No. 4 is identical to my recommendation No. 3; namely, that the 70 percent and 80 percent rule for salaried only plan eligibility rules be applied to all regular salaried employees—where nonsalaried (e. g., hourly) employees are excluded from eligibility under the plan, or have a separate plan of their own—with different benefits.

3. Remedy for possible abuses under recommendation No. 4 is to retain integration

However, if this 70 percent and 80 percent rule is not deemed an adequate control for salaried employees only type of plans (where nonsalaried employees have no plan or one with different benefits), then it would seem that retention of the integration rules under the present tax law is preferable to the 10 percent keyman rule for this type of salaried employees only plan.

4. All other more limited classifications must meet the 10 percent keyman or integration rules

Any other classification, beyond those I have described above, such as those for employees earning in excess of a specified amount, or those employed in a designated plant, division, department, or other operating unit of the employer could be required to meet either the 10 percent keyman rule, or, if deemed necessary the present integration rules, as a basis for qualification.

IV. Vesting Where Collectively Bargained Plan Replaces Employer's Plan

It may also be observed that employees now covered under an existing qualified plan may, pursuant to collective bargaining negotiations, subsequently become participants in a separate plan for the collective bargaining unit but which is financed in whole or in part by the employer. Obviously, in most instances, the employer cannot afford to contribute both to his own and the plan for the collective bargaining unit. Provision is therefore usually made that upon becoming participants in a negotiated plan to which the employer contributes the employees shall not be entitled to benefits under the employer's plan established for his regular employees who are not in the collective bargaining unit. If this materializes, the position currently taken by the Internal Revenue Service is that the employer's plan has been terminated or, at least, terminated with respect to those employees who go over to the plan for the collective bargaining unit. In such

event, it is required under Revenue Ruling No. 33 "At such time the rights of all participants should be fully vested."

This is an unfair and costly requirement which the employer must meet, especially in view of the fact that the situation was not of his choosing. Also, it should be remembered that if this relief is not granted it would discourage employers generally from covering any employees who might some day be covered by a collectively bargained pension plan. This would be just the opposite to the sound trend of encouraging an employer to cover all his regular employees.

Recommendation No. 5—No vesting to be required

It is therefore recommended that the situation should be remedied by an explicit provision to the effect that no vesting is required as to benefits funded by employer contributions made on behalf of employees who subsequently become participants in a separate plan for the collective bargaining unit to which the employer is required to make contributions.

V. 30 Percent Shareholders' Rule Is Too Severe

Thus far, I have deliberately separated the 10 percent keyman rule from the 30 percent shareholders' rule because each rule has a different impact.

The 30 percent shareholder rule can be lived with—but I believe it is unnecessarily harsh and will discourage establishment of plans by smaller businesses.

Obviously, the 30 percent shareholder rule does not bother a large or sometimes even medium-sized company. It only limits small companies but yet this, in point of numbers, is the area for greatest potential growth of the pension and profit-sharing movement in the future. Therefore, to impose too confining a limitation here can slow down the establishment of these types of plans. This is not good for our economy as employees would have one less reason to want to work for small companies if they do not have the same opportunity for security under a pension plan as if they worked for big business. The practical solution is to try to prevent undue tax advantage to shareholder-employees and still encourage these smaller plans.

A. Recommendation No. 6—Change 30 Percent Rule to a 50 Percent Rule

A more reasonable and logical rule, for plans that do not meet the 25 percent (or 50 percent) coverage test, would be a 50 percent shareholders' rule. Thus, a limited classification type of plan, e. g. salaried employees only, meeting the tests indicated in my recommendations 2, 3, or 4, would be deemed to be prima facie acceptable if up to, but not exceeding, 50 percent of the employer's contributions were used to provide benefits for shareholder-employees. This would indicate that at least one-half of the employer's contributions were for the benefit of nonshareholders (as defined) and hence for the exclusive benefit of the employees. However, if the employer's contributions for shareholder-employees (as defined) exceeded 50 percent, it would be deemed prima facie as a tax-deductible dividend device and should be prohibited.

Some views have been expressed that in a case of two shareholders, husband and wife, who are the only employees, the plan could meet the 50 percent rule and hence concentrate all of the benefits for the two shareholder-employees. This example is correct in theory but in practice it would be an insignificant aspect of the whole weight of tax-deductible contributions for pension plans.

After all, corporations do not establish themselves or stay in business merely to set up tax-deductible pension funds. As they grow they have to add employees and they certainly want to grow. So the pension plan is merely incidental. As the organization grows the portion that the shareholders get would keep on shrinking, and if the organization does not grow the impact on revenue can be disregarded as being insignificant. Meanwhile, it is the lesser price to pay to encourage small- and medium-sized employers to establish these plans particularly if there is incorporated some reasonable shareholder rule such as herein suggested.

B. Alternate Recommendation No. 7—Change Fixed 30 Percent Rule to a Flexible Percentage Rule

If a liberalized percentage, such as 50 percent, is not acceptable, I would suggest a new approach to a flexible yardstick as the complement of the top corporate tax bracket that is in the code as it may exist from time to time.

In this connection, it should be remembered that the original 30 percent figure for a shareholder rule was born in an atmosphere of excess profits during the World War II period, so it was, in a way, based on this idea of being the net amount that might be left to a corporation after corporate taxes.

For example, if the 1954 top corporate tax rate is 52 percent then up to 48 percent of the employer contributions could go for the benefit of shareholder-employees (as defined). If, in some subsequent years, the top Federal corporate tax bracket reaches a 70 percent excess profits tax overall rate, then in those years there would be no more than 30 percent allocated for the benefit of shareholder-employees.

In any event a minimum of 30 percent should be allowed.

VI. Retroactive Tax Penalties Should Be Removed From Pension Plans

I believe the greatest deterrent to the establishment of pension and profit-sharing plans has been the fear of employers that they might suffer retroactive tax disallowances for their contributions for prior "open" tax years (usually at least three) if they failed to meet regular annual payments.

A. PROFIT-SHARING PENALTIES HAVE BEEN REMOVED

This dread has been removed in H. R. 8300 by eliminating the need for a definite predetermined formula requirement under a profit-sharing plan. Thus, employer contributions to a profit-sharing plan may be made at such times and in such amounts as the employer, in his sole discretion, may choose.

B. RECOMMENDATION NO. 8, ALSO REMOVE PENSION PLAN PENALTIES

Now the Congress should go the whole way and match this provision for pension plans. Otherwise the Congress will have removed one inequity, but retained another.

Hence, the single most important thing which the Congress can do to encourage the continued growth of private pension plans is to remove any necessity for fixed or annual employer contributions and to merely limit the maximum allowable tax deduction in any 1 year.

1. Small organizations most affected

It is the expressed intent of the Congress to encourage the establishment and continuation of private pension plans. Most of the large corporations in our country now have private pension systems, so the area of greatest growth in the future lies with the medium-sized and small organizations. My 23 years of experience as a pioneer in this field, having discussed this subject with literally thousands of employers, have convinced me that the greatest single deterrent to the establishment of a pension plan by medium-sized and small organizations is the fear of retroactive tax disallowance for their prior open tax years if they don't make minimum payments to a pension plan.

2. Some flexibility exists under present law

There is no doubt that under the present tax law and H. R. 8300 there is considerable flexibility of employer contributions provided the employer contributions remain within the minimum allowable limits of the code. Nevertheless, thousands of employers have been deterred from establishing pension plans because of their dread of a retroactive tax disallowance of their contributions for prior open tax years if they fail to meet the minimum contribution requirements—or fail to establish a valid reason for curtailment or termination.

3. Advance funding better than unfunded pay-as-you-go plan

If an employer wants to establish a pay-as-you-go pension plan and merely express to his employees that he hopes to give them pensions of a certain amount when they retire, such a pension plan is not any protection to either the employees or the employer if the employer is later unable or unwilling to provide these pensions.

Consequently, Congress should do all that it can to encourage employers to fund pensions ahead of time in order to protect the employees and the employers and, to this end, should give the tax incentive of a tax deduction for any payments that are made ahead of time for advance funding. Any payments so made should not be subject to retroactive tax disallowance. If this is not permitted, many employers would continue to be afraid to set up funded pension plans.

4. Differences between profit-sharing and pension plans

Pension and profit-sharing plans are based on different concepts and each is designed to meet a definite need. Neither replaces the other.

I believe it is in the public interest for our tax laws to be so designed that an employer can choose either a pension plan, a profit-sharing plan, or both, according to his objectives and employer-employee relations problems and not be swayed in either direction because of any tax advantage or tax disadvantage of either plan.

H. R. 8300, in its laudable desire to improve the profit-sharing provisions of the code, has, I believe, unwittingly left many areas of tax favoritism in favor of profit-sharing plans and against pension plans.

This is contrary to the history of the movement in the United States which shows that, left to their own resources, employers will adopt pension plans at about 2⅓ times the rate of profit-sharing plans. For example, the various tax and pension and profit-sharing releases indicate that about 70 percent of plans currently in existence are pension plans, and about 30 percent are profit-sharing plans.

The employer who establishes a pension plan has a commitment to his employees which is greater than any tax restrictions can impose. If he hopes to remain in business and retain the loyalty and support of his employees he can't play high, wide, and handsome. The employees know what the plan provides and expect the stated benefits when they retire. The employer, however, should not be hamstrung by commitments as to the means of funding the plan benefits. If, in the exercise of his business judgment, he finds it necessary to use funds for plant improvement or expansion to keep his organization competitive with low cost producers, or for inventory increases, or other purposes, he should not be compelled to forego such use in order to make a required contribution under a pension plan. He knows what benefits he has promised his employees and whether he makes his contributions periodically or with any degree of permanency should not jeopardize his tax position, that of the plan or trust, or of the employees, for either the current or prior open tax years.

Why not give the employer who is willing and anxious to provide long-range security for his employees the same tax treatment as is being furnished for the employer who can now establish a "one-shot" profit-sharing plan?

From the employee standpoint, of course, employees like to know that their employer's objective is to give them a specific amount of pension in their old age and they are all grown-up enough to know the facts of life, namely, that whether you call a plan a pension plan or profit-sharing plan it all comes out of the same pocketbook, that is, the profits of their employer. So my experience has been that, left to their own resources, employers will generally prefer a pension plan and, may I repeat, the tax law should permit an employer to continue to make this free choice between types of plans without tax fear or tax favor.

5. Employer objections to profit-sharing plans

(*a*) *Profit-sharing plans do not solve pension problems for many years.*—There are many reasons why most companies have selected pension plans as their first plan. For instance, a profit-sharing or stock bonus plan cannot generally solve the pension problem of an employer during most of the first generation of its existence because of inadequate past service benefits that are permitted taxwise under either the present law or H. R. 8300.

(1) Example 1—15 years' participation needed for employee earning $3,600 per year: Let us take, as example 1, an employee earning $3,600 per year final pay at retirement. His primary social security maximum under present law is $1,020 per year, or 28.3 percent of his $3,600 per year. If his employer wants to provide a pension of one-half of final pay including primary social security, he would need to supply the difference of $780 (i. e., $1,800 half pay pension less $1,020 social security). This would cost from an insurance company today a single premium of about $10,000 for a life annuity without refund for a man aged 65. This amount is 2.8 times the employee's final pay of $3,600 per year.

Assuming that the profit-sharing plan, including forfeitures, averaged 15 percent of his pay or $540 per year, and it accumulated at 2½ percent compound interest under a profit-sharing trust, it would take about 15 years for the employee to build up enough money in the profit-sharing trust to purchase the required pension. This means, then, that any such $3,600 employee who was over age 50 when the profit-sharing plan began would not have a sufficient amount in the profit-sharing trust to provide the stated pension objective.

(2) Example 2—15 years' participation needed for employee earning $15,000 per year: Now, let's take, as example 2, an employee earning $15,000 per year and repeat the same requirements to provide him with one-half of his final pay, including primary social security, at his age 65. His primary social security maximum under present law is $1,020 per year, or 6.8 percent of his $15,000 per year salary. If his employer wants to provide a pension of one-half of final pay including primary social security, he would need to supply the difference of $6,480 (i. e., $7,500 half pay pension less $1,020 social security). This would cost from an insurance company today a single premium of about $83,000 for a life annuity without refund for a man aged 65. This amount is 5.6 times the employee's final pay of $15,000 per year.

Assuming that the profit-sharing plan, including forfeitures, averaged 30 percent of his pay (i. e., two times the 15 percent for the lower-paid employees) or $4,500 per year, and it accumulated at 2½ percent compound interest under a profit-sharing trust, it would take about 15 years for this employee to build up enough money in the profit-sharing trust to purchase the required pension. This means, then, that any such employee who was over age 50 when the profit-sharing plan began would not have a sufficient amount in the profit-sharing trust to provide the stated pension objective.

Thus, it may be noted that if a company has some employees who are going to be eligible for normal retirement in the early years, there just is no substitute for a pension plan.

(*b*) *Profit-sharing plans open door to factfinding fishing expedition.*—Another reason why many companies prefer a pension plan over a profit-sharing plan, particularly among smaller and medium-sized closely held business enterprises, is the fear that a profit-sharing plan could make a company more vulnerable to a factfinding fishing expedition which could be very embarrassing to the employer. Also the trade secrets which might be uncovered could be damaging in the hands of his competitors.

C. PROFIT-SHARING PLAN WITHOUT A DEFINITE PREDETERMINED FORMULA IS LIKE A PENSION PLAN WITHOUT A FIXED COST COMMITMENT

It has always been a traditional concept that a so-called profit-sharing plan is not a true profit-sharing plan if it does not have a definite predetermined formula. In other words, every employee knows at the beginning of each year what he may expect as his profit-sharing bonus as of the end of the year if the predetermined profits are realized. That is the incentive for him to create the profits. The rules of the game are laid out ahead of time. Under H. R. 8300 there are no more such rules. The employer will decide, in his own discretion, what, if anything, he will contribute to the profit-sharing plan—regardless of the profits of the business—whether large or small. This means that H. R. 8300 proceeds on the premise that the problem of how much profits should be shared—and if and when—should be left to be carved out via employer-employee relationship, and no tax threat should be invoked to control the employer's decisions and the employer's policy.

Likewise, I feel that Congress should permit an employer to decide how much and when he should contribute to a pension plan—within the maximum allowable limits—without any threat of a retroactive tax penalty. Thus, the employer's basic relations with his employees will control his decisions as to contributions, just like in a profit-sharing plan.

In fact, the pension plan will be a great magnet for employer contributions than a profit-sharing plan because the employer will have expressed an intent to deliver predetermined pension benefits to his employees, and every employer will know ahead of time that he must contribute some minimum—on the average over the years—in order to meet his moral commitment to his employees. The only real freedom he will have is to choose the amounts to be contributed in a particular year or years, within the maximum allowable limits, without any fear of a retroactive tax disallowance.

D. PENSION PLANS WILL BE MORE PERMANENT WITHOUT A RETROACTIVE TAX THREAT

It is my opinion, that the threat of a retroactive tax penalty has caused some employers, fortunately but a small percentage of the total pension plans in force, to drop their plans who otherwise might have retained them. This, opposite to the intended result, has come about this way: An employer's business changed from profits to losses, or smaller profits. Meanwhile the pension costs had mounted because of general inflation. So he was in a squeeze play. If he applied

to the Internal Revenue Service for termination of the plan they would grant it—without adverse tax consequences—because he had a valid reason, i. e. business necessity. But, if he went to the Internal Revenue Service and said, "I would like to suspend contributions, temporarily, until things improve"—he couldn't get such approval without the threat of tax penalties. Thus, it was safer taxwise for him to terminate the plan. That's just the thing I want to avoid—so that plans won't terminate during recurring cycles of recession—but will remain alive so they can rebuild their pension funds in each inevitable recurring cycle of normal and prosperous times.

E. IN PRACTICE, THERE IS NO RETROACTIVE TAX THREAT WHERE PENSION PLANS ARE SUBJECT TO COLLECTIVE BARGAINING

In passing, it may be noted that an employer who sets up a pension plan as a result of collective bargaining does not necessarily provide anything more than a pay-as-you-go pension fund and yet any advance funding contributions by such employers are tax deductible without any retroctive tax disallowance.

In other words, the Internal Revenue Service does not attempt to invoke its administrative ruling, PS 57, calling for at least the current cost payments to be made in such cases because there is deemed to be no prohibited discrimination. All that the Internal Revenue Service requires (PS 64) is that the employer certify that an actuarial computation has been made and that such computation establishes that the stated contributions are enough to provide the indicated benefits for all employees expected to retire during the term of the union agreement and also that they are enough to pay for the normal cost plus interest on the unfunded past service liability for all employees under the plan. Consequently, in practice, there are many collectively bargained pension plans where the union goes through some hocus-pocus pay-as-you-go projections, of cash payments out versus projected estimated income to the fund, which purports to be an actuarial valuation, which the employer accepts and certifies to. Since the Washington staff of the Internal Revenue Service is limited in actuarial personnel, it does not ask that the computations be submitted to the Internal Revenue Service for any checking. So in fact, all the employer has to do is pay the amount called for by his commitment with the union as a result of collective bargaining. Thus, if the employer pays the cents per hour required by the collective bargaining agreement and if that turns out to be only enough to make payments on a pay-as-you-go basis out of the fund—or, not even enough to pay pensions in order of retirement—in either event, there would be no retroactive tax disallowance to the employer.

The point here is that the Internal Revenue Service has not endeavored to use retroactive tax penalties on pension contributions as the vehicle with which to control employer-employee relationships resulting from collective bargaining. It is my position that the new tax law should carry out this same policy for employers who establish pension plans for their employees where they are not subject to collective bargaining. Here too, the controlling element should be the employer's relationship with its employees.

F. REMEDY FOR POSSIBLE ABUSES UNDER RECOMMENDATION NO. 8—CURRENT COST TEST

It is realized, however, that unless some restraints are provided, discrimination in contributions or benefits may result in favor of higher paid employees in the event of the discontinuance of a plan after the benefits for such higher paid employees have been funded.

To prevent this, my recommendation No. 8 is that there be a requirement at the time a plan begins, that the current costs be met, i. e. normal cost for future service plus at least the interest on the unfunded past service, before lump sums can be paid out to any of the 25 highest paid employees.

Such a requirement will provide reasonable safeguards at the time of distribution to prevent discrimination in favor of highly compensated employees. The employer should then be permitted to make his contributions into the pension plan in such amounts and at such times as he sees fit and obtain deductions therefor, within the allowable limits. Also, if the current costs have been met, lump sum distributions, if otherwise available, should be permitted without further restrictions. This would enable the higher paid employees included in the plan to benefit from the same long-term capital gain treatment as would be applicable to other employees.

G. ALTERNATE REMEDY FOR POSSIBLE ABUSES UNDER RECOMMENDATION NO. 8—CURRENT COST PLUS FUNDING FOR ANY OF THE 25 HIGHEST PAID WHO RETIRE DURING FIRST FEW YEARS

If current cost funding is not deemed adequate, there could be added a further requirement, namely, that the benefits for the 25 highest paid employees be required to be restricted through some modification of mineograph 5717 of the Internal Revenue Service. Thus, with such modified restriction, in the event of early termination of a plan, the 25 highest paid employees will be permitted to obtain only their unrestricted benefits but any excess contributions will have to be reallocated among the lower paid employees.

The proposed modified mineograph 5717 should permit lump sum distributions subject to capital gains if the current costs have been met, and, if also, the additional sums are contributed into the plan which are necessary to fully fund the cost of any lump sum distributions to any of the 25 highest paid during the early years of the plan, preferably not over 5 years and surely not over 10 years.

It should be noted that lump sum pay-outs on a long-term capital gains basis will be permitted under H. R. 8300 for profit-sharing plans without restriction as to how long the profit-sharing plans have been in existence or how much the highest paid will take out in the first 10 years of a profit-sharing plan. Similar treatment for a pension plan—with the safeguards I have suggested above—are indicated to maintain the balance between these two methods of providing benefits at retirement.

VII. DEFINITION OF COMPENSATION FOR PENSION PLANS

Bonuses, commissions, and overtime pay are as much a part of total compensation as the basic or regular rate. Bonuses remunerate for greater efforts and must be left to the determination of management as to how they are to be expended.

Many employers have traditionally operated their business on the conservative policy of low fixed salaries and high bonuses—entirely discretionary with the employer—and determined from year to year based on his appraisal of performance of the employees. The employees know this and are entirely satisfied. In fact many of them like the idea. However, both the employer and the employees expect the total compensation to be the measuring rod of their pension benefits. If discretionary bonuses are omitted, the pension system fails to facilitate orderly retirements because the pensions do not bear an adequate and reasonable relationship to the total compensation of the employee on which his cost and standard of living is based.

It has long been recognized that the benefits under a qualified plan may be based on total compensation. The present section 165 (a) (5) of the Internal Revenue Code provides in part: "Neither shall a plan be considered discriminatory * * * merely because the contributions or benefits of or on behalf of the employees under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation of such employees * * *."

The Commissioner of Internal Revenue, in his "Guides for Qualification under section 165 (a) of the Internal Revenue Code" (Revenue Ruling No. 33), points out at part 5 (h) that benefits under a plan may be doubled by doubling the final compensation of a favored employee, but also shows how this may be prevented by requiring that increases in compensation during the last five years of employment are not to be considered for the purpose of computing benefits.

Also, to prevent abuse, the original past service compensation base can be required to be based on an average of up to 5 years prior earnings, where discretionary bonuses have been unusually high in the years prior to adoption of the plan.

Recommendation No. 9—Total compensation to be allowed under pension plans

Thus, an ample administrative safeguard exists, and it is submitted that a legislative requirement for adefinite formula for amounts other than basic or regular rate of compensation is not necessary and should not be imposed under pension plans.

In passing, it might be further observed that the principle of using total compensation as the base for benefits has been permitted generally in connection with profit-sharing plans under the present law.

VIII. Maximum Tax Deductible Contribution for Pension Plans

Deductions under profit-sharing plans are allowable within the 15 percent of payroll limitations and, when there are credit carryovers up to 30 percent of payroll (to average out 15 percent per year).

Deductions for past service contributions are presently allowable under a pension plan over a 10-year period only if the entire past service liability is paid in full at the inception of the plan. It has always been my view that the original intent of the Congress under the Revenue Act of 1942 was to permit an employer to fully deduct and thereby get all his past service liability paid off in 10 years. This is in the public interest because the sooner the past service is paid off the sooner all the employees will be surer of their full benefits if the plan should terminate thereafter and the plan is forever safer thereby. Past service contributions under a pension plan, however, while ostensibly limited to a 10-year spread only are usually required by the present and proposed tax bill to be extended beyond such period because of the interest element and Internal Revenue Service administrative rules.

A. INTEREST HAS USUALLY EXTENDED DEDUCTION TO ELEVEN AND ONE-HALF YEARS

If past service costs are paid over a period of years, the interest accumulations increase the liability and, since only the original past service liability can be deductible over 10 years, the payments on account of interest are necessarily deductible beyond the 10-year period. This means that it takes about 11½ years under current Internal Revenue restrictions to obtain full tax deductions—including interest. It is therefore submitted that a more equitable arrangement can be effected by allowing the past service deduction to the extent of 10 percent a year plus payments for interest on the unfunded past service liability so as to permit a deduction on account of past service in 10 years. Such a position would insure the deduction without subjecting it to involved calculations.

B. INTERNAL REVENUE SERVICE BULLETIN HAS EXTENDED BEYOND ELEVEN AND ONE-HALF YEARS

Another reason why employers have not been able to deduct their past service contributions in 10 years has been the requirement of the Internal Revenue Service Bulletin re section (p) (1) (A) and (B) of the code which restricts the actuarial assumptions on which tax deductions could be claimed, particularly in self-administered pension trusts or deposit administration group annuity contracts. In other words, an employer who wanted to use ultraconservative actuarial assumptions was not permitted to do so because of the limitations on his tax deductions. Consequently, when such an employer found in actual experience, as a result of the actuarial assumptions which he was permitted to use for tax-deduction purposes, that his fund sustained losses in excess of gains, then the resultant net losses further extended the number of years necessary to fully fund his past service liability.

This created the anomaly of a conflict of interest between the Government's natural desire to limit deductions in a taxable year as against the Government's equal desire to have pension funds fully financed and safe for the employee participants.

Thus, the additional actuarial factors resulting from compliance with the administrative bulletin could have the effect of extending the period required to deduct and amortize the past service for an additional year, or two, or more. Therefore, in the aggregate, it could take some employers a total of say, 12 to 15 years, or more to pay off and deduct their past service liabilities even if they pay the maximum currently tax deductible each year under present Internal Revenue Service administrative rules.

The tax law should permit an employer to be as conservative as he desires in his actuarial assumptions, in order to make his plan as safe as possible, provided, however, that the past service contributions could not be fully deducted any earlier than in 10 years.

C. H. R. 8300 REMEDY—PARTIAL CURE BUT REQUIRES MORE THAN 10 YEARS

H. R. 8300 does remedy the defect to some extent because the measure of deduction for past service costs will be 10 percent of such costs at the beginning of the taxable year including past service costs previously funded until

such costs are completely funded. But this still would generally require more than 10 years for full deductions of past service.

D. RECOMMENDATION NO. 10—PAST SERVICE TO BE FULLY DEDUCTIBLE IN 10 YEARS

Consequently, I recommend that the law permit an employer to deduct 10 percent of his initial past service (and supplementary costs) plus interest and excess of losses over gains, so that these can be fully tax deductible in 10 years.

E. RECOMMENDATION NO. 11—PENSION PLAN CARRYOVERS DEDUCTIBLE UP TO 20 PERCENT OF PAST SERVICE BASE

A further recommendation is that the unpaid normal cost plus 10 percent of the base for past service contributions, plus interest and net losses, be permitted as a carryover in any year or years not used up, up to a maximum of 20 percent of past service base in addition to the amounts otherwise deductible in that year. The idea would be still to carry out the original purpose of permitting tax deductions of all normal costs to date plus the full liquidation of the past service over a 10-year period. The principle is similar to a profit-sharing plan which can bunch up the failure to contribute the 15 percent of compensation in previous years up to 30 percent deductible in any year. Under the proposed profit sharing rules an employer can pick and choose any year or years that he desires and deduct up to 20 percent of compensation for that year if he has failed to utilize the full 15 percent in any of the prior years. Similarly, under a pension plan the right to bunch up to 20 percent of past service base in 1 year would make up the employer's failure to use up his 10 percent of past service base in any previous year or years.

F. ALTERNATE RECOMMENDATION NO. 11A—EXCESS CARRYOVER NOT TO EXCEED AN EXTRA 15 PERCENT OF PAYROLL

If desired, this new extra pension plan carryover could be limited to an overall deduction of an additional 15 percent of total compensation of the covered employees to match the extra 15 percent carryover deductible under profit sharing plans.

IX. Affiliated Companies Rule To Apply to Pension Plans

Provision is made that in the case of an affiliated group of companies under a profit-sharing plan the companies having profits may make a contribution on behalf of a member having a loss and obtain deductions therefor. No similar provision is made for a pension plan. Although the contributions under a pension plan are not geared to profits, they are of necessity dependent upon profits, because without profits there cannot be a plan of any kind.

It should also be observed that under existing law a deduction is allowed to an employer, within the applicable limits, for a contribution on behalf of his own employees. He is not allowed a deduction for a contribution on behalf of employees of an affiliated company.

Recommendation No. 12—Affiliated companies rule to apply to pension plans

I recommend, therefore, comparable treatments for both pension and profit-sharing plans.

X. $5,000 Death Benefit Exclusion for Pension Plans

The $5,000 death benefit exclusion applies under a profit-sharing plan from which a lump-sum payment is made under conditions giving rise to the long-term capital-gain treatment regardless of whether the employee had a nonforfeitable right to the payment prior to his death. In the case of a pension plan, however, such exclusion is to apply only if the employee did not possess a nonforfeitable right to the payment prior to his death.

The principle of making the $5,000 death benefit tax free, regardless of whether or not it is forfeitable makes sense. Otherwise, the employer would be torn between trying to give his employees vested rights during their lifetimes but subjecting their families to income tax on the death proceeds as against not giving them vested rights during life in order to permit their families to get such proceeds free from income tax at death.

Recommendation No. 13—To apply to nonforfeitable rights under pension plans

I recommend, therefore, that the $5,000 death benefit be made exempt from tax whether the right was forfeitable or nonforfeitable under a pension plan, the same as it is being proposed under a profit-sharing plan.

XI. Retroactive Provisions

It may also be pointed out that retroactive application is to be given to the provisions for allowable investments, prohibited transactions, and the indicated date of June 30, 1954, for unrelated business income will soon be here.

Recommendation No. 14—All effective dates prospective

A more equitable approach can be taken if such provisions be made applicable at some future time after the enactment of the new code.

XII. In Appreciation

I have here merely attempted to point out some of the more troublesome areas in the proposed revised code. However, I am fully appreciative of the time allotted to me and, in order not to encroach upon the time schedule of others who may be expected to elaborate upon these subjects, I conclude my direct testimony.

Thank you, gentlemen, for your kind indulgence.

XIII. Appendix—*Reference guide to H. R. 8300 and committee reports*

Section	Pages	Description	Committee reports		
			General statement	Detailed discussion	Minority report
37	10-11	Retirement income	7-8	A16-A18	
72	14-18	Annuities	10-11	A21-A27	
101	20-22	Death benefits	14	A29-A32	
381 (c) (11)	93	Predecessor's carryovers	41	A141	
401	96-97	Employee annuities; def. comp.	42	A145-A147	B15
402	97-98	Taxability of benef. of trust	42-43	A147-A149	
403	98-102	Deduction for employer contributions	43-44	A149-A153	
404	102	Life insurance salesmen		A153	
501 (c)	119-121	Employees' trusts	44-45	A165-A169	B15-B18
502, 503, 504	121-123	Prohibited transactions	45	A169-A170	
505	123-124	Allowable investments	45-46	A169-A170	
511-514	124-129	Unrelated business income	46	A171-A175	
6033	651	Returns by exempt organizations (including employees' trusts).		A399	
7851	813	Effective date		A440	

The Chairman. I ask the remaining witnesses to review what you have to say and keep it as short as possible. We are about halfway through our list, and we are more than halfway through the morning. You may proceed.

Mr. Goldstein. Senator, because of that I am just going to give an oral presentation of what I think are the high spots of policy questions which might be involved.

The Chairman. Go ahead.

Mr. Goldstein. As far as a general statement is concerned, there is so much good in the new pension and profit-sharing provisions that I am not going to comment on those because of the time limitation, and I will just confine myself to constructive suggestions.

The expressed intent of the Congress is to continue the growth and expansion of these private pension and profit-sharing plans in the country.

Mr. Goldstein. The first point that I want to make is that if H. R. 8300 went in as it is now, it would cause temporary stagnation in the

growth of new pension plans and the amendment of existing ones, because the pension and profit-sharing section is unique in that taxpayers don't make a move until they get, first, a written letter ruling from the Internal Revenue Service stating that their plan is approved.

And I remember in 1942 I had the privilege of appearing before this committee at that time when the revenue act was enacted. But it wasn't until almost 2 years later, the summer of 1944, before the Internal Revenue Service began issuing these letter rulings with any regularity.

Now, we will be going through exactly the same thing. We will have a period of stagnation for a couple of years, probably, before the regulations come out, and before these rulings start rolling from the Internal Revenue Service. Therefore, my recommendation is that a grace period be allowed for this transition period, wherein a taxpayer can take his choice of either the improvements that have taken place under this H. R. 8300, or the existing law, so that there won't be that stagnation during this interim period. And I would suggest that perhaps a period at least until the end of 1955, would give that grace period that is necessary.

The CHAIRMAN. Is that being considered by the staff?

Mr. SMITH. Yes, sir.

Mr. GOLDSTEIN. Thank you.

Now, the next one deals wth the question of employer coverage. A new rule and a fine one has been developed, whereby if a company covers 25 percent or more of its employees—if it has more than 40 employees—that would be sufficient to meet the tax test of coverage, so far as discrimination is concerned. That is fine in a great many cases. However, there are areas where that 25 percent rule isn't practical, and where a new rule has been substituted, a 10-percent-keymen rule. Where you have a company that has part of its employees subject to collective bargaining, and the union has a separate pension plan for the members of the collective bargaining unit, then it is obvious that a company has to have the freedom to establish its own type of plan, with different benefits, for those employees who are not members of the collective bargaining unit.

So what we need is a separate category in the tax law, which will give relief to companies who can only deal with their own employees that are not subject to collective bargaining—whether the employees in the collective bargaining unit have a plan or not. And that has been omitted and it is an obvious omission.

The CHAIRMAN. Have you considered that?

Mr. SMITH. Yes, we have, Senator.

Mr. GOLDSTEIN. Thank you.

Then, from that grows another type, namely, the salaried employees only type of plan, which is troublesome, because I have been trying as best I can, in the written testimony, to control possible abuses, because what we don't want to have happen is a reversion to some of the abuses that we had prior to 1942. And I have given the staff some suggestions which I hope will be helpful in that regard.

The next point that I want to address myself to is a point in which I think the Congress can do more to encourage small- and medium-sized businesses to establish plans than any other one thing, and that is to take away the threat that now exists of a retroactive tax penalty,

if a company starts a pension plan and then fails to make certain minimum standards of payments thereafter. Now, that has been cured in profit-sharing plans under H. R. 8300, and that same cure should be extended to pension plans.

I have much testimony on that point, but because of the time element involved——

The CHAIRMAN. You have that in your statement?

Mr. GOLDSTEIN. Yes, sir, I have.

Then along with that same thing, a great many companies, including companies, for instance, in the textile business, that Mr. Milliken spoke of today, have a system of paying low fixed salaries and then paying discretionary bonuses at the end of each year, so they keep their fixed overhead low, and then when they have good performance they give the bonuses at the end of the year.

Now, H. R. 8300 would exclude the right to put those discretionary bonuses in, in considering the compensation base for pension payments, and that is not a healthy thing and there should not be any interference with the normal development of the running of a business, and I hope that the staff will take that into consideration.

The CHAIRMAN. You have submitted that to the staff?

Mr. GOLDSTEIN. Yes, I have, sir.

We come next to the question of maximum tax deductible contributions. It has always been my opinion that the Congress intended to encourage taxpayers to get their past service paid off over a period of 10 years from the time the plan is established or a plan is liberalized. The idea is that when a company starts a plan, it has to make some arrangement to take care of all the years of past service of its employees, and that is a large lump sum. That frightens many companies against establishing a plan, because they are afraid of that accrued liability for past service credits.

So the Congress has seen fit—and I believe wisely—to encourage the rapid funding of the past service credits by permitting a tax deduction toward funding the past service in any year or years that suit the taxpayer, subject to a maximum tax-deductible limit. But in the interpretation of this by the administrative department of the Internal Revenue Service, the amount of the tax deduction has been restricted. So I would recommend that the Congress state in plain English that the purpose is to permit a taxpayer to amortize his past service over a period of 10 years, and I am sure then the details can be worked out to carry out that intent.

The CHAIRMAN. Are you suggesting that?

Mr. GOLDSTEIN. Yes. That is in here, sir.

Then we come to the question of affiliated companies. H. R. 8300 takes care of the case of a profit-sharing plan where there are some loss companies that don't have any money to put in because they are losing money, and yet they have employees working for them in an affiliated group. So they grant that relief, whereby the profit-making companies of the affiliated group can make extra contributions to protect employees of the loss companies. And we suggest that that same procedure be carried out so far as pension plans are concerned, in order to give those employees the same type of treatment.

Then, in a similar manner, there has been a special $5,000 death benefit, which is in the code now, and that has been extended as far as the

profit-sharing plan is concerned, so it doesn't have to be what is called nonforfeitable. We submit that this tax relief also should be afforded to pension plans, because otherwise we will have the anomaly in the tax law that an employer will be torn between two objectives. He wants to give vested rights to his employees who sever employment, so they can take away part of the money that has been contributed. But if he does that, under the H. R. 8300 proposal, then when the employee dies his beneficiaries will be subjected to an income tax on the $5,000; that is, the $5,000 won't be exempt from income tax to the beneficiaries because the right to the $5,000 payment was nonforfeitable, that is, vested, if he had severed employment on the day he died. And so I suggest that, just as in profit-sharing plans, regardless of whether that right is forfeitable or nonforfeitable, there should be relief under pension plans, the same as profit-sharing plans. And that, too, is in my written statement attached.

Then, on the question of retroactive provisions, it has already been suggested, I think by previous speakers, that any changes should be made prospective. I don't believe there have been any abuses, Senator, which would require any urgency to make these things retroactive, when many taxpayers didn't have a chance to know what the rules of the game were.

My final suggestion, which is not included in the written testimony because it came to my mind afterward is, instead of making an arbitrary $4,000 as the breaking point at which an employer can give a lower benefit, that is, the point up to which social security gives coverage, and a higher benefit above that, that instead of having a fixed figure such as $4,000 that will get out of date the minute we change social security in the future, and all pension plans will be correspondingly out of date, we establish in the Internal Revenue Code a flexible point as being the point up to which social security taxes extend. If social security taxes go up to, say, $4,800, then the supplementary private pension plan can have a lower benefit, or none, on the first $4,800. Thus, automatically, both the tax law and the private pension plans can move as social security moves, without any necessity of amending either the tax law or the private pension plans if they have such a flexible provision contained therein.

Thank you very much, Senator.

The CHAIRMAN. Thank you very much.

Mr. Downs.

STATEMENT OF JOHN W. DOWNS, ATTORNEY, BOSTON, MASS.

Mr. DOWNS. Mr. Chairman.

My name is John W. Downs and I am an attorney from Boston. I represent several of the largest insurance partnerships in that city.

I ask permission, sir, to address myself to section 736, payment to a retiring partner or a deceased partner's successor in interest. And, particularly, as to the payments other than for interest in partnership, which we find in H. R. 8300 under that section (A) and (B).

Subsection (a) provides that the distributive share to the recipient of such income of other items for 5 years is treated as a distributive share, and the recipient pays taxes on it.

Subsection (b) then reverses the proposition and changes it from a distributive share to charging the taxes back to the surviving part-

ners, on income that they never had and, in the case of my clients, under executed contracts that they have to pay out.

The CHAIRMAN. Mr. Stam, what about that?

Mr. STAM. The question involved there is whether the partnership can take a deduction for these payments to the surviving parties. Now, this 5-year provision, which admittedly has a lot of defects, we are working on that. We have heard this gentleman's testimony and I am pretty sure that you will want to do something about it, when you get into executive session.

The CHAIRMAN. Thank you very much.

Mr. STAM. I have talked to this gentleman about the problem, and I think we will be able to remedy it.

Mr. DOWNS. Do you want me to cease then?

The CHAIRMAN. There is no use in talking about that any more.

Mr. DOWNS. That covers the whole situation. Thank you very much.

The CHAIRMAN. Thank you.

(The prepared statement of Mr. Downs follows:)

To the Honorable Members of the Senate Finance Committee, Washington, D. C.

GENTLEMEN: Your attention is respectfully called to the following provision of the proposed new Internal Revenue Code, H. R. 8300:

"SEC. 736. PAYMENTS TO A RETIRING PARTNER OR A DECEASED PARTNER'S SUCCESSOR IN INTEREST.

"(a) PAYMENTS OTHER THAN FOR INTEREST IN PARTNERSHIP.

"(1) GENERAL RULE. In the case of the liquidation of the interest of a retiring partner or a deceased partner, the amount of income or other items of a partnership allocable to the retiring partner or a successor in interest of the deceased partner, except to the extent provided in subsection (b), shall—

"(A) with respect to payments made within 5 years after the partner's retirement or death, be considered a distributive share to the recipient of such income or other items, and

"(B) with respect to payments made more than 5 years after the partner's retirement or death, be included in the distributive shares of the remaining partners (without increasing the adjusted basis of their interests in the partnership) and excluded from the gross income of the recipient."

I represent several of the largest insurance partnerships in the city of Boston. One of my clients has been in business since 1876, and all of them have had partnership agreements in force for a great many years. These executed agreements provide for the purchase by the partnership of the interest of any retiring or deceased partner and further provide that a retiring partner or the legal representative of a deceased partner may continue as an interested party in the partnership for a term of 10 years.

These agreements are in conformity with Massachusetts General Laws, chapter 175, entitled "Insurance," section 173, as amended, relating to the granting of licenses to brokers. This section provides that executors, administrators, and trustees of the estates of deceased partners may be partners in the partnerships for periods not exceeding 10 years from the death of such partner, for the purpose of protecting any rights of such deceased partner. Under the requirements of the said executed agreements, the insurance partnerships are now paying distributive shares of income to the estates or heirs of deceased partners or to retired partners, and will be required to continue such payments beyond the 5-year limitation set forth in the proposed amendment.

When these agreements were entered into, there was no limitation of time in the Internal Revenue Code, and, of course, such a limitation was not then anticipated. The proposed amendment would insert such a limitation in the law for the first time. Moreover, when the agreements were executed, it was assumed, of course, that the estate of a deceased partner or a partner who had retired would continue to pay taxes on the income received from the partnership throughout the 10-year period just as the deceased or retired partner had paid such taxes during the period of his active participation in the partnership. The proposed amendment would shift the tax burden after the 5-year period to the

remaining partners. This would obviously result in unjust and unexpected benefit to the estate of the deceased partner or the retired partner and unjust and unexpected detriment to the remaining partners.

Therefore, it is respectfully requested that in order to avoid this injustice the Senate Finance Committee change the 5-year limitation to a 10-year limitation.

If for any reason which is not apparent it is deemed unwise by this committee to make the above suggested change, then as an alternative, it is respectfully requested that a provision be inserted in the above-quoted subsections (A) and (B) to exempt from the 5-year limitation provision all bona fide partnership agreements in force on the date when the new tax law becomes effective. Such existing agreements, of course, the remaining partners are now powerless to change or modify to compensate for the shift in the tax burden.

The United States Treasury should receive about the same tax revenue under a 10-year limitation as under a 5-year limitation and about the same revenue under the other change suggested above. This appears from the testimony given by Mark H. Johnson, Esq., of New York City, on behalf of the American Bar Association before the Committee on Ways and Means of the House of Representatives, found on page 1370 of the transcript of the hearings before that committee. Mr. Johnson's testimony was in part as follows:

"* * * Let me emphasize this point that very few of the problems involve overall revenue consideration. By and large, one set of solutions will, in the long run, produce about the same total taxes as another set of solutions. The problems in the partnership field usually involve the question of which partner is to be taxed and when. * * *

This is a serious matter for many insurance partnerships throughout the United States. Unless the proposed amendment is changed, they will be in a difficult position with no corresponding benefit to the United States Treasury.

Respectfully submitted.

JOHN W. DOWNS,
Attorney at Law.

The CHAIRMAN. Senator Saltonstall, we are glad to have you present. Do you wish to introduce your constituent and make a statement?

Senator SALTONSTALL. I would appreciate the opportunity, sir.

The CHAIRMAN. Please go ahead.

STATEMENT OF HON. LEVERETT SALTONSTALL, A UNITED STATES SENATOR FROM THE STATE OF MASSACHUSETTS, ACCOMPANIED BY KENNETH W. BERGEN, ATTORNEY, BOSTON, MASS.

Senator SALTONSTALL. I would like to present to the Finance Committee Mr. Kenneth W. Bergen, a partner in Warner Stackpole, Stetson & Bradlee in Boston, which is a highly reputable firm of lawyers in Boston. He is chairman of the Tax Forum of Boston. I believe you have already met him, as he has appeared before this committee at various times.

Now, the Tax Forum is composed of many of the leading tax lawyers and accountants, and some of the professors of law in the Greater Boston metropolitan area. He is here to speak to you in due course on charitable trusts and the problem of accumulations.

I don't know whether we are different in our section from other sections of the country. I do know that we have a number of charitable organizations which are interested in this problem, out side of the charitable trusts which Mr. Bergen may represent this morning. They are the United Community Services in the metropolitan area, The Massachusetts General Hospital, the Massachusetts Memorial Hospital, and a number of other hospitals and charities.

Now, I was chairman of the Greater Boston Community Fund 1 year and was responsible for raising something over $4 million. We worked very hard on it. The beneficiaries of the fund are reputable institutions for which one united campaign is conducted. The question before you, as I understand it, is one that would affect accumulations and would affect our systems of charities in the Greater Boston area, because in Massachusetts accumulations for charitable purposes are permitted.

I personally happen to be a trustee of one small trust that has been in existence now almost 100 years, under which we accumulate a small amount each year. So that the issue in which Mr. Bergen is interested does become a problem, as I had not realized, even in the case of the trust under which I am an active trustee.

This is a question that involves the welfare, the good health, and the hospitalization of many of our citizens, and I know that it will receive your sympathetic consideration.

The CHAIRMAN. I am sure it will.

Senator SALTONSTALL. I appreciate your permitting me to introduce Mr. Bergen, whom I can vouch for as a responsible tax authority.

The CHAIRMAN. Thank you.

(Off the record.)

The CHAIRMAN. Mr. Bergen.

Mr. BERGEN. Mr. Chairman, my name is Kenneth W. Bergen. I am an attorney in Boston, Mass. I appreciate very much the opportunity you have given me to appear before you.

First of all, I have been asked by the Tax Forum of Boston, a group of tax practitioners from many of the large law and accounting firms in Boston, to make a few general remarks about H. R. 8300. This group, I believe, is representative of the Tax Bar of Boston and possibly New England.

The Tax Forum believes that a remarkable and herculean job has been done in putting together this tax bill. Too much credit cannot be given to the many who have labored over it. However, the Tax Forum feels that some parts of the bill need drastic revision, if it is to become workable and something we can live with comfortably. Although the Tax Forum is not making specific suggestions, it would like to endorse the suggestions made by the American Bar Association, the American Law Institute, and the American Institute of Accountants. It is understood that groups from these organizations are working and cooperating with the staffs of the joint committee and the Treasury Department, and the Tax Forum would like to urge that this cooperation be continued just as long as possible in the working out of this bill, so that we can have as good a bill as possible.

So much for my statement on behalf of the Tax Forum. I would like now to get to the question involving charities, which Senator Saltonstall spoke to you about a few minutes ago.

As he said, I represent a number of charitable trusts in Boston. Rather than read the formal statement which I have here, I would respectfully ask that it be included in the record, and then that I be permitted to summarize it briefly.

The CHAIRMAN. That is exactly what we want you to do. Put it in the record, please.

(The statement referred to follows:)

Hardship on Charitable Trusts Required to Accumulate Income

One of the most ambiguous and uncertain provisions of H. R. 8300 is to be found in paragraph (1) of sections 504 (a) and 681 (c). It is respectfully submitted that this provision should be eliminated prior to the final enactment of H. R. 8300.

As a result of the enactment of a similar provision by Congress in 1950 (secs. 162 (g) (4) (A) and 3814 (1) of the Internal Revenue Code), many genuine charitable trusts now find themselves in danger of losing their tax exemptions and deductions even though the trust income must be used for the benefit of charity and even though no personal benefits can inure to the benefit of the creators of the trusts.

The 1950 legislation took the form of an amendment to the Internal Revenue Code denying charitable exemptions and deductions of trusts in which there are income accumulations "unreasonable in amount or duration in order to carry out such purposes of the trust." No guide to interpreting this language is available, and it is impossible to administer with any degree of certainty.

This provision was a small part of the 1950 overall revision of the tax law relating to charities. This overall revision was enacted largely because certain charitable trusts and foundations were taking advantage of their tax exemption either through tax-avoidance schemes or through private benefits to the creators of the trusts. The House Ways and Means Committee held extended hearings and Congress enacted numerous provisions designed to prevent these abuses without harming worthy charities. The great majority of these provisions were commendable and should be continued in the Internal Revenue Code. However, there is nothing in the history of this legislation indicating that the provision taxing accumulation trusts was intended to prevent the abuses which Congress sought to prevent.

A brief history of the 1950 charitable amendments as applied to accumulations of income by charitable trusts is set forth below.

HOUSE WAYS AND MEANS COMMITTEE

In section 321 of H. R. 8920, the House Ways and Means Committee proposed that certain income accumulations by charitable trusts be subjected to Federal income tax. However, the bill exempted from such tax the following:

(1) All irrevocable trusts created prior to June 1, 1950, where accumulation of income was mandatory;

(2) All income actually distributed to charity;

(3) All income of testamentary trusts received within 25 years after date of death of the decedent.

SENATE FINANCE COMMITTEE

Because the Senate Finance Committee thought that the proposals made by the House were too inflexible and would be injurious to many worthwhile charitable organizations, section 341 of H. R. 8920 eliminated entirely the tax on accumulations as proposed by the House and substituted merely the requirement that charitable trusts claiming deductions for accumulations for charitable purposes file information returns with the Commissioner of Internal Revenue.

JOINT CONFERENCE COMMITTEE

The joint conference committee retained the Senate amendment requiring the filing of information returns but otherwise rejected both the House and Senate proposals, enacting what is now sections 162 (g) (4) and 3814. Thus, the joint conference committee and the law as finally enacted subject to income tax all charitable trusts accumulating income as provided in the law even though (1) the trusts were created prior to the date of the enactment of the law, (2) the income is accumulated by testamentary trusts, and (3) most of the income is actually distributed to charity. The only limitation on the tax is that the accumulation be "unreasonable in amount or duration," a phrase which is extremely indefinite in meaning.

As the above legislative history indicates, the law now imposes a more harsh rule on charitable trusts that either the House or the Senate versions of the 1950 revenue bill.

The number of trusts endangered by present section 162 (g) (4) (A) of the Internal Revenue Code is great. In one city alone, the number of trusts in this

category might well run into the hundreds. As a result, millions of dollars intended for charity are in danger of being diverted through taxes at a time when charities are desperately in need of funds to meet ever-increasing costs.

Typical examples of trusts affected by this law are—

(1) The will of a person dying subsequent to 1950 provides that property is to be held in trust to pay specified amounts to named elderly annuitants and that the balance of the income is to be accumulated. On the death of the last surviving annuitant, the trust principal and all accumulated income is to be paid to named hospitals and colleges. Because the amount of income paid to the annuitants each year will constitute a relatively small fraction of the income received each year, there is serious danger that the income accumulated each year will be regarded as unreasonable in amount and, therefore, will be subject to Federal income tax.

(2) A man died in 1948 leaving a will which provided that the residue of his property was to be held in trust to pay 90 percent of the income to specified charities and to accumulate 10 percent for 50 years. Because of the accumulation provision, there is serious danger that the 10-percent accumulation will be regarded as unreasonable in duration in which event the trust would be taxed in the same manner as an individual with the deduction for its charitable distributions being limited to 20 percent of its income, although 90 percent is required to be distributed to charity.

It is difficult to understand why there should be any social or other policy against such accumulations per se so long as they are used for bona fide charitable purposes. Since other provisions (secs. 162 (g) (4) (B) and (C) and 3814 (2) and (3); H. R. 8300, secs. 504 (a) (2) and (3) and 681 (a) (2) and (3)) are designed to prevent charitable trusts from being used to the private advantage of the creators of charitable trusts, the provision preventing unreasonable accumulations is unnecessary. In fact, it tends to discourage gifts for the benefit of charity.

It is respectfully submitted that sections 504 (a) (1) and 681 (c) (1) of H. R. 83000 should be eliminated altogether from H. R. 8300.

Mr. BERGEN. H. R. 8300 contains a provision which subjects to tax trusts which accumulate income. The test for determining the taxability of the trust is whether the accumulation is unreasonable in point of time, or in amount. If either test is met, then the trust loses its exemption, and is subject to a Federal income tax, to the full extent of its income, regardless of whether the income is distributed, and its deduction for charitable contributions is limited to 20 percent, just as in the case of an individual.

Perhaps I can illustrate this to make it a little clearer: Suppose a man dies, leaving a will which provides for a trust to pay an annuity of $10,000 a year to his wife for the rest of her life and to accumulate the balance of the income until the wife dies, at which time the accumulation of income and principal is to be paid over to the American Red Cross. Let's say the income of the trust is $20,000, so that 50 percent is accumulated and 50 percent is paid out to the wife. Under the provision, about which we are concerned, there is a serious danger that that trust will lose its exemption, and that the 50 percent accumulation will be subject to income tax, even though eventually it is going to be paid to the American Red Cross.

This provision was first enacted in 1950 as a part of overall legislation designed to prevent charities from competing in business or engaging in activities for the benefit of private individuals. The legislation was commendable, and certainly should be continued in the law. But the provision about which I am concerned was not designed to prevent any of these abuses. The other provisions of the law adequately take care of them.

I think you will be interested to know some of the harsh results of this provision. The law applies even though a trust was created

before the enactment of the law in 1950 and even though the trust is required to accumulate income. I suppose the classic examples of this type of trust are the ones created by Benjamin Franklin many years ago. While I don't know the exact details of that trust, it is public knowledge that there are 2 trusts, 1 in Philadelphia and 1 in Boston. I understand that the income was to be accumulated for 100 years. At the end of that time one-half of the trust property and accumulated income was to be paid out to charity. The balance was to be accumulated for the second hundred years, at the end of which time the trust was to terminate.

Now, I can't say for certain that the Franklin trusts are affected by the present tax law, but it is the kind of trust we are worried about. A 200-year accumulation might very well be regarded as unreasonable in point of time by a court.

The law also applies even though most of the income has to be distributed by a trust. We have a case where a trust is to pay out 90 percent of its income to charity each year, and to accumulate 10 percent for 50 years. Thereafter all the income is to be paid out to charity. It is quite likely that a 50-year accumulation would be unreasonable in point of time. And if it is, the trust loses its exemption. 100 percent of the income less a 20 percent charitable deduction, is subjected to tax, although 90 percent is actually paid out to charity.

We have some investigation of the number of trusts involved in this situation in Boston, and it could run into the hundreds.

The CHAIRMAN. Has the staff studied that situation?

Mr. STAM. Yes. Of course what he is talking about, Senator, is the provision of existing law.

Mr. BERGEN. That is right.

Mr. STAM. Which was merely carried into the code. It was put in, I think, in 1950.

Mr. BERGEN. In 1950, that is correct.

Mr. STAM. And it was designed—the purpose of it was to prevent unreasonable accumulations in certain types of trusts, which would jeopardize the interests of the beneficiary.

For instance, we had a situation where the trust was investing in stock of the grantor, and the thing was very speculative and it appeared from facts that there was a possibility that beneficiaries might not get anything out of the trust at all. So, certain of these restrictions were written into the law to take care of that situaion. And we have had his called to our attention. We haven't been able to find a solution for it at the moment.

Mr. BERGEN. Now, take the case that you have just mentioned——

The CHAIRMAN. Give us a solution.

Mr. BERGEN. I don't think the solution should prohibit accumuations. We can't see any social policy against accumulations per se. But, if those accumulations are going to jeopardize the interests of charity, we agree the trust ought to lose its exemption, and there is a specific provision in the law which would deny a trust an exemption in that case. I refer to paragraphs (2) and (3) of section 504 of H. R. 8300.

We also agree if they participate in certain prohibited transactions, they ought to lose their exemption. But we do say that mere accumu-

lation is not socially bad. Too many trusts have done too much good to say that that alone is sufficient to cause a charitable trust to be penalized.

So, we are, therefore, asking that the provision against accumulation be stricken.

It is interesting to note that the law as finally enacted goes further than either the House suggestion in 1950, or the Senate Finance Committee suggestion. The Senate Finance Committee in 1950 struck out altogether this provision, and in conference, as a compromise, the conference committee came up with this solution of taxing trusts which accumulate income unreasonably in amount or duration. And it does seem to be unduly harsh on trusts, which merely are accumulating.

Now, the trusts to which I am referring are only the most conservative type of trusts, with banks as trustees. They are not engaging in shenanigans. Most of them are trusts under wills of decedents long since deceased, who are not interested in jeopardizing the interests of charities.

I have here a long list of leading charitable organizations in Boston, the officers of which agree with the position which I have taken here today, and I should like to ask that it be inserted in the record, rather than read it.

The CHAIRMAN. It will be inserted.

Mr. BERGEN. I might point out it includes many hospitals and the United Community Services of Metropolitan Boston.

Again I wish to thank you, Senator, for permitting me to appear.

The CHAIRMAN. We are glad to see you.

(The list referred to follows:)

LIST OF CHARITIES, OFFICERS OF WHICH AGREE WITH POSITION TAKEN BY KENNETH W. BERGEN REGARDING CHARITABLE TRUSTS

United Community Services of Metropolitan Boston
Massachusetts General Hospital
Massachusetts Memorial Hospitals
Boston Lying-In Hospital
Children's Medical Center
Robert Brigham Hospital
Industdial Home for Crippled Children
Family Service Association of Greater Boston
Massachusetts Charitable Fire Society
Massachusetts Eye and Ear Infirmary
Faulkner Hospital
Boston Home for Incurables
Franklin Technical Institute
Massachusetts Heart Association
Boston Heart Association
Boston Tuberculosis Association
Boston Symphony Orchestra
Free Hospital for Women
Family Welfare Society of Boston
Family Society of Cambridge

The CHAIRMAN. Mr. Denniston.

STATEMENT OF ROBERT DENNISTON, ATTORNEY, MOBILE, ALA.

Mr. DENNISTON. My name is Robert Denniston. I am an attorney, representing myself, from Mobile, Ala.

I am interested personally in a banking company in Mexico. I wish to present a proposal concerning section 552 of H. R. 8300, which concerns the foreign personal holding company law. I have a written proposal to submit, and some verbal comments to add.

The CHAIRMAN. We will put that in the record.

(The statement referred to follows:)

PROPOSED AMENDMENTS TO H. R. 8300, SECTION 552 AND SECTION 6035, FOREIGN PERSONAL HOLDING COMPANY LAW

1. Purpose

As they affect the subject here discussed, the provisions of H. R. 8300 are the same as those contained in the existing law. As written they discriminate severely against investment by United States citizens in legitimate foreign banking institutions, because no such bank is exempt from the Foreign Personal Holding Company tax. Only corporations under subchapter F (sec. 501 and following) are exempt, whereas in the case of domestic corporations there are five different provisions exempting banking and financial institutions. The first, section 542 (c) (2), exempting "banks" as defined in section 581, was in the original act first defining domestic personal holding companies. The other four exemptions were added later to protect legitimate installment finance and small loan companies which did not qualify as banks. Up to now apparently there has been no agitation to extend a similar protection to legitimate foreign financial institutions.

The present proposal is designed to remove this inequity in the law. A similar one was submitted to the Joint Committee and to the Bureau of Internal Revenue under date of January 2, 1954, by the writer, but was apparently received too late for consideration by the joint committee. So far as this writer knows it was never rejected or disapproved by the joint committee or by the Bureau of Internal Revenue and it is therefore being submitted to the Senate Committee on Finance for their consideration.

2. Proposal

Amend section 552 (b) of H. R. 8300 so as to read in its entirety as follows:

"SEC. 552 (b). The term 'Foreign Personal Holding Company' does not include: (1) a corporation exempt from taxation under subchapter F (sec. 501 and following); (2) a banking or financial institution organized and doing business under the general laws of a foreign country applicable to such institutions, which is regularly engaged in, and a substantial part of the business of which consists of making loans and discounts or of mortgage credit or installment finance operations (whether or not such institution is authorized to receive deposits), and which is subject by such laws to supervision and examination by governmental authority of such foreign country having supervision over banking institutions."

Add a new subsection (b) (3) to sec. 6035, to read as follows:

"(b) (3). CLAIM OF EXEMPTION. Each United States shareholder of a foreign corporation which would otherwise qualify as a foreign personal holding company, but which is claimed to be exempt under the provisions of section 552 (b) (2), shall attach to and file with his income-tax return for each taxable year in which he has been such a shareholder for any part of such year, a return which shall show the name and address of such corporation, the citation to the law of the foreign country under which such foreign corporation is organized and operates, and the last annual financial statement of said foreign corporation as submitted to the governmental authority having supervision over it, in such form as the Secretary or his delegate may prescribe; such return need not be submitted if, within 60 days after the close of the last calendar year of which such taxable year forms a part, such foreign corporation makes a return submitting the same data together with the name and address of each United States shareholder for whom an exemption is claimed thereunder."

3. Discussion

The language proposed for section 552 (b) (2) is patterned after the definition of a bank under the domestic law in section 581, but it is somewhat broader to cover some legitimate financial institutions which are not banks. The distinguishing feature of a bank in its narrower sense is that it is authorized to receive deposits. It will be recalled that in the domestic law four long and detailed exemptions were added to cover specific types of financial institutions, not banks of deposit, which had developed under State laws. To attempt such detailed definitions to fit the many financial institutions of foreign countries in Europe, Latin America, and elsewhere would be futile. Most foreign countries very strictly regulate, by statute and by governmental supervision, the organization and operation of the various classes of banking, financial and mortgage credit institutions, because money, credit and banks exert such a profound influence on the fiscal, economic and political well-being of the land. Therefore, in the definition here suggested, some financial institutions other than banks of deposit are exempted, but only those which are organized under the banking laws, which actually and regularly engage in such business and which are supervised and examined by a banking commission or similar body.

The addition of subsection (b) (3) to section 6035 provides the Secretary with information necessary to establish legitimacy of the institution with respect to which the exemption is claimed. There is no such requirement with respect to exemptions under the domestic personal company law, so this provision should go a long way to protect against abuse.

4. Encouragement of American investment abroad

The Randall Commission Report of January 23, 1954, in its treatment of the subject of United States Taxation and Investment Abroad (pp. 22-26) and the Reed-Simpson Minority Report of January 25, 1954 (pp. 8-9) both treat kindly the encouragement of American investment abroad. The subject considered in the proposal here submitted was not specifically mentioned in those reports, but the spirit of both reports was certainly to remove discriminations against investment abroad as compared with investment in this country. To many people "investment abroad" means the establishment of factories and other plants in foreign countries or investment of funds by our citizens in agriculture, mining or industry of those countries. But to an internationally minded banker this means in banking institutions abroad, because that is the business he knows best. A banker with tremendous resources may well invest in or establish institutions involving so many people that the holding company question is no problem, but the smaller banker generally can find far fewer associates willing to risk an interest in foreign banking. Also, the additional hazards attendant to investing abroad make the voting control highly desirable, though of course not always essential, for the Americans who are involved.

5. Typical foreign banking law

To answer some questions regarding the opportunity for abuse under the proposed amendment, attention is respectfully invited to the provisions of the General Law of Banking (Credit) Institutions and Auxiliary Organizations of Mexico. Although the writer is not familiar with such laws in Europe or the East, it is believed that this law is typical of those found in other Latin American countries. The law in Venezuela, which the writer has also studied, is similar though briefer. Particular attention is invited to the following from the Mexican law:

(*a*) Title I, article 1, provides that the law shall govern the concerns whose purpose is to engage habitually in banking and credit operations, and that the Secretariat of Finance and Public Credit shall be competent authority for everything relating to banking institutions.

(*b*) Title I, article 2, provides that an authorization from the Federal Government shall be required to engage in banking and credit operations, and then it lists the separate categories of banking and credit operations as follows:

I. Banking deposit operations.
II. Savings deposit operations.
III. Financial operations.
IV. Mortgage credit operations.
V. Capitalization operations.
VI. Fiduciary operations.
VII. Home savings and loan operations.

Each category of the foregoing is then allocated by the Mexican banking law to a separate type of institution (except fiduciary functions, which may be performed by certain of the others), and a separate chapter of the law is devoted to each type of bank.

(c) Title I, article 5, prohibits the use of the words "bank", "financial" (this word is an attempt at a one-word translation; the Spanish word is "financiera"), etc. in the business name without express authorization in accordance with Article 2.

(d) Title II, chapter III, deals with financiers. Article 33, its companion article 17 relating to deposit banks, and like articles relating to other banks, establish many prohibitions which would render such institutions a poor means of attempting to circumvent the personal holding company laws. The most obvious prohibitions are those restricting the corporation from loans in excess of a very conservative figure to any one individual borrower and those limiting loans to directors and stockholders.

(e) Article 8, section VII, provides an example of the unintended inequity of the present United States law. That section contains a traditional banking requirement that "at least 10 percent of the profits must be set aside to form a capital reserve fund, until same amounts to paid-up capital." If the company were a foreign personal holding company this would automatically subject the American stockholders to the tax on retained earnings.

(*f*) Title IV, article 95, provides that all banking institutions must publish a monthly statement of their operations and an annual general balance sheet according to models approved by the National Banking Commission.

(*g*) Title V is devoted to inspection and vigilance, and sets up the functions of the National Banking Commission. The writer knows from experience that the examinations by this commission and reports required of every transaction, no matter how minute, are thorough and detailed to the extreme, and enforced with scrupulous honesty.

6. Case in point

The particular case which causes the writer to make the recommendation here submitted involves a banking institution in Mexico. The writer is personally interested in this institution as a stockholder. It is in the category described under the "General Law of Banking (Credit) Institutions and Auxiliary Organizations" as a financiera. Financieras fall midway in the scale of banking activities running from commercial banks for sight-deposit and short-term loan activities, to mortgage credit companies, for a long-term real estate loan activities. By article 26 of the general law of banking institutions they can perform most of the functions of commercial banks, except that their loans are the medium term variety and they cannot ordinarily accept sight deposits (which is further prohibited by art. 28, sec. II, of the law). Thus they lend from their capital and from credit they obtain from loans, rediscounts and bond issues. In the field in which they operate these institutions play a vital part in the development of industry, commerce and agriculture in Mexico.

The institution in which the writer is interested is a small one called the Financiera Colon, S. A. and is well known in banking circles in Mexico City, where it has been operating since 1946. Among the founders was the writer's father, who was also engaged in banking in Mobile, Ala., and who has since died. Its presidente or chairman, is Mexican, but its gerente or manager, is the writer's brother, an American citizen residing in Mexico. There are both Mexican and American sharehholders. Its capital funds are about 3,500,000 pesos (8.60 pesos to the United States dollar) and its resources are about 7,500,000 pesos. For some years it has paid most of its earnings out in dividends. Because of the substantial American interest in the ownership and the management, in addition to credit from Mexican banks, it has had a distinct advantage in being able to obtain good lines of credit for rediscount facilities from various banks in the United States—additional dollars which have been extensively utilized to help answer the ever-growing need for credit in the development of the Mexican economy. Its principal activity to date has been the financing of many imports from the United States to Mexico, of automobile and truck assembly plant production, of automotive and appliance sales of all sorts, including heavy agricultural machinery, buses and radios, and commodity loans.

For several years some of the American shareholders have had the opportunity to buy more stock from the Mexican shareholders or to enlarge the stock of the institution, and thereby to expand their investment in Mexico in a business which they know, but they have not been able to do so because of the penalty features of the foreign personal holding company law.

This is one small case only, and the only one known to the writer, but it is entirely possible throughout the world that investment of American capital of this particular type is likewise arrested or stagnated for the same reason.

7. General

It is not felt that any tax loss to our Government would result from the adoption of such an amendment, because the present law is so prohibitive that participation in such foreign personal holding companies has probably been avoided in the past so that no such tax would accrue in the first place. The writer will be very happy to submit such other data as the Committee on Finance might deem to be of value on this subject.

Respectfully submitted.

R. P. DENNISTON.

Mr. DENNISTON. The provisions of H. R. 8300 are similar in substance to the provisions of the previous law on this subject, and do not allow for any exemption under the foreign personal holding company law with respect to banking institutions.

Under the domestic personal holding company law, there are five different exemptions, with respect to banking institutions. The first exemption was put into the law when it was first written, and exempted banks of deposit. Subsequent to that time, under the domestic law, there were four exemptions added over a period of time, exempting certain types of installment finance institutions and savings and loan institutions organized under Federal or State laws.

I believe, without knowing, that the principal reason why there is no exemption under the foreign personal holding company law, with respect to banking institutions, is that no one has probably ever proposed it or asked that it be done. I would suppose, without knowing, that an additional reason would be that it could be thought that such an exemption would be subject to more abuse than one in the United States, where the taxing authorities are more familiar with the laws respecting banks.

I am personally familiar and interested in a banking situation in Mexico, and I would like to use this as an example, which I would feel has analogies in other countries. I don't know whether it has or not, but I would think so.

Under the banking laws of Mexico, the banks are divided into a number of different categories, such as banks of deposit, banks of the installment finance field, mortgage credit banks, savings banks, and so forth. They are all regulated by federal law, and they operate under a federal statute. There is a national banking commission which supervises and controls their activities. They have to submit detailed reports of their activities and of their financial statements to this banking authority. They have to receive permission from the banking authority before they can issue dividends, and so forth.

The one that I am familiar with is known as the Financiera Colon, S. A., in Mexico City. It was founded some 10 to 12 years ago by some members of my family and about 40-odd other Americans living in the general region of Alabama, in Louisiana, Mississippi, and Florida, and also some Mexican people. This company operates under such a law, is carefully regulated by the Mexican authorities, and operates, we feel certain, a legitimate banking institution. It is of considerable benefit, I think, in a modest way, in financing the import of products from the United States to Mexico, including importation of many products to the assembly plants in Mexico, incidentally, by Americans who are working and employed in Mexico.

It likewise has financed the sale regularly, over that same period of time, of all types of appliances, automobiles, and the like, and also the movement in international trade of commodities. In other words, it is a typical legitimate banking institution. On the other hand, it is true of this institution, and I feel probably true of many others, that there are relatively few Americans, compared to the number of people in this country, who are sufficiently interested and familiar with investing money abroad, who are willing to take the risks of exchange and of the particular problems involved in foreign countries.

I know in this one, for example, since this company has been founded, the Mexican peso has been devalued twice, once only 3 days ago. So, for a person interested only temporarily in investing in a foreign country, that would not be a worthwhile investment. It has to be for those who are interested in the long pull. In this case, one of the members of my family, my younger brother, has since moved to Mexico and is one of the functionaries and interested parties in this institution. He is a typical American who wishes to do something abroad. He is a loyal citizen, nevertheless, having been a veteran of World War II, and is as vitally interested in the United States of America as any of us here, I am sure.

Those people are interested in the long pull. There are many investors in this country, or prospective investors, who are not. For this reason, this company is presented with a situation which is probably typical of that facing a good many people who would be interested in banking or financial institutions in foreign countries—that is, that there are only a handful who know enough about any one proposition to be interested in it. As it happens in this case, some of the American investors in this company would like to expand and invest more money in this particular institution, which has been relatively successful and has established a respected and recognized position in financial circles of Mexico. They are unable to do so because of the provisions of the foreign holding company taxes, which penalize an American investor, if a group of United States investors is such as to qualify under the personal holding company laws.

And I think that, although in many respects the foreign personal holding company tax is not tremendously more onerous than the ordinary taxes, there is a certain stigma attached even to the words "personal holding company," which makes prospective investors feel, "Is this a bank or a holding company?" They don't realize it could be two. And the net effect is that American investors in foreign countries would shrink away from that type of investment which is legitimate and which the law, I don't think, is intended to work against.

For that reason, I have submitted to the joint committee a proposal. I am afraid that it got in too late for their serious consideration before the bill went to the House. I believe Mr. Stam will correct me, but up to the present time it hasn't been rejected by them. They had not had the opportunity to give it thorough consideration. So, at the suggestion of them and other people, I have taken the opportunity of presenting it to the Senate Finance Committee. I am deeply honored for the opportunity to be here, and I thank you very much for your time.

The CHAIRMAN. We are very glad to have you. Thank you.

Is Mr. Splane here?

Mr. Winslow, sit down and be comfortable and identify yourself for the reporter.

STATEMENT OF ROBERT I. WINSLOW, JR., KANSAS CITY, MO.

I am Robert L. Winslow, Jr., Kansas City, Mo. The purpose of my appearance here is to urge that section 736 of H. R. 8300 be clarified. I am not a lawyer. I am sure that you have on your technical staff experts who are fully qualified to deal with the legal aspects of this matter. I am here for the purpose of telling the committee how section 736 will affect me as a businessman.

The CHAIRMAN. You have a lawyer right beside you.

Mr. WINSLOW. Yes, sir.

I am a member of a partnership known as T. H. Mastin & Co., which operates and manages a casualty insurance carrier. The partnership agreement under which we operate was originated in 1913—long before income taxes were of any significance. Therefore, our partnership agreement cannot be considered in any sense a tax-avoidance device. A provision in this partnership agreement provides that in the event of retirement or death of a partner, a portion of his interest in future, contingent profits of the firm is to be paid monthly to him of his designees in the event of death, for a period of 21 years. These amounts paid are not unrealized receivables at date of death or retirement. Rather, they are speculative, contingent, future profits payable only if and when earned. This partnership is a personal service partnership operating without assets or capital. All equipment, furniture, fixtures, premiums in course of collection, cash and investments are the property of the insurance carrier. The very desks and pencils, and so forth, which we use are all the property of the insurance carrier.

The CHAIRMAN. Where do you operate?

Mr. WINSLOW. We operate in about 38 to 40 States.

The CHAIRMAN. Where is your headquarters?

Mr. WINSLOW. Kansas City, Mo.

The partnership of T. M. Mastin & Co. at this time consists of 4 active partners, age 82, 67, 41, and 37, respectively. It will be noted that these partners fall in two age groups. My partner, Henry Burr, is 41. I am 37. Of our senior partners, the youngest is 67. Payments to several designees of 3 deceased partners and to 2 retired partners are being made at the present time under the provisions of our partnership contract.

The CHAIRMAN. That goes back to 1913?

Mr. WINSLOW. Yes, sir.

The CHAIRMAN. It hasn't been changed?

Mr. WINSLOW. Just the addition of new partners being added, that's all.

It is my understanding, and I am informed by our counsel, that section 736 as it is now written provides that in the case of certain types of partnerships, any payments to retired partners or designees of deceased partners, made within 5 years after date of retirement or death, are in effect to be treated as a distribution of profits and the income tax would be paid by the recipient in each case at ordinary rates. Any payments made to the retired partners or designees of a deceased partner after 5 years would not be treated as a distribution

of profits and the active partners would pay income tax at ordinary rates on the entire profits of the partnership.

It may be seen in the case of T. H. Mastin & Co. that in the normal course of events the two youngest partners, of which I am one, will be the only surviving active partners of the firm. Due to the present respective interests of the partners, approximately 65 percent of the profits will, by contract, be distributed to retired partners and designees of the deceased partners after the death or retirement of the 2 oldest partners. This situation, of course, would be an impossible one for the two remaining active partners if section 736 in its present form were to become law. When the 5 years had elapsed after the death or retirement of the present oldest active partners, the 2 youngest partners would be in a position of paying income tax on 100 percent of the profits and making distribution to the retired partners and designees of deceased partners, according to contract, from what remained after taxes.

Based upon our recent experience, assuming the 2 youngest partners to be the surviving active partners, after paying taxes on 100 percent of the profits and making distributions to various retired partners and designees of deceased partners, according to contract, not only would we have nothing remaining for our services, but it would be necessary to go into debt to meet the contractual obligations to designees and others.

The CHAIRMAN. Mr. Stam, was that considered?

Mr. STAM. It is under consideration now, Senator. It is somewhat the same problem as the other witness presented, and it is being worked on, and we will do something about it.

Mr. WINSLOW. Shall I continue, sir?

The CHAIRMAN. Please do.

Mr. WINSLOW. If we were receiving something in return—inventory, machinery and equipment, valuable assets of any kind, there would at least be the justification of paying taxes on a capital investment. However, there is nothing which we can buy or nothing the retired or deceased partners can sell us. So, it might be seen that the present provision of section 736 means a hardship to the degree that it would put us out of business.

The CHAIRMAN. Supposing the old fellows outlive you younger fellows. Then what happens? Would they have to carry this burden?

Mr. WINSLOW. Yes, sir. If I should die, my designees are to receive a certain percentage for 21 years.

Even under present conditions, the situation would be next to impossible: 33 percent of the profits of the firm are being paid to retired partners and deceased partners' designees. If the present active partners were to pay income tax on 100 percent of the profits and make distributions according to contract, there would be little remaining for our services. It is impossible to change these existing agreements. There are a number of designees, many of whom I do not know. Naturally, neither they, nor the retired partners, would be willing to forego the money that they know legally belongs to them. It is my understanding that there are many other personal service partnerships in a similar position—those comprising lawyers, accountants, consulting engineers, and others of a like nature. Many of these organizations must be worried about this provision as it would undoubtedly

ruin them financially. If they are not worried they do not understand what may happen to them.

I wish to make this perfectly clear: I am not suggesting for a minute that the payment on account of deceased or retired partners should not be subject to a tax at ordinary rates. What I am suggesting is that the tax be paid by the person who gets the money, and not by the succeeding partners who make it and pay it to the designees and retired partners.

As the law is written, it apparently imposes a tax on one taxpayer with respect to income of another. It is evident from the report of the Ways and Means Committee that the House Committee did not intend section 736 to apply to a personal service partnership having no capital and owning no assets. Nobody is shooting at a partnership like ours, yet we are being hit. Our position is that income taxes should be paid, not by the remaining partners on moneys which, under the partnership contract, they do not own and never have owned, but should be paid by the people who get this money.

We respectfully request this committee to clarify section 736 to the end that in the case of personal service partnerships, with no capital and no assets, payments of future, unearned, contingent profits to retired partners and designees of deceased partners will be taxed at ordinary rates to the recipients as has been the case for many years. Otherwise, it would be impossible for our firm, which was organized in 1907, to continue business.

In order to clarify section 736, I suggest that after subsection (a) (2) there be added a new subsection numbered (a) (3). I will not take the time to read it. It is shown in my written statement. I also ask the privilege of submitting a substantiating statement for the record.

The CHAIRMAN. It will be done.

Mr. WINSLOW. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

(The statements referred to follow:)

STATEMENT OF ROBERT L. WINSLOW, JR. IN SUPPORT OF PROPOSED AMENDMENT TO SECTION 736 OF H. R. 8300

I am Robert L. Winslow, Jr., Kansas City, Mo. The purpose of my appearance here is to urge that section 736 of H. R. 8300 be clarified. I am not a lawyer. I am sure you have on your technical staff, experts who are fully qualified to deal with the legal aspects of this matter. I am here for the purpose of telling the committee how section 736 will affect me as a businessman.

I am a member of a partnership known as T. H. Mastin & Co., which operates and manages a casualty insurance carrier. The partnership agreement under which we operate was originated in 1913—long before income taxes were of any significance. Therefore, our partnership agreement cannot be considered in any sense a tax avoidance device. A provision in this partnership agreement provides that in the event of retirement or death of a partner, a portion of his interest in future, contingent profits of the firm is to be paid monthly to him or his designees in the event of death, for a period of 21 years. These amounts paid are not unrealized receivables at date of death or retirement. Rather, they are speculative, contingent, future profits payable only if and when earned. This partnership is a personal service partnership operating without assets or capital. All equipment, furniture, fixtures, premiums in course of collection, cash, and investments are the property of the insurance carrier. The very desks and pencils, etc., which we use are all the property of the insurance carrier.

The partnership of T. H. Mastin & Co. at this time, consists of four active partners, age 82, 67, 41, and 37, respectively. It will be noted that these partners fall in two age groups. My partner Henry Burr is 41. I am 37. Of our senior

partners, the youngest is 67. Payments to several designees of 3 deceased partners and to two retired partners are being made at the present time under the provisions of our partnership contract. It is my understanding, and I am informed by our counsel, that section 736 as it is now written provides that in the case of certain types of partnerships, any payments to retired partners or designees of deceased partners, made within 5 years after date of retirement or death are in effect to be treated as a distribution of profits and the income tax would be paid by the recipient in each case at ordinary rates. Any payments made to the retired partners or designees of a deceased partner after 5 years would not be treated as a distribution of profits and the active partners would pay income tax at ordinary rates on the entire profits of the partnership.

It may be seen in the case of T. H. Mastin & Co. that in the normal course of events the two youngest partners, of which I am one, will be the only surviving active partners of the firm. Due to the present repective interests of the partners, approximately 65 percent of the profits will, by contract, be distributed to retired partners and designees of the deceased partners after the death or retirement of the two oldest partners. This situation, of course, would be an impossible one for the two remaining active partners if section 736 in its present form were to become law. When the 5 years had elapsed after the death or retirement of the present oldest active partners, the two youngest partners would be in a position of paying income tax on 100 percent of the profits and making distribution to the retired partners and designees of deceased partners, according to contract, from what remained after taxes. Based upon our recent experience, assuming the two youngest partners to be the surviving active partners, after paying taxes on 100 percent of the profits and making distributions to various retired partners and designees of deceased partners, according to contract, not only would we have nothing remaining for our services, but it would be necessary to go into debt to meet the contractual obligations to designees and others. If we were receiving something in return—inventory, machinery, and equipment, valuable assets of any kind, there would at least be the justification of paying taxes on a capital investment. However, there is nothing which we can buy or nothing the retired or deceased partners can sell us. So, it might be seen that the present provision of section 736 means a hardship to the degree that it would put us out of business. Even under present conditions, the situation would be next to impossible. Thirty-three percent of the profits of the firm are being paid to retired partners and deceased partners' designees. If the present active partners were to pay income tax on 100 percent of the profits and make distributions according to contract, there would be little remaining for our services. It is impossible to change these existing agreements. There are a number of designees, many of whom I do not know. Naturally, neither they, nor the retired partners would be willing to forego the money that they know legally belongs to them. It is my understanding that there are many other personal service partnerships in a similar position—those comprising lawyers, accountants, consulting engineers and others of a like nature. Many of these organizations must be worried about this provision as it would undoubtedly ruin them financially. If they are not worried they do not understand what may happen to them.

I wish to make this perfectly clear: I am not suggesting for a minute that the payment on account of deceased or retired partners should not be subject to a tax at ordinary rates. What I am suggesting is that the tax be paid by the person who gets the money, and not by the succeeding partners who make it and pay it to the designees and retired partners. As the law is written, it apparently imposes a tax on one taxpayer with respect to income of another. It is evident from the report of the Ways and Means Committee that the House committee did not intend section 736 to apply to a personal service partnership having no capital and owning no assets. Nobody is shooting at a partnership like ours, yet we are being hit. Our position is that income taxes should be paid, not by the remaining partners on moneys which, under the partnership contract, they do not own and never have owned, but should be paid by the people who get this money.

We respectfully request this committee to clarify section 736 to the end that in the case of personal service partnerships, with no capital and no assets, payments of future, unearned, contingent profits to retired partners and designees of deceased partners will be taxed at ordinary rates to the recipients as has been the case for many years. Otherwise, it would be impossible for our firm, which was organized in 1907, to continue business.

In order to clairfy section 736, I suggest that after subsection (a) (2) there be added a new subsection numbered (a) (3), as follows:

"PAYMENTS OF PERSONAL SERVICE PARTNERSHIPS WHOSE ASSETS ARE NOT SIGNIFICANT AS COMPARED WITH INCOME

"In the case of the liquidation of the interest of a retired partner or a deceased partner of a personal service partnership whose assets are not significant as compared with income, the amount of income or other items of a partnership allocable to a retiring partner or a successor in interest of a deceased partner, shall be taxable to the recipient at ordinary rates."

I ask the privilege of submitting a substantiating statement for the record.

MEMORANDUM RE H. R. 8300

The following discussion relates to sections 736 and 751 (more particularly sec. 736) of H. R. 8300.

In reading these sections in the light of the report of the Committee on Ways and Means it is believed—

(1) That these sections do not apply to a personal service partnership having no capital and owning no assets; that, if so, then in the interest of clarification, subparagraph (B) of paragraph (1) of (a) of section 736 should be amended with the prefatory words, "Except as to personal service partnerships having no capital and owning no assets," so that such paragraph (B) shall read:

"Except as to personal service partnerships havings no capital and owning no assets, with respect to payments made more than 5 years after the partner's retirement or death, be included in the distributive share of the remaining partners (without increasing the adjusted basis of their interest in the partnership) and excluded from the gross income of the recipient."

(2) In the event that the foregoing sections, and particularly section 736, should be considered to include personal service partnerships having no capital and owning no assets, then and in that event, in order to recognize the realities in connection with such partnership and the well established law of the country, said paragraph (B) heretofore referred to should be amended as above set out.

In reading sections 736 and 751 in the light of the report of the Committee on Ways and Means, it is apparent that, inherent in these sections is contemplated a partnership possessing capital or assets, or both. The discussion of the intent of the Ways and Means Committee with respect to the foregoing begins on page 70 of the report of that committee. It is stated on page 70: "* * * and at the same time to prevent the use of the sale of an interest in a partnership as a device for converting rights to income into capital gain."

As appears clearly from a reading of pages 70, 71, and 72 of the report, this basic purpose was to be accomplished by treating certain enumerated types of income separately insofar as taxes are concerned, from the sale of a retired or deceased partner's interest in the partnership. This is made apparent in paragraph (B) above referred to of (a), section 736, by the words in parenthesis, "(without increasing the adjusted basis of their interest (of remaining partners) in the partnership)."

In paragraph (1) on page 70 of the report, the committee states:

"Under present decisions the sale of a partnership interest is generally considered to be a sale of a capital asset, and any gain or loss realized is treated as capital gain or loss. It is not clear whether the sale of an interest whose value is attributable to uncollected rights to income gives rise to capital gain or ordinary income."

Basically, it is apparent that the committee was considering the item of "uncollected rights to income". The committee made it clear by this expression that it had reference (par. (2), p. 70 of the report) to unrealized receivables or fees, and/or substantially appreciated or depreciated inventory or stock in trade.

In the third paragraph on page 71 of the report, in referring to "unrealized receivables or fees", the committee stated:

"The provision is applicable mainly to cash basis partnerships which have acquired a contractual or other legal right to income for goods or services."

Obviously, since the committee uses as a basis of its considerations under paragraph (1), page 70 of the report, "uncollected rights to income," and the right of the partnership which represented a contractual or other legal right to income for goods or services, it meant at the retirement or death of a partner

where goods had been sold, but not paid for, and the consideration was represented by an unrealized receivable or the services had been rendered but the fee not paid at the time of retirement or death, these, along with defined appreciated or depreciated inventory or stock in trade, as referred to in paragraph third on page 71, constituted the basis of section 736 of H. R. 8300.

Here is a statement by the committee of its intent with respect to section 736 that what it was dealing with in this section of H. R. 8300 was certain things, and only these things, exclusive of actual purchase and sale of retired or deceased partner's interest in the partnership, and these things consisted of appreciated or depreciated inventory or stock in trade, and unrealized receivables and unrealized fees. All of these things were predicated upon an existing condition at the time of retirement or the death of a partner.

In the second paragraph on page 71 of the committee's report, it states: "A decedent partner's share of unrealized receivables and fees will be treated as income in respect of a decedent."

That is, in the case of a retired or deceased partner, if goods had been sold and there existed at the time an unrealized receivable, or if services had been rendered at the time but there existed in payment therefor an unrealized fee, that for 5 years, under subparagraph (A) of paragraph (1) of (a), section 736, the payments when received for a period of 5 years would be treated as income to the recipients, but after 5 years these limited sources of income as enumerated above would no longer be taxable to the recipients under ordinary income tax rates, but would be taxable to the remaining partners without the right of deduction as to amounts paid to the designees of a deceased partner or to a retired partner. This is made again manifest by (E) at the bottom of page 71 of the report, in which it is stated, in referring to section 736: "When a partner retires or payments are made to the estate or heir of a deceased partner, the amounts paid may represent several items. They may, in part, represent the withdrawing partner's capital interest in the partnership; they may include his pro rata interest in unrealized receivables and fees of the partnership and its potential gain or loss on inventory."

Again, on page 72 of the report, among other things, the committee stated: "For this purpose payments for a 'capital interest' do not include amounts attributable to a partner's interest in unrealized receivables and fees, amounts paid for substantial appreciated or depreciated inventory, and amounts paid for goodwill in excess of its fair market value."

The committee further states: "A different treatment is provided for the portion of payments to a withdrawing partner which is not made in exchange for capital interest of such partner. Such payments are treated as distributive share of partnership income to the withdrawing partner. Thus, they are taxable to the withdrawing partner in the same manner as if he continued to be a partner and are excluded in determining the income of the remaining partners."

This is, under the bill, permitted for a period of 5 years, and thereafter the remaining partners, without a purchase or sale, are taxed at ordinary income-tax rates, and without the right of deduction with respect to such unrealized receivables and fees and appreciated or depreciated inventory or stock in trade.

Section 736, undoubtedly, recognizes the rule that the property, of whatever character, which becomes part of the estate of a deceased for estate-tax purposes, is property owned by the deceased at the time of his death. Manifestly, this section recognizes the contractual ownership of a deceased partner in unrealized receivables and unrealized fees and appreciated or depreciated inventory or stock in trade at the time of death, and that, therefore, these items would become a part of the estate of the deceased and would be subject to estate tax. In other words, this section is dealing with items that are owned, or in which the deceased partner has a contractual right at the time of his death. All of this becomes clear in the statement of the committee, second paragraph, page 71: "A decedent partner's share of unrealized receivables and fees will be treated as income in respect of a decedent. Such rights to income will be taxed to the estate or heirs when collected, with an appropriate adjustment for estate taxes."

Thus, it is apparent that the plain intent of the committee was to deal with a partnership having capital or assets, or both, and that the intent was to separate specifically unrealized receivables and unrealized fees, as defined above, and appreciated or depreciated inventory or stock in trade, from the assets of the partnership, which would be the subject of a purchase and sale.

This memorandum, however, deals, not with a partnership possessing capital or assets, or both, but only with a personal service partnership that possesses neither capital nor assets. With respect to unrealized receivables or fees, in

the absence of subparagraph (A) of paragraph (1) of (a), section 736, such items would be treated as part of the assets of the partnership and would be the subject of purchase and sale. Subparagraph (A) changes the situation for a period of 5 years. This memorandum, however, treats only with distributions from a personal service partnership having neither capital nor assets, of future unearned contingent profits, which would eventuate, if ever, following the retirement or death of a partner. They would have no relationship to a transaction that occurred prior to the retirement or the death of a partner. They would not constitute, under the definition and discussion of the committee, unrealized receivables or fees, and, naturally, could not refer to appreciation or depreciation of inventory or stock in trade, since such a partnership would have no inventory or stock in trade.

Clearly, if personal service partnerships, having no capital and owning no assets, were covered by section 736 and section 751, there would be a plain discrimination between such partnerships and those having capital and assets, because, in the case of the latter, the partnership agreement could provide for the payments of unrealized receivables and unrealized fees and appreciated and nonappreciated inventory or stock in trade, for a period of 5 years with the right of the remaining partners to deduct from the income of the partnership arising from such sources, amounts paid to the recipients, and then provide, at the end of 5 years, a purchase and sale of the retired or deceased partner's interest. Thus, after 5 years, where the remaining partners could not deduct payments to the retired partner or deceased partner's estate, they would, in turn, get the assets that belonged to the retired or deceased partner, whereas, with respect to a personal service partnership, without capital or assets, there could be no sale, since there is nothing to sell and the remaining partners would pay income taxes at ordinary income-tax rates on future contingent unearned profits for the period of the agreement. Manifestly, this would be not only unsound but very unfair.

The purpose of this memorandum is neither to evade nor avoid taxes. Its purpose is solely, with respect to any payments of future possible contingent profits earned, if ever, after the retirement or death of a partner by a personal service partnership having no capital nor assets, to establish that, under those circumstances, income tax at ordinary income-tax rates should be paid by the recipients of such future contingent profits, and not by the remaining active partners.

This is in line with the realities with respect to such a partnership and according to the well-established law of this country for the following reasons:

In the case of a personal service partnership having neither capital nor assets, there can be:

(1) No sale of the interest of a partner in a personal service partnership, having neither capital nor assets.

Bull v. *United States*, 295 U. S. 247, 79 L. Ed. 1421, 1426.
Whitworth v. *Commissioner*, 204 Fed. (2d) 779, 783 (C. C. A. 7th), Cert. denied, 98 L. Ed. 64.
Boyd C. Taylor Estate, 17 T. C. 627, Decision 18,560. Affirmed, 200 Fed. (2d) 561 (C. C. A. 6th), (on authority of *Bull* v. *U. S. supra*).

(2) Future unearned speculative profits are wholly contingent and cannot be income or property at time of death or retirement.

United States v. *Safety Car Heating and L. Co.*, 297 U. S. 88, 80 L. Ed. 500, 504, 507.
North American Oil Consolidated v. *Burnet*, 286 U. S. 417, 76 L. Ed. 1197, 1200.
Workman v. *Commissioner*, 41 Fed. (2d) 139, 140, 141. (C. C. A. 7th).
Carol F. Hall, et al. v. *Commissioner*, 19 T. C. 445, Decision 19346. Promulgated December 11, 1952.
Commissioner v. *Oates*, 207 Fed. (2d) 711, (C. C. A. 7th), affirming 18 T. C. 570.
Commissioner v. *Edwards Drilling Co.*, 95 Fed. (2d) 719, 720, (C. C. A. 5th).

(3) No goodwill attaches to the person of a partner in a personal service partnership.

M. M. Gordon, et al. v. *Commissioner*, 9 T. C. 203. Decision 17,547 (M). Entered March 14, 1950.
The Danco Co., 14 T. C. 276, Decision 17,503.
John Q. Srunk v. *Commissioner*, 10 T. C. 293, Decision 16,253.
Providence Mill Supply Co. 2 B. T. A. 791, 793.
Northwestern Steel and Iron Corp. 6 B. T. A. 119, 124.

(4) To include such partnerships in the proposed sections would violate the "claim of right" doctrine.
North American Oil Consolidated v. *Burnet*, 286 U. S. 417, 424, 76 L. Ed. 1197, 1200.
Commissioner v. *Wilcox*, 327 U. S. 404, 408; 90 L. Ed. 752, 755.
In re Lashells' Estate, 208 Fed. (2d) 430, 435. (C. C. A. 6th). December 4, 1953.
(5) The contingent right to future contingent income or profits is not a capital asset. (See cases under point (2) supra.)
It is apparent from the foregoing that if personal service partnerships having no capital or owning no assets should not be covered by sections 736 and 751, that to prevent misunderstanding and confusion, the amended paragraph (B) as set out on page 1 hereof should be adopted.
Respectfully submitted.

HOWELL, JACOBS & HOWELL.

KANSAS CITY, MO.

The CHAIRMAN. Mr. Vander Ark. Sit down and be comfortable and identify yourself to the reporter.

STATEMENT OF JOHN A. VANDER ARK, MANAGING DIRECTOR, NATIONAL UNION OF CHRISTIAN SCHOOLS

Mr. VANDER ARK. Mr. Chairman, my name is John Vander Ark. I am managing director of the National Union of Christian Schools with headquarters in Grand Rapids, Mich. I shall hereafter refer to the organization which I represent as "The National Union."

The National Union is a union of educational organizations in 21 States of the United States, which are corporations organized and operated exclusively for educational purposes within the definition of section 101 (6) of the Internal Revenue Code. Contributions to these organizations and to the National Union itself are deductible under sections 23 (O) and (Q). None of the organizations is endowed.

The constituency of the school organizations which form the National Union are primarily members of the Christian Reformed Church in America, although members of other Reformed and Presbyterian groups are among its supporters. The avowed purpose of our member societies is to set up and operate primary and secondary day schools which integrate the principles of the Reformed faith with the curricula in the respective schools.

While the Christian Reformed Church, as a denomination, is committed to the principle underlying these Christian schools and does give it moral and financial support, the church itself does not own, operate or control them.

Now, the rationale for this distinction between the church and school has philosophical and theological implications, which are not pertinent to this summary. We emphasize this distinction for it has an important bearing upon the problem which we are presenting for your consideration. This separation of church and school requires the setting up of separate organizations comprised of church members who subscribe to this principle.

The National Union expresses its hearty approval of section 170 of H. R. 8300, which increases the charitable contribution limit for individuals from 20 percent to 30 percent, the additional 10 percent to be allowed with respect to contributions to educational institutions, and so forth.

We are also in hearty agreement with the reasons for this change, as stated in the report of the Ways and Means, namely, that "this

amendment is designed to aid these institutions in obtaining the additional funds they need, in view of their rising costs. * * *"

We feel, however, that the full effect and benefit of this amended provision will not be realized by the contributors to National Union schools unless and until the definition of "contribution" is broadened to include amounts contributed by parent members which are now designated as "tuition" payments or are determined to be such by the Internal Revenue Service.

Just for interpretation, the visible means of support of these Christian schools comes from tuition, church offerings and individual gifts.

Now, the National Union urges your committee to give consideration to this change in the Internal Revenue Code for the following reasons:

1. There is no standard by which tuition in our schools can be determined with any degree of uniformity. In some schools it may cover 50 percent of the operating costs; in others a somewhat higher percentage. On the other hand, some of our schools have no designated tuition rates at all but rely solely on pledges from supporters, parents, and nonparents alike. In some cases, where the support comes from the members of a single church in the area, the entire operating cost of the school may be raised by freewill offerings designated for the school.

You may ask why tuition? Our second reason:

2. Where tuition systems are in effect, they are designed primarily as a guaranty to the school board of some measure of regular income. In case of inability to pay the stated amounts, parents pay what they can and the slack is taken up by other supporters or by the churches as a benevolence project. Pupils are not barred because of the nonpayment of tuition.

3. Tuition rates are, in effect, suggested minimum contributions for parents. In other words, they are not so much assessments as suggested payments. Human nature being what it is, without some measure of guidance, some parents might be inclined to shirk their responsibilities.

4. Taxes for the support of public schools are deductible from taxable income of parents and nonparents alike. The tuition payments made by parent supporters of Christian schools, the establishment of which relieves the community of part of its tax burden, are not deductible. Christian school supporters pay both taxes for the support of public schools and tuition for the support of their own schools. And, I may add that our parents pay their taxes for the support of public schools willingly. Both payments are, essentially, for the same purpose, yet are treated differently under the tax law.

5. Here we are very much in common with other church groups that operate their parochial schools, but the problem is that contributions by Catholic and Lutheran parents, for example, for the operation of parochial schools which are owned, operated, and controlled by the church, are made to the one integrated church organization. Any attempt at a segregation or determination of the amount of such contributions which could be deemed to constitute tuition would be an extremely difficult if not impossible administrative task for the Internal Revenue Service. Nonparochial Christian schools, such as those in the National Union, should not be placed at a disadvantage

merely because of their independent corporate structure and their pattern of financial operation.

6. Tuition payments to so-called private schools are to be distinguished from payments to the type of schools represented in the National Union. The latter payments of tuition are, in effect, contributions to support a movement endorsed and strongly advocated by a church body. Tuition payments for a private school—and I mean strictly a private school—are to cover the cost of an education designed for personal advantages. A parent elects to send his child if he can afford it. The question of religious conviction is not involved.

I would like to make a comment on section 151. The National Union also wishes to take cognizance of the provisions in H. R. 8300, namely section 151, which broadens the earnings test for dependents. This amendment admittedly affords some tax relief to parent taxpayers in the case of dependents who are college students, as tuition payments will constitute a substantial factor in determining the degree of their support. Our problem, however, lies below that level, primarily in the area of grammar and high school pupils where the economic factors weigh even heavier.

The fact that the Ways and Means Committee deemed it equitable to include in H. R. 8300 both sections 151 and 170 is a gratifying indication of the concern of Congress with the problem of educational expenses of taxpayers.

We appreciate the opportunity of presenting our problem to you. We trust that it may receive your serious consideration and that steps will be taken to remove what we consider to be an inequity to the constituency of our nonparochial Christian school system in America. We feel that this can be accomplished by a simple amendment of the definition of "contribution," to include the amount paid by parent members of the nonparochial Christian schools.

Thank you.

The CHAIRMAN. Thank you very much. We are glad to have you.

Thomas J. White. Sit down and be comfortable, Mr. White and identify yourself to the reporter.

STATEMENT OF THOMAS J. WHITE, ATTORNEY, REPRESENTING THE COMMISSION OF PUBLIC DOCKS OF THE CITY OF PORTLAND, OREG., THE PORT OF ASTORIA, OREG., THE OREGON STATE PUBLIC PORT AUTHORITIES ASSOCIATION, AND THE PORT OF NEW YORK AUTHORITY

Mr. WHITE. Mr. Chairman, my name is Thomas J. White. I am an attorney from Portland, Oreg., representing the Commission of Public Docks of the City of Portland and Ports of Astoria, Longview and Vancouver, Wash., the United States members of the Pacific Coast Public Port Authorities, which consists of the principal public ports of California, Oregon, and Washington.

In the interests of time of the committee, I am also here representing the Port of New York Authority, the Airport Operators Council, which operates the principal airports of this country, and the American Association of Port Authorities, which represents the principal public ports of this country.

Both the airports and the public ports administer assets totaling many billions of dollars. Seated with me is Mr. Daniel Goldberg, assistant general counsel of the Port of New Your Authority.

We are appearing here, asking the committee to delete section 274 of H. R. 8300. This section, which is very brief, provides that no deduction shall be allowed for amounts paid or accrued to a State or any political subdivision for the use or occupancy of the property acquired or improved out of the proceeds of any industrial development revenue bonds.

Then there is a definition under that subsection, which defines industrial development revenue bonds. It states that these are, when they are issued, to finance the acquisition or improvement of real property which is to be used to any substantial extent by nonpublic lessees for manufacturing articles.

Mr. Chairman, the effect of that section would disallow, as the deductible business expense, rentals paid by an industry, manufacturing lessee, to a municipality, which issues revenue bonds as a method of financing used extensively by the public ports and airports of this country, and its future use is even more encouraging.

There are four main points in our objection, and I might say, Mr. Chairman, I am also speaking for Mr. Tobin of the New York Port Authority, who is the following witness, and covering orally the remarks in a statement previously submitted to this committee.

There is nothing in this legislation which would protect or which would tend to limit it to the relocation of industry. The ostensible reason for this legislation was to prevent the alleged rating of industries from New England States to the Southern States. The public ports and airports seem to be caught in the middle. However, this legislation also applies to the establishment of new industry, or the improvement of existing facilities.

My second point, and which is highly important to the public ports and airports, is that there is no definition contained in the law as to what a manufactured article means. This becomes quite important, because in the House report issued it is stated:

> The term "manufactured articles" is used in a broad sense and includes processing and related activities, such as canning, tanning, and so forth, the result of which is to make available for sale an article or product.

I have researched the question and definition of the term "manufactured articles" which I have included in my written statement. There has been actual litigation in the courts of our country over such terms as to whether or not taking ice from a river and storing the same for sale is manufacture; blending and packaging tea, blending and packaging coffee; treating oranges to avoid blue mold, and sorting, processing, and treating redried tobacco; storing and sorting and packing apples; finishing rough lumber and shelling and sorting peanuts.

Some of these have been classified by the courts as being within the terminology of "manufacturing" or "manufacturing articles." When you are issuing revenue bonds, there can be no doubt as to whether or not these articles come within the term of "manfactured" or whether or not the facility which the tenant tends to lease would be a manufacturing facility.

To show the committee that this is no problematical or theoretical problem, the city of Portland, Oreg., has stopped right now, just on the threat of this litigation, the addition of a large grain storage facility to its existing grain terminal. This storage would comprise 6,500,000 bushels, which, added to the existing facility, would make it the largest watertight grain terminal on the Pacific coast.

And I would like to read for the record the essence of a letter from one of our distinguished and largest law firms in Portland, representing the 10. These negotiations have already been concluded prior to the introduction of this evidence. This letter is addressed to myself, as counsel for the Commission of Public Docks:

> Reference is made to the proposed lease from the city of Portland, Oreg., acting by and through its the Commission of Public Docks, to our client Kerr Gifford & Co., Inc., covering the present grain elevator and storage bins located at Municipal Terminal No. 4, Portland, Oreg., together with additional grain elevators at this terminal which are to be constructed as an annex thereto.
>
> We have given careful consideration to the provisions of section 274 of H. R. 8300. If this section or a section of substantially the same import should become a part of United States Revenue Code of 1954, we will be constrained to advise our client that it would be placed in an intolerable situation if it consummated the proposed lease, and we must recommend that it must not do so.

The CHAIRMAN. What are the terms of that lease?

Mr. WHITE. The terms of that lease——

The CHAIRMAN. I mean as far as taxes are concerned.

Mr. WHITE. As far as taxes are concerned?

The CHAIRMAN. Yes.

Mr. WHITE. The taxes are included in the rental. In other words, the commissioner of public docks for the city of Portland charges a rental to this form, which allows and includes an estimated amount for taxes.

The CHAIRMAN. Who pays the taxes?

Mr. WHITE. There are no taxes on municipal port properties any place on the Pacific coast that I know of, and I believe that is generally true.

The CHAIRMAN. Is your point to protect the exemption of the tax?

Mr. WHITE. No, sir. Our point is to find desirable tenants to lease facilities, such as grain elevators, and induce them to enter into long-term leases which will retire or amortize the facility.

The CHAIRMAN. I understand that, but what is the tax angle that you are trying to protect?

Mr. WHITE. Sir, there is no tax angle. Obviously, one of the advantages in doing that—and while we are able to in Portland, as in Seattle and San Francisco, get these grain elevators to attract the grain from the hinterlands, that is a definite advantage. That is one of the reasons why the public builds them. They feel it is an advantage to them.

The CHAIRMAN. I don't believe I made myself clear. Why is your problem of interest to this committee?

Mr. WHITE. Beg pardon, sir?

The CHAIRMAN. Why is your problem of interest to this committee? There must be a tax angle or you wouldn't be here.

Mr. WHITE. No, sir. The reason we are here, we are just giving the committee a particular point, and it affects all other ports. We cannot find a tenant who will enter into a long-term lease if his lease money that he pays to the municipality is not deductible——

The CHAIRMAN. That is a tax angle, isn't it?

Mr. WHITE. Yes, sir. Excuse me. I thought you meant a tax on the facility itself. No; obviously, the point, as I opened my statement, was that the effect of this is to refuse to allow the rental payments to be tax deductible. The airports in Seattle, Wash., and Denver, Colo., have similar problems in negotiations concerning the building of facilities there and leasing them out.

The third point is that the purpose of this legislation, as I explained, was to stop this rating of industry from the North to the South. It doesn't, however, accomplish that. It encourages the use of general obligation bonds. In a survey made by the Port of New York Authority, it was found that all that we are talking about—the purpose of this legislation—is about $3 million worth of revenue bonds issued by certain southern communities. There was approximately about eight issues—and there is a much larger sum in which they have done the same thing—in which they issued general obligation bonds. In other words, it puts a penalty on revenue bonds. It is just as simple, if the facility can't sustain itself and pay its way out by revenue bonds, then it goes to general obligation bonds, in which many more in dollar amounts have been issued for this purpose.

The legislation doesn't accomplish, as a result of our survey, the purpose for which it was intended.

Now, the fourth and last point——

The CHAIRMAN. How do you feel about that, Mr. Stam?

Mr. STAM. I think the committee over there, when they considered this problem, felt if they extended it to the general bonds of the State, there would be some question about the thing actually being bonds of the State. I mean where the State is willing to assume full faith and credit for the bonds, it was pretty close to a State obligation.

The CHAIRMAN. Yes.

Mr. STAM. But where they didn't assume the full faith and credit of the so-called revenue bonds, which was dependent entirely upon whether the operation was producing revenue, they felt they could reach that without raising any constitutional question. That is the reason they limited it that way.

Mr. WHITE. The fourth point, Mr. Chairman—and we feel this is quite important and perhaps the major thing—is that affects the basic philosophy of our Government. That is Federal and State rights. We may not, any of us, agree with the policy of municipalities in attracting industry from other sections of the country, but it is our contention that the Federal Government should not step in and through a device of eliminating the tax deductions, take away that power of the State to determine what they will do to attract industry.

In other words, we might condemn that practice, but I think we should defend the right of the State to do as it chooses.

The CHAIRMAN. We also must defend our Federal revenues. That is our job.

Mr. WHITE. There is no revenue involved here.

The CHAIRMAN. You have a tax exemption.

Mr. WHITE. Of course the answer is as far as the public ports and airports, there is not going to be any lease available. There will be no financing for additional facilities. And, as I gave an example earlier, a large grain elevator in Portland, Oreg., is stopped right now

because of that reason. So there wouldn't be any tax revenues, because you can't get a company to enter into a lease with this provision here. The very threat of it has stopped our elevator in Portland, Oreg.

The CHAIRMAN. Your elevator depends upon the tax exemptions?

Mr. WHITE. That is right.

The CHAIRMAN. And that is what you are trying to protect, and it is the business of this committee to protect the revenues. The more exemptions we give, the less we protect the revenues.

I have no opinion on this. I am just trying to get at what the meat of it is.

Mr. WHITE. Yes, sir. Mr. Chairman, may I say it is not a tax exemption. It is tax allowance as a business expense.

The CHAIRMAN. It all comes to the same thing: less taxes.

Mr. WHITE. If this grain company out in Portland, Oreg., rented this facility from the Prudential Life Insurance Co., it could deduct its rental payments as a business expense. Under this provision, if it rents it from a port, it cannot. We claim that is discrimination. It deducts its office rent that it pays as a business expense, but it cannot under this legislation deduct the rental it pays for our municipal elevator there.

Thank you very much, Mr. Chairman.

The CHAIRMAN. You are welcome, indeed. We are glad to have you here.

(The statements of Mr. White and Mr. Tobin follow:)

STATEMENT OF THOMAS J. WHITE, ATTORNEY, REPRESENTING THE COMMISSION OF PUBLIC DOCKS OF THE CITY OF PORTLAND, OREG., THE PORT OF ASTORIA, OREG., THE OREGON STATE PUBLIC PORT AUTHORITIES ASSOCIATION, THE PORT OF VANCOUVER, WASH., THE PORT OF LONGVIEW, WASH., AND THE UNITED STATES MEMBERS OF THE PACIFIC COAST ASSOCIATION OF PORT AUTHORITIES, WITH RESPECT TO CLARIFICATION OF THE DEFINITION OF "MANUFACTURING ARTICLES" AS USED IN SUBSECTION (B) OF SECTION 274, H. R. 8300

H. R. 8300 has passed the House of Representatives and is now before this committee for consideration.

Section 274 of the bill provides as follows:

"(a) GENERAL RULE. No deduction shall be allowed for amounts paid or accrued to a State, a Territory, a possession of the United States or any political subdivision of any of the foregoing or the District of Columbia for the use or occupancy of property acquired or improved out of the proceeds of any industrial developments revenue bonds authorized after February 8, 1954.

"(b) DEFINITION. For purposes of subsection (a) the term "industrial development revenue bond" means any obligation—

"(1) Issued (whether before or after the acquisition or improvement of the property concerned) to finance the acquisition or improvement of real property which is to be used to any substantial extent by nonpublic lessees for manufacturing articles; and

"(2) Which does not pledge the full faith and credit of the issuing authority for the payment of interest and principal."

Chapter 1 (B) IX of the portion of House Report No. 1337 entitled, "Detailed Discussion of the Technical Provisions of the Bill," discusses the purpose and legislative intent of section 274 in the following language which is set forth below to show its broad, inclusive scope:

"This is a new section which disallows as a deduction any amounts paid or accrued to a State, Territory, possession of the United States, or a political subdivision thereof, or the District of Columbia, as payments for the use or occupancy of property acquired or improved by such State or Territory with the proceeds of any industrial development revenue bond.

"The bonds covered by this section are any obligations issued to finance the acquisition or improvement of real property which is to be used to any substantial extent by nonpublic lessees for manufacturing articles and which do

not pledge the full faith and credit of the issuing authority for the payment of interest and principal. The term "manufacturing articles" is used in a broad sense and includes processing and related activities, such as canning, tanning, etc., the result of which is to make available for sale an article or product. A public utility producing electricity or gas would not be "manufacturing articles." Obligations issued for the acquisition or improvement of real property used principally for recognized governmental purposes shall not be considered industrial development revenue bonds even though a minor portion of the property may be availed of for manufacturing purposes incidental to the primary activity for which the entire property is used. The prohibition of the section will apply whether such bonds are issued before or after the acquisition or improvement of the property with respect to which rental payments are made.

"The section applies only to rental payments paid or accrued on property acquired or improved with the proceeds of any bonds issued after February 8, 1954."

Initially, the House Committee on Ways and Means had proposed to remove the tax exemption from "Interest received from so-called industrial development bonds of State and local government units." [1]

Following a wave of protests from State and local officials this proposal was discarded but in its place now stands the above proposed section 274 which in effect would disallow as a deductible business expense, rentals paid by an industrial lessee to a municipality which issues revenue bonds.[2]

There appears no doubt that this provision was and is aimed directly at the very prevalent practice of a number of southern communities in issuing revenue bonds to finance the construction or acquisition of properties upon which are then erected industrial plants. The public ports, which use revenue bond financing in accomplishing public purposes for which they were created, appear to be caught in the middle.

Section 274 of H. R. 8300 would of course effectively prohibit such arrangements by the simple expedient of disallowing as a business expense the rental payments to be paid by the lessee.

The principal direct concern of the organizations which I represent, all of whom are public agencies, is directed at the definition of "manufacturing articles." It would, however, be timely to point out that there is a strong feeling that the proposed section 274 is but the first step in an effort to tax the interest from all municipal obligations. The fact that section 274 is directed only at revenue bonds is small comfort to municipal corporations, first, because in many instances it is far easier and more practical to issue revenue bonds for public financing, if there is a market for them, than to issue general obligation bonds; and second, because there is no assurance whatsoever that Congress would not in the future disallow rental payments paid under general obligation bond issues as well.

The practical effect of section 274 cannot be ignored. A private concern proposing to lease facilities of any particular nature from a municipality would certainly be hesitant to enter into such an arrangement and would undoubtedly abandon the project altogether if there appeared any possibility that its rental payments would not be deductible as business expenses. In any event the private concern would certainly insist upon lower rentals to offset this possibility. This would result in lowering the rent income of the municipality so that the net income of the municipality from that particular operation would be reduced or completely wiped out.

Obviously, then, with respect to any revenue bond issue the problem reduces itself to ascertaining when the real property is to be used by the private concern for "manufacturing articles." Unfortunately, this term is as broad as it is long and so has resulted in great alarm among public ports. The report of the House Committee on Ways and Means in which it was stated, "The term 'manufacturing articles' is used in a broad sense and includes processing and related activities, such as canning, tanning, etc., the result of which is to make available for sale an article or product," has served to intensify this alarm.

Even with this indication of the interpretation of the term "manufacturing articles," it would be next to impossible to predict the ruling of a court as to

[1] Committee announcement, January 20, 1954.
[2] Press release issued by Representative Daniel A. Reed, chairman, House Ways and Means Committee, on February 9, 1954.

whether or not any particular program of a municipality would be affected by section 274, on the grounds that the private lessee was engaged in "manufacturing articles."

A short, concise statement of the law on this point would be illustrative. Although the term involved here has probably never been used in any statute of similar context, "article of manufacture" is a term often used in patent statutes and the term "manufacture" has been used in safety regulations, personal property tax statutes, and Interstate Commerce Commission regulations, and the decisions of the courts in this respect would probably be persuasive to say the least.

For example, the courts have ruled that none of the following constitutes "manufacturing": [3]

Taking ice from a river and storing the same for sale; blending and packaging tea; and roasting, blending, and packaging coffee; cleaning and bagging wheat; treating oranges to avoid blue mold; and sorting, processing, and treating redried tobacco.

On the other hand, the courts have ruled that the following do constitute "manufacturing": [4]

Storing, sorting, and packing apples; finishing rough lumber and shelling and sorting peanuts.

Unfortunately, when the courts themselves are not in agreement, it could not be expected that a private lessee would be willing to risk a long-term lease involving tax considerations of such magnitude.

The organizations which I represent here are all public bodies and fall under the broad category of "municipal corporations." Almost without exception, substantial portions of their activities consist of the erection of wharf, terminal, and various specialized harbor facilities, many of which are either leased to or used by private concerns.

This is particularly true on the west coast of a harbor facility such as a grain elevator, which this new proposed legislation has already affected. Notwithstanding ambitious expansion programs on the part of many of these ports, the tremendous wheat harvests of recent years have precipitated a drastic shortage of storage and terminal space. In this connection, it should be recognized that municipalities simply cannot operate the grain elevators which are so necessary to their economy, as the grain business is international in scope and requires worldwide commercial connections and extensive credit quite beyond the capability or legal power of most municipal corporations. So the elevators owned by the municipalities are leased to private grain concerns under long-term leasing arrangements that afford a reasonable return to the port and permit the private operators to make a profit. (This is true of all of the many public grain elevators owned by the ports of the Pacific coast.) Grain is not only stored in the tidewater elevators but is sorted by grade, blended, washed, purified, and in some instances sacked. The question immediately arises as to whether or not an operation such as this results in "manufacturing articles."

This concern is not merely theoretical or speculative. The effect of this proposed legislation has now effectively halted an important maritime facility on the Pacific coast. The city of Portland, Oreg., has owned a tidewater grain elevator to serve the farmers of its hinterland for over 30 years. Desiring to modernize and enlarge the same, an agreement to enter into a new lease with the present tenant was made, the rentals therefrom designed to provide the basis for the issuance and retirement of revenue bonds. After public hearings and with widespread public approval, this project (which would result in the largest tidewater grain facility on the Pacific coast), was publicly announced. Today, because of the threat implicit in this legislation, the entire project is being held up.

This problem is not limited solely to grain elevators. Ports carry on many other endeavors which would or could be affected by this legislation, such as the operation by private concerns of publicly owned bulk handling facilities and wharf properties, where such activities as sorting, grading, storing, bagging,

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[3] *People v. Knickerbocker Ice Co.* (99 N. Y. 181, 1 N. E. 669 (1885)); *People ex rel. Union Pacific Tea Co. v. Roberts* (145 N. Y. 375, 40 N. E. 7 (1895)); *Frasee v. Moffitt* (18 Fed. 584 (1872)); *Fruit Growers, Inc., v. Brodgex Co.* (283 U. S. 1, 51 Sup. Ct. 328, 75 L. Ed. 801 (1931)); and *Interstate Commerce Commission v. Yeary Transfer Co., Inc.* (104 F. Supp. 245, affirmed 202 F. (2d) 151 (1953)).

[4] *Red Hook Cold Storage Co. v. Department of Labor of New York* (295 N. Y. 1, 64 N. E. (2d) 265, 163 A. L. R. 439 (1945)); *Stearns Coal & Lumber Co. v. Thomas* (295 Ky. 808, 175 S. W. (2d) 505); and *Interstate Commerce Commission v. Weldon* (90 F. Supp. 873, affirmed, 188 F. (2d) 367, certiorari denied, 342 U. S. 827, 96 L. Ed. 625, 7 Sup. Ct. 50 (1950)).

strapping, coopering, and assembly are carried on every day. It is quite conceivable that the proposed legislation could be interpreted to directly affect these and other similar activities.

The end result of section 274, if it is allowed to stand or without appropriate amendment, would be to effectively prohibit a substantial part of all revenue bond financing by public ports, simply because private concerns would be afraid to enter into long-term leases if section 274 could possibly be applied to them.

It is respectfully urged that this committee give the matter serious consideration to the end that section 274 be stricken from H. R. 8300, or as an alternative that the committee give due consideration to amending the section to exempt public port bodies from its provisions when carrying out the purposes for which they were created.

THOMAS J. WHITE,
Attorney at Law.

PORTLAND, OREG.

STATEMENT OF AUSTIN J. TOBIN ON SECTION 274 OF H. R. 8300, REPRESENTING THE PORT OF NEW YORK AUTHORITY, AIRPORT OPERATORS COUNCIL, THE AMERICAN ASSOCIATION OF PORT AUTHORITIES

I appear in opposition to section 274 of H. R. 8300 which would prevent the States and municipalities from using their revenue bonds, without a pledge of their full faith and credit, to acquire or improve property to be leased to private persons for manufacturing purposes.

I am the executive director of the Port of New York Authority, a bistate governmental agency of New York and New Jersey, concerned with the construction and operation of bridges, tunnels, airports, bus, truck, marine and other terminal and transportation facilities, and the development of the commerce of the port of New York. I appear on behalf of the Port of New York Authority and on behalf of the Airport Operators Council which includes the major State and municipal airport operators of the country, and also on behalf of the American Association of Port Authorities which includes all major public port operators. I also appear as an individual who is deeply concerned that the balance between our State and Federal Governments should be preserved and that the States be not destroyed as independent units of Government by Federal control of their finances.

I should say at once that the Port of New York Authority is not directly affected by this proposal although it condemns the section's purpose, philosophy, and effect. The Port of New York Authority does not issue bonds without a pledge of its full faith and credit. However, many States and municipalities are compelled by law or decisions of policy to use revenue financing for the development of their airports, seaports, and other improvements which are capable of supporting themselves through revenues.

Technically, section 274 does not prohibit the States and cities from using revenue financing for industrial development purposes. But that is both the announced purpose and the inevitable effect of this provision. By its terms the section would disallow deduction from gross income of rental payments made by private lessees to States or their political subdivisions for the use of public property acquired or improved by the State or its agencies with the proceeds of revenue bonds.

According to the press releases of the Ways and Means Committee of the House, the provision was aimed at discouraging the relocation of established industry attracted to new locations by the opportunity to rent plants financed by State and municipal credit.

It so happens that I am personally opposed, as are the proponents of section 274, to the use of public credit as a means of raiding industries from section to section. But I feel about this as I feel about free speech. Devotion to the principle of free speech is proven only by defending the right to speak on policies in which you do not believe. So here, a deep belief in the independence of State government as a vital part of our system of dual State and Federal sovereignties requires me to support the right of any State, within the limits of the Federal Constitution, to adopt local policies I oppose, and to deny the right of Congress to sit in review upon those local policies and thwart them by ostensible use of a taxing provision which can yield no taxes.

With the committee's permission, I will return to this fundamental objection of policy. But first I would like to indicate how far section 274 goes even beyond

its announced purpose. What it has actually done is to make it impossible to go forward with important public improvements throughout the country which are wholly unrelated to the purposes of its proponents. The evil it would do far outweighs any possible transitory gain of anchoring a few factories to their present sites.

Thus, while the announced aim of the provision is to discourage the raiding of industry, nothing in its language limits its effect to relocation of established industry. It applies just as much to a new industry which a State or municipality wishes to attract in the first place, for perfectly proper reason in the development of the prosperity of its people, as it does to the relocation of an existing plant from any other part of the country. A wholly new industry may be involved like a plastics factory or an aircraft parts manufacturing plant. Or in cases of existing industrie which are expanding, a wholly new factory may be established. Reclamation of lands or new power developments in the West or in New York may naturally invite the location of industry nearby. And sections of the country with great new population increases which serve as markets as well as sources of labor supply, may require as well as attract wholly new industrial developments.

If there is anything morally wrong with the attraction of plants which are already established, that condemnation cannot apply to wholly new plants which never had a situs anywhere. Yet States and municipalities wishing to finance such plants by revenue bonds would be prevented from doing so by section 274.

I should say, categorically, that any use which the public-airport operators and port authorities of this country have made of revenue financing of industrial developments has been for the establishment of new developments and not the raiding of industries from existing locations.

Furthermore, the provision restricts its operation to manufacturing plants, but there is no definition of the word "manufacturing." Fear that manufacturing will receive a very broad definition has already destroyed an opportunity for a Pacific coast public-airport operator to secure the location of a new and important aviation base at that airport. The airline proposing to rent base facilities to be constructed by the public agency pointed out that certain of its operations in preparing aircraft for flight might be considered manufacturing, and that it was completely uneconomocal for the airline to establish a base under those circumstances so long as the rental paid to the public agency would not be allowed as an ordinary business deduction on its income-tax return.

The State of North Carolina, with no purpose of industry raiding at all, has established grain storage and processing plants by the issuance of revenue bonds and has leased those facilities for operation by a private lessee, with the objective, and I believe the result, of protecting the price of grain produced by the farmers in North Carolina. If the cleaning, drying, sorting, and bagging of grain is manufacturing under section 274, that policy of that State may be completely frustrated.

In Oregon, the mere pendency of section 274 in the present bill has brought to a dead stop negotiations for the establishment of a similar grain terminal facility to be built through revenue financing but operated by a private lessee.

The doubt and fear arising over the undefined use of the term "manufacturing" is not unfounded. It is compounded by language of the House Ways and Means Committee report that—

"The term 'manufacturing articles' is used in a broad sense, and includes processing and related activities, such as canning, tanning, etc., the result of which is to make available for sale an article or product."

Another serious objection is demonstrated by the experience of public airport operators and marine port authorities. Section 274 makes no distinction between property acquired or improved solely to attract new or relocated industry, and situations where the property is already held and must continue to be held for some other public purpose, where it becomes advisable in the public interest to devote a portion of the area to incidental uses which are consistent with the primary governmental purpose for which the property as a whole is held.

It is well known that airports cannot be made self-supporting solely out of the revenues from aircraft operators. It is also obvious that airports must occupy tremendous areas of land for the accommodation of their runways and to assure sufficient distance from ends of their runways for aircraft to attain an altitude from which aircraft noise will not unreasonably interfere with the owners of land below. In other words, airports require much more land than can be

occupied by runways, hangars, and administration buildings. These two factors, inadequacy of takeoff and landing fees to cover costs and the necessity of having to own more land than is occupied by direct air-terminal structures, have led to the development of incidental revenues from airport properties, as a means of easing their burden on the local taxpayer. State and municipal airports have built and rented out structures on their peripheral areas, usually for purposes related to the aviation industry although not directly concerned with the immediate process of the landing and taking off of aircraft. For example, we have heard of an instance where a surplus airport hangar was converted by the municipal owner to the manufacturing of light aircraft parts. And we have heard of negotiations for the establishment of an aviation instrument plant at another airport.

Far from there being anything wrong in such incidental uses of property already held for a public purpose, we suggest rather that the public officials administering such public properties would be derelict in their duty if they did not seek to devote such property to this type of incidental use. Yet, financing such improvements through revenue bonds would be stopped by section 274 just as if it were open to the objections which have been expressed against State financing for plant relocation.

I should note also that section 274 encourages States and municipalities to issue general obligations rather than revenue bonds, because the penalty it imposes does not apply if full faith and credit bonds are used, even for the very type of factory relocation which the proponents of the measure disapprove. I submit that this discrimination against revenue financing is wrong for two reasons. In the first place the type of financing used for lawful local purposes seems to be the business of the States and not of the Federal Government. Secondly, the financial stability of State and municipal credit is in some cimcumstances more severely affected by the use of general obligations than of revenue bonds, so that it may often be economically unsound to encourage the use of general obligations and discourage the use of revenue bonds for the same purpose.

Oddly enough, the use of municipal revenue bonds to finance industrial development is extremely rare. I have studied the figures and find 8 such instances involving an aggregate of only about $3 million in revenue bonds. So that even if the process is evil, it has not assumed any proportions which remotely justify congressional intervention.

Finally, I should like to return to the most serious objection of all—that of governmental philosophy. We are dealing with State and municipal financing which is admittedly lawful in the States within which it is accomplished both as a matter of State law and Federal law. Under such circumstances there is no warrant for Congress to set itself up in judgment as to the wisdom of the State legislatures in authorizing such State and municipal fiscal policy. It is wrong from the point of view of the Congress as well as of the States. Congress is overloaded as it is with obligations to pass upon purely Federal policy without assuming the impossible burden of reviewing the policies of 48 State legislatures on matters of purely local concern.

But more important, it is stultifying to the States and to the dual system of State and Federal Governments which assures to the States exclusive jurisdiction in matters of purely State concern. It cannot be the proper business of Congress to review the numerous purposes for which State and municipal borrowing is undertaken and to work out penalties and rewards to discourage some sovereign State purposes and encourage others.

Section 274 of this bill makes it impossible for the States and their political subdivisions to issue revenue bonds for manufacturing purposes. The next bill could penalize the use of full faith and credit bonds for the same purpose. A further bill could enlarge the purposes Congress would penalize—a process often urged by special interests. Last year, for example, representatives of private electric companies proposed to penalize by special taxation the issuance of bonds for the acquisition and improvement of public electric plants. I submit, respectfully, that the Congress should not wish to enter upon this stony and unending path of reviewing State fiscal policy.

If the States are to survive as sound and healthy units of local government, their policies should not be subject to control by direct or indirect use of the taxing power of the Federal Government, with the objective of making the internal policy of our State legislatures into carbon copies of those of Congress.

I respectfully urge that this honorable committee recommend the deletion of section 274 from the present revenue bill.

The CHAIRMAN. Dr. Momsen.

STATEMENT OF DR. RICHARD P. MOMSEN, DIRECTOR, AMERICAN CHAMBER OF COMMERCE FOR BRAZIL, RIO DE JANEIRO, AND SÃO PAULO, BRAZIL

Dr. MOMSEN. My name is Richard P. Momsen. I realize how pressed the committee is for time and fully appreciate the opportunity that you have given me to say a few words on behalf of the American Chamber of Commerce for Brazil.

After an examination of the provisions of the proposed new Internal Revenue Code of 1954, our directors held meetings in Rio de Janeiro and São Paulo last Tuesday, and at their request I came to this country from Brazil on Saturday to explain our disappointment over certain provisions of the House bill.

My statements are based upon over 40 years of residence in Brazil, which is one of the most important areas of the free world for American trade and investment. It is my purpose to try to explain very briefly the practical effects of section 923, entitled "Business Income from Foreign Sources."

The exclusion of wholesale establishments from the proposed 14-point tax differential will bar a very important sector of American business establishments abroad, which is the outlet for a large volume of American-manufactured machinery, chemicals, railway equipment, automobiles and trucks, airplanes, household and office equipment, steel and other metal products upon which our industrial prosperity depends.

I wish to emphasize that this type of business is today meeting ever-increasing serious competition from other countries. Our unique position after the last war of being the sole supplier to the world has ended and we must again face the realities of severest competition. Excessive taxation in this field in competition with other countries which favor their nationals with exemption or reduced taxation may mean the difference between success and failure to keep our markets and create new ones.

Countless examples of what is taking place could be given, but I merely give one for illustration: Coming up on the plane last Friday, a fellow American passenger, representing one of our large railway car manufacturers, who was returning home without an order, told me of a contract recently awarded by the Brazilian Government-owned Central Railway. There were 13 bidders from 7 different countries. The contract was for $21 million, and was awarded to a British company which is receiving a $12 million financing through the World Bank and, my informant told me, a 27 percent tax advantage over his, the American bidder.

A second point in favor of American branches and subsidiaries abroad engaged in the sale of American products is that they almost invariably maintain American sales and American technical staffs which are necessary to obtain orders. They perform inestimable maintenance and repair services and keep stocks of spare parts on hand to assure foreign buyers and users of equipment efficient and continuous operation. I know this to be true in Brazil in many types of businesses, such as trucks and automobiles; tractors and agricultural machinery; machinery for the shoe industry; radios, motors, and many types of electronic equipment for the home, factory, and

public utilities; typewriters, adding machines, calculators, cash registers, and similar products; sewing machines for the home and for industry; elevators; printing and typesetting machines; and many others.

In all of these lines, American business has won for itself a vast market in Brazil and these results are in large measure due to the maintenance of permanent establishments with facilities which can give assurance to customers that guaranties of performance will be carried out. It seems anamolous to see them excluded from the benefits of the proposed tax revision.

Another important feature of the advantages to American interests from foreign branches and subsidiaries in the promotion of the sale of American manufactured products by reason of the facilities they have, being on the ground, is to evaluate and grant credits. In some cases, such credits are granted in dollars through the principal office in this country, but in many cases they involve the granting of credits in foreign currencies.

In Brazil, bank credits in local currency are only possible through locally established companies. It is common knowledge that one of the great obstacles which has always confronted American business abroad is the long credits granted by European countries, particularly Germany and England. The granting of credits in foreign currencies abroad involves great risks in exchange fluctuations, a risk not assumed in transactions wholly performed in the United States. Yet, American business abroad must meet European and other competition if it is to survive.

The importance of granting better credit terms was emphasized in the report of Senator Capehart's Committee on Banking and Currency after the committee's recent trip to South America.

The allegation that sales branches and subsidiaries do not represent an investment of capital is unfounded. In almost every instance they carry stocks of merchandise which necessarily represent a considerable investment, and this is accentuated when, because of competition from European and other sources, they are required to sell on time. In such countries as Brazil, which have ever-changing regulations governing imports and dollar remittances, it is frequently necessary to carry ample stocks in anticipation of future restrictions. Because of the scarcity of suitable space for stocks, spare parts, and maintenance in an expanding economy, such as that of Brazil, American companies have been obliged to purchase or build their own warehouses and other facilities involving the employment of substantial amounts of capital. Those principally engaged in the importation and wholesaling of American products are subject to the same risks and handicaps as are manufacturing and retail establishments—such as monetary depreciation, import and exchange restrictions, local taxation, employees' indemnities, and other burdens. Why should they be singled out and not entitled to the benefits of the bill under consideration?

I am sure that an analysis of effects of the proposed section 923 will best illustrate how it will work if put into operation, and will be the most convincing proof of the injustices it will create.

We have compiled a list of 166 of our chamber members with American corporate interests involved. Of these, approximately 80 percent are either non-Western Hemisphere branches, Brazilian corporations

or Brazilian limited companies, which would therefore have to qualify under sections 37 and 923 of the proposed new legislation.

The CHAIRMAN. What do you mean by a nonhemisphere branch?

Dr. MOMSEN. They are those branches which do not qualify as a Western Hemisphere corporation.

Analyzing the activities of these 166 companies, without taking the Western Hemisphere angle into consideration, the following results have appeared:

Only 26, or 15 percent, would definitely qualify under the title of "factory." Only 3, or less than 2 percent, would qualify as a "mine." None would qualify under the title of "oil or gas well" because these activities are reserved to the Brazilian Government. Only 2, or less than 1 percent, would qualify as a "public utility facility." When we come to the title of "retail establishment," the only other specific activity mentioned in the bill, we run into difficulties: 6 are importers and retailers, 2 are manufacturers, importers and retailers, 4 are manufacturers and retailers—which of these would qualify I would not attempt to answer. In any event, they are 12 in number and make up 8 percent of the total.

Now, 41, which are engaged solely in importing or exporting, or more than 25 percent, would clearly be disqualified as establishments engaged principally in the purchase or sale, other than retail, of goods or merchandise.

But the greatest number of all, 44, are both manufacturers and importers or exporters, representing 27 percent of the total.

I just have a few lines more, Senator.

The CHAIRMAN. Go ahead.

Dr. MOMSEN. This 27 percent might be disqualified from the benefits of the law. At the very best, their status is dubious and they could not rely upon being entitled to the benefits of the bill as it now reads.

While it is true that the Ways and Means Committee in its report has indicated that the phrase "or other like place of business" should be interpreted so that it may—and I repeat may—include a bank or an air transportation business, what is the tax destiny of 28 other companies operating in Brazil, representing 17 percent of the total, and which are engaged in communications, travel, insurance, film rentals, investment banking, publishing, advertising, and other unclassified activities?

From these figures it is evident that more than 50 percent are either specifically excluded from the benefits of the bill or are in a doubtful category.

The CHAIRMAN. What are you suggesting?

Dr. MOMSEN. I suggest that the restrictions in the bill, which now only cover factories, mines, oil and gas wells, public utilities and retail establishments, be extended so that wholesaling will be included, also transportation—and there are a number of other kinds of business—or that the provision be in more general terms, Senator.

Thank you very much. May I have the privilege of filing an additional statement with the committee?

The CHAIRMAN. Yes. Thank you.

Dr. MOMSEN. Thank you very much.

(The additional statement of Dr. Momsen, when received, follows:)

STATEMENT BY RICHARD P. MOMSEN IN BEHALF OF AMERICAN CHAMBER OF COMMERCE FOR BRAZIL (RIO DE JANEIRO AND SÃO PAULO)

The American Chamber of Commerce for Brazil, established in the cities of Rio de Janeiro and São Paulo, Brazil, which for many years has been advocating more favorable tax treatment by the United States Government on income from foreign sources, has noted with satisfaction the growing interest in this subject, particularly in the legislative and executive branches of our Government.

We have from time to time in recent years been favored with visits of eminent public officials, among them distinguished Members of the United States Senate and the House of Representatives. We have availed ourselves of these opportunities to bring to their attention the need, in the best interests of the United States, of certain changes in our tax policies to encourage American investments abroad and to stimulate our foreign trade. These contacts have been maintained by visits of our directors and members to Washington where they have invariably been well received by our officials, who have always indicated a sympathetic attitude to our representations. We recognize that a policy of taxation based upon citizenship rather than source of income can only be changed gradually and over a period of time, especially in periods when our Government is confronted with the problem of finding revenue to balance the budget and to maintain adequate appropriations for our national defense.

It is gratifying to know that the Ways and Means Committee of the House of Representatives in preparing H. R. 8300, 83d Congress, saw fit to include provisions for a 14 point rate differential for the purpose of encouraging foreign investments (sec. 37 and 923). We of course regret that the proposed tax reduction has been so restricted in the bill that in its present form it falls far short in the field of activities in which a large segment of American business abroad is engaged and that the language of the bill will bring about inequities and situations which will create grave doubts in many instances as to whether or not the proposed relief will be applicable or not. Some of these deficiencies have been pointed out in the verbal statement of our representation to the members of the Senate Finance Committee and it is unnecessary to repeat them here.

We have also noted that in the bill (sec. 911 d) in the case of individual bona fide nonresidents when a taxpayer is engaged in a trade or business in which both personal services and capital are material income-producing factors, the maximum allowance as compensation for personal services has been increased from 20 percent to 30 percent, same to be considered as earned income. Although this indicates a definite trend to encourage Americans to engage in business abroad, in the same manner as corporations, it still leaves our citizens in a very unfavorable tax position as compared with the citizens of other countries which grant either complete exemption from such taxation or very substantial reductions of their normal rates. And this is particularly true because of the present high tax rates on individual citizens of the United States. We hope that the policy of placing our citizens abroad in a better competitive tax position will be continued in the future in order to further reduce and to eventually eliminate the handicap under which they now operate.

There is another area of taxation on income derived from foreign sources which thus far has received little or no attention and that is the matter of investments abroad by individual American citizens, whether residing in the United States or abroad. This type of unearned income is now fully taxable by the United States excepting that the taxpayer, with certain limitations, is permitted to credit the foreign tax against the United States tax. It appears to be a logical inference by studying H. R. 8300 (83d Cong.) and House Report 1337 of the Ways and Means Committee, which accompanied the bill, that in the field of taxation on income from foreign sources, it is now the policy of our Government to encourage investments abroad by giving certain tax incentives. We consider this to be a sound measure because it will stimulate the substitution of Government aid in the form of grants or loans by greater private investments abroad, especially in the underdeveloped areas.

Various studies which have been made by others on this subject appear to take the position that American investments abroad in the past, and that this will also occur in the future, are and will continue to be almost confined to those of large American companies and that but inconsequential foreign investments can be expected of individual American citizens. Based on our experience and

knowledge of conditions in Brazil, we disagree with these conclusions as far as that country is concerned.

Brazil, during the past few years has been rapidly changing its general overall economic structure and although agricultural products still account for the major part of its total production, industries of every kind have been springing up. As an example, the Volta Redonda Government-owned steel mill (in part financed with loans from the Export-Import Bank) which started with an initial capacity of about 400,000 tons is now doubling its production and in addition to producing rails, it also produces sheet and bar steel, as well as tinplate, thereby providing materials for subsidiary industries such as the manufacture of refrigerators, the canning industry, automobile and truck spare parts, tanks and other equipment for chemical plants, etc. There are already several companies which are not only mining bauxite ore but smelting it for subsidiary aluminum industries. As a result of these and other developments the need for new capital in industry shows a constantly growing demand.

Until a few years ago about the only outlet for surplus capital was real estate. The same pattern of change which occurred in the United States at the turn of the century is now taking place in Brazil: closely held family enterprises are now being transformed into corporate entities and their securities are being offered to the public. Two American groups in the investment banking field of underwriting and distributing securities have been established and these have been followed by others entirely Brazilian-owned in the same field.

During the past few years successful public distributions of securities have been accomplished. One large American public utility company which has been expanding its output as rapidly as possible to keep up with the ever-increasing demand for power has sold substantial blocks of common stock in several of its operating subsidiary companies thereby supplying additional capital needed for capital expenditures in local currency. Two tire manufacturing companies, one British and one American, have recently sold issues of stock. A European-managed concern engaged in the manufacture of motors and household equipment has been financed through the public sale of its stock and a substantial block of stock was sold in a cement plant which is being operated by American equipment and for the first time employing Brazilian natural gas as fuel. Several investment trusts with portfolios of Brasilian securities have been formed.

These few examples are mentioned to illustrate that there are exceptional opportunities in Brazil for the American investor who now has facilities in Brazil, through locally established investment firms, to place private capital in remunerative industries with great possibilities for future development and expansion. However, under our present laws which tax American citizens on their investments abroad there is no incentive to enter the foreign field. The credit for foreign-income taxes, being merely a deduction from the American tax, is no inducement because the tax rate remains the same. At the same time the American investor is subject to currency depreciation and other risks which do not occur in dollar investments made in the United States.

President Eisenhower in his budget message to Congress (Congressional Record, Jan. 21, 1954) stated:

"Our tax laws should contain no penalties against United States investment abroad, and within reasonable limits should encourage private investment which should supplant economic aid."

As far as we are aware, the proposed new Internal Revenue Code, although making provision for some tax inducements to corporate investments makes no provision whatsoever for the individual investor. It would appear to be an appropriate time for the Senate to initiate the extension of some tax advantage to foreign income derived from individual investments. This could be done on an experimental basis in order to establish the degree to which the President's recommendations are a factor in having private capital supersede Government aid. A reasonable tax incentive would not mean any substantial loss of revenue and, in fact, because of larger earnings in most foreign areas, would probably mean even greater revenue to our Government. We earnestly hope that some incentive in this direction may be included while the present bill is still in legislative channels.

Now that we have discussed some of the specific tax areas in which relief is needed, it may be appropriate, even though some of these observations have been made by us before, to repeat a few of the basic reasons for our concepts of taxation on foreign income.

Prior to the First World War most of our country's problems were domestic. Although these have not diminished those related to international affairs have

increased. The United States has changed from a debtor to a creditor nation. Our technological progress and mass production methods, together with the devastating effects of two wars in other industrial centers, made us the world's principal supplier. This privileged trade position, has, however, already passed. With our financial and other foreign-aid programs we helped rebuild the industries of other nations. This program to restore their economic strength has quite naturally stimulated them to again seek outlets for their production in the world markets. In the meantime we increased our productive capacity in many branches of industry so that our foreign trade has become a vital factor in our own overall economy. We are, therefore, now again in a highly competitive situation.

Our methods of mass production to some extent offset our high labor costs. But under our system of levying income taxes on our enterprises even on foreign earnings we have placed our manufacturers and business interests in a disadvantageous competitive position as compared with most other countries which either grant complete exemption or reduced tax rates on earnings abroad. This handicap is accentuated by the high tax rates which now prevail in the United States. It is, therefore, imperative, if we wish to stimulate American investments abroad and commerce with other countries that our citizens be given the opportunity to meet the present ever-increasing competition by equitable tax relief.

In Brazil industrialization, fostered by exchange and import restrictions, has made it necessary for some American manufacturers who formerly exported their products to that country, to establish assembly or manufacturing plants. But a new development has arisen since the Second World War—the inroad into Brazil of European and far eastern industrialists. For political reasons their approach to the problem is different than ours. American industry, while it may decide in certain instances, to establish a plant in Brazil to protect its past market and look to the long-range possibilities, nevertheless expects to carry on a profitable venture in the interests of its stockholders or owners. Many European and far eastern investors, however, having suffered great losses if not extermination in the two world wars, are often satisfied if they can remove their capital, machinery, and personnel from the shadows of the Iron Curtain and be freed from the possibility of repetition of the losses they have suffered in the past.

Countless examples could be cited of new industries being established in Brazil during the past 5 years by Swedish, Italian, German, and Hong Kong interests. The following is quoted from a report prepared by our chamber of commerce in São Paulo:

"In the investment field, let us list some of the projects which are already under way or are in active negotiations. In heavy industry we have the German Mannesmann industries putting up a large integrated steel operation in Belo Horizonte. The Krupp interests are planning a locomotive and railway car plant. The French Schwartz-Hautmont people are expanding their already considerable local interests. In the heavy equipment field, the British Metropolitan Vickers, the French Creusot, the Swiss Brown Bovery, the Swedish Bofors, and the Schindler groups are all reported to have ambitious plans. In the automotive field we have the recent negotiations between the Italian Fiat and Fabrica Nacional de Motores (built originally by the Brazilian Government for the manufacture of airplanes), a Mercedes plant being erected on the road to Santos, the very extensive plans for the local manufacture of the German Volkswagen, a projected factory in the south by the French Renault, and a large motorcycle factory being planned by Italian and Brazilian interests. In rubber and chemicals we have both Dulop and Imperial Chemicals already well entrenched."

The concept of special tax treatment to income produced abroad by American investments and business does not envisage tax evasion or avoidance but simply to give American private enterprise a fair opportunity to meet the ever-increasing competition with the nationals of other countries which grant complete exemption or reduced tax rates to their nationals in their overseas transactions.

The CHAIRMAN. I submit for the record a statement by Senator Kuchel, urging the adoption as an amendment to the pending bill, H. R. 8300, the adoption of S. 3115 which would permit rapid amortization of devices, structures, machinery, or equipment for the prevention or elimination of air pollution.

Senator Kuchel's statement is accompanied by letters of endorsement from the Governor of California and many mayors and city managers of California cities.

(The statement and accompanying documents follow:)

STATEMENT BEFORE SENATE FINANCE COMMITTEE RE S. 3115 BY SENATOR THOMAS H. KUCHEL

Mr. Chairman, in coming here today I desire to express my appreciation for this opportunity permitted me to urge committee consideration of S. 3115, a measure that will give impetus to and supplement the varied efforts of municipal, county, and State governments as well as industry, in attempting to overcome the vexatious problem of air pollution.

I should like to make a general statement on the seriousness of this problem which is becoming more and more acute in many metropolitan areas throughout the country. As you are undoubtedly aware, air pollution—generally referred to as smog—has become a matter of great concern in the metropolitan areas of Los Angeles, San Diego, and San Francisco. A variety of bold steps have been taken to counter the problem and at every level citizens are facing this threat to their happiness and well-being. But California is not alone in its awareness of the problems brought on by this phenomenon. This is testified to by the fact that when somewhat similar legislation was considered before another committee testimony in favor of such legislation was given by officials from Indiana, Michigan, New Jersey, New York, Ohio, Pennsylvania, and Rhode Island.

Smog is no new phenomenon. Back in the Middle Ages London first became alarmed about the serious consequences of contaminated air. But in the last few years growth of industry and the rapid expansion of major cities have caused public officials and civic leaders to begin measuring the cost of atmospheric pollution which has a wide range of consequence.

As for the problem in Los Angeles which has become so widely known, our people are not asking the Federal Government to take on responsibility for its solution. They already have undertaken energetically and with determination programs that call for substantial expenditures of money and human effort. The California Legislature paved the way several years ago by forming an air pollution control district now policing the metropolitan area, investigating causes of air pollution, studying remedial measures. Our leading industries are participating vigorously—one in particular, oil producing and refining, has already spent over $15 million to control and reduce pollutants and in addition spent $1,250,000 for what then was called "the most extensive and expensive research program" ever undertaken. The aid of automobile designers and manufacturers has been enlisted in the hope of preventing more contamination of the atmosphere by the growing number of motor vehicles.

However, these efforts must be supplemented by help and encouragement from the Federal Government. Education and persuasion will not solve the problem alone. Adoption and enforcement of regulations and ordinances are only a partial answer to the question of how we are going to clean up our atmosphere. Closing of industries would upset our economy drastically, and dispersal would bring at best only temporary relief and be exceedingly costly.

The damages from smog are so great they cannot be computed. No one knows the toll in the way of infection of humans. Agriculture has suffered greatly—the loss to crops in the Los Angeles area during one short period of serious smog last year was figured at $500,000—and properties of all kinds, homes and automobiles and clothing, are affected.

When we require industries to cut the output of smoke and fumes we force them to make substantial outlays for equipment and construction changes. Floating roofs on oil storage tanks, precipitators for exhaust stacks, and intricate apparatus are very expensive. The legislation would permit accelerated depreciation of these capital expenditures. And I know many small industries of which we have thousands in my State, cannot put out the money required to comply with antismog regulations unless they get help in the shape of tax relief.

S. 3115 in essence amends the Internal Revenue Code to permit for tax purposes the rapid amortization (over a period of 5 years) of devices, structures, machinery, or equipment for the prevention or elimination of air pollution. This special tax benefit would be available, however, only from the date of enactment of this amendment, and then only at the election of the taxpayer.

Legislation of this type is necessary as a means of securing a sound and con-

tinuing solution to the air-pollution control dilemma. I have pointed out that the installation of small control devices are costly. It must be remembered that the installation of air-pollution prevention equipment is of no direct benefit to the company installing it. In fact, the capital expenditures result in higher operation costs because of added power requirements, the necessity to dispose of large quantities of fly ash and increased maintenance expenses.

For a period of many years the Federal Government has stimulated Government expansion in many sections of our country and this growth of industry has, of course, been in the Nation's interest. Having thus encouraged the expansion of industry it appears to me feasible and advisable that the Federal Government through its tax structure and for the welfare of the community provide for the encouragement of the construction of air pollutant control devices. This is in no sense of the word a handout to industry. It is a method by which the huge capital outlays expended by industry will be recognized by the Government.

The bill before you carries a provision with reference to soil- and water-conservation expenditures permitting farmers to expense, rather than to capitalize, expenditures for soil and water conservation including the expenditures for water and land erosion. There is, it seems to me, the same public policy which permits this in the case of farmers in the instant amendment to urban areas.

I would urge the committee's favorable consideration of this amendment.

SACRAMENTO, CALIF., *April 13, 1954.*

Hon. THOMAS H. KUCHEL,
United States Senator,
Senate Office Building, Washington, D. C.:

I am pleased to give my support to S. 3115 and H. R. 7703. The principle involved appears to me strongly and I am urging others here in California to support these measures which I believe will speed up the acquisition of instrumentalities and equipment for smog abatement, particularly in southern California. These bills represent a distinct forward step and if they are enacted I contemplate suggesting to our legislature that appropriate action be taken in California to offer similar exemptions to State taxpayers.

GOODWIN J. KNIGHT, *Governor.*

SAN DIEGO, CALIF., *April 8, 1954.*

The Honorable THOMAS KUCHEL,
Member of Congress, Washington, D. C.

DEAR TOM: The San Diego City Council has asked me to write you expressing the city's strong endorsement of your pending amendment to the Internal Revenue Code, S. 3115.

Here in San Diego we have an incipient smog problem which we feel can be corrected through proper and timely legislation. The rapid tax amortization for air pollution control facilities is the type of legislation which we feel will accomplish a great deal.

Sincerely,

JOHN BUTLER, *Mayor.*

GLENDALE, CALIF., *April 6, 1954.*

Ho 'HOMAS H. KUCHEL,
·te Office Building, Washington 25, D. C.

DEA ENATOR KUCHEL: We wish to express our appreciation to you for your sponsorship of Senate bill 3115.

We know that you are familiar with the beautiful residential and commercial area which makes up Glendale and also that you are aware of the suffering of our people from air pollution as it presently exists.

Our city government and most of our citizenry have taken the position that the solution of the smog problem in the Los Angeles metropolitan area requires an approach which takes into consideration all avenues of improvement, regardless of how slight. In an effort to do all we can to help, we have constructed a half-million dollar incinerator which fully complies with air pollution regulations. We now spend $300,000 a year of our citizens' money for the collection

and smog-free disposal of combustible rubbish. Therefore, you can readily understand how urgently we feel the need for any and all remedial measures which may help with the problem.

May we also take advantage of this communication to send you our best wishes and our deep appreciation for the splendid representation that you are giving us in the United States Senate.

Very sincerely yours,

C. E. PERKINS, *City Manager.*

CULVER CITY, CALIF., *April 1, 1954.*

The Honorable THOMAS KUCHEL,
United States Senator,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR KUCHEL: On behalf of the city government and surrounding area, this is to express the hope that your Senate bill No. 3115 providing for tax amortization for certain air pollution control facilities will be approved at an early date.

It is imperative that everything possible be done by all agencies of government to aid in the solution of this problem with which you are completely familiar.

I am sure that all concerned are grateful to you for this bill or any other measure which you may feel disposed to introduce which will in any way assist in alleviating the condition which is giving the residents of this section such concern and which is so detrimentally affecting them.

With kindest regards and all good wishes, I am

Very truly yours,

M. TELLEFSON, *City Attorney.*

TORRANCE, CALIF., *April 7, 1954.*

Hon. Senator THOMAS H. KUCHEL,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR KUCHEL: The city officials of the city of Torrance, Calif., offer their full support of your bill, S. 3115, as a provided means for the control and elimination of air pollution in our area. We believe that the rapid tax amortization provided will permit installations which should control and reduce the volume of air contamination. As a resident of this area you know the seriousness of the problem in Los Angeles County.

Please be assured of our full support in any manner possible.

Yours very truly,

GEORGE W. STEVENS, *City Manager.*

MERCED CITY CHAMBER OF COMMERCE, INC.,
Merced, Calif., April 9, 1954.

HON. THOMAS H. KUCHEL,
Senate Office Building, Washington 25, D. C.

DEAR SENATOR KUCHEL: The chambers of commerce of Merced County wish to support you and urge you to do everything you can concerning your Senate bill 3115. Copies of this letter are being sent to Senators Knowland and Millikin and Congressman Oakley Hunter.

May we take this means of thanking you for your constant and effective efforts in our behalf.

Sincerely,

JACK M. ROTH,
President, Merced City Chamber of Commerce, Inc.
GYLE MILLER,
Chairman, National Affairs Committee.

MERCED, CALIF., *April 6, 1954.*

Hon. THOMAS H. KUCHEL,
United States Senator, Senate Office Building,
Washington 25, D. C.

DEAR SENATOR KUCHEL: I am sending you a copy of a letter to Senator Capehart and would also like to relay to you the endorsement of the City Council of the City of Merced of your bill, S. 3115, now pending before the Finance Committee when it takes up the Revenue Revision Act of 1954.

We believe that making some provision for accelerated write-off of investments in air-pollution devices will encourage and enable industry to make installations to abate or reduce air contamination. Due to the serious threat of the air-pollution blight to American cities this problem needs to be attacked immediately and vigorously. Furthermore, due to the large capital outlays which are required by industry to make effective installations of pollution-control devices some arangement needs to be made so that it will be within the realm of practical possibilities for industries to take these preventive measures.

Respectfully submitted.

RUSSELL J. COONEY,
City Manager.

PERRIS, CALIF., *April 8, 1954.*

Senator THOMAS H. KUCHEL,
Senate Office Building, Washington, D C.

DEAR SIR: The council of the city of Perris, at their April meeting, voted to go on record as definitely supporting your amendment, S. 3115, to provide rapid tax amortization for air-pollution-control facilities.

We are keenly aware that air pollution has become a serious problem in many areas of the State and living here in an agricultural area, we realize the damage that can be done by this blight to plants and vegetation of all kinds, as well as possibly affecting the health of residents.

We are highly in favor of any legislation that will assist in controlling or eliminating this scourge to health, business, and agriculture.

Very truly yours,

CITY OF PERRIS,
By M. B. MARTIN, *Clerk.*

LA VERNE, CALIF., *April 8, 1954.*

Hon. THOMAS H. KUCHEL,
Senate Office Building, Washington, D. C.

DEAR SENATOR KUCHEL: The City Council of La Verne has been informed, through a letter from Mr. Richard Carpenter, executive director and general counsel of the League of California Cities, of your introduction of legislation to amend the Internal Revenue Code in connection with air pollution control facilities.

The council has studied the provisions contained in the amendment to the Internal Revenue Code which provides rapid tax amortization for air pollution control facilities built by industries and has instructed me to inform you of their specific interest and complete support of the amendment. The council and residents of the city are very much aware of the seriousness of the blight caused by air pollution and the retardation of satisfactory development of the community. Very adverse effects have been evident in the health, business, agriculture, and general welfare of the city.

The council wishes to convey its strongest encouragement to you in obtaining this legislation, S. 3115, since we consider it a matter of the utmost importance.

Very truly yours,

JOHAN A. KRABBE,
Administrative Officer.

PACIFIC GROVE, CALIF., *April 8, 1954.*

Senator THOMAS KUCHEL,
Senate Office Building, Washington, D. C.

DEAR SENATOR KUCHEL: We would like to endorse your bill S. 3115 which provides rapid tax amortization for air pollution control facilities built by industries in conformance with State or local law.

While the problems in our immediate area are not now critical, they may well be in the near future, and we know that the problem is very acute in the metropolitan areas in California.

I hope that you are able to gain passage of this legislation at this session of Congress.

Sincerely yours,

CLARENCE A. HIGGINS, *Mayor.*

HAYWARD, CALIF., *April 6, 1954.*

Subject: Air pollution.
To: Senator Thomas Kuchel, Washington, D. C.

SENATOR THOMAS KUCHEL: 1. We are heartened to learn of your proposal (S. 3115) to amend the Internal Revenue Code to provide rapid tax amortization and insured construction loans for air pollution control facilities, as well as support for research in that field.

2. The San Francisco Bay area during the past 2 or 3 years has first experienced incidents which presage a smog problem. Observing the extent to which that same problem has become critical in the southern part of this State and aware of the imposing difficulties present in abatement programs, we support vigorously your proposed legislation.

LOHN R. FICKLIN, *City Manager.*

CAJON VALLEY UNION SCHOOL DISTRICT,
CUYAMACA SCHOOL,
El Cajon, Calif., April 2, 1954.

Senator KUCHEL,
Senate Office Building,
Washington, D. C.

DEAR SENATOR KUCHEL: The Cuyamaca School PTA, of El Cajon, Calif., voted unanimously in favor of Senator Kuchel's bill, S. 3115, which is pending before the Senate Finance Committee for consideration.

We urge you to give this bill your support.

Yours very truly,

MAMIE BRIGHTWELL,
Legislative Chairman of Cuyamaca PTA.

CULVER CITY CHAMBER OF COMMERCE,
Culver City, Calif., April 8, 1954.

Hon. THOMAS KUCHEL,
United States Senator, Senate Office Building,
Washington, D. C.

DEAR SENATOR KUCHEL: On behalf of the Culver City Chamber of Commerce it is our desire to go on record favoring the passage of your Senate bill 3115 providing tax amortization concerning certain air pollution control facilities which will be approved at an early date.

We feel that it is imperative that something be done at the earliest possible moment in securing Government aid in solution of the problem which is such a menace to the future development of the Los Angeles area.

We are grateful to you for presenting this bill for consideration of the Senate. Residents of this community will be happy when they are informed when it is passed the hearing.

With kindest personal regards.

Very truly yours,

CULVER CITY CHAMBER OF COMMERCE,
GLEN H. PRESTON, *Manager.*

HAYWARD, CALIF., *April 9, 1954.*

Subject: Air pollution.

Senator KUCHEL,
241 Senate Office Building,
Washington, D. C.:

1. The city of Hayward is well aware of the smog potentiality of our area, should there be no controls.

We are definitely in accord with your proposed Senate bill (S. 3115) and wish you to know that we urge its passage.

R. A. DERR, *Industrial Agent.*

HAYWARD, CALIF., *April 9, 1954.*

Subject: Air pollution.

Senator KUCHEL,
241 Senate Office Building,
Washington, D. C.:

1. The city of Hayward is tremendously in favor of the passage of your S. 3115.

We are glad to know that our Legislature is working to end a condition before it becomes an impossibility.

Rest assured that our vigorous support for your bill is already at work.

R. A. DERR, *Industrial Agent.*

IN THE CITY COUNCIL OF THE CITY OF SAN LEANDRO

RESOLUTION NO. 2320—C. M. S.

RESOLUTION URGING FAVORABLE CONSIDERATION OF S. 3115; PERTAINING TO AMORTIZATION OF AIR-POLLUTION-CONTROL FACILITIES

Whereas air pollution is a serious problem in rapidly growing industrial areas such as San Leandro, Alameda County, Calif., and its environs; and

Whereas present provisions of the United States's Internal Revenue Code prevents rapid amortization of air-pollution-control facilities built by industries in conformance with State or local law; and

Whereas S. 3115 introduced by Senator Kuchel and now pending before the Senate Finance Committee for consideration provides for rapid tax amortization of air-pollution-control facilities:

Now, therefore, the City Council of the city of San Leandro does resolve as follows:

That this city council urges the Senate Finance Committee to give S. 3115 early and favorable consideration to the end that the same may be included in the Revenue Revision Act of 1954.

Introduced by Councilman Swift and passed and adopted this 5th day of April 1954, by the following called vote:

Ayes: Councilmen Bellini, Cannizzaro, Swift, Vlahos, Dunnigan, 5.

Noes: Councilmen, none.

Absent: Councilmen Knick, Musson, 2.

HALSEY K. DUNNIGAN,
Mayor of the city of San Leandro, pro tempore.

Attest:

H. H. BURBANK, *City Clerk.*

SAN RAFAEL, CALIF., *April 7, 1954.*

Subject: Air pollution, S. 3115

Hon. THOMAS H. KUCHEL,
241 Senate Office Building,
Washington, D. C.

DEAR SENATOR KUCHEL: The City Council of the city of San Rafael wishes to express its support of Senate bill 3115. It is our understanding that you have

introduced legislation to amend the Internal Revenue Code in order to provide rapid tax amortization for air-pollution-control facilities built by industries in conformance with State or local law.

We wish to compliment you on your vision in introducing such a measure. You are well aware, of course, that this legislation is consistent with the national policy adopted by the American Municipal Association. There is little doubt that air pollution sets up a hazard to the public health and welfare of any community.

The city of San Rafael is situated on the north side of the San Francisco Bay and is just beginning to feel the effect of air pollution. While air pollution does not originate in our own city of San Rafael, under particular meteorological conditions the air surrounding this city does become polluted to a certain degree. While this problem might not be severe at the moment, there is every possibility that it might become so in the future.

It is our experience that air pollution, or smog as we call it in California, can hamper subdivision development and the construction of homes, as well as creating a blight situation in developed areas.

To this date air-pollution control in the San Francisco Bay area has been on a voluntary basis. The city council feels that Senate bill 3115 will greatly accelerate any voluntary program.

Very truly yours,

WILBER SMITH, *City Manager.*

The CHAIRMAN. We will recess until 10 o'clock in the morning.

(By direction of the chairman, the following is made a part of the record:)

STATEMENT OF ROBERT M. WADDINGTON OF PHILADELPHIA, PA., IN RE SECTION 1237 OF THE PROPOSED INTERNAL CODE OF 1954 (H. R. 8300) RELATING TO CAPITAL GAINS ON SALES OF INVESTMENT PROPERTY BY REAL ESTATE DEALERS

My name is Robert M. Waddington. I am a licensed real estate broker and maintain an office at 7102 North Frankford Avenue, Philadelphia, Pa.

Since for over 30 years I have been active in all phases of the real estate business in Philadelphia, the question of the proper income tax treatment of gains from sales of investment property held by real estate dealers has been a matter of real concern to me. Therefore, it was with considerable gratification that I learned that the Committee on Ways and Means in drafting the proposed Internal Revenue Code of 1954 had recognized some of the problems which are peculiar to real estate dealers.

PRESENT LAW

Under the present Internal Revenue Code, if a real estate dealer realizes a profit on the sale of property held by him for investment purposes, in order to be taxed at capital gain rather than ordinary income rates on such gain, the dealer must bear the burden of proving that the property in question was not "held * * * primarily for sale to customers in the ordinary course of his trade or business." That test creates innumerable factual issues in each case and leads to considerable dispute between taxpayers and auditing agents of the Internal Revenue Service.

SECTION 1237 OF THE PROPOSED INTERNAL REVENUE CODE OF 1954

Section 1237 of the proposed new Internal Revenue Code grants limited capital gains treatment with respect to gains from sales of real property by noncorporate real estate dealers if the following conditions are met:

1. The property is clearly identified as investment property before the end of 30 days after its acquisition or 90 days after enactment of the new law, whichever is later;
2. No substantial improvements were made in the property while held by the taxpayer and certain related taxpayers; and
3. The property was held by the taxpayer for more than 5 years.

If these conditions are met, to the extent of 5 percent of the sale price, the gain on the sale of the property is treated as ordinary income and the balance of the gain is treated as capital gain.

If the property has been identified as investment property, losses from the sale of the property are to be treated as losses from the sale of a capital asset or

property used in a trade or business regardless whether the other conditions of the section have been met.

The expenses in connection with the sale of the property are first used to reduce the ordinary income arising out of the sale (but only to the extent of such ordinary income) and the balance is used to reduce the capital gain elements of the sale.

The section is applicable to sales occurring after March 15, 1954.

NEED FOR CLARIFYING AMENDMENTS

Before discussing some of the more fundamental changes in the section which I wish to recommend for the consideration of this committee, I would like to suggest the following changes to clarify the intent of the section:

1. As presently drafted the apparent effect of the section is not to deny capital gains treatment for any transactions which would receive such treatment under present law. Thus, if a taxpayer can show that property was not held for sale to customers and otherwise qualified under present law as a capital asset, a gain from the sale of such an asset would continue to receive capital gains treatment even though the property failed to meet the tests of section 1237 of the proposed new code. While I believe that such is the intent of the section as presently drafted, it seems advisable in order to avoid later arguments as to this point to amend the section to explicitly so state.

2. One of the conditions which must be met before the benefits of the section are available is that the property be held "by the taxpayer" for more than 5 years. It is not uncommon for owners of real property to take title in the name of a nominee or strawman. I would assume that under such circumstances the real and beneficial owner will be considered as holding the property for the required period although title is for all or a part of such period in the name of a nominee. However, an amendment to clarify this point would prove helpful.

It frequently happens that a real estate dealer holds investment property jointly with his wife as tenants by the entirety. As presently drafted, section 1237 leaves some room for dispute as to its effect on sales of property so held by the dealer and his wife. To avoid such dispute and to carry out the apparent intent of the section, it is recommended that it be amended to provide that the period during which the property is held by the dealer and his spouse as joint owners be included in computing the period during which the property was held by the taxpayer.

3. If it is determined that the rule which denies the benefits of the section to property on which the taxpayer has made substantial improvements is to be retained, it is recommended that it be clarified to indicate that improvements to the property by persons other than the taxpayer and the specified related persons will not serve to disqualify the property. Examples of such improvements which should not disqualify the property are site improvements installed by or pursuant to an order of a governmental body.

OTHER RECOMMENDED CHANGES

In addition to the clarifying amendments mentioned above, I should like to recommend for the consideration of the committee certain modifications of section 1237.

1. *Rule against substantial improvements.*—Presumably the reason underlying the provision which denies the benefits of the section to property on which the taxpayer (and certain related persons) have made improvements is to prevent the conversion of so-called ordinary builders profits into capital gains. In seeking to prevent this result the present draft of section 1237 imposes what I believe are unnecessarily broad restrictions regarding improvements.

In the interests of promoting the normal development of investment realty and at the same time guarding against the conversion of normal builders' profits into capital gains, it is recommended that the section be amended to define substantial improvements as including buildings, warehouses, elevators, and similar structures but as not including normal site improvements such as streets, utilities, and sewers.

Further, it is recommended that the section be amended to provide that only those substantial improvements which are made by the taxpayer during the required holding period be considered in applying the section. Such a qualification is deemed advisable to avoid the situation in which the owner of real property which has once been identified under section 1237 as investment

property will hesitate to make any improvements for fear that if the property is ever sold (no matter how many years later) the gain will be treated as ordinary income. A provision of law which encourages the wasteful failure to develop real property for productive use is to be decried at any time; but it seems particularly out of place in a revenue bill, one of the stated purposes of which is to encourage production and investment.

2. *Holding period.*—Section 1237 (b) (3) provides that the benefits of the section will not be available unless the property has been held by the taxpayer for more than 5 years. That period was apparently chosen as representing a ready rule-of-thumb test of the investment aspects surrounding the acquisition and sale of the property. While I appreciate that the price of certainty in the tax laws is often the acceptance of rules which may seem arbitrary to those whom they penalize, I believe that in this situation, certainty can be achieved by the adoption of a holding period rule which, while concededly arbitrary, is nonetheless more in keeping with the commonly accepted tests of what constitutes investment property.

Based upon my experience of over 30 years in the real-estate business during which time I have dealt in all types of real property including downtown, suburban, residential, commercial, and industrial property, it is my opinion that a holding period of 18 months is a more realistic indication of investment features than the proposed 5-year period. Certainly any period longer than 3 years seems unwarranted in the light of the other restrictions contained in the section.

3. *Five percent ordinary income rule.*—If property qualifies under section 1237, to the extent of 5 percent of the sales price, the gain on sale of the property will be considered ordinary income and the balance of the gain will be treated as capital gain. However, if property has once been identified as investment property under the section, even though the property for some reason fails to meet the other tests of the section, any gain on the sale will at least to the extent of 5 percent of the sales price be considered ordinary income. Thus, if a dealer in real property identifies a piece of land as investment property under section 1237, subsequently erects an apartment building on it and 20 years after the apartment is completed the property is sold at a gain, to the extent of at least 5 percent of the sales price, the gain will be treated as ordinary income, although, if the unimproved property had not been so identified 20 years earlier, all of the gain would have been capital gain.

Not only does the 5 percent ordinary income rule lead to such bizarre results as that just mentioned, in addition it seems to be founded on the premise that in selling property held for investment purposes, 5 percent of the sales price represents compensation for the dealer's services which he would have rendered had he been acting as a broker in the sale of another person's property. In my opinion such a characterization of a part of the sales price of investment real estate is unjustified. In selling investment property the dealer does not consider any part of the sales price as compensation for personal services rendered to himself and the buyer certainly does not intend a part of his purchase price as personal service compensation for the dealer.

GENERAL STATEMENT

I have attempted to point out certain features of section 1237 which I believe require clarification or modification. However, I do want to state that my criticisms of particular features of the section should not be construed as an indication that I am opposed to retention of the section in the bill. The section represents a sincere effort to introduce into at least a limited area some certainty to replace the present doubt as to the tax treatment of certain sales of real property. While I believe the section could be improved, I also believe that it represents a step in the right direction.

I am informed that certain representatives of the National Association of Real Estate Boards have taken the position that unless section 1237 of the proposed Internal Revenue Code of 1954 is amended to meet their objections they will urge that the entire section be deleted from the bill. I am, and have for many years been, a member of my local real-estate board and have attempted to cooperate with representatives of the National Association of Real Estate Boards in all matters including the presentation of tax problems of real-estate dealers. However, I wish to disassociate myself from the position of the representatives of the National Association of Real Estate Boards as to the deletion of section 1237 of the proposed code.

The "do it our way or not at all" attitude of the representatives of the National Association of Real Estate Boards was not to the best of my knowledge adopted as the result of consultation with or advice from the officers of either the national association or its component boards. I believe that the attitude does not reflect the feelings of any sizable part of the approximately 400,000 real-estate brokers of this county or even of the approximately 50,000 who are members of real-estate boards. In this connection I think it should be noted that, even assuming that the representatives of the National Association of Real Estate Boards speak for all members of all real-estate boards, they would still be speaking for only one-eighth of the Nation's real-estate brokers.

In my opinion the lack of expression of opposition by more of the rank and file of real-estate brokers to the position taken by representatives of the National Association of Real Estate Boards can be explained by the fact that those representatives have taken no steps to inform members of real-estate boards of the position they proposed taking. In my own case, I learned of the proposed position of these representatives only within the last 10 days and then only as a result of my own inquiries.

In conclusion I wish to respectfully urge that recommendations for changes in section 1237 of the proposed new Internal Revenue Code be considered on their merits and that for the sake of the many real-estate brokers throughout the country for whom some definite tax rules in this area are a practical necessity, the section not be deleted at the behest of a small group which is apparently committed to a policy of abandoning the attempt to improve the law if it is not undertaken strictly in accordance with their views.

OPPENHEIM, APPEL, PAYSON & DIXON,
CERTIFIED PUBLIC ACCOUNTANTS,
New York 6, N. Y., April 20, 1954.

Re H. R. 8300, a bill to revise the internal revenue laws of the United States; sections 6015 and 6654: Declaration of estimated tax.

MR. CHAIRMAN: In accordance with your permission, I am herewith submitting the following statement to be incorporated in the record of the hearings of the Senate Finance Committee on H. R. 8300, sections 6015 and 6654.

My name is Henry Oppenheim, a certified public accountant of the State of New York and senior partner of the accounting firm of Oppenheim, Appel, Payson & Dixon, 33 Rector Street, New York City 6, N. Y. I appreciate this opportunity to bring to your attention a provision of H. R. 8300 which vitally affects many of my clients who include some of the Nation's larger distributors of United States Government and commercial corporate securities, members of the New York Stock Exchange and American Stock Exchange, and investors in venture capital businesses such as real estate, theatrical productions, and the exploration and development of natural resources.

The particular provision of the bill to which I refer is section 6654. This deals with the penalties for a failure by an individual to pay his estimated tax.

Under the present law, section 294 (d) of the Internal Revenue Code of 1939, a taxpayer has been able to avoid penalties arising from an underestimate of his estimated tax either by paying his current estimated tax on the basis of the previous year's income, or, by paying at least 80 percent of the tax due for the year by the 15th of January after the close of the year.

But the penalty applied by the proposed provision, section 6654, is at the rate of 6 percent per annum from the time of the underpayment of any installment, until paid. The underpayment is the amount by which one-fourth of 70 percent of the tax shown on the final return exceeds the installment actually paid. An illustration of the way this works is given in section 6015 of the House report.

The penalty can be avoided in three ways. The first two are consistent with present law and provide for the payment of the current estimated tax based on the previous year's tax or income. But the third method is new and merits serious reconsideration.

It provides that the penalty can be avoided if the installment of the estimate is based on actual income earned to the last day of the month preceding the due date of the installment. The income for that period is placed on an annual basis. The installment is then computed on 70 percent of the tax so arrived at. The House report indicates that this provision is designed to help taxpayers "who expect to receive the greater part of their income in the latter part of the year."

Based on my many years of working experience, the proposed provision would work a great hardship on people whose income varies from year to year, depending on events occurring during the year. In this group we can include thousands of merchants, professional men, commission salesmen, securities dealers, and numerous other business groups.

These people cannot pay their estimated tax based on previous year's income. They have no assurance of any year's income. On the other hand, their estimate during the year of their final tax can often be nothing but a sheer guess. It can cost them a heavy penalty if they have underestimated and strip them temporarily of necessary capital if they have overestimated.

The only other alternative open to them is to base their estimates on actual income. As drafted, the formula has two defects:

(1) It assumes that the rate of income earned for the computation period will continue for the rest of the year. For example, if a taxpayer has an income of $20,000 for the period January 1 to March 31, in paying his April 15 installment it will be assumed that his income for the year will be $80,000. The 1954 tax on $80,000 of net income for a married man is about $30,500. The April 15 installment on a 70-percent basis would be about $6,900. If, however, the taxpayer breaks even for the rest of the year, his full final tax would only total about $5,300. He would have overpaid $1,600, or 30 percent of his final tax. This capital would be tied up and not available for business use for more than a year.

(2) No provision is made for a refund within a reasonable period if a taxpayer should actually operate at a loss in a subsequent period. Should the taxpayer in the above example operate at a deficit of $15,000 for April and May, which is very possible in venture-capital businesses, his net income for the period January 1 to May 31 would be $5,000. Placed on an annual basis, his income would then be $12,000, with a total tax of about $2,700. Under the formula of section 6654 (d) (3), all that would have been due through the June 15 installment would be about $950, which is 70 percent of one-half of $2,700. Since the taxpayer paid $6,900 on April 15, there is no payment due in June. There is no way for the taxpayer to recover his overpayment of nearly $6,000 until some time after he files his final return, and he thus suffers a loss of working capital.

I see no reason why the law should be changed to create hardships. But should you deem it necessary to make a change, the proposed draft could be amended in the following respects:

(1) The formula for paying on the basis of actual income should be revised so as to annualize the tax, and not the income. In effect, the taxpayer should not be subject to the penalty if he pays 70 percent of the total tax computed on his actual income to date. In this way the taxpayer will really be paying as he goes, which is the fundamental objective of the whole tax system. Because of the progressive tax rates, the income annualization requirement, in effect, makes the taxpayer pay on income which he has not as yet received and may never earn.

(2) Provision should be made for a quick refund based on an amended estimate. This is simple justice and may, without exaggeration, give quick relief to many individual proprietorships whose capital and credit are limited. If this places an administrative burden on the Treasury, it is at least matched by the inconvenience to the taxpayer of computing his income four times a year.

I am submitting for your consideration a supplementary memorandum containing my thoughts as to how the above suggestions may be implemented. It also contains a discussion of the difficulties caused by the effective dates of the new provision.

Supplementary Memorandum Submitted by Mr. Henry Oppenheim in Connection With Sections 6015 and 6654 of H. R. 8300

1. All of the sections of H. R. 8300 dealing with the declaration of estimated income tax by individuals are located in subtitle F. Section 7851 (a) (6) provides that the provisions of subtitle F "shall take effect on the day after the day of enactment" of the bill. Presumably, then, any installments due on the declaration after the enactment would be subject to new section 6654. This presents an almost impossible administrative problem for both the Government and the taxpayer with respect to installments due before the enactment. How, if at all, would penalties for underdeclaration affect such prior installments?

In addition, taxpayers may be subjected to an additional burden. Suppose that the bill is enacted June 14. The June 15 installment would then be covered, without adequate opportunity for the taxpayers to prepare.

It would seem that the most equitable solution for both the Government and the taxpayer is to have the new provisions dealing with the declaration of estimated tax by individuals applicable only to taxable years beginning after the date of enactment. In that way the Government's rights for underdeclaration penalties for the entire year would be clearly maintained, and taxpayers would have ample opportunity to adjust their affairs to conform with the new law.

2. The first amendment to section 6654 suggested in my major text could be implemented by amending subsection (d) to read as follows:

(d) EXCEPTION. Notwithstanding the provisions of the preceding subsections, the addition to the tax with respect to any underpayment of any installment shall not be imposed if the total amount of all payments of estimated tax made on or before the last date prescribed for the payment of such installment equals or exceeds whichever of the following is the lesser—

(1) The amount which would have been required to be paid on or before such date if the estimated tax were whichever of the following is lesser—

(a) The tax shown on the return of the individual for the preceding taxable year, if a return showing a liability for tax was filed by the individual for the preceding taxable year.

(b) An amount equal to the tax computed, at the rates applicable to the taxable year, on the basis of the taxpayer's status with respect to personal exemptions under section 151 for the taxable year, but otherwise on the basis of the facts shown on his return for, and the law applicable to, the preceding taxable year.

(2) An amount equal to 70 percent (66⅔ percent in the case of individuals referred to in section 6073 (b) relating to income from farming) of the tax computed on the taxable income for the months in the taxable year ending before the month in which the installment is required to be paid, as if such taxable income were the taxable income for the entire taxable year.

(3) I am not submitting any draft to implement my second suggestion concerning a quick refund of estimated tax. The mechanics of such a proposal present policy questions for the Treasury. One method which can be adopted, however, is to add a provision to chapter 65 of subtitle F similar to section 6411, dealing with tentative carryback adjustments.

STATEMENT OF MR. HENRY OPPENHEIM—H. R. 8300, SECTIONS 275 AND 312 (C) AND (D): NONDEDUCTIBILITY OF AMOUNTS PAID BY CORPORATIONS ON CERTAIN INSTRUMENTS

Mr. Chairman, in accordance with your permission, I am herewith submitting the following statement to be incorporated in the record of the hearings of the Senate Finance Committee on H. R. 8300, sections 275 and 312 (c) and (d).

My name is Henry Oppenheim, a certified public accountant of the State of New York, and senior partner of the accounting firm of Oppenheim, Appel, Payson, and Dixon, 83 Rector Street, New York City 6, N. Y. I appreciate this opportunity to bring to your attention a provision of H. R. 8300 which vitally affects the railroad industry of the United States. A number of my clients hold substantial interests in various railroads.

These provisions have the effect of denying an income tax deduction for interest paid on certain corporate obligations. The deduction is denied where the interest is dependent upon the earnings of the corporation and is not unconditionally payable at or before maturity.

Hardest hit by these arbitrary provisions is the railroad industry which has many millions of dollars of this type of obligation outstanding.

The report of the House Ways and Means Committee states that no deduction shall be allowed for "those income debentures which are not true debt obligations of the issuer." The committee also states that it intends to include within the definition of the term "securities," the interest on which is deductible, "bona fide debts only."

Apparently, then, the intent inherent in these provisions is to prevent a corporation from getting a deduction for amounts paid on money which is superficially a loan but actually an investment of capital. This intent is borne out by 312 (c) (1) which also denies the deduction for interest paid on "loans" from shareholders which are subordinated to other creditors. The drafters of the bill evidently concluded that an indebtedness, the interest on which is dependent solely upon earnings, demonstrates an equal lack of bona fides.

It may be that the provisions are sound when applied to obligations owed to the shareholders of a closely held corporation or to income bonds issued in ex-

change for outstanding preferred stock. It seems perfectly obvious, however, that the provision is untenable as it affects the bonds of a publicly held railroad corporation.

The majority of the railroad income bonds now outstanding were issued in exchange for fixed indebtedness in connection with section 77 bankruptcy reorganizations of the companies. The original indebtedness was incurred for cash and bore fixed interest. The obligations were recognized as bona fide indebtedness in the reorganization proceedings, as evidenced by the fact that in most cases equity shareholders received common stock, if anything. The indebtedness was, therefore, bona fide when issued, bona fide at the time of reorganization and is bona fide now.

Section 77 (d) of the Federal Bankruptcy Act provides, among other things, that, in connection with railroad reorganizations, "the (Interstate Commerce) Commission shall render a report and order in which it shall approve a plan, which may be different from any which has been proposed, that will in its opinion meet with the reiquirements of subsections (b) and (e) and will be compatible with the public interest;" The Supreme Court, in *Ecker* v. *Western Pacific Railroad* (63 Sup. Ct. 692 (Mar. 15, 1943)), stated that railroad reorganizations are "something more than contests between adversary interests to produce plans which are fair and in the public interest. When the public interest, as distinguished from private, bulks large in the problem, the solution is largely a function of the legislative and administrative agencies of government with their facilities and experience in investigating all aspects of the problem and appraising the general interest."

It would appear then, that these provisions of H. R. 8300 are based upon the view that it is against the public interest to allow deductions for interest paid on obligations which the Interstate Commerce Commission and the courts specifically decided were in the public interest to issue.

The application of these new provisions of H. R. 8300 to the American railroads would create great hardships. To some of the weaker roads, it might well be financially disastrous. Obviously, any road able to do so would refinance its indebtedness to escape the disallowance. Those companies which are in the weakest condition, and which are, therefore, of the greatest public interest, would not be able to do so and would bear the full brunt of the penalty.

In conclusion, this loop-hole-closing provision should be limited to those cases where loopholes actually exist and should not be extended to income bonds originally issued as indebtedness by a publicly held corporation for valid business reasons and in the public interest.

HERSHEY CHOCOLATE CORP.,
Hershey, Pa., April 20, 1954.

Re sections 309, 354 (b) and 359 (a) of proposed Internal Revenue Code of 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
(Attention: Mrs. Elizabeth Springer, clerk, Senate Finance Committee.)
(Attention: Miss Elizabeth Springer, clerk, Senate Finance Committee.)

DEAR SIR: This letter is written because the Internal Revenue Code of 1954 will, if it becomes law in the form of H. R. 8300, inflict a real hardship upon Hershey Chocolate Corp. and its stockholders. I am taking the liberty of addressing this letter to you because of the important role you are playing in the shaping of the new Internal Revenue Code.

Please let me make it clear at the outset that there is so much that is constructive in H. R. 8300 that it is with great reluctance that I find myself in the role of critic.

Nevertheless, I should call to your attention two aspects of H. R. 8300 which, if enacted, would work a genuine hardship on Hershey Chocolate Corp. and its shareholders. They are:

(1) The 85-percent-transfer tax imposed by section 309, which tax in our case may amount to from approximately $1 million to over $5 million depending on circumstances, and

(2) The tax free advantages accorded to publicly held corporations by section 354 (b) in connection with statutory mergers and consolidations, and the exclusion of Hershey Chocolate Corp. from the category of publicly held corporations by the definition in section 359 (a).

That the hardship threatened by those sections is real, that it is unjust, and that it will hit other legitimate corporations as well as Hershey Chocolate Corp., will, I trust, be evident upon a reading of this letter.

I. IMPACT OF SECTION 309

Section 309 if enacted will impose a so called transfer tax on certain amounts paid by corporations within the next 10 years in the purchase or redemption of their preferred stock. Hershey Chocolate Corp. has $11,612,100 par value of preferred stock outstanding. If in each of the next 10 years it redeems 2 percent of its preferred stock it would, if section 309 is enacted, have to pay a transfer tax of approximately $1,083,000. (2 percent per annum is mentioned because it is the bare minimum amount of preferred stock which the corporation must purchase or redeem as a condition precedent to the continued payment of dividends on the common stock.) Furthermore, if the corporation were to redeem all its outstanding preferred stock, the transfer tax would, if section 309 is enacted, be over $5 million.

What is this preferred stock? Who holds it? How did it come to be issued?

The outstanding preferred stock of the corporation consists of 232,242 shares of series A 4¼-percent preferred stock of the par value of $50 per share. It is redeemable at the corporation's option. Its current redemption price is $52.50 per share unless the purpose of redemption is to meet the 2 percent-per-annum-sinking-fund requirement above mentioned, in which case the current sinking fund redemption price is $50.75 per share. Both prices will be reduced from time to time until the first mentioned redemption price becomes $51 per share in 1960 and the sinking fund redemption price becomes $50 per share in 1960. (All redemption prices mentioned are plus an amount equal to preferred dividends accrued to the redemption date.)

The series A 4¼ preferred stock is listed on the New York Stock Exchange and currently sells for more than $53 per share.

Ninety-one percent of the preferred stock is held by approximately 4,100 public stockholders. The remaining 9 percent is owned by a charitable organization, a school for orphan boys founded in 1909 by the late M. S. Hershey and now known as "Milton Hershey School." The school also owns, and for the past 27 years has continuously owned, the controlling common stock interest in the present Hershey Chocolate Corp. (a Delaware corporation organized in 1927). From 1918 to 1927 the school owned all of the common stock of a predecessor corporation of similar name (Hershey Chocolate Co., a Pennsylvania corporation).

The present 4¼ percent preferred stock was issued in November 1949. At that time the corporation had 253,742 shares of old (noncallable) convertible preference stock outstanding, 91 percent of which was owned by the public. By vote of the holders of more than two-thirds of the convertible preference stock and of more than two-thirds of the common stock each share of convertible preference stock was reclassified into a package consisting of 1 share of series A 4¼ percent preferred stock (par value $50 per share), 1 share of series B 4½ percent preferred stock (par value $50 per share), and 1 share of common stock (of no par value but with a then market value of approximately $37.50 per share. Before this classification was voted on, the Internal Revenue Bureau, on application by the corporation, had issued a ruling to the general effect that the reclassification was taxfree and that, if the stockholdings of the corporation remained approximately the same as they were then, the redemption of series A or series B preferred stock would constitute a partial liquidation under section 115(c) of the present code (and thus subject to capital gain or loss treatment). Except for the redemptions mentioned below, the stockholdings of the corporation have remained approximately the same as they were in the fall of 1949.

In October 1950 the corporation redeemed at a cost of approximately $13 million, all of the series B 4½-percent preferred stock. Since then the corporation has also redeemed or purchased, at a cost of approximately $1,100,000, 21,500 shares of series A 4¼-percent preferred stock pursuant to sinking-fund requirements.

How did the old convertible preference stock happen to be issued? It was issued in 1927 when the corporation was organized. It (together with a minority block of common stock) was sold directly by the corporation for cash to a banking house for resale to the public—all in an arm's-length bargaining transaction utterly devoid of any tax avoidance motivation whatsoever. Allocating, as between the two classes of stock, the combined price received by the corporation

for the common stock and convertible preference stock which it sold, the price allocated to the convertible preference stock was $65 per share.

Why would the section 309 tax apply to the redemption by the corporation of its series A 4¼ percent preferred stock? Isn't such a redemption adequately saved from tax by one or more of the exemptions provided by section 309? The answer is believed to be "No."

In analyzing how the corporation would happen to be taxed under section 309 on redemptions or purchases of its series A preferred stock in the next 10 years one cannot help but be impressed by the important part played by certain wholly arbitrary assumptions which are made by section 309 but which in the case of Hershey Chocolate Corp. are contrary to fact. In the first place the series A 4¼-percent preferred stock is arbitrarily deemed to have been issued on January 1, 1954, although, admittedly, it was actually issued in November 1949 in reclassification of a convertible preference stock issued in 1927. In the second place the fact that the series A 4¼-percent preferred stock was not itself issued for cash but was issued (along with 1 share of series B 4½-percent preferred stock and 1 share of common stock) in exchange for old convertible preferred stock has unfortunate, and arbitrarily determined, consequences under section 309. By the terms of this section no regard is paid to the fact that, from a business standpoint, the corporation in 1949 received full value for its issuance of preferred and common stock, such value consisting of the benefit accruing in eliminating the old convertible preference stock which hung like a millstone round the corporation's neck. No attention is paid to the fact that on its own merits, and prior to any public hint of the fact that a reclassification was under consideration by the management, the old convertible preference stock was selling on the New York Stock Exchange at approximately $130 per share.

On the contrary, the 1949 value of the convertible preference stock is completely disregarded, and attention is directed solely to the amount of cash which the corporation received for the old convertible preference stock in 1927. The amount so received is, I assume, then allocated as between the series A preferred stock, the series B preferred stock and the common stock issued in exchange.

Figured on this basis the cash proceeds arbitrarily treated as if received by the corporation for its series A 4¼ percent preferred stock is estimated by me to amount to approximately $23.96 per share.

To this amount the corporation is permitted to add an additional 5 percent, making a total of $25.15 per share. Anything over this amount paid in redemption or purchase of the present preferred stock would be subject to an 85 percent tax.

When a corporation is confronted with a tax, particularly a confiscatory tax of 85 percent, it is only natural for those most directly concerned to review what the corporation has done that gives rise to such a tax. In considering section 309 from this standpoint we note that if section 309 becomes law the corporation would be taxed because of the wide disparity between (i) the redemption price of series A 4¼ percent preferred stock and (ii) that portion of the price received in 1927 for the convertible preference stock which is deemed allocable to the series A 4¼ percent preferred stock. The fact that the price received in 1927 was a fair price at that time, arrived at by arm's-length bargaining, apparently does not save the corporation. Nor does the corporation receive any comfort from the fact that by 1949 the market value and investment position of the old convertible preference stock had risen to such point that the public holders thereof would simply not have voted for a stock reclassification unless the new preferred stock issued thereunder had terms (including redemption prices) as favorable as the terms which were actually presented to them.

In testing the nature of the section 309 tax, let us also consider what might have happened if, instead of rising in value, the convertible preference stock had remained at or around the price received for it by the corporation. If this had happened, it might have been reclassified not into 2 shares of $50 par value new preferred stock and 1 share of common stock but into 1 share of $50 par value new preferred stock and one-half share of common stock. If this had happened, then the one share of preferred stock issued in reclassification could have been redeemed without the penalty of any section 309 tax.

This, of course, comes dangerously close to saying that Hershey Chocolate Corp. would, if section 309 were enacted, be subject to tax (and an 85 percent tax at that) because, and only because, the public investors in its convertible preference stock had realized a profit on their investment.

This also comes close to saying that the corporation would be taxed under section 309 not because it had gotten something in the way of money, property, income, or advantage, but because (without any fault of its own) it hadn't gotten something.

In fact the section 309 tax as it would apply to Hershey Chocolate Corp. is so contrary in spirit to everything that the sponsors of H. R. 8300 stand for in the fostering of investment that I cannot help but think that some unintentional error must have attended its original conception.

I may be wrong but it would appear that the sponsors of this section were laboring under the mistaken impression that whenever a corporation pays out in redemption or purchase of preferred stock more than 105 percent of the cash proceeds which it originally received when the stock (or a predecessor preferred stock) was issued, the present redemption payment as well as the original issuance must necessarily be so tainted with tax avoidance motivation that the payment must be suppressed by a confiscatory, not to mention retroactive, excise tax.

With all respect, this is not true.

May I suggest that, although preferred stocks are frequently sold with redemption premiums of 5 percent, or less than 5 percent of the issue price, there may nevertheless be numerous valid and bona fide business reasons (quite unconnected with tax avoidance motivation) why there may be a greater disparity than 5 percent between the proceeds which a corporation received upon the original issuance of its preferred stock (or a predecessor preferred stock) and the amount now required to be paid to effect the repurchase or redemption of the same.

Without enumerating all of the circumstances under which this situation has arisen or can arise, may I invite attention to the following:

(*a*) The issuance of a preferred stock at a time when market conditions, or the issuer's investment stature, are such that the purchasers (whether a group of investment banking houses purchasing for resale to the investing public, or a group of insurance company buyers) can successfully insist, as a condition of their purchase, that the redemption premium be more (in some historic instances, much more) than 5 percent of the issue price.

(*b*) The nonpayment of cumulative dividends for many years—with the result that the cost of repurchasing or redeeming the stock (including as it does the amount of dividend arrearages) may be 1½ to 2 times the amount originally received for the stock. Frequently corporations meet this situation by issuing new preferred stock equal in par or stated value to the par value and aggregate dividend arrearages of the old preferred stock. In such case, the redemption price of the new preferred stock (although it may not be more than 5 percent of the par value of the new preferred stock) will necessarily be 1½ to 2 times the proceeds originally received by the corporation for the old preferred stock.

(*c*) The original issuance of noncallable preferred stock at a time (such as the end of World War I) when money rates were very high, with the result that the preferred dividend rate may have to be as high as 6, 7, or even 8 percent for the stock to be salable. Assuming that such stock is of sound investment stature, it is only natural for it to sell at very substantial premiums upon a general lowering of money rates such as has occurred over the last 20 years. Indeed, some of the oldest, largest, and most distinguished corporations in America still have outstanding in the hands of the public noncallable high-dividend-rate preferred stock. Originally issued at $100 per share they may now sell on the stock exchange for premium prices, such as, for example, $178 per share, or even (in the case of one famous 8-percent preferred) $211 per share.

(NOTE.—In referring to these companies I would not suggest that, but for the enactment of section 309, they would be disposed to repurchase their outstanding noncallable preferred by open-market purchases or by calls for tenders in the next 10 years. For the most part they have shown no disposition to do this in the past. What they might consider doing, however, if section 309 is not enacted, and what wouldn't be worth doing if it is enacted, would be to submit to the vote of their various classes of stockholders a plan of recapitalization under which the old noncallable preferred would be reclassified into new redeemable preferred stock or into new redeemable preferred stock and common stock. This is what some other companies having noncallable preferred stocks have done in the past. In some cases such reclassification has been soon followed by the redemption of all of the new redeemable preferred stock. It is on this type of redemption that section 309 would impose a confiscatory penalty.)

(*d*) The original issuance of noncallable preferred stock which is convertible

into common stock and which, with a rise in the market value of the common stock, sells at a corresponding premium. The classic illustration of this is the convertible preference stock of Hershey Chocolate Corp. already discussed.

No doubt there are other examples of legitimate instances of a greater disparity than 5 percent between a preferred stock's present redemption or repurchase price and the amount originally received by the issuing corporation. May I suggest, however, that the examples which have been cited, particularly the detailed story of Hershey Chocolate Corp. itself, are sufficient to point up the dangers inherent in the basic approach of section 309.

By "basic approach" I refer to the fact that, as stated in the committee report, section 309 was primarily intended to stamp out "preferred stock bail-outs" of the type unsuccessfully attacked by the Bureau in the Chamberlin case. This objective could have been, and should be, achieved by legislation which is custom tailored, or (to switch metaphors) which is pinpointed on the real target.

Section 309, however, represents an entirely different approach. Its first sentence imposes what in effect is a flat prohibition (for an 85-percent tax can be nothing else) on all payments in redemption of all preferred stocks. This is done on the theory that the five exemptions in clause (*a*) will cover all situations which should be exempt from the tax.

Obviously such an approach puts upon the draftsman the grave responsibility of conjuring up all the situations which should properly be excepted from the general prohibition. This responsibility is particularly grave because of the confiscatory nature of an 85-percent tax. An 85-percent tax is dynamite when it misfires.

May I suggest that in the case of Hershey Chocolate Corp. and the other instances mentioned on pages 5 and 6 the 85-percent tax of section 309 misfires, and misfires badly.

Since no one could ever be sure of carving out all the appropriate exceptions to the section 309 tax, may I suggest that section 309 should either be scrapped in toto, or be redrafted to apply only to future preferred stock bail-outs of the true Chamberlin type.

II. IMPACT OF SECTIONS 354 (B) AND 359 (A)

Let us take two corporations—corporation A and corporation B. Let us assume that each would be benefited by acquiring the stock or the assets of corporation X, through the issuance of the acquiring corporation's stock in a statutory merger or consolidation.

Let us assume that the proposed new Internal Revenue Code is so framed that such acquisition by corporation A is completely tax-free, not only to corporation A and its stockholders but also to corporation X and its stockholders. Let us further assume that under the same Internal Revenue Code a completely similar acquisition by corporation B would result in taxable gain or loss, not only to corporation B and its stockholders but also to corporation X and its stockholders.

If this were the case, there would be no doubt that corporation A had received from the new revenue code a tremendous advantage in its competition with corporation B for the acquisition of the stock or assets of corporation X.

If sections 354 (b) and 359 (a) are enacted in their present form, Hershey Chocolate Corp., will be put in the same disadvantageous status above attributed to corporation B, vis-a-vis publicly held corporations as defined in section 359 (a).

The apparent theory of sections 354 (b) and 359 (a) is that a publicly held corporation is, by reason of the character of its stock ownership, inherently less likely to abuse the tax-free statutory merger and statutory consolidation provisions of section 354 (b) than a corporation which is not publicly held.

With this theory in mind, let us look at the owners of the common stock of Hershey Chocolate Corp. Let us see whether they would be more likely, or would be less likely, to seek tax avoidance in statutory mergers and consolidations than would be the case with corporations which fit the publicly held definition of section 359 (a).

We will find that 69 percent of the common stock of Hershey Chocolate Corp. is owned by Milton Hershey School. This a tax-exempt charitable organization which has been ruled by the Bureau to meet not only the standards of section 101 (6) of the present code but the even more restrictive standards of a genuine educational organization as specified in sections 54 (f) (2) and 3813 (a) (2).

With all respect, I can think of no stockholder less likely to be motivated toward tax avoidance than an organization which is tax-exempt in the first place.

As for the remaining 31 percent of the common stock (now having an aggregate market value of approximately $31 million) who are its owners?

They consist of approximately 8,800 public investors. It is upon them that 31 percent of any disadvantage to Hershey Chocolate Corp., inherent in the new Revenue Code would indirectly fall. Certainly, from their standpoint the common stock which they hold in Hershey Chocolate Corp., is held for the same investment reasons as any other stocks. I am confident they would be at a loss to understand why a corporation in which there is such a large public stock interest should be placed at a disadvantage vis-a-vis other corporations whose securities are traded on the stock exchange.

I will admit that to date it has not been the policy of Hershey Chocolate Corp. to acquire other businesses and the corporation may well adhere to such policy indefinitely. It is submitted, however, that it should not be deprived of the ability, which it now has under existing law, to diversify its business through tax-free statutory mergers or consolidations if in the future the business wisdom of such course should be indicated.

Very truly yours,

W. E. SCHILLER, *Treasurer.*

BRIEF WITH RESPECT TO PROPOSED AMENDMENTS TO H. R. 8300

To the Finance Committee of the United States Senate.

GENTLEMEN: Consideration of the following proposed amendments to H. R. 8300 as adopted by the House of Representatives is most respectfully requested. These proposed amendments fall into two broad categories: (1) Proposed changes in certain provisions of the bill as so adopted; and (2) proposed amendments to the code not embodied in the bill as so adopted.

Under the first category the proposed amendments submitted herewith are as follows:

I

The provision in H. R. 8300 permitting consolidation of subsidiaries where 80 percent or more of the voting stock (as defined) is held within the consolidated group is a desirable modification of the code, but in its present form it appears it would work an unwarranted hardship on certain corporations. If consolidation is elected, the system would be required to consolidate all includible subsidiaries from January 1, 1954. In cases where a corporate system consisted of a number of subsidiaries, 95 percent or more of whose voting stock was owned and which had previously been consolidated, and also of another company or group of companies where the group ownership was 80 percent or more but less than 95 percent, the taxpaying system would, under the provisions of the present law, appear to be faced with 1 of the following 3 alternatives, each of which would involve the possibility of a burden or loss:

(*a*) To continue to consolidate all includible subsidiaries, which would subject the taxable income of the 80- to 95-percent subsidiaries to the 2-percent penalty tax on consolidation, to say nothing of losing the benefit of the $25,000 surtax exemption as to each such 80- to 95-percent subsidiary;

(*b*) To elect not to consolidate: This might subject the system to even greater penalty or tax loss, due to inability to offset losses of one or more of the subsidiaries in which 95 percent or more of the stock was owned against profits of other such subsidiaries, and also through the double taxation involved with respect to 15 percent of corporate dividends received from such subsidiaries;

(*c*) To elect to consolidate, but to eliminate the penalty or loss incident to consolidating the hitherto nonconsolidated subsidiary or subsidiaries (80 to 95 percent) by disposing of sufficient stock to reduce the voting-stock ownership below 80 percent: This would involve burdens and possible losses in another form, namely, first, by increasing the minority interest in such subsidiaries, contrary to the normal desire of the holding company; then, too, the amount of stock so to be disposed of might be considerable (it could, theoretically, equal 14 percent of the stock outstanding), and with no market or an inactive market for the stock, sale thereof might involve an unnecessary and unwarranted loss which still might represent the lesser evil, considering all 3 possible alternatives. Under the present provisions of H. R. 8300, even such a disposition would not eliminate (but merely reduce) the penalty which might arise from consolidation of such subsidiaries, since it appears the system, if it elected consolidation, would be required to consolidate such subsidiaries from January 1, 1954, to the date

the holdings were reduced below 80 percent, so that an unwarranted and inequitable penalty would apply for this period, in any event.

Accordingly, it is respectfully submitted, that H. R. 8300 be amended so that—

(X) Where a corporate group filed a consolidated return for 1953 (or the applicable fiscal year), then it could elect to continue such consolidation as to 1954 without including therein any subsidiaries as to which it owned 80 percent or more, but less than 95 percent of the voting stock (as defined) on some designate date (date of enactment of the new statute, for example); in such event the inclusion of such subsidiaries would be permissive, but not mandatory. The system would, however, be required to include all newly acquired subsidiaries (i. e., those acquired after the designated date) as to which 80 percent or more of the voting stock was owned. Such an amendment would permit hitherto consolidated groups to continue to consolidate without being penalized by one of the alternatives above mentioned; or

(Y) In case the amendment submitted above in X was not adopted, then, to minimize the penalty, provision should be made that where any corporate group electing to consolidate disposes of stock in subsidiaries at any time during 1954 (or, if preferred, say within 90 days after enactment of the statute) so as to reduce the holdings therein of the includible group below 80 percent such subsidiary shall not be required to be included in the consolidation for any portion of the year 1954.

II

It appears that the present provisions of the code determine the election as to consolidation according to the form of return next filed after the new statute is adopted. The writer is informed that this provision is not considered entirely clear, but there seems to be considerable opinion that, unless amended, the filing of a 1953 consolidated return after enactment of the statute would have the effect of binding the corporate group to consolidate for the year 1954 and thereafter until a new election right should arise. Thus, companies which had received extensions of time for filing their 1953 consolidated returns might unknowingly be binding themselves as to 1954 due to their ignorance of this provision and its interpretation. It is respectfully submitted that this provision of the code be clarified so as to make it plain that the new election would be evidenced by a return for the 1954 calendar year or applicable fiscal year.

Under the second broad category above mentioned, the following are most respectfully submitted:

I

The provisions relating to corporate reorganizations generally are now broad enough, seemingly, to permit treatment as nontaxable of any form of reorganization where the required percentages of securities are continued in the hands of the former owners of the controlling interests, regardless of the form such reorganization may take; i. e., merger, recapitalization, or transfer of assets to a new corporation. Thus, for instance, if a recapitalization took place with an exchange, for instance of preferred for common stock, the control would continue in the hands of the true former owners (in this case the old preferred stock), the tax base would of course continue, and the accumulated surplus or deficit in earnings for tax purposes would apply to dividends thereafter declared on the new common stock in determining the taxability of such dividends to the recipients thereof.

However, if the reorganization took place by way of a transfer of assets to a new corporation in exchange for its securities, and the common stock of the new company were distributed to the preferred stock of the old, with the same ultimate result as described above, the tax basis continuing from the old to the new corporation, there appears to be considerable doubt, under the court cases, whether a tax surplus or deficit of the old company would be carried forward to the new, as it would be in the case of a recapitalization or merger. If the holders of the old preferred stock are considered as the true owners of the enterprise at the time of the reorganization, and if the operations represented an accumulated tax deficit at that time, then it would seem unfair that, in continuing their ownership in the future, they should be taxed on future dividends which were paid from capital, merely because the reorganization had taken the form of organizing a new corporation with a transfer of assets. The converse also, is true. Here, it would seem, the statutes governing taxability of dividends, and determining of accumulated earnings and profits, etc., follow the same technical treatment which formerly plagued corporate re-

organizations and which was designed to be eliminated by the congressional legislation in the early 1940's.

It is, therefore, respectfully submitted that, to carry out fully the concept of continuing interest, tax deficits or surpluses should be carried forward in nontaxable reorganizations, whether they be carried out through the medium of a merger, transfer of assets or recapitalization, or otherwise. In any case equity would seem to require that the remaining corporation inherit whatever tax surplus or deficit previously existed in the predecessor so that the continuing stockowners would have their dividends held to be taxable or nontaxable on the basis of the same broad concepts as those applied to taxability of the reorganization itself. It is, therefore respectfully submitted that the code be amended so as to provide for the carrying over to the successor corporation of tax surpluses or deficits in any reorganization which meets the tests of nontaxability under the provisions of the code relating thereto. Dividends are one element of the continuing ownership and it would seem illogical to treat this ownership as flowing freely forward regardless of the means employed, and then determine the carrying forward of surplus or deficits on the technical basis of the particular form of the reorganization transaction.

II.

In determining accumulated surplus or deficits for tax purposes, for the purpose of determining taxability of dividends to recipients, there appear to be a considerable number of cases where consolidated returns were filed by corporations during many years in the past and where interest on then existing promissory notes of subsidiaries held by the parent were taken as deductions by the subsidiary and as income by the parent, purely in routine accounting. This treatment, because of the consolidation, had no tax significance in terms of tax liability for the period. It appears that even in cases where it is demonstrable that the subsidiary was insolvent at the time the interest was accrued on the books, it might be doubtful whether it could presently be sustained that such interest should be eliminated as income of the parent in determining the present accumulated tax earnings and profits of the latter. It is submitted that some statutory test of the includability of such income, together with provisions that the accrual thereof on the books in past years should not require inclusion of such interest as income of the parent for the determination of the accumulated earnings and profits, where, because of consolidation (or losses) there was no tax consequence from the treatment of such interest, and where it can be reasonably demonstrated that assets of the subsidiary were not of sufficient value to pay its liabilities, including such interest so accrued. It might be provided that subsequent cancellation of the indebtedness of the subsidiary upon which such interest was accrued, in reorganization or otherwise, solely for stock of such subsidiary, would represent prima facie evidence of the noncollectibility of such interest at the time of its accrual, and, accordingly, the right to eliminate it from the accumulated earnings and profits of the parent corporation.

From the writer's investigation, both with respect to clients and otherwise it appears that the foregoing proposed amendments would affect a considerable number of corporate taxpayers. A substantial number of taxpayers would come within the purview of item I of category 1. It is impossible to determine the number that might be affected by item II of category 1, but the number here might be even greater, particularly the smaller corporation without expert tax advice.

Respectfully submitted,

WILLARD F. STANLEY,
President, Corporate Services, Inc.

NEW YORK CITY, *April 20, 1954.*

JOHN J. LANG & CO.,
CERTIFIED PUBLIC ACCOUNTANTS,
St. Louis 1, Mo., April 20, 1954.

HON. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: I have been corresponding with Congressman Thomas B. Curtis regarding a proposal to amend the Internal Revenue Code to provide for the application of the carryover principle to such contributions as may be made by

taxpayers in excess of the limitations set out in the law. Section 170 of H. R. 8300 has made provision for an additional 10 percent allowance for contributions made by individuals to churches, educational organizations, or hospitals. It is not proposed to suggest any change in the percentages now specified. The original proposal had been referred to Mr. Colin Stamm's office and Congressman Curtis now makes the suggestion that I address a statement to you and request that such statement be included in the hearings. I am therefore submitting herewith:

(1) Proposed amendment to section 170, H. R. 8300.

(2) Statement regarding reasons why proposed amendment to section 170 permitting a contribution carryover should be adopted.

The proposal has also received the approval of: F. Emerson Andrews, director of studies in philanthropy, Russel Sage Foundation; Theodore Geiger, National Planning Association. Both of these organizations feel that they cannot express an opinion thereon because of their tax-exempt status.

It is believed that the proposal would be a step forward in encouraging charitable contributions by individuals and corporations without any appreciable loss of revenue to the Government. This proposal would simply insure that full tax benefit would be received by the contributor in subsequent years for contributions made in any one year in excess of the limitations. The most recent application of this principle is set out in section 175 dealing with expenditures for soil and water conservation. Here the excess is allowed as a deduction in the succeeding taxable years.

I hope you will have your committee give this proposal its earnest consideration and that you will be able to incorporate it in your hearings. I do not believe that it is necessary to take up the time of your committee at any scheduled public hearing but submit this proposal strictly upon its merits and trust your committee may approve it.

Respectfully submitted.

John J. Lang.

Contribution Carryover—Individual and Corporations

Proposed Amendment to Section 170, H. R. 8300, Revenue Code of 1954

(d) If for any taxable year a taxpayer has made contributions which would have been deductible in such year except for the fact that such contributions were in excess of the percentage limitation set out in subparagraph (b) then the amount of such excess shall be a contribution carryover. Such contribution carryover shall be deductible as a contribution for each of the five succeeding taxable years to the extent that the contributions in such year and the amount of the carryover do not exceed the percentage limitation set out in such paragraph (b).

Statement Regarding Reasons Why Proposed Amendment to Section 170, H. R. 8300, Permitting a Contribution Carryover Should Be Adopted

The proposed amendment has certain advantages both to the Government and the taxpayer.

Briefly, the purpose of the proposed amendment is to give application to a principle which has found acceptance in the tax law, making far more equitable taxes over a long-term period, namely, the carryover principle. This principle allows the benefit of a deduction set out in the statute, for which the entire benefit is not received in 1 year, to be carried over into subsequent years. Illustrations of this carryover principle are:

(1) Net operating loss carryover.

(2) Capital loss carryover.

(3) Unused excess profits credit.

(4) Excess soil and water conservation expenditures (sec. 175).

The application of this principle to the contribution deduction is justified on the following grounds:

(1) Individual and corporate taxpayers do not know before the end of the year what their adjusted gross income or net income will be on which figure the percentage deduction of 20 percent (or 30 percent) and 5 percent, respectively, is allowed. Consequently, if contributions in the year exceed the amount computed on the respective incomes, then the taxpayer loses the benefit of the deduction of the excess contribution.

(2) This situation has the natural tendency to cause taxpayers, particularly with fluctuating incomes, otherwise willing to make contributions equal to the maximum amount allowable, to seek to keep below this amount so that there will be no loss of tax benefit.

(3) The organizations, the beneficiaries of these contributions, are thus deprived of amounts which would otherwise come to them.

(4) It is generally acknowledged that it is good public policy to encourage contributions to organizations set out in the Internal Revenue Code to whom deductible contributions may be made, and the proposed amendment would do this without any percentage increase.

(5) The proposed amendment would definitely make it possible for a taxpayer to make a contribution to an organization in one lump sum instead of spreading it over a period of years. This would be of particular benefit to the organization receiving the contribution in those cases where the contribution would be for building or expansion or for a specific project which could not be spread over several years.

(6) The proposed amendment would be in line with the principle set out in section 175, H. R. 8300, which provides that if the expenditures for soil and water conservation "exceeds 25 percent of the gross income derived from farming during the taxable year such excess (xxx) shall be deductible in the succeeding taxable year in order of time; but the amount so deductible under this section for any one such succeeding taxable year, plus the expenditures actually paid or incurred during the taxable year, shall not exceed 25 percent of the gross income derived from farming during the taxable year."

(7) The proposed amendment would not have any material effect on the tax revenues—no increase in percentage allowance is contemplated—taxpayer would only receive assurance that contributions in excess of percentages specified could be carried forward into a succeeding period or periods.

LAW OFFICES,
DAVIES, RICHBERG, TYDINGS, BEEBE & LANDA,
Washington 5, D. C., April 20, 1954.

Re Depletion on salt—1954 Revenue Act.

SENATE FINANCE COMMITTEE,
United States Senate, Washington, D. C.

GENTLEMEN: We are writing you on behalf of the Salt Producers Association, Inc. The depletion rate on salt under the present law is 5 percent; under H. R. 8300 currently under consideration by your committee this rate would remain at 5 percent in the 1954 Revenue Act.

The Salt Producers Association, speaking on behalf of practically the entire industry in this country, including so-called small producers, testified before the Ways and Means Committee through a labor-management group of spokesmen last fall, and undertook to demonstrate by facts that the 5-percent rate is inadequate for the industry and should be increased to not less than 23 percent.

The failure of the Ways and Means Committee, as reflected in H. R. 8300, to provide any increase over the current 5-percent rate constitutes, we respectfully submit, unreasonable discrimination against the salt industry in fact of the numerous rate increases in H. R. 8300 for minerals for which a greater need in our economy cannot possibly be shown.

According to the language of section 613 (b) of H. R. 8300, an incalculable number of minerals for which no percentage depletion was established by prior law will be allowed a 15-percent depletion rate. In other words, all minerals not specifically referred to in the act, which includes literally hundreds, would be entitled to 15-percent depletion, despite the fact that for nearly all of these minerals no case for any percentage depletion rate has ever been made before Congress. Yet it is proposed to limit salt, the most widely needed mineral of all, to the present 5 percent.

We specifically request your committee to include as part of its record for present consideration the statement on behalf of the Salt Producers Association commencing on page 2043 of part III of the hearings before the Ways and Means Committee beginning August 6, 1953.

We believe that upon careful consideration of the statements of this labor-management salt-industry group the members of your committee will be satisfied that the salt deposits of the United States constitute a major national resource

not only for food, but also because of the eminent position of America in the chemical and industrial fields requiring salt. You will also be impressed by the fact that salt in usable form is not readily available, as might be generally believed by persons who do not realize that the cost of locating deposits of the proper chemical composition, and of mining and purifying the output of these deposits, must be economically feasible to the producer. The necessity for a substantial increase in the present 5-percent depletion rate is shown in the cost figures set forth in the statements referred to. Further justification for an increase derives from the fact that a salt industry financially able to meet the increasing demands for salt essential to our national welfare is of greatest importance to our country, and salt ranks second to none of the innumerable minerals for which H. R. 8300 provides a 15-percent depletion rate.

We request that the committee's earnest consideration of an increase in the depletion rate for salt to at least 23 percent.

Sincerely,

ARTHUR D. CONDON.

NATIONAL OIL JOBBERS COUNCIL,
WASHINGTON, D. C., *April 20, 1954.*

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Committee on Finance, Senate Office Building, Washington 25, D. C.

DEAR MR. CHAIRMAN: On behalf of the members of the National Oil Jobbers Council, I appreciate the opportunity to submit a statement to the Senate Finance Committee in connection with its present inquiry on the tax revision bill, H. R. 8300. As you may recall, the National Oil Jobbers Council is composed of 26 State associations of independent jobbers and distributors of petroleum products. An oil jobber is a marketer of petroleum products primarily engaged in wholesale distribution, although some jobbers also engage in the operation of service stations. The word "independent" as it applies to a jobber means that he owns his own business and is in no manner affiliated with, a subsidiary of, or in any manner financially controlled or dominated by integrated oil companies.

With this brief word of explanation as to the nature of our organization and the type of function performed by its membership, I should like to proceed immediately to the presentation of the problem we would like to have considered by your committee.

Under the present provisions of the Internal Revenue Code, the 2 cents per gallon Federal excise tax levied on gasoline is imposed on the manufacturer or producer of such gasoline. This 2 cents per gallon tax is, in turn, passed along to the jobber who distributes the gasoline to retail outlets. The retail dealer passes the tax on to the ultimate consumer. It should be noted that one of the incidents of a jobber's method of doing business is the storage of bulk quantities of gasoline for distribution to his customers. In the event the gasoline being sold for resale by the jobber is destroyed or lost by fire, flood, or other casualty, under the present provisions of the Internal Revenue Code the jobber must absorb such losses.

This is an inequitable situation in that the jobber not only acts as a tax collection agent without compensation for the United States Government, but if such gasoline is lost while in his possession, he has no recourse or means of obtaining a refund for the gasoline excise tax he has been required to pay to his supplier.

The National Oil Jobbers Council has been requesting for some years that the Congress amend the Internal Revenue Code so as to eliminate this inequitable situation and provide a means whereby the petroleum products jobbers, wholesaler, retail dealer, or persons in a comparable position, can obtain a refund of the taxes they have paid and thereby recoup to that extent their losses. It is an anomalous situation that in a number of the States, provision is made by statute for obtaining a refund of the State gasoline tax on casualty losses of this type. In our opinion, the Federal Government should be equally realistic and fair in the treatment of this problem.

On January 23, 1953, Senator Hugh Butler and Senator Schoeppel introduced S. 594 which would provide a refund of the Federal tax paid on gasoline where the gasoline is destroyed by fire or other casualty while held for resale by a jobber, wholesaler, or retail dealer. This bill proposed to amend chapter 29 of the present Internal Revenue Code by adding a new section 3454 which would set up the mechanics for refunding the amount of tax imposed under section 3412 of the

code which has been paid on gasoline destroyed by the named casualties. The bill was referred to the Senate Committee on Finance and I am informed that as of this date no action has been taken by the committee on this particular bill.

Inasmuch as the Senate Committee on Finance has before it at the present time the Internal Revenue Code omnibus revision bill, we respectfully suggest that the terms and provisions of S. 594 be incorporated into H. R. 8300 as an amendment. There will be no real loss of revenue involved in such amendment and it would have the practical effect of eliminating a gross inequity that can only be remedied by statute.

Respectfully submitted.

OTIS H. ELLIS,
General Counsel.

STATEMENT SUBMITTED BY THE AIRCRAFT INDUSTRIES ASSOCIATION OF AMERICA, WASHINGTON, D. C., IN OPPOSITION TO SECTION 274 OF INTERNAL REVENUE CODE OF 1954 (H. R. 8300)

This statement is submitted on behalf of the Aircraft Industries Association of America in opposition to section 274 of the Internal Revenue Code of 1954, because of the adverse effect which such section will, if enacted into law, have upon the aircraft manufacturing industry.

The Aircraft Industries Association of America has about 130 members representing almost all of the manufacturers of aircraft, aircraft engines, and related equipment in the United States. The members include almost all the prime contractors with the Department of Defense in the aircraft field. They are located in every section of the United States, and the hardship which will be imposed by the enactment of the proposed section 274 will apply to all sections of the country.

It is believed that any new proposal in this bill which adversely affects this important segment of industry should be of serious concern to the members of the Senate Finance Committee.

Section 274 is aimed at what is said to be an abuse of the "privilege" of States and political subdivisions thereof to issue securities, the income from which is exempt, under existing law, from taxation by the Federal Government. On page 33 of the report of the Committee on Ways and Means of the House of Representatives on this bill, the following comment appears with respect to section 274:

"Present law exempts from Federal income-tax interest on securities issued by States and their political subdivisions as well as Territories and possessions of the United States. There has been a growing abuse of this privilege by many local governments which issue securities to finance the construction of industrial buildings for lease to private industry. * * *"

Without tackling the abuse, which is the issuance of tax exempt industrial bonds by local governments, section 274 will penalize a large segment of industry.

Section 274, in substance, provides that amounts paid or accrued to any State, Territory, possession, or other political subdivision, for the use and occupancy of property acquired or improved through the use of funds derived from the proceeds of any industrial development revenue bonds authorized after February 8, 1954, will not be deductible as a business expense. Thus, the users of property improved or acquired through the use of the proceeds of any such bonds will, if section 274 is enacted, be denied the ordinary tax deduction for rent paid for the use of such property.

If there is an evil or an abuse in tax exempt securities, the proceeds of which are used for the development of industrial property, it is believed that any such evil or abuse should be eliminated by removing the tax exempt character of the securities rather than to penalize innocent third parties.

As the members of the committee are aware, aircraft manufacturing plants, of necessity, are adjacent to airports. Most airports and the adjacent property are owned by State, county, or municipal governments.

This will be even more necessary in the future with the increased cost of developing airports resulting from the advance of the jet age.

With respect to future projects, whether the airport be located at Los Angeles, Wichita, Seattle, or any other locality, if, by reason of plant dispersal or any other cause, an aircraft manufacturer should build a plant on property acquired by a State, county, or municipality through industrial revenue bonds, then amounts paid or accrued by the manufacturer, regardless of the amount,

would not be deductible for tax purposes by the aircraft manufacturer. The rent might be equal to or even higher than the going rate in the vicinity for factory sites; but this makes no difference under section 274. In addition, it is a common provision in leases of airport sites that any building erected will revert immediately to the municipality owning the land, upon completion of the construction or at the termination of the lease. Section 274 in its present form is also susceptible to the interpretation that amortization of the cost of construction of the manufacturing plant will not be deductible, in such a circumstance. This is considered to be a shocking consequence of a provision designed to reduce the use of tax exempt securities.

With respect to existing projects, current amounts being paid or accrued by a manufacturer who has already built a plant on an airport site will, under section 274, no longer be deductible, if the municipality which owns it should make even the slightest improvement to that property through the use of the proceeds of revenue bonds. Moreover, the jeopardy affecting the amortization of the facility of this manufacturer will at once arise.

Members of the aircraft industry have built their plants on public property and have paid substantial rent for many years. It makes absolutely no difference so far as section 274 is concerned whether the land was acquired by the city or county through the sale of tax exempt securities or whether the buildings were paid for in full by the industry, which is the case in most instances.

Most leases of this type give to the manufacturer the right to land and take off its planes at the airport. If a municipality should decide to repair a runway and to finance this through the issuance of industrial revenue bonds, then the entire rent of the manufacturer for an area on which his plant is located and which he has occupied for years and years will no longer be deductible as a business expense.

The effect of all this is merely to increase the rent of aircraft manufacturers by the amount of tax which they will pay through the loss of the deduction; the purchasers of the tax exempt securities are not affected in any way by this provision, since the income from such securities will continue to be exempt from the Federal income tax.

The injury which will result from the operation of section 274, if it is enacted into law, will apply to many airports throughout the country which will be restricted in their ability to expand.

It is not an answer to say that, in the future, aircraft manufacturers should locate their plants away from publicly owned airports. This is a well-established industry. It cannot be moved overnight. The development of airport property has become essentially a governmental function. Consequently, this provision is a direct impediment upon the expansion of a truly Government function and will operate as an unreasonable hardship upon the aircraft manufacturing industry.

It is recommended, therefore, that further study be given to this problem, and that, pending such study, section 274 be eliminated from this bill.

STATEMENT OF DONALD V. FRASER, PRESIDENT, MISSOURI-KANSAS-TEXAS RAILROAD CO., CONCERNING H. R. 8300

My name is Donald V. Fraser. I reside in St. Louis, Mo., and I am president of the Missouri-Kansas-Texas Railroad Co. The Missouri-Kansas-Texas, which is more familiarly known to many of you as the Katy, would be adversely affected by sections 305, 306, 309, 312, and 275 of H. R. 8300, as passed by the House of Representatives. These sections similarly adversely affect many other railroads. They would prevent the Katy and other railroads from making effective use of section 20b of the Interstate Commerce Act. In passing that act, which relates to the modification of railroad financial structures, Congress sought to protect the interests of the public, the railroads, and investors in rail securities. Recapitalizations under this section, as well as reorganizations of insolvent railroads under section 77 of the Bankruptcy Act, and acquisitions, mergers, and consolidations under section 5 of the Interstate Commerce Act would be impossible if sections 305, 306, 309, 312, and 275 are not amended so as to make them inapplicable to securities, the issuance of which is approved by the Interstate Commerce Commission.

To illustrate the irreparable harm that would result to the Katy and other railroads similarly situated now or in the future, I wish to briefly outline the

problem facing our railroad. Our stock capitalization is made up of about $66 million of 7 percent, $100 par preferred stock, and approximately an equal amount of common. From 1930 until 1952 the Katy was unable to pay dividends on its preferred stock with the result that there is now an accumulation of approximately $150 a share or a total of over $100 million. The current dividend rate of 7 percent is unrealistic and, even though we have been able to resume payments recently, we could not make the full payment of $7 which would have been necessary to avoid further accumulations. Because of this situation, we have no prospect of being able to pay off the back dividends on our preferred. The existence of these large arrearages has a substantial and adverse effect on our railroad, on the marketability of our securities, on our credit standing and, therefore, on our ability to refund our bonds at reasonable rates or obtain needed funds for the improvement, maintenance, and operation of the railroad. Furthermore, so long as this arrearage exists, the common stock, which has voting control of the property, cannot participate in earnings. The Congress, in passing section 20b, specifically recognized the needs of the Katy and cited it as an example of a road whose capital structure should be recast to avoid future financial difficulties. Accordingly, after the expenditure of great time and effort, our railroad filed with the Interstate Commerce Commission a proposed plan of recapitalization under section 20b. Unfortunately, after our hearing, it became apparent that the plan we submitted would not be acceptable to 75 percent of our security holders as required by the act.

During the intervening months we have been in the process of drafting an amended plan for submission to the Commission. There are severe limits with which we must comply in preparing such a plan. First, the Commission will not approve a plan with a total capitalization in excess of the capitalizable assets of the railroad. There is a second ceiling on the amount of securities our company may issue which is determined by the Commission by capitalizing estimated future earnings. Then the Commission has certain general standards relating to the amounts, types, and classes of securities that may be issued and a legal standard governing the allocation of new securities as between the various classes of outstanding securities. This latter standard is sometimes referred to as the priority rule under which a senior security must be granted the economic equivalent of the rights he surrenders before a junior security may be given anything.

It is essential to preserve the greatest amount of flexibility possible in order to, first satisfy the requirements and standards of the Commission, and, second, to give security holders a package of new securities in exchange for those surrendered which at least three-fourths of them will accept. Of course, as to the three-fourths accepting the plan, it is voluntary, but, as to the 25 percent that do not accept the plan, it is involuntary.

Under the present tax statute the recapitalization plan we submitted to the Commission would be tax free. In fact, our old plan was so ruled by the Internal Revenue Service. That is to say that no income or gain would have been recognized on the exchange by our stockholders since they would have received no money or other property as part of the new package. Many recapitalizations and reorganizations of railroads have been consummated without tax consequences to the holders of stock at the time of exchange of old securities for new. It has always been held that, as in the case of recipients of stock dividends who merely receive more paper representing the same interest in the corporation, no taxable incident has occurred and no tax is payable until the new paper is sold.

Under sections 305, 306, 309, 312, and 275 of the bill, as passed by the House, our situation would be completely changed. We would have no real possibility of achieving a recapitalization under section 20b as I shall show by a discussion of each of these sections.

In section 305 any recapitalization involving the elimination of dividend arrearages through the issuance of new stock or securities is taxable as a dividend to the extent that the new securities are attributable to the arrearages. The proposed statute says that such a distribution is to be deemed in lieu of money."

Secion 306 (c) provides the same result in the case of interest arrearages on bonds. The effect of these sections seems to be that, if there is an arrearage of interest or dividends on outstanding bonds or stocks and new securities are issued in exchange for such bonds or stocks, then income is received on which a tax must be paid. Such a result is in my opinion wholly inequitable and wholly unfair in that it does not take into account whether there is a probability that the dividend or interest arrearage could or would be paid in cash. In all

plans of recapitalization filed under section 20b the Commission has carefully scrutinized the past and prospective earnings of the railroad in question, and, if it concluded that there was even a reasonable prospect of the railroad paying off the arrearages in the next 15 or 20 years, it has refused to approve the plan. It has taken this action a number of times. Thus, any recapitalization plan approved by the Interstate Commerce Commission is based on the premise that the security holders could not be paid in cash for the accumulated interest or dividends. I, therefore, reiterate that it is unreasonable and unfair to treat the piece of paper received under a 20b plan as the equivalent of cash that could never be received. I am certain that no such result was intended by those who drafted these provisions and that they were unaware of the effect of these sections on railroad recapitalizations.

The concept in section 305 and 306 (e) to which I have referred also is completely at odds with the treatment given stock dividends under the new bill. There it is recognized that where a company merely capitalizes surplus no taxable event occurs. I can see no real distinction between capitalization of surplus from which future dividends might be paid (as in the case of the stock dividend) and the capitalization of surplus in discharge of a dividend arrearage. No money passes out of the corporation in either case and the stockholder merely gets more or different paper representing the same interest in the surplus and the same claim on liquidation that he previously possessed.

It must be readily apparent to anyone that, if section 305 as it presently reads is passed, we will never be able to obtain the 75-percent assents of security holders required by section 20b. Stockholders cannot be expected to vote for a plan which at the time of exchange of securities creates taxable income, but provides no money with which to pay the tax on it.

Another provision of H. R. 8300 that would substantially adversely affect recapitalizations under section 20b is section 275. This provides that interest on income bonds shall no longer be deductible for income-tax purposes. Income bonds have been widely used in railroad financing. Their issuance has been approved by the Interstate Commerce Commission in all recent reorganizations as being in the public interest and in the interest of the railroads. A plan of recapitalization for our railroad that will comply with the many standards and requirements of the Commission and at the same time be acceptable to at least 75 percent of our stockholders will have to provide for the issuance of some income bonds. The income bond has proven useful in rail reorganizations for several very valid reasons. The issuance of securities by railroads is strictly controlled by the Interstate Commerce Commission. The amount of fixed interest debt that they may issue is severely limited. The amount of income bonds is also restricted. Income bonds issued by railroads represent true debt securities having a fixed maturity and they afford railroads an absolutely necessary flexibility in reorganizations that otherwise cannot be made sufficiently attractive to secure the necessary assents of security holders. Over a billion dollars of such securities is now outstanding. Section 275 would not only affect those already issued, but would close the door to a necessary, useful, and legitimate method of recapitalization and reorganization financing for railroads. In my opinion, it would be most unjust to deny this method of financing to railroads such as the Katy, particularly when the use of income bonds has proven so helpful and beneficial to other railroads in solving their financial problems.

Finally, I would like to invite your attention to the adverse effect upon our recapitalization problem of section 309. This section imposes upon corporations an exorbitant 85-percent penalty tax if they redeem preferred stocks or income bonds. Many of the indentures under which bonds have been issued in recent years contain mandatory sinking funds for the retirement of a certain percentage of such bonds each year. Both Congress and the Interstate Commerce Commission have repeatedly stated that railroads whenever possible should buy in their securities, particularly when they can be obtained at a discount. Under many conditions section 309 would impose a prohibitive tax on a railroad company which buys in its securities either under a mandatory sinking fund or in furtherance of the policy declared by Congress and the Commission. I am certain that there was no intention to place the railroads between the upper and nether millstone. The committee will recognize that a railroad purchases its securities either under indentures approved by the Commission or pursuant to congressional policy and not for the purpose of avoiding taxes.

I am told that in certain unregulated industries abuses have grown up which the sections I have discussed are designed to correct. I am certain, however, that none of these abuses has been found in the railroad industry and they will

never occur in our industry. Railroad financing is closely controlled and governed by the Interstate Commerce Commission. No stock or securities may be issued, no reorganization, recapitalization, merger, consolidation or acquisition may be consummated without the approval of the Commission.

It is my earnest suggestion that, if the abuses in unregulated industries warrant the adoption of sections 305, 306, 309, and 275 in their present form, the committee should not visit the sins of others on the railroads. It should take cognizance of the generic difference in railroad recapitalizations and grant them exemption by a separate section as has been done in the case of changes to effectuate FCC policy, exchanges in obedience to SEC orders, and in nonrailroad reorganizations under chapter X of the Bankruptcy Act.[1] Believing as I do that the railroads are entitled to and must have equivalent treatment in order to effectuate necessary recapitalizations and reorganizations approved by the Interstate Commerce Commission pursuant to acts of Congress, I submit for the consideration of the committee a suggested new section to H. R. 8300.

As for the nondeductibility of interest problem under section 275 and the penalty tax on redemptions under section 309, although I believe that those sections are unwise and should be eliminated, in the alternative I ask the committee to exempt railroads from the provisions of sections 275 and 309.

PROPOSED NEW SECTION TO H. R. 8300 RELATING TO INVOLUNTARY REORGANIZATIONS UNDER THE JURISDICTION OF THE INTERSTATE COMMERCE ACT

(a) EXCHANGES BY SECURITY HOLDERS AND STOCKHOLDERS.

(1) IN GENERAL. No amount shall be includible in income, and no gain or loss shall be recognized if participating or nonparticipating stock or securities of a railroad corporation (as defined in section 77m of the Bankruptcy Act (49 Stat. 922, 11 U. S. C. A. 205)) are exchanged solely for participating or nonparticipating stock or securities in such corporation or in another railroad corporation, with the approval of the Interstate Commerce Commission pursuant to a plan of reorganization, recapitalization, acquisition, merger, or consolidation under the Bankruptcy Act or the Interstate Commerce Act, or in a receivership proceeding.

(2) GAIN FROM EXCHANGES NOT SOLELY IN KIND. If an exchange would be within the provisions of paragraph (1) if it were not for the fact that the property received in exchange consists not only of property permitted by such subsection to be received without the recognition of income or gain, but also of other property or money, then the income or gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and fair market value of such other property.

(b) EXCHANGES BY CORPORATIONS.

No gain or loss shall be recognized if property of a railroad corporation is transferred in a proceeding described in subsection (a) in consideration of the acquisition solely of participating or nonparticipating stock or securities of another railroad corporation organized or made use of to effectuate a plan within the provisions of subsection (a).

(c) LOSS FROM EXCHANGES NOT SOLELY IN KIND.

If an exchange would be within the provisions of subsection (a) or (b) if it were not for the fact that the property received in exchange consists not only of property permitted by such section to be received without the recognition of income, gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(d) INAPPLICABILITY OF CERTAIN SECTIONS.

Any exchange to which the provisions of subsection (a) or (b) are applicable shall not be subject to the provisions of sections 309, 305 (c), and 306 (e).

STATEMENT OF T. C. DAVIS, CHAIRMAN OF THE BOARD OF DIRECTORS, MISSOURI PACIFIC RAILROAD CO.

My name is T. C. Davis. I reside in New York City, and I am chairman of the board of directors of the Missouri Pacific Railroad Co. While there are many provisions in H. R. 8300, I am limiting my comments to sections

[1] Secs. 1071, 1081, and 871.

275, 305, 306, and 309 because of the irreparable harm which will result to the Missouri Pacific if those sections are passed in their present form.

As you all know, the Missouri Pacific has been in reorganization under section 77 of the Bankruptcy Act for 22 years. Three plans of reorganization have failed and there is now pending before the Interstate Commerce Commission a fourth plan proposed by its examiners which will require still further modification before it will be acceptable to various classes of security holders. We are seeking to accomplish a reorganization of the Missouri Pacific at the earliest possible date. However, the section 77 procedures are exceedingly cumbersome and expensive. Accordingly, the debtor company is attempting to secure permission to reorganize under the less expensive, more expeditious procedures of section 20b of the Interstate Commerce Act. By section 20b (13) Congress indicated that this new procedure should be made available to railroads in bankruptcy. Therefore, the debtor is vitally interested in the effects of sections 275, 305, 306, and 309 on reorganizations under section 20b of the Interstate Commerce Act as well as reorganizations under section 77 of the Bankruptcy Act.

It will be virtually impossible for the debtor to conclude a reorganization under either section 77 or 20b if the foregoing sections in H. R. 8300 are enacted in their present form. Our 22 years of experience testify to the difficulties of achieving an acceptable plan of reorganization under section 77 even under the present tax laws. Under H. R. 8300 these difficulties would become practically insurmountable. At the same time the alternative procedures of section 20b would be rendered nugatory since the 75 percent assents of securityholders required under the statute could not be obtained. Thus, the enactment of sections 275, 305, 306, and 309 would be contrary to the public interest as declared by Congress in enacting section 77 and section 20b of the Interstate Commerce Act and for all practical purposes would nullify those statutes. Sections 275, 305, 306, and 309 also will adversely affect many other railroads that may be similarly situated either now or in the future. They will also deter or render impossible acquisitions, consolidations, and mergers under section 5 of the Interstate Commerce Act.

Sections 305 and 306 strike at the very heart of any reorganization involving the elimination of interest or preferred dividend accumulations. Under present tax statutes such a reorganization would be tax free. However, section 305 (c) of H. R. 8300 provides that any distribution of securities whether bonds or stock made in order to eliminate a preferred dividend arrearage, even though made pursuant to a plan of recapitalization or reorganization under section 20b of the Interstate Commerce Act or section 77 of the Bankruptcy Act, is taxable to the stockholder as money. This treatment is contrary to the concept of stock dividends and employee stock options wherein it is recognized that income is not realized until the stock is disposed of by the securityholder. This treatment of railroad preferred stockholders is in direct conflict with section 371 (b) which permits a hat company, which is not affected with the public interest, to reorganize tax free under chapter X of the Bankruptcy Act. This treatment is contrary to the congressional purpose in enacting section 20b of the Interstate Commerce Act, is contrary to a long line of court decisions, and, in my opinion, is contrary to the intent of those who drafted this bill. To the same effect are sections 306 (d) and (e) as they relate to reorganizations involving interest accumulations on securities.

The Missouri Pacific not only has substantial interest accumulations on its bonds, but, in addition, the dividend arrearages on its preferred stock now total more than $150 per share. Neither the bondholders nor the stockholders would vote for a plan under section 77 or under section 20b if securities distributed for interest and dividend accumulations were taxed as money received. In the absence of the assent of its securityholders the Missouri Pacific would be prevented from reorganizing and might be forced to stay in bankruptcy for a long time.

The Missouri Pacific also is seriously affected by section 275 which provides that interest payments on income bonds cannot be deducted for tax purposes. Railroads are strictly regulated by the Interstate Commerce Commission not only as to rates that may be charged for service, but also as to the issuance of securities. The Commission has adopted standards which limit the respective amounts of fixed interest bonds and income bonds which may be issued. The income bonds approved by the Commission are true debt securities and have a fixed maturity date. Their issuance has been held by the Commission to be in the public interest because such bonds help railroads avoid bankruptcy if their earn-

ings are depressed from time to time. Thus, income bonds have been used in practically all railroad reorganizations in modern times. It is believed that over a billion dollars of income bonds are now outstanding. The railroad industry as a whole would be seriously affected if the present tax law were changed so as to deny the deduction of interest payments on these bonds for tax purposes. Such a denial would severely restrict, if not prevent, us from working out a plan of reorganization for the Missouri Pacific under section 77 or 20b. It is extremely unjust for one Government agency to restrict the amount of fixed interest debt that railroads can issue and for another Government agency sitting across the street to impose a tax penalty on railroads because they are prevented from issuing additional fixed interest debt. This is particularly true if the resulting tax penalty effectively prevents parties from working out an acceptable plan of reorganization.

The Missouri Pacific will also be adversely affected by section 309 which imposes a prohibitive penalty tax of 85 percent on the redemption of preferred stocks and income bonds. In plans of reorganization the Interstate Commerce Commission usually requires sinking funds for income bonds. Congress has declared that it is in the public interest for railroads to improve their financial structure by redeeming bonds and stocks in the market at a discount. This severe penalty tax imposed by section 309 on redemptions under mandatory sinking funds and on redemptions for the purpose of improving the financial condition of the company, not only is unjust, but is in contravention of a stated congressional policy.

Therefore, I urge you to carefully reconsider sections 275, 305, 306, and 309. Railroads are a regulated industry both as to rates and as to issuance of securities. Financing of railroads is subject to the careful scrutiny of the Commission and is permitted only if it is in the public interest.

It is my firm belief that the committee should provide a separate section for railroads comparable to those relating to reorganizations under chapter X of the Bankruptcy Act, changes to effectuate FCC policy, and exchanges in obedience to SEC orders. I wish to submit a new provision which I believe meets the objections outlined in this statement. I further wish to impress upon you that any new provision must be applicable to section 20b and section 5 of the Interstate Commerce Act as well as section 77 of the Bankruptcy Act. If section 20b is not included, then the Missouri Pacific by reason of any variance in tax treatment may be denied the benefits of proceeding under section 20b and, as such, would be forced to go through the long, arduous, expensive procedure under section 77 of the Bankruptcy Act. I respectfully request that you give the following amendment to H. R. 8300 careful consideration.

PROPOSED NEW SECTION TO H. R. 8300 RELATING TO INVOLUNTARY REORGANIZATIONS UNDER THE JURISDICTION OF THE INTERSTATE COMMERCE ACT

(a) EXCHANGES BY SECURITY HOLDERS AND STOCKHOLDERS.

(1) IN GENERAL. No amount shall be includible in income, and no gain or loss shall be recognized if participating or nonparticipating stock or securities of a railroad corporation (as defined in section 77m of the Bankruptcy Act (49 Stat. 922, 11 U. S. C. A. 205)) are exchanged solely for participating or nonparticipating stock or securities in such corporation or in another railroad corporation, with the approval of the Interstate Commerce Commission pursuant to a plan of reorganization, recapitalization, acquisition, merger, or consolidation under the Bankruptcy Act or the Interstate Commerce Act, or in a receivership proceeding.

(2) GAIN FROM EXCHANGES NOT SOLELY IN KIND. If an exchange would be within the provisions of paragraph (1) if it were not for the fact that the property received in exchange consists not only of property permitted by such subsection to be received without the recognition of income or gain, but also of other property or money, then the income or gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and fair market value of such other property.

(b) EXCHANGES BY CORPORATIONS.

No gain or loss shall be recognized if property of a railroad corporation is transferred in a proceeding described in subsection (a) in consideration of the acquisition solely of participating or nonparticipating stock or securities of another railroad corporation organized or made use of to effectuate a plan within the provisions of subsection (a).

(c) LOSS FROM EXCHANGES NOT SOLELY IN KIND.

If an exchange would be within the provisions of subsection (a) or (b) if it were not for the fact that the property received in exchange consists not only

of property permitted by such section to be received without the recognition of income, gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(d) INAPPLICABILITY OF CERTAIN SECTIONS.

Any exchange to which the provisions of subsection (a) or (b) are applicable shall not be subject to the provisions of sections 309, 305 (c) and 306 (e).

MEMORANDUM FOR THE SENATE FINANCE COMMITTEE REGARDING THE PROVISIONS OF H. R. 8300, RELATING TO PROFIT-SHARING PLANS AND TRUSTS FILED BY COUNCIL OF PROFIT SHARING INDUSTRIES, APRIL 23, 1954

The Council of Profit Sharing Industries is a nonprofit association of employers in the United States and Canada who have established profit-sharing plans. Its purpose is to promote profit-sharing and good will and harmony among employees and employers and to provide a means of bringing together people who are interested in the profit-sharing movement. As of January 1, 1954, the council had 815 members, including such well-known organizations as Sears, Roebuck & Co. and Procter & Gamble, pioneers in the profit-sharing movement. As of that date there were 802,000 employees employed by members of the council. (A list of the members as of January 1, 1954, is attached hereto.)

The council appreciates the enormous task which has been undertaken by the Congress in revising the revenue laws of the country. There can be no quarrel with the proposition that a revision of those laws is a desirable thing. While the council does not presume to judge all of the provisions of the proposed legislation, it feels that there are some features concerning profit-sharing on which we can offer constructive criticism. It is in this spirit that the following recommendations are made.

SECTION 83 (C)—RETIREMENT INCOME

Subsection (c) defines retirement income for purposes of the credit against income tax allowed by section 38 of the proposed bill. Since profit-sharing distributions from qualified profit-sharing trust exempt from tax under section 501 (a) of the proposed bill are taxable to the employees as annuities under section 402 (a), they are probably within the purview of section 38 (c). Nevertheless, we feel that some change in language is desirable to put this beyond question.

We, therefore, recommend that section 38 (c) be revised to include "distributions from a profit-sharing trust exempt from tax under section 501 (a)."

SECTION 101 (B)—EMPLOYEE DEATH BENEFITS

Under this section amounts up to $5,000 paid by or on behalf of an employer to the beneficiaries or to the estate of an employee by reason of the death of the employee would be excluded from gross income. Subsection (B) makes it clear that amounts distributed from an employees' stock bonus or profit-sharing trust which is exempt from tax under section 501 (a) are within the exclusion, whether or not the employee's interest before his death was subject to forfeiture. However, this exclusion is made available only if the employee's total interest in the trust is distributed within a single taxable year of the distributee.

Since distributions under life-insurance contracts and every other type of employee death benefit falling within this exclusion may be distributed either in one lump sum or in installments over a period of years, it is suggested that distributions to the beneficiaries of a deceased employee from a qualified employees' stock bonus or profit-sharing trust should be equally entitled to the exclusion whether made in one lump sum or in installments.

Presumably the objective of the section dealing with employees' death benefits is to place self-insured death-benefit plans, at least to the extent of the first $5,000, on a basis of equality with insurance plans. Application of the requirement for full distribution within a single taxable year to death benefits paid under profit-sharing and stock bonus trusts, but not to other death benefits, operates to defeat that objective.

The provisions of section 101 (b) as approved by the House of Representatives will tend to encourage and in some cases practically force the trustees of profit-sharing trusts to make lump-sum distributions when the best interests of the

widow or other beneficiary might well be served by smaller distributions over a period of years. Particularly for the widow of a low-income employee, it might be very undesirable to force upon her the making of decisions with regard to the investment or expenditure of a relatively large sum of money. The availability of the capital gain treatment afforded total distributions made within a single taxable year already provides an incentive for lump-sum payments. To add the further incentive of a $5,000 tax-free distribution would in many instances make it practically impossible for the trustees to exercise proper judgment as to the type of distribution which would be in the long-term best interests of the widow.

It is urged, therefore, that subparagraph (B) be revised to read as follows:

"(B) Nonforfeitable Rights. Paragraph (1) shall not apply to amounts with respect to which the employee possessed, immediately before his death, a nonforfeitable right to receive the amounts while living (other than amounts which are paid to a distributee by a profit-sharing or stock bonus trust which is exempt from tax under section 501 (a))."

SECTION 402—TAXABILITY OF BENEFICIARY OF EMPLOYEES' TRUST

I

This section continues the present requirement of section 165 (b) of the Internal Revenue Code that the distribution be "within 1 taxable year of the distributee" if capital gain treatment is to be accorded to it. The council has long felt that this requirement presents a hardship in cases where the employee's services are terminated near the end of the calendar year, or under circumstances which give him a right to share in his employer's profits for the year in which termination occurs. In such cases there may not be sufficient time to compute the entire benefit due the employee before the end of the year or such computation is not possible because the employer's profits are not yet known. In many such cases, particularly where the employee dies leaving a widow, it is desirable to make a payment of the benefit due as quickly as possible even though the total amount of the benefit cannot be ascertained until the following calendar year. Yet if part of the benefits are paid in one taxable year and part in another, the capital gain rates do not apply. This seems to defeat the true intent of the statute.

The council, therefore, recommends that section 402 (a) (2) be revised to extend capital-gain treatment to cases where the total distribution is made within 1 year from the date of the event giving rise to capital-gain treatment.

If it should be felt that the opportunity to make distributions in 2 taxable years and still qualify for capital-gain treatment might open the door to abuses, perhaps a proper solution to the problem would be to modify the definition of "total distributions" so as to cover distributions of the total amount of the employee's interest in the trust fund determinable as of the date of the taxable event even though the participant may be entitled to receive an additional distribution in a subsequent year, if such subsequent distribution represents only amounts attributable to the employer's contribution to the trust for a taxable year of the employer which ends after the separation from service.

At the same time it is recognized that the present rule of section 165 (b) of the Internal Revenue Code, which has been continued in section 402 (a) (2) of the bill, should not be abandoned entirely, but used as an alternative. Under some plans it may be possible that the lump-sum payment, though made within 1 taxable year of the distributee, is not made within a period of 1 year from the employee's death or other event giving rise to capital-gain treatment. Accordingly, in order not to affect those plans adversely, it is felt that the provisions of section 402 (a) (2) should be retained as an alternative.

II

In section 402 (a) (2) provision is made for capital-gains treatment for "any employee's trust described in section 501 (c) which is exempt from tax under section 501 (a)." This might be construed to deny capital-gain treatment to trusts which qualify for tax exemption under section 501 (a) by virtue of section 403 (c), since strictly speaking such trusts are not described in section 501 (e). Since this same problem arises in other sections of the new code, it might be best to include a provision in section 403 (c) to the effect that any trust which continues to be governed by section 165 (a) shall be deemed to meet the requirements of section 501 (e).

SECTION 501 (E)—EXEMPTION FROM TAX OF EMPLOYEES' TRUSTS

I

Nondiscriminatory classification

Paragraph (3) of this section sets forth acceptable classifications of employees to be covered by a qualified plan or trust and then prescribes limitations on those classifications in terms of the percentage of key employees covered and the percentage of regular employees covered. While the council advocates as broad a coverage as possible under a profit-sharing plan, it recognizes that as a practical matter there are many instances where coverage must be limited. The requirements of section 501 (e) are unduly restrictive and more stringent than the practices under existing law.

The apparent purpose of the section is to prescribe classes of employees which are acceptable without question. This is desirable but the proposed bill defeats this purpose when it applies the proviso of the section to all classes of employees described therein. It seems to us that the test laid down by the proviso has application only where a classification is set up by the employer which is not one of the classifications described in the statute or a combination thereof.

Moreover, the rules give no latitude to the employer who has a plan covering employees in a collective-bargaining unit who wishes to establish a plan covering employees not so situated. Nor do the proposed rules take into account in applying the percentage limitations employees who elect not to become covered by the plan. This often occurs where the plan is contributory.

Accordingly, we recommend two changes:

(a) The following classifications should be added to section 501 (e) (3):

"(vii) who are within a collective-bargaining unit;

"(viii) who are not included in a collective-bargaining unit;

"(ix) who are subject to the provisions of the Fair Labor Standards Act;

"(x) who are exempt from the provisions of the Fair Labor Standards Act;

"(xi) who qualify under any classification which is a combination of any of the classifications specified in clauses (i) through (x);

"(xii) who qualify under any other classification set up by the employer; provided that not more than 10 percent of the participants in the plan are key employees, except that in the case of an employer having not more than 20 regular employees, such classification shall be acceptable if 50 percent or more of all such regular employees are participants in the plan and in the case of an employer having more than 20 regular employees, such classification shall be acceptable if 10 of such regular employees or 25 percent or more of all such regular employees, whichever is greater, are participants in the plan;

Provided further, That not more than 30 percent of the contributions under the plan are used to provide benefits for shareholders. A plan shall be considered as meeting the requirements of this paragraph during the whole of any taxable year of the plan if on 1 day in each quarter it satisfied such requirement."

(b) The definition of "participants" contained in subparagraph (B) of paragraph (3) should be revised to include employees who are eligible to participate in the plan but who elect not to be covered thereunder and employees under a collective-bargaining unit which has rejected a plan offered to the unit by the employer.

II

Ratio of contributions and benefits

Subparagraph (B) of paragraph (4) of section 501 (e) requires that 75 percent of the employer's contributions be so allocated that no employee receives greater benefits, as a percentage of compensation, than any other lower-paid employee. The other 25 percent can be allocated in any manner desired as long as no employee receives more than twice as much, as a percentage of compensation, as any other lower-paid employee.

Under present law the Commissioner of Internal Revenue also requires correlation between benefits and compensation. This correlation is tested by classifying the employees into salary groups. The benefits allocated to the higher-salary groups as a percentage of compensation cannot be substantially greater than the benefits allocated to the lower-salary groups.

The rule required under the proposed law is more rigid, as it does not provide for a grouping of employees in testing whether there is discrimination. Instead, the test is applied in terms of individual employees. Thus, if there is one highly compensated employee who does not meet this test, the whole plan will be disqualified. In view of this, our first recommendation is that any test that is devised should be applied to groups or classes of employees rather than individual employees.

Second, the rule set out in section 501 (e) (4) (B) uses only compensation as a measuring stick for determining employee benefits. It does not take into consideration the fact that benefits under many employees' trusts are related not only to compensation but also to other factors, such as years of service or age of the employee. Such methods of determining benefits are desirable in view of the fact that the major purpose of an employees' trust is to insure that a retiring employee will have ample security to allow him to live comfortably for the rest of his life. By giving greater proportionate benefits to older employees, or those with greater seniority, their retirement security is being enhanced. However, the rule under section 501 (e) (4) (B) would not permit such a method of allocating benefits except to a very limited extent.

We do not mean to say that compensation should play no part in determining the empolyees' benefits. For example, we do not believe that one employee should receive a substantially greater percentage of benefits to compensation merely because he is in a high salary bracket. On the other hand, where years of service weigh quite heavily in the calculation of benefits, a highly compensated employee should get the same percentage of benefits as any other employee with the same number of years of service, even though it may be more than twice what some other more recently hired employee receives.

We are not submitting with this paper a proposed amendment to this code section. Instead, we request recognition of these two principles:

(1) Any test that is devised to test discrimination in the allocation of the company contribution should be applied to groups of employees rather than individual employees.

(2) At the present time the benefits provided by many employees' trusts are determined on a basis other than compensation. The test for discrimination in the allocation of the company contribution should, therefore, not be based strictly on benefits as a percentage of compensation.

III

What constitutes compensation

Section 501 (e) (4) defines the term "compensation" for the purposes of that section. Such a definition is necessary because of the limitations which the section sets out with regard to the benefits which employees may receive in relation to their compensation. This definition of compensation includes the employee's regular rate of compensation plus any other compensation which is determined under a definite formula. However, it does not include such items of compensation as discretionary bonuses paid to employees each year. Many companies pay such a bonus, and the amount paid is often determined by such factors as the profits of the company and the merit of the individual employee, etectra. Moreover, the practice has been to recognize such discretionary bonuses where they follow an established pattern or are averaged over a 3- or a 5-year period.

It would seem that the method of determining compensation should not be of import in determining the amount of benefits a member of an employees' trust should receive. It would seem more desirable that the term "compensation" include all taxable compensation paid to the employees, including the amount of any discretionary bonus not computed by means of a definite formula.

SECTION 403—DEDUCTIONS FOR CONTRIBUTIONS OF AN EMPLOYER

Section 403 (a) (4) permits a deduction to the employer for contributions to a trust which would qualify for exemption under section 501 (a) except for the fact that it is organized outside of the United States. This paragraph recognizes the need of a deduction for contributions to employees who are working outside of the United States. However, it does not meet the problem arising when an employee who is participating in a domestic trust is sent abroad to work for a subsidiary or affiliated corporation. In such a case the employee will not receive full benefit from the trust unless the domestic employer is permitted to make contributions to the trust during his absence.

We recommend that section 403 of the proposed bill be amended to permit the deduction of contributions for employees under these circumstances.

SECTION 505—ALLOWABLE INVESTMENTS FOR EMPLOYEES' TRUSTS

The council does not believe that there is any necessity for the Internal Revenue Code to restrict the type of investments available to an employees' trust. It is recognized that the Government may require a trust to meet certain standards if it is to be accorded favorable tax treatment but we submit that the Government is amply protected by other sections (notably, sec. 503 and secs. 511–514) against the misuse of a qualified employees' trust.

It must also be pointed out that much of the benefit to the employee and his beneficiaries to be derived from a qualified profit-sharing trust arises from the accumulation of trust income through wise and profitable investment of trust assets. Restrictions on trust investments is a matter for action by the States and should not be the subject of the Internal Revenue Code since it has no relation to raising revenue.

For these reasons the council recommends that section 505 be deleted from the proposed bill and that section 504 be made inapplicable to employees' trusts qualified under section 501 (a) and (e) of the proposed bill.

In the event the committee does not agree with the council and decides to retain the provisions of section 505, we wish to point out certain objectionable features of that section:

(*a*) The limitation regarding the investment of trust assets in real estate is too restrictive. By limiting any one investment in real estate to 5 percent of the value of the trust assets the bill denies the benefit of such investments to all but the large trusts. It would take a trust having assets of $1 million to make a single investment of $50,000 in real estate under the 5-percent limitation. Trusts that large are definitely in the minority.

(*b*) It is also difficult to see the logic in the 5-percent and 10-percent limitations contained in paragraph (7). If it is recognized that stock of A company is a legitimate investment for 100 percent of the assets of the A company's employees' trust, it should also be a legitimate investment for the trust of Company B. If the purpose is to prevent the acquisition of businesses by a qualified trust, the 5-percent limitation is also meaningless. Five percent of the assets of a trust may or may not be sufficient to purchase a controlling interest in a company. Nor is it realistic to prohibit the acquisition of more than 10 percent of the voting stock of any one issuer as proposed in this paragraph. A 10-percent acquisition may give voting control if the corporation is widely held but not if it is closely held.

(*c*) The limitations in paragraphs (6) and (7) are particularly objectionable when read in light of the requirement that the investment rules be met at the close of each quarter of the taxable year. For example, if a trust has invested 5 percent of its assets in the stock of company A and 95 percent in common stocks of other companies and there is a slight drop in the security market on the last day of the quarter adversely affecting all stocks except that of company A, the trust is disqualified merely because too much is invested in an investment which is obviously sound.

(*d*) The proposed bill will discourage the establishment of profit-sharing plans and trusts. Heretofore it has been the policy of the revenue laws to encourage the establishment of such trusts. However, as indicated above, it will be possible for a trust to unknowingly become disqualified by a fortuitous change in the securities market on 1 day out of the year. As a result the employer may lose its deduction for contributions for that year—or at best it will be postponed for an indefinite period—and the trust will be taxable on income for the year. Such obstacles will definitely discourage the development of the profit-sharing movement.

In the event the members of the committee or members of its staff wish to discuss the recommendations herein made by the council, the council will send qualified representatives to Washington to meet with them at their convenience.

STATEMENT OF THE NATIONAL EDUCATION ASSOCIATION OF THE UNITED STATES OF AMERICA REGARDING THE DEDUCTION OF PROFESSIONAL EDUCATIONAL EXPENSES

The National Education Association of the United States of America is a nonprofit organization of teachers, chartered under the laws of the District of Columbia in 1886 and by act of Congress in 1906. It is an organization of over

550,000 active members and nearly 1 million members by affiliation, located in each and every one of the States and Territories.

The purpose of the association is "to elevate the character and advance the interests of the profession of teaching and to promote the cause of education in the United States." The association has been concerned with the Federal income-tax status of teachers for many years, especially since the Public Salary Law of 1939, because most of the association's members are public-school teachers.

A characteristic of the business of teaching school is that the teacher never ceases to be a student. To be an effective teacher one must periodically take meaningful steps to keep abreast of the ever-changing conditions in his field. His preparation for teaching does not end when he completes his preservice training. Unlike the requirements of many other occupations, a teacher must withdraw from service for a year of sabbatical study, or use his vacation period for summer-school attendance, or attend night school at the end of his teaching day, in order to meet his responsibilities. By any of these methods he incurs expenses. He has never been given adequate tax relief by way of permission to deduct his expenses for professional education as a necessary business expense.

In 1921 the Bureau of Internal Revenue ruled that summer-school attendance of teachers was not deductible as a necessary business expense (O. D. 892). This ruling, having been made prior to the time when salaries of public-school teachers were taxable, could logically be applied to private-school teachers only. Private-school teachers are not subject to the same legal requirements of professional growth as public-school teachers. Hence the association considered the 1921 ruling of the Bureau inapplicable to public-school teachers.

In January 1942 the National Education Association filed a letter with the Commissioner of Internal Revenue presenting the logic and the legality of the deduction of summer-school expenses by public-school teachers, urging the Commissioner to modify the 1921 ruling accordingly. In this letter the association pointed out that teachers are required to attend summer school by State laws and local school board regulations as conditions precedent to renewal of certificates (licenses) and/or to increments in established salary schedules. It also pointed out that actors' expenses of keeping in good physical condition are deductible under the Hutchinson (13 B. T. A. 1187) and Denny (33 B. T. A. 738) decisions and that keeping in good mental condition is the equivalent in the teaching profession.

The Commissioner replied that expenses of summer-school attendance were not deductible. Under date of May 25, 1942, the Commissioner wrote the association as follows:

"It is the opinion of this Office that any expenses incurred for the purpose of educating oneself should be treated as personal expenses, regardless of whether such expenditures are voluntarily incurred or are incurred as a result of requirements of State laws or board of education rules and regulations. In the latter case the expenditures are not essentially different from those incurred for basic education. In either case the education has a bearing upon the obtaining or holding of employment and upon the amount of compensation which will be received. In neither case, however, should the expenditures be classified as ordinary and necessary business expenses."

In the Commissioner's reply he also stated that the Bureau had not acquiesced in the Hutchinson and Denny decisions.

On June 2, 1945, the National Education Association again took up this matter with the Bureau of Internal Revenue, referring to the decision of the United States Supreme Court in *Dobson* v. *Commissioner* (320 U. S. 489), wherein the Court discussed the desirability of administrative uniformity in tax matters and the weight that should be given to decisions of the Board of Tax Appeals. The association felt that under the Dobson decision, the Bureau should desist from continuing rulings on professional educational expenses of teachers that were contrary to decisions of the courts in analogous situations.

In the 1945 letter the association attempted to compromise the situation by accepting the principle that teachers who attend summer school for the purpose of self-improvement only incurred the expense voluntarily under such circumstances that their deductibility could be denied on the theory that they are personal expenses. We insisted, however, that when a teacher is required to obtain additional education to hold his position or to maintain his certification status, his expense in so doing is a necessary business expense. Since requirements of this sort apply to all teachers within a school system or within a State and are recurrent at stated intervals, it is an ordinary expense—ordinary and necessary in the business life of the public-school teacher.

The Bureau replied on November 9, 1945, in the following words:

"On several different occasions this Office has considered the question of whether the above expenses constitute ordinary and necessary business expense. On each occasion, after thorough consideration, the conclusion has been reached that the expenses of a teacher in attending summer school, whether incurred voluntarily or by reason of State requirement, are not incident to performing the duties devolving upon him by reason of his holding the teaching position, but, rather are incident to preparing himself in order that he may better perform such duties. Such expenses are, therefore, personal expenses, the deduction of which is specifically prohibited by section 24 (a) (1) of the Internal Revenue Code."

The Bureau failed to take notice of *McDonald* v. *Commissioner* (65 Sup. Ct.). Even in the limited scope of section 23 (a) (2) of the Internal Revenue Code as enunciated by the Court in the majority opinion of the McDonald case, a distinction must be made between expenses incurred in obtaining a position and those incurring in carrying on such employment. The Supreme Court of the United States does not question the right of a taxpayer to deduct expenses incurred in carrying on a trade or business. The Bureau of Internal Revenue has set itself above the Court.

In 1947 Senator Pepper (without any request by the NEA) introduced a bill which would have made summer-school expenses of all teachers deductible for Federal income-tax purposes. The National Education Association thanked the Senator for his interest on behalf of the teaching profession, but took no active part in urging the adoption of his proposal. As you know, Congress did not enact Senator Pepper's bill. However, on the floor the following comments were made:

"Mr. TYDINGS. Does the Senator from Florida have any knowledge as to whether or not in spite of the ruling of the Internal Revenue Bureau, a case was ever presented and carried before the Court of Tax Appeals to obtain a determination?

"Mr. PEPPER. I will say to the Senator from Maryland that I think the teachers have simply accepted the ruling of the Internal Revenue Bureau, except that the National Education Association, which strongly approves my amendment, has been trying to have the ruling changed for some time. I have a statement in the Record from the National Education Association.

"Mr. TYDINGS. It seems to me that if the prima facie evidence presented by the Senator from Florida were presented to the proper court which we have designated to rule on such cases, it would find it difficult to adjudicate against the philosophy of the Senator's amendment. The reason I asked the question was that I cannot conceive that such a court would allow medical and other men travel expenses and would deny them to the school teachers. I shall support the Senator's amendment, and even if we find later on that we have overlooked some point in it, which I doubt very much we have, the conferees will be in a position to correct it. I think the Senator has made a just case, and I think we ought to give the amendment the support it merits. * * *"

The Pepper bill was lost by 10 votes only.

These proceedings on the Senate floor encouraged one of the members of our association to appeal a decision rendered against her by the Internal Revenue Bureau. Nora Payne Hill was a public-school teacher in Virginia. She held the highest grade certificate issued by the State and had taught in Danville, Va., for 27 years. Her certificate required renewal at the end of each 10-year period. In order to renew it she was required to attend summer school or take an examination on a specified program of professional reading. She chose to attend summer school at Columbia University during the summer of 1945. She received a deficiency notice from the Bureau dated September 27, 1947. The deficiency was caused by the disallowance of her education of summer-school expense of $239.50 as a necessary business expense. The Tax Court held that there was no evidence that public-school teachers ordinarily attend summer school when alternative methods of showing professional growth are available, and supported its decision by reference to the 1921 ruling (O. D. 892) previously mentioned in this statement.

Mrs. Hill appealed her case to the Fourth Circuit Court of Appeals, which ruled that in her individual circumstances her summer-school expenses were deductible, saying:

"The existence of two methods for the renewal of these certificates, one or the other of which is compulsory, is not in itself vital in this connection. If the particular course adopted by the taxpayer is a response that a reasonable person would normally and naturally make under the specific circumstances, that

would suffice. Even if a statistical study actually revealed that a majority of Virginia teachers adopted the examination on the selected books, in order to renew their certificates, rather than the method of acquiring college credits, our conclusion here would be the same * * *. We note that the statistical requirement does not seem to have been enforced in the cases subsequently cited in this opinion [in which the Tax Court allowed the deduction of specialized training as an ordinary and necesasry business expense]." [1]

Following the decision in the Hill case the Bureau of Internal Revenue issued the following ruling:

"SECTION 23 (a)—DEDUCTIONS FROM GROSS INCOME: EXPENSES

"Section 29.3 (a)-1: Business expense, "1951-2 13518
(Also sec. 22 (n), sec. 29.22 (n)-1; sec. 29.23 (a)-2) "I. T. 4044

INTERNAL REVENUE CODE

"I. T. 4044: Summer school expenses incurred by a public-school teacher in order to maintain her position are deductible as ordinary and necessary business expenses under section 23 (a) (1) (A) of the Internal Revenue Code, and such expenses may be deducted in determining adjusted gross income under section 22 (n) of the Code. [O. D. 892 (C. B. 4, 209 (1921)) modified.]

"Reconsideration has been given to O. D. 892 (C. B. 4, 209 (1921)) in the light of the recent decision in *Nora Payne Hill* v. *Commissioner* (181 Fed. (2d) 906).

"In O. D. 892, supra [isued in 1921], it was held that expenses incurred by school teachers in attending summer school are in the nature of personal expenses incurred in advancing their education and are not deductible in computing net income.

"In the Hill case [in 1950], the taxpayer had taught in the public schools of the State of Virginia for some 27 years and had obtained the highest-certificate issued to public-school teachers by the State board of education. She was notified of the expiration of her certificate and that the certificate could not be renewed unless she acquired college credits or passed an examination on five selected books. She elected the former alternative and attended summer school at Columbia University. Thereafter she sought to deduct the expenses which she incurred in that connection as ordinary and necessary business expenses. The United States Court of Appeals for the Fourth Circuit held that such expenses, including tuition, room rent, cost of travel, and the difference between the cost of living while at summer school and at home, properly constituted ordinary and necessary business expenses incurred in carrying on a trade or business which are deductible under section 23 (a) (1) (A) of the Internal Revenue Code.

"In reaching its conclusion, the court stressed the fact that the taxpayer incurred the expenses "to maintain her position; to preserve, not to expand or increase; to carry on, not to commence." Thus it is apparent that the court did not hold that all teachers attending summer school may deduct their expenses as "ordinary and necessary business expenses." In cases in which the facts are similar to those present in the Hill case, the rule of that case will be applied. O. D. 892, supra, is hereby modified to conform with this conclusion.

"In general, summer school expenses incurred by a teacher for the purpose of maintaining her position are deductible under section 23 (a) (1) (A) of the code as ordinary and necessary business expenses, but expenses incurred for the purpose of obtaining a teaching position, or qualifying for permanent status, a higher position, an advance in the salary schedule, or to fulfill the general cultural aspirations of the teacher, are deemed to be personal expenses which are not deductible in determining taxable net income.

"Summer school expenses which are deductible under section 23 (a) (1) (A) of the code may, under appropriate circumstances, be deducted in determining the adjusted gross income of a teacher under section 22 (n) of the code. Expenses of travel, including meals and lodging, while away from home, incurred by a teacher in connection with the employment, are deductible under section 22 (n) (2) of the code. To the extent that other expenses, including tuition, are reimbursed expenses which qualified as deductible items under section 23 (a) (1) (A) of the code, they may be deducted in computing adjusted gross income under section 22 (n) (3) of the code. Reimbursements or expense allow-

[1] *Nora Payne Hill* v. *Commissioner* (181 F. (2d) 906 (CCA 4th 1950)).

ances received by a teacher are includible in gross income. (See I. T. 3978, C. B. 1949—2, 24.)"

The entire preceding statement is a quotation from the Internal Revenue Bulletin of January 22, 1951. The opening paragraph (I. T. 4044) states the basic rule which takes the place of rule O. D. 892.

This ruling indicates that the Bureau has construed the decision in the Hill case most narrowly, and evidences the need for instructions from the Congress to the Bureau as to the deductibility of professional educational expenses of teachers.

The professional educational expenses of teachers may be incurred by means of extension work or by attendance at night school or summer school. The same legal principles apply in any of these circumstances. Greater emphasis has been placed upon summer-school attendance merely because attention was accidentally focused on it at the beginning. The National Education Association has compiled legal and statistical data with regard to the professional educational expenses of teachers; these data are here furnished for the information of the committee.

STATUTORY AND REGULATORY PROVISIONS REQUIRING TEACHERS TO ATTEND SUMMER SCHOOL

Public-school teachers attend summer school under a variety of statutory and regulatory provisions which constitute a direct or indirect element of legal and moral obligation. There are requirements which must be met in order to continue in employment in the same position, at the same salary, in the same school system. There are requirements which are conditions precedent to salary increments in the same position. There are requirements which must be met in order to continue eligibility as a legally qualified teacher anywhere in a State under State certification standards. There are requirements which must be met in order to complete a probationary period and those which must be met in order to maintain a permanent status after having completed the probationary period.

There are penalties for failure to meet the requirements of periodic professional growth—such penalties include salary reduction within the same school system, return to probationary status, loss of position in the school system, and disqualification for public-school service anywhere within the State.

CERTIFICATION REQUIREMENTS

In every State teachers are required to be certified. Without a certificate, a teacher cannot pursue his chosen profession. The teacher's certificate is like the license of a physician or a lawyer, with this exception: A physician or a lawyer is licensed for life subject only to revocation for malpractice; most teachers are certified for a definite period subject not only to revocation for cause, but subject also to renewal only by meeting specified requirements.

In most States there are a number of grades, ranks, or classes of certificates. When an individual completes his preparation for entering the teaching profession he is granted his initial certificate of a certain grade depending upon the type and extent of his preparation. That initial certificate is renewable upon expiration on the basis of the quality of the service rendered during its life and the successful completion of renewal requirements. Or, the initial certificate may be exchanged for one of higher grade if the holder has met the advance requirements. The second certificate, upon expiration, may be renewed or exchanged in the same way if the holder meets the specified requirements. The number of renewals of a certificate is frequently limited and a teacher is required to qualify for exchange to a certificate of higher grade, the qualifications for which necessitate additional college attendance.

When a teacher has exchanged his certificate for the highest grade issued in the jurisdiction, he is usually not even then licensed for life. The highest grade certificates are often of limited duration subject to renewal. Renewal is not automatic upon expiration but again depends upon meeting qualifications therefor.

Qualifications for the renewal of certificates usually include (*a*) successful teaching experience, and (*b*) evidence of professional growth. Evidence of professional growth includes attendance at an accredited college or university for the purpose of study in prescribed or recommended courses listed by the State or local school administrators as necessary for the improvement of the teacher's service in the public schools.

Some certification requirements provide a teacher with alternative methods of proving professional growth. In some jurisdictions the teacher is required to attend the specified number of classes at acceptable colleges or universities and to complete those courses successfully. In other jurisdictions certification requirements provide the teacher with alternatives so that the certificate—which is essential in following the public-school teaching profession—may be renewed even in the event that the teacher is for some personal or economic reason unable to attend such classes. In some jurisdictions educational travel is an alternative; in others correspondence courses are acceptable; and in still others reading of educational literature with an examination thereon may be substituted for other requirements.

In recent years educational travel has increased in popularity. University credit is granted for approved travel at some institutions and it has a growing acceptance. However, the State legislatures, State departments of education, local boards of education, and the teachers themselves understand that these requirements mean that college attendance is the ordinary method of meeting the qualifications and that alternative methods are merely alternatives which may be substituted in individual cases within the discretion of the employing school board. The general practice is that the teacher is expected to attend college classes to meet requirements unless permission is given by the local school board or the State department of education to substitute some other acceptable method of establishing evidence of professional growth.

The association understands that the committee cannot examine into these statutory and regulatory provisions, but an example will be shown as evidence: The Illinois School Code of 1945 requires teachers without bachelor's degrees to attend college classes and earn 5 semester hours of credit every 3 years, and all other teachers to meet such requirements for professional growth as are prescribed by the State examining board, as a condition for renewal of certificates.

A number of States empower the State board of education or the State superintendent of schools to establish regulations for the issuance of teachers' certificates, any many of these regulations require the earning of a specified number of college credits as a condition for the renewal of certificates. Failure to meet these requirements would preclude employment of the teacher in any public school in the State.

TENURE REQUIREMENTS

Teacher tenure laws in some States require periodic school attendance of teachers in order to avoid dismissal. Such provisions are of two kinds: There may be the general statement that the dismissal of a permanent teacher is justified by his failure to make satisfactory professional growth. There are other laws in which the number of college credits to be earned and the frequency with which the requirements must be met are specified. Examples of the latter exist in Florida, Georgia, and Nebraska. Failure to meet these requirements would preclude employment of the teacher in the particular school system.

SALARY REQUIREMENTS

Any number of local salary schedules provide that professional improvement is required for increases in salary; e. g., Berkeley, Calif.; Danville, Ill.; East Aurora, Ill.; Fresno, Calif.; Rockford, Ill. Examples of two of these provisions may be quoted to illustrate this type of requirement:

"Additional training of not less than 4 semester hours will be required every 4 years." (Danville, Ill.)

"In general, each certificated employee is required to meet a training requirement for every 5-year period.

"(*a*) This requirement must be met before placement on steps 6 and 11 of the teachers' schedule and is accomplished by earning 10 semester hours of credit, or 8 semester hours if all are graduate units, or their equivalent. No more than four of these credits, in either case, may be earned through extension division courses.

"(*b*) Each certificated employee, after reaching a maximum salary, shall be expected to meet a training requirement of 5 units every 5 years. All of these units may be earned through extension division courses.

"(*c*) Certificated employees holding administrative or supervisory positions shall be expected to meet a training requirement every 5 years as in (*b*) above." (Berkeley, Calif.)

It should be noted that in Berkeley, requirements for continued professional growth apply to teachers after they have attained the maximum salary as well as along the steps toward the maximum.

In these two illustrations a teacher must meet the requirements in order to obtain an increase in salary. The Santa Monica, Calif., and Cedar Rapids, Iowa, provisions illustrate requirements which a teacher must meet in order to avoid a decrease in salary:

"Each certified employee shall be granted one increment or step in the salary schedule for each year of satisfactory service until the maximum is reached, subject to the provisions for professional improvement. [These provisions for professional improvement set up an 18 point condition which all certificated employees shall be required to fulfill during each 4-year period of service.] If an employee fails to meet the periodical professional growth requirement he shall be held at the attained salary level for 1 year. If at the end of that year he has not met the requirement he shall be set back one step on the salary schedule. This procedure shall be repeated, if necessary, until the employee reaches the salary level at which he entered the Santa Monica schools. Any employee who shall have attained the maximum salary shall manifest his professional interest by meeting the control-level requirements every 4 years in order to remain at the maximum; otherwise, the procedure outlined in the preceding paragraph shall operate (Santa Monica, Calif.).

"Each teacher shall attend not less than 6 weeks of summer school earning a minimum of 5 semester hours of credit or shall earn a minimum of 5 semester hours of credit in other residence work when previously approved by the superintendent, in a member institution of the North Central Association or in an approved institution of the North Central Association each 5-year period during the service of said teacher in the Cedar Rapids schools. Failure to comply with this ruling means that the teacher shall remain stationary on the salary schedule providing the teacher has not already reached the maximum. If maximum has been reached, then the teacher shall step back vertically on the schedule one step and shall remain there until he or she complies with the rule (Cedar Rapids, Iowa)."

STATISTICAL DATA

The NEA has made several statistical surveys of teachers' summer-school attendance; the most recent was a special study of rural teachers. It was found that the typical rural school teacher goes to summer school every third year at an average cost of $177. In order to do so, however, the typical rural teacher found it necessary to borrow the money. The average rural school teacher borrowed $266 in 1951, and to defray the costs of summer-school attendance was the second most frequently mentioned reason for borrowing. About 20 percent of the rural teachers who attended summer school borrowed some money. It is obvious that attendance would have been more widespread if these teachers as a group could have afforded the expense of summer-school attendance. Our other studies were more general, including both rural and city teachers.

The first survey of summer-school attendance of teachers was made by the association during the war years and was not entirely satisfactory for this reason. In the fall of 1949 a second survey was made. This study showed that about one-fourth of the summer-school attendance had been motivated by reasons implying compulsion by State or local requirements for continuance in current positions or renewal of certificates; about one-half of the summer-school attendance had been motivated by reasons which would improve the attendant's position economically or professionally; and about one-third attended summer school for general professional improvement.

The 1949 study found that the total expenses of summer-school attendance averaged slightly over $200, half of which was for college expenses (tuition, fees, books, etc.), one-fourth for travel, and the rest for living expenses above living expenses at home. Less than 10 percent of the teachers received any financial aid from their local employers to meet these expenses, and those who did were reimbursed from one-half to two-thirds of their total expenses only. The practice of reimbursing summer-school expenses is not prevalent and, should such expenses be deductible, those few recipients of financial aid should offset the reimbursement and deduct only the excess expenses.

The third general survey of summer-school attendance of teachers was made by the association in October 1951. About two-fifths of 3,246 teachers in this study reported that they had attended summer school for the general reason

of improving their services, including to get a higher degree, to keep up to date, and to learn new methods. The next most frequent motivation for summer-school attendance was to qualify for a certificate of higher grade. All these teachers had had at least 1 year of teaching experience; their experience ranged from 2 to 56 years.

Regardless of their reasons for attending summer school these 3,246 teachers averaged about 25 years of experience. With regard to the number of years of employment in the present school system, the average was around 15 years. These teachers averaged 6 years in public-school experience; they also averaged 6 years of employment in their present school system. Motivation for summer-school attendance did not vary greatly in accordance with length of experience.

"To qualify for a certificate of higher grade," mentioned previously as the most frequently checked reason for the group as a whole, was checked most frequently in 19 States and second in frequency in 10 other States. State laws and local school board regulations were mentioned occasionally in many States, but in no State did it show up as the most compelling reason, and in two States only did it rank second in frequency of mention. "Renewal of certificate of the same grade" ranked first in five States, but it was relatively infrequently mentioned in most of the other States. Only one State showed a preponderance of motivation to qualify for a scheduled salary increment based on seniority in the same class in the same position.

The fourth general survey conducted by the National Education Association was a followup study of 354 individuals who had participated in the third survey. They were chosen because of having reported that the reason for summer-school attendance was to keep up to date and improve their services. A bachelor's degree was held by 27 percent of these teachers and over two-thirds of them had master's degrees. Many had additional graduate college credits and three held doctorates. Thus it cannot be said that these teachers attended summer school to complete basic training.

The grade of certificate held by these teachers was examined to determine if there was any indirect relationship between their summer-school attendance and the renewal of their certificates. In all but 26 cases there could be no such relationship since the certificates held were of indefinite duration or for life, not requiring renewal, or the renewal requirements did not include additional advanced college credits. In the 26 cases a relationship could have existed, and since it was impossible to determine if the summer-school attendance was needed to fulfill renewal requirements, these 26 include all who could possibly have attended in order to renew a certificate and probably include some whose attendance actually had no bearing upon the status of their certificate.

The exact school positions of the respondents were compared with the courses listed for the last summer school attended so as to classify each respondent's summer-school study (*a*) as directly related to his job, (*b*) as indirectly related, or (*c*) as having no relation thereto. In the group of 328 whose summer-school attendance could have no relation to renewal of certificate, 62.5 percent pursued studies directly related to their jobs; and in the group of 26 whose summer-school attendance might have some relation to renewal of certificate, 73.01 percent pursued studies directly related to their jobs. Only 5.8 percent of the first group and 4.2 percent of the second group enrolled in courses that definitely were not related to their positions.

The criteria used in determining relative directness of summer-school studies to subjects taught or the duties of the position held may be outlined as follows:

For administrators, superintendents, supervisors: Workshops for superintendents and/or supervisors, school finance, school law, school administration, school construction, school lighting, curriculum construction, etc., were considered directly related. Psychology, human relations, teaching methods, teaching technics, audiovisual aids, etc., were considered indirectly related.

For classroom teachers: Psychology, teaching methods, teaching technics, audiovisual aids, individual differences, and the subjects taught, remedial technics, reading, etc., were considered as directly related. Tests, guidance, occupational information, mental hygiene, curriculum construction, administration, and school law were considered indirectly related.

It should be emphasized that the foregoing is not offered as a standard for defining direct and indirect relationship. It was merely a practical guide for purposes of this study. Actually, many of the items listed as indirect are to an increasing extent becoming essential courses in the preparation of classroom teachers and school administrators.

Since the duties described by each respondent were for the present position and the subjects often were taken several years ago, it was necessary as the next step to examine the returns to determine whether or not the respondents had changed their positions since summer-school attendance. It was discovered that less than 10 percent had changed their positions since the summer school reported. Even fewer had changed the school system in which employed (about 3 percent).

Although three-fourths of the total group of 354 had changed school systems since they first began as public-school teachers, over 92 percent of the total had more than 10 years of public-school experience; over 60 percent of the total had served at least 10 years in the present school system and almost 60 percent of the total had served at least 10 years in the present specific position, at the time they last attended summer school. At the time of this study in the fall of 1951, which in some cases was as much as 3 years after the summer-school attendance reported (1948), 60 percent of the 354 had served in their present specific position for over 10 years.

The effect of summer-school attendance upon the salary received after attending summer school was found by tabulating answers to the specific question: "For the summer school reported, did you receive a salary increment or increase for the next school year? Yes------ No------. If you received a salary increment or increase that would have been paid regardless of your summer-school attendance, check 'no.'" Only 6.2 percent of the respondents reported salary increases as a direct result of the summer-school attendance.

This survey of the reasons for summer-school attendance indicates that the Nora Payne Hill case covers only a small proportion of the teachers attending summer school. The most frequently reported general reason for summer-school attendance was to improve service and to keep up to date; the most frequently reported specific reason was to qualify for a certificate of higher grade. Neither of these reasons would justify deduction of summer-school expenses according to the present rule of the Bureau of Internal Revenue.

However, the findings of this study indicate that teachers consider summer-school attendance a necessary part of their public-school careers. They attend summer school even when they already have advanced college degrees, when their attendance does not result in increased salary, and when, because of life certificates, they are under no legal compulsion to obtain further training. Thus the evidence of this study is that for a majority of public-school teachers summer-school attendance is a necessary business expense incurred by experienced and qualified persons.

TABLE 1.—*Percent checking specified reasons for last summer-school attendance*

Reason for last summer-school attendance	Percent of total checking each reason	
	As sole reason	As 1 of 2 or more reasons
1	2	3
To comply with a State law or local school-board regulation setting increased standards for employment in present position	2.3	5.4
To comply with a State law or local regulation requiring periodic attendance regardless of certificate, salary, or promotions	3.8	5.8
To qualify for renewal of certificate of same grade	1.9	2.6
To qualify for a certificate of higher grade	10.5	12.3
To qualify for a scheduled salary increment based on seniority in same salary class in same position	2.3	5.7
To qualify for a higher training class in salary schedule in same position	6.1	10.0
To qualify for a new position	7.0	10.0
To improve service, for a refresher course, for degree, etc., only	38.8	[1]

[1] The questionnaire asked for checking this reason only when the preceding specific reasons did not apply. If a specific reason was checked and this general reason also, the specific reason was tabulated as a partial reason but no tabulation was made of the returns on the general question except those who checked it only.

The NEA is of the opinion that the ruling of the Bureau of Internal Revenue is too restrictive; that it should be broadened to include all summer-school attendance that is directly or indirectly related to the duties of the job held (as

defined on p. 14); that it should include all professional educational expenses of teachers regardless of whether incurred in summer school, night school, or full time on sabbatical leave.

COUGHLIN CASE

If it had not been for the 10 years of frustrating negotiations with the Bureau, the NEA could have been encouraged by the recent decision in the case of Coughlin versus Commissioner, decided in the spring of 1953. In this case a lawyer was granted deduction of his expenses incurred in attending the tax institute held by New York University. The court said that Couglin was morally bound to keep himself informed and up to date and expenses of this sort were deductible when they are "directly connected with" or "proximately resulted from" the practice of a taxpayer's profession. Teachers are morally bound to grow professionally. They too should be able to deduct expenses for this purpose.

CONCLUSIONS AND RECOMMENDATIONS

The NEA has attempted to obtain from the Bureau of Internal Revenue a ruling permitting teachers to deduct their summer-school expenses on Federal income-tax returns as an ordinary and necessary business expense. In denying this deduction the Bureau has, in effect, decided for teachers that it is not necessary for them to attend summer school, although the Bureau makes no attempt to decide for any other group of taxpayers which of their business expenses are necessary.

The Bureau discouraged the NEA to the extent that the association would have been willing to accept a ruling permitting the deduction of expenses only when teachers were required to attend college for additional training, if the Bureau had been willing to accept evidence that these requirements exist under varied circumstances as described in this statement. The Bureau, however, held to a strict and narrow construction of the circumstances under which teachers were "required" to attend summer school and refused to broaden its ruling.

Teachers are required to attend summer school under a variety of circumstances, and they attend also because they feel the moral obligation to keep abreast of the times. When teachers take additional training to learn new methods, regardless of the application to them of some law or regulation, they are incurring business expense nevertheless. The effect of the Bureau's attitude is to reduce summer-school attendance to those who are required to attend in the most narrow possible interpretation of a legal requirement, and it tends to eliminate those who want to go to school in order to improve their teaching. Thus through a tax policy the Bureau deprives society of the benefits which would accrue if teachers could afford to incur these expenses to make them better teachers. The association feels that only through congressional action can justice be achieved.

Many States are in the process of upgrading the general level of the quality of teaching by increasing standards for the profession. Certification is in a fluid stage. As the State raises its level of requirements, it is creating a necessary business expense over which the individual teacher has no control.

Salary and personnel policies of local school systems tend to create a pressure toward additional preparation. A teacher may be wholly acceptable to the State from the angle of certification but still be unable to continue teaching in his position because of local requirements. It is true that the teacher who obtains additional training also may obtain a higher salary, but the same is true of many of the so-called necessary business expenses in other occupations. A merchant who increases his stock does so in the expectation that he will increase his business and his income; the movie star who takes off 30 pounds in weight does so in order to continue in pictures and to have better opportunities, or maybe to qualify for a particular role. The teacher who improves his qualifications is in the same category.

Furthermore, to encourage educational refresher courses by equitable tax relief through the deductibility of these expenses of teachers would be profitable to the Federal Government. The additional revenue from higher salaries for which teachers may qualify by meeting higher standards is likely to be larger than the revenue that might be lost by the deduction of the expenses of attending college courses to meet these standards. Also, the number of persons employed by institutions these teachers attend is increased because of the attendance of teachers, and their salaries furnish additional sources of revenue.

In June 1953 the National Education Association placed these facts before the Ways and Means Committee, hoping that the committee would include in the general revenue bill provision for the deductibility of certain aspects of educational expenses which are incurred in carrying on a trade or business—namely, expenses incurred (a) in carrying on one's profession, (b) in making oneself beter qualified for his profession, or (c) to increase his remuneration from his profession. These matters were embodied in H. R. 4393, which was before the Ways and Means Committee at the time it began its 1953 tax hearings. When the Ways and Means Committee reported H. R. 8300, no steps had been taken to relieve the inequality of taxation described by the association in the preceding pages.

Therefore, the National Education Association urges the Senate Finance Committee to take cognizance of the occupational requirements that necessitate expenses for professional education of teachers, and trusts that the committee will recommend an amendment to the Internal Revenue Code by inclusion in H. R. 8300 provisions that will require the Internal Revenue Bureau to grant the deductibility of these expenses when incurred in connection with the occupation of a taxpayer.

REPORT ON H. R. 8300 BY SECTION ON TAXATION NEW YORK STATE BAR ASSOCIATION, ALBANY, N. Y.

The extent of the changes from existing law in the proposed revenue bill and limitations of time have made impossible a full and complete study of H. R. 8300. By enlisting the collaboration of a considerable portion of the tax bar in the State of New York, it has been possible to make an analysis of the more complicated sections of the proposed new code in which the more troublesome features are likely to be found.

We are wholly sympathetic with the objective of the Congress in reorganizing the code, simplifying its structure, clarifying its provisions, removing existing inequities, and providing a degree of certainty in this necessarily complex area of Federal law. The new bill evidences the very large amount of work that has gone into its drafting. It does a very great many things which have long needed doing.

In the preparation of this report the section has assumed that there will be new revenue legislation before the end of the present session of Congress, that H. R. 8300 will constitute the basis of such new legislation, and that the Senate will want to have before it the considered judgment, criticisms and recommendations of the practicing tax bar. If this report is predominantly critical, it should not be assumed that the section is unappreciative of the innumerable good features of H. R. 8300. It is of the view that in the limited time available it may be of the greatest service by devoting this report to those parts of the bill as to which changes seem necessary to clarify, to make practicable or to eliminate inequities and hardship on the one hand and tax avoidance on the other. Where criticism is offered, a conscious effort has been made to be constructive.

In their study of H. R. 8300 the members of our technical committees have been able to bring to bear and to test the provisions of the new bill against their cumulative everyday experience in tax matters. Their observations, incorporated in this report, are addressed primarily to the technical aspects of H. R. 8300. Policy matters have studiously been avoided except where they are inextricably interwoven with technical considerations. Some aspects of the new bill which might logically be expected to be considered in this report have not been discussed where the section is aware that the Senate Finance Committee has before it or will have before it the detailed studies of other professional groups.

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS

A. DISTRIBUTION BY CORPORATIONS (SECS. 301–312)

(1) Introduction

Sections 301–312 cover distributions by corporations. Important improvements have been made which will reduce uncertainty and eliminate much litigation. For example, the law with respect to stock dividends and recapitalizations has been liberalized to permit the unrestricted distribution of stock without tax despite changes in the interests of the stockholders (sec. 305). Specific rules of disproportion have been provided to remove uncertainties as to whether a

redemption constitutes a dividend or a sale of stock (sec. 302 (a) (4)). The effect of corporate distributions on earnings and profits has been clarified (sec. 310). However, in making these major changes, and particularly in connection with efforts to eliminate possibilities for tax avoidance in connection with preferred stock "ballouts," a number of serious problems have been raised involving both the substance and the draftsmanship of these sections.

(2) Effect on shareholder of redemption of stock (sec. 302)

(*a*) A distribution of inventory in redemption of stock will sometimes be treated as a taxable dividend to the extent of the corporation's earnings and profits, even though, had cash been received, the transaction would have been taxed as a sale. For example, assume a common-stock holder purchased a share of preferred stock for $100 cash and in a transaction in which his entire interest in the corporation was terminated, received inventory worth $100 for the preferred stock. Although a cash redemption would have been treated as a sale, under the bill the taxpayer will be deemed to have received a dividend of $100. Furthermore, there would appear to be no provision permitting the stockholder to recover the cost of the preferred stock.

(*b*) The redemption of the stock owned by an individual will be taxed to him as a dividend under the bill in many other situations where it would have been treated as a sale under present law, and under circumstances which would not seem to justify such harsh treatment. For example, assume that a taxpayer has a 5-percent interest in the common stock of a small bank, and that at the time of the depression in the early 1930's, to prevent the bank from failing, he purchased an entire issue of $100,000 of its preferred stock, or that at a later time he acquired from the RFC an issue of preferred stock which it had purchased under similar circumstances. The bank has prospered during recent years and is now in a position to retire this stock. If it should do so, under the bill, the taxpayer would be taxed, as a dividend, upon the receipt of the entire $100,000. The bill apparently does not even allow the stockholder to recover the $100,000 cost of the stock.

It is true that the tax could be avoided in this situation if the taxpayer knew in advance of the redemption and disposed of just over 4 percent of his common stock. However, it is the committee's feeling that such substantial tax consequences in the redemption of the preferred stock should not depend upon some mechanical, nonbusiness handling of his common stock.

(*c*) The technical and unrealistic approach of the section is also demonstrated by the following variation of the above example: Assume that the taxpayer owned no common stock of the bank, but that his son owns 1 percent of its common stock. If, prior to the redemption of the stock, the taxpayer were to sever all relations with the bank, the redemption of the preferred stock would be treated as the purchase of the stock, as under present law. However, if the taxpayer were to remain with the bank as a director, the entire cash proceeds of the redemption of the stock of $100,000 would be taxed to him as a dividend. Here the combination of the fact that his son owns a small interest in the bank, and the fact that the bank wishes to retain the benefit of his experience as a director, turns a $100,000 sale at no gain into a fully taxable dividend of $100,000.

The purpose of the bill is to reach distributions essentially equivalent to taxable dividends in a manner which is practically self-administering. This is a most difficult problem and, although rough justice may be accomplished by such an approach, there is no question but what many legitimate transactions will be penalized because they do not fit within the precise pigeonholes of the bill. By the same token, the revenues will undoubtedly suffer under some circumstances through the application of such arbitrary rules and percentages. For example, a redemption which should be taxed may be free of tax under the bill because other stock which the taxpayer owns has some unsubstantial preference which takes it out of the category of participating stock.

It is our recommendation that some type of relief valve be afforded. The taxpayer whose bank stock was redeemed in the examples above should certainly receive the same treatment accorded him under present law. A possible solution would be an overriding provision that the self-administering rules will not be applicable if the taxpayer can satisfy the Secretary or his delegate that the transaction involved is not in pursuance of a plan having as one of its principal purposes the avoidance of income tax.

(*d*) If there is a complete redemption of an individual's stock and he reacquires any interest within 10 years, the redemption price may under some cir-

cumstances be taxable retroactively as a dividend. For this purpose, the corporation's earnings and profits are computed as of the time of the redemption so that the amount of earnings and profits available for distribution would remain contingent until the end of the 10-year period, and the status of all intervening distributions would remain in doubt.

(c) If a delayed tax is imposed under section 302 (e) (2), it should be made clear that a credit will be allowed for any tax paid on gain realized and reported on the original redemption.

(3) Distributions to pay death taxes (sec. 303)

(*a*) Section 303 treats the redemption of stock to pay death taxes and related expenses in certain limited situations as a sale rather than a dividend. However, the provision is limited to estate, inheritance, legacy, and succession taxes, and funeral and administration expenses. The principles which make necessary special treatment in the case of these expenses apply with equal force in the case of claims against the estate. It is therefore the committee's recommendation that section 303 (a) (2) be amended by adding the words "and claims against the estate" in the first line following the word "expenses."

(4) Distributions of stock for accrued dividends (sec. 305)

(*a*) Under section 305, the receipt of stock in discharge of dividends in arrears on preferred stock is taxable as a dividend even though received in a tax-free merger, recapitalization, or reorganization. This is contrary to present law, and would seem to impose undue burdens upon the reorganization of financially embarrassed companies.

(5) Exchange of bonds for preferred stock (sec. 306)

(*a*) Under section 306, the receipt of long-term bonds in exchange for preferred stock, where the preferred stockholder has no other substantial interest in the corporation, is taxed as a sale of the preferred stock. Under present law, such a transaction will ordinarily be considered a tax-free exchange. There would appear to be no justification for this change, provided the taxpayer can satisfy the Secretary or his delegate that the transaction was motivated by legitimate business purposes.

(6) Attribution of ownership (sec. 311)

(*a*) The broad scope of this section, which attributes ownership to the taxpayer of shares of stock held by others, assumes a family solidarity which seems to us to be contrary to fact. For example, the bill would impose a dividend tax on a person in a transaction which would otherwise be a sale simply because his grandchild held some stock of the same company inherited, perhaps, from a relative unrelated to the taxpayer. It is our recommendation, in view of the serious tax consequences involved under these sections, that the family attribution test be limited to the taxpayer's spouse and minor children.

With respect to trusts and estates, also, the section seems to be unduly broad. For example, assume that a trust has 2 income beneficiaries, and owns 1 percent of the participating stock of a corporation. Even though each beneficiary has only a 50 percent interest in the income of the trust, they are both deemed to own the 1 percent interest in the corporation. In the event of a redemption of preferred stock of the corporation held individually by the two beneficiaries, both would be deemed to have received a dividend, although it would seem that they should both be exempt under the 1 percent minority rule. Assuming that the trust had 3 beneficiaries, and that an independent trustee had discretion to pay the income to any one of them, all 3 would be taxable under the circumstances described.

(7) Transfer tax (sec. 309)

(*a*) *Purpose of the tax.*—This section imposes a tax of 85 percent on amounts paid by a corporation to redeem preferred stock within 10 years from the date of its issuance. This tax is intended to prevent use of a device know as the "preferred stock bail out," which permits a stockholder, without substantial change in his common stock position, to withdraw earnings from a corporation at rates applicable to a capital gain rather than those applicable to a dividend. Preferred stock is issued s a tax-free stock dividend. The dividend stock is then sold and sometime later is redeemed. Even though the preferred stock is subject to immediate redemption from the purchaser, the transaction may produce only a capital-gains tax on the shareholders who sold the preferred stock.

Section 309 of the bill is defective in two respects: First, it imposes a penalty retroactively on a transaction which may have been permitted by the law in

effect at the time it was carried out; and second, it subjects to the tax redemptions which do not involve bail outs.

(*b*) *Retroactivity.*—In the case of preferred stock which is now outstanding, there may be a contractual obligation to redeem within 10 years. It seems unfair to impose a tax on the corporation under such circumstances. The tax would apply even though the stock was issued more than 10 years ago, because it would be deemed to have been issued on January 1, 1954, for this purpose. The stock may have changed hands many times since its issuance. The original recipient may, or may not, have realized a tax saving when he sold the dividend stock. If he was in a low income tax bracket, his tax on a dividend might have been no greater than his tax on the capital gain.

The tax would presumably defer redemptions of outstanding stock where the issuing corporation is under no contractual obligation to redeem at any specific time. Such a deferment might impair the value of shares held by an innocent purchaser who had no connection with any bailout scheme. As to stock now outstanding, the tax avoidance, if any, was accomplished when the original recipient sold has dividend stock. The new tax will not right this wrong, but it may harm innocent purchasers by deferring redemption.

(*c*) *Unfair effect on nonbailouts.*—The next objection is that the transfer tax is applicable in situations where the preferred stock was not issued as a part of a bailout. If in the course of reorganization, a common-stockholder exchanged his holdings for preferred stock, redemption of the preferred stock does not constitute a bailout. There would also be no bailout invoked in the redemption of preferred if the original recipient had sold his common stock prior to the redemption of the preferred. In both cases no avoidance of the tax on dividends is accomplished when the preferred stock is redeemed.

(*d*) *Redemption at a premium.*—Another common situation which would seem to be clearly outside the bailout doctrine arises where a corporation, in order to make its preferred stock salable, provides for a call premium in excess of 5 percent. Premiums of 10 percent are not uncommon and several well-known securities have been outstanding for many years which have premiums from 15 to 25 percent. Section 309 would impose a tax on their redemption of 85 percent of the distribution in excess of 105, assuming the shares were issued for cash at $100 par.

There are a number of even more extreme cases. For example, assume a corporation issued for cash at par many years ago a noncallable preferred stock with a dividend rate of 7 percent. Thereafter, in a recapitalization or merger, it exchanged the outstanding noncallable stock, which at the time had a market value of $150 per share, for new 5 percent preferred stock having compulsory retirement provisions on a basis of 1½ shares of new stock for each share of outstanding stock. Under section 309 of the bill, upon the redemption of the new stock, even though it may have been outstanding for 5 years, the corporation will be required to pay a transfer tax of $25 on each $100 share redeemed.

Even amounts paid to dissenters in a statutory merger would be subject to this tax, and perhaps preferred stock issued bona fide for past services.

It is recommended that this section should be amended as follows:

(i) It should not apply to redemptions of stock outstanding prior to enactment of the bill. Certainly, in any event, the 10-year period should begin on the actual date of issuance and not January 1, 1954.

(ii) The tax should not apply in any case where there is a redemption from the original recipient of the stock. In such case, if any "bailout" is involved, the proper treatment is to tax the redemption price as a dividend to the shareholder.

(iii) Some escape valve should be provided to permit a taxpayer to show that a premium in excess of 5 percent was required for legitimate business reasons. The present provision penalizes the small, financially weak corporation which is not in a position to obtain capital on such a favorable basis.

B. CORPORATE LIQUIDATIONS (SECS. 331–336)

(*1*) *Introduction*

Sections 331–336 of the bill deal with partial or complete liquidations which are taxable under present law, tax-free liquidations, and collapsible corporations. They make a number of important improvements in the present law which should tend to reduce litigation, including the elimination of the tax on the liquidation of a company owning appreciated assets (sec. 331); permitting a corporation to use the cost of stock purchased to acquire assets as the cost of the

assets, on the principle of *Kimbell-Diamond Milling Co.* v. *Commissioner* (187 F. 2d 718 (sec. 334 (c)); and the elimination of the difficult problem involved in *Commissioner* v. *Court Holding Company* (324 U. S. 331 (1945)) of a double tax on the liquidation of a corporation followed by the sale of its assets (sec. 333).

The new provisions accomplish a stepped-up basis, and the elimination of a double tax with respect to all assets except appreciated inventory. This new concept, however, introduced in the bill for the purpose of preventing tax avoidance in connection with the sale of inventory and the use of collapsible corporations nullifies in great part the objectives which the bill seeks to accomplish.

(2) Inventory assets and appreciated inventory

Section 336 (d) defines "inventory assets" as including not only property includible in inventory and property held primarily for sale to customers, but also depreciable property and real property, used in the trade or business, held for less than 5 years. This definition is so broad as to include any tangible property of a corporation held for less than 5 years.

The bill also introduces a new concept of appreciated inventory. If inventory assets, apparently taken collectively, have a fair market value in excess of 120 percent of the adjusted basis of such assets, the assets will constitute appreciated inventory if that portion of the basis of the stock attributable to the inventory assets is in excess of the corporation's basis for such assets.

(3) Purchase of stock to acquire assets

Although it was clearly the intention of the new provisions of the bill to simplify the acquisition of an incorporated business, it fails to do so. For example, if stock is purchased in order to acquire assets, the cost basis of the assets acquired will be less than the amount paid for the stock. Section 36 (d) provides that the basis of appreciated inventory distributed in liquidation shall be the adjusted basis which such assets had in the hands of the corporation. The result is that one wishing to purchase a business for the purpose of operating it is precluded, because of the low basis he will have for the assets, from purchasing the stock and then liquidating the corporation, if important assets used in the business have not been held by the corporation for at least 5 years.

(4) Purchase of assets

On the other hand, if the purchaser buys assets from the corporation, a double tax will be incurred on the sale and liquidation under section 333 (a) to the extent that the assets sold are included in the broad category of appreciated inventory. The result is that the bill does not accomplish the objective intended. It does not give the purchaser of the stock a stepped-up basis for the major part of the assets of the corporation. Nor does it permit the sale of assets by the corporation without a double tax on a major part of its assets.

(5) Liquidation followed by sale

A third possibility is liquidation of the corporation, followed by sale of the assets. Although a low basis to the purchaser or a double tax on the corporation and the old stockholders can be avoided in this way, this procedure is impossible or at least very difficult where there are many stockholders, or where the list of stockholders includes estates, trusts, etc.

Furthermore, liquidation followed by sale raises the difficult problem involved in the Court Holding Company case, the solution of which under the bill may result in the imposition of high taxes on the stockholders. This is discussed in the following section.

(6) Court Holding Company problem

The bill attempts to solve the problem raised by the Court Holding Company case by providing (sec. 333 (b)) that the sale or exchange of an asset after such asset has been distributed to the shareholder shall not be attributed to the corporation. It is further provided (sec. 333 (a)) that no gain shall be recognized to a corporation upon a sale of an asset after the adoption of a plan of liquidation, provided certain conditions are met, except with respect to any sale which is in the ordinary course of business or a sale of an inventory asset where the amount received exceeds 120 percent of the basis of the asset. Gain not recognized to the corporation is under section 332 (c) included in the income of the shareholder, with the character of the income remaining the same. If the gain would have been ordinary income to the corporation it is taxed to the stockholder as ordinary income in whatever bracket he then falls.

If a corporation makes a sale not coming within the nonrecognition provisions of section 333 (a), the corporation is taxed on the profit at the usual corporate rate applicable to a sale of the type made, i. e., on ordinary income or long-term capital gain. There will then be a further tax to the stockholders on the distribution in liquidation.

If the corporation makes no sale after the adoption of the plan of liquidation and distributes all its assets, the gain on a subsequent sale by a stockholder of an asset coming within subparagraph (1), (2), or (3) of section 336 (d) is under section 333 (c) taxed to him as ordinary income in whatever tax bracket he then happens to fall. Thus, under the bill as drafted, in the case of property includible in inventory or held primarily for sale to customers, there is a double tax if the corporation makes the sale and a tax at the rate applicable to individuals if the stockholder makes the sale. Even an individual who otherwise would be in a relatively low tax bracket can quickly get into a very high bracket where the corporation distributes finished goods or items includible in inventory.

It is recommended that section 332 (c) be changed to provide that the tax to a stockholder on the gain from a sale by the corporation of noncapital assets shall not be higher than the rate at which the gain would have been taxed to the corporation if the gain had been recognized to the corporation. It is further recommended that the gain from a sale by a shareholder of distributed assets defined in paragraphs (1), (2), and (3) of section 336 (d), and to which section 336 (e) (1) is applicable, shall be taxed to such shareholder at a rate of 52 percent.

Gain not recognized to a corporation under section 333 (a) is under section 332 (c) taxed only to the shareholders holding participating stock. Under the definitions in section 312 a class of stock which participates in earnings may be nonparticipating stock. It seems unfair that all of the gain should be taxed to holders of shares meeting the strict definition of participating stock contained in section 312 (b). It is our recommendation that further consideration be given to this question.

(7) Sale of inventory assets by shareholders

Section 333 (c) provides that if a shareholder receives assets which in the hands of the corporation immediately before the distribution were inventory assets as defined in section 336 (d), and to which section 336 (e) (1) is applicable, such assets, regardless of how held, disposed of or realized upon, shall be deemed inventory assets in the hands of such shareholder. This subsection is not confined to, but includes, appreciated inventory. The report of the Ways and Means Committee indicates that if the sale of assets by the corporation, although considered inventory assets under section 336 (d), would not have produced ordinary income upon sale by the corporation, the sale of the assets by the recipient will not result in ordinary income unless they in fact constitute inventory in his hands. If the stockholders liquidated their corporation for the purpose of selling the assets received, they might be deemed to hold such assets for sale to customers. In such case the transaction could not be cast in the form of a liquidation followed by a sale of assets. It is our recommendation that the bill be clarified to assure that capital assets, including depreciable assets held for less than 5 years, will not be taxed at ordinary gain rates to the shareholder.

(8) Pledge of inventory

The report of the Ways and Means Committee interprets section 333 (c) as providing that in the case of the pledge of inventory by the distributee in liquidation, the money realized as a result of pledge would be taxable as ordinary income. This result seems unduly harsh, at least if the distributee is personally liable on the loan to secure which the inventory was pledged.

(9) Adjustments under section 331 (e) (2) and (3)

Section 331 (e) (2) provides that for the purpose of determining the amount of gain or loss to be recognized on the liquidation, the basis of the stock shall be reduced by that part of such basis attributable to appreciated inventory, determined as provided in section 336 (e) (2), and the basis and fair market value of the assets received shall be reduced by the basis and fair market value, respectively, of the appreciated inventory. Section 332 (e) (3) provides that for the same purpose, the basis of the stock shall be increased by the amount required under section 332 (c) to be included in the income of the shareholder.

The amount of gain recognized to a shareholder on the overall liquidation may vary according to which occurs first, the adjustments under section 331 (e) (2) or the adjustment under section 331 (e) (3), on which the bill is not clear. Furthermore, the amount of recognized gain may vary depending upon whether the transaction takes the form of a purchase of stock followed by a liquidation or the form of a liquidation followed by a sale of assets.

(10) Collapsible corporations

It is felt that many of the provisions relating to corporate liquidations (pt. II) and particularly sections 333 (c) and 336 (d) and the provisions dealing with appreciated inventory, are occasioned by the fact that part II covers the areas dealt with in section 117 (m) of the 1939 code. It is also felt that the provisions of part II could be made more equitable in their application to liquidations in general if the area now covered by section 117 (m) was treated separately. Where assets used in the business have appreciated in value more than 20 percent, and have been held by the corporation for less than 5 years, part II as now drafted practically precludes the route of a purchase of stock followed by a liquidation. This method is often, for reasons unconnected with taxes, the only feasible way of purchasing a business, or certainly the better way.

It is therefore recommended that collapsible corporations be treated separately and that the provisions relating to appreciated inventory be deleted from part II.

Attention is called to the fact that except for sales of stock to which section 353 (b) will apply, the bill does not contain provisions which treat gain on the sale of the stock of a collapsible corporation as ordinary income, as does section 117 (m) of the 1939 code. Also, except for distributions to which section 353 (b) is applicable, distributions, not in liquidation, by a collapsible corporation, to the extent not covered by earnings or basis of the stock, will not under the bill be taxed as ordinary income, as they are according to the Treasury Department regulations interpreting section 117 (m).

If collapsible corporations are to be treated in part II, it is recommended that the definition of inventory assets in the normal situation be changed by eliminating paragraph (4) of section 336 (d).

(11) Basis of properties received in liquidation subject to a liability

If an individual purchase all the stock of a corporation and liquidates the corporation to operate the business and assumes a liability or receives the assets subject to a liability, the basis of the assets after liquidation would in all probability under section 334 (c) as now drafted be the purchaser's basis of the stock. Such basis would be the fair market value of the assets less the liability.

For example, assume that an individual taxpayer purchases the stock of a corporation for $200,000 in order to acquire its sole asset, which is a building worth $400,000 subject to a $200,000 mortgage. The corporation is immediately liquidated. Under present law, the taxpayer's basis for the property, for depreciation purposes, would be $400,000. Under section 334 (c), the basis would be only $200,000.

It is recommended that section 331 (e) (5) be changed to provide that the rule there stated with regard to the basis of the stock shall apply to section 334 (c).

(12) Taxation of gain to corporate stockholder

(*a*) *In general.*—Gain recognized to a corporate shareholder is, under section 332 (b) (1) of the bill, to be "treated as a dividend." The amount of earnings and profits of the liquidating corporation is for this purpose immaterial. Section 243 (a) allows as a deduction an amount equal to 85 percent of dividends received. At a 52-percent corporate income-tax rate, this presumably means that recognized gain on a corporate liquidation would be taxed to a corporate stockholder at an effective rate of 7.8 percent.

However, section 246 (b) provides that the deduction allowed by section 243 shall not exceed 85 percent of the taxable income. If section 246 (b) limits section 243 (a) for purposes of section 332 (b) (1), and if the corporate stockholder distributee has a loss apart from the dividend income from the liquidation, the 85-percent dividends-received deduction will not be fully effective and an amount in excess of 15 percent of the gain, and up to 100 percent of the gain, will be taxed at the full corporate rate on ordinary income, and not at the rate applicable to long-term capital gain, regardless of the holding period of the stock.

It is recommended that the bill be changed to provide, in effect, that only 15 percent of the gain to a corporate shareholder on the liquidation of a domestic

subsidiary other than gain to a parent on the liquidation of a subsidiary shall be subject to tax at the full corporate rate on ordinary income.

(*b*) *Foreign corporation liquidated—Domestic corporate stockholder.*—Section 243 (a) allows a deduction only in respect of dividends received from a domestic corporation. Section 245 allows a partial deduction for dividends from a foreign corporation only if for at least a 3-year period the foreign corporation has been engaged in trade or business in the United States and has derived at least 50 percent of its gross income from sources within the United States. Thus, if the corporation being liquidated is a foreign corporation, a domestic corporate stockholder may be taxed on the full amount of the recognized gain as ordinary income, subject to possible credit for foreign taxes under section 902.

(*c*) *Domestic corporation liquidated—Foreign corporate stockholder.*—A foreign corporate stockholder is not entitled to a dividends-received deduction unless it is engaged in trade or business within the United States. A foreign corporation not so engaged is under the bill taxed at a 30-percent rate on dividends (in the absence of a treaty provision fixing a different rate) rather than an effective 7.8-percent rate on a dividend or a 25-percent rate on a long-term capital gain. It is not recommended that this treatment be changed.

Section 332 (b) (1) of the bill provides that the gain shall be "treated" as a dividend. This is the term used in section 115 (g) of the old code. The distributing corporation must withhold Federal income tax on a section 115 (g) distribution if the distributee is a nonresident foreign corporation. Not only, however, may a "dividend" coming under section 332 (b) (1) of the bill not involve cash or sufficient cash to cover the withholding tax, but the distributing corporation may well not know the cost to the foreign corporate stockholder of its stock, and therefore cannot compute the amount of gain.

It is recommended that section 1442 be amended to provide that tax need not be withheld on gain recognized on the liquidation of a corporation.

(*13*) *Liquidation of subsidiary* (*old sec. 112* (*b*) (*6*))

Section 336 (g) of the bill defines "a parent corporation" to mean a corporation owning not only at least 80 percent of the voting stock but also owning "at least 80 percent of the total number of shares of all other classes of stock of another corporation."

It is recommended that this be clarified to indicate whether or not the term "stock" includes income debentures, which may be "nonparticipating stock" under sections 312 (c) and (d).

Under the bill, loss to a parent corporation on liquidation of a subsidiary corporation will be recognized as a capital loss, which can be utilized only to offset capital gain.

If gain is recognized it is, under section 332 (b) (1), "treated" as a dividend, with a provision that "the deduction for dividends received provided in section 243 (a) shall be 100 percent." As previously mentioned, section 246 (b) provides that the deduction allowed by section 243 shall not exceed 85 percent of the taxable income. If section 246 (b) limits section 243 (a) for purposes of section 332 (b) (1), the possible result that some part of the gain on the liquidation will be taxed at the full corporate rate may be aggravated in the case of the liquidation of a subsidiary into a parent.

Under present law, no gain is recognized to the corporate stockholder on a section 112 (b) (6) liquidation and therefore, even though capital gain is also personal holding company income, a personal holding company liquidating a subsidiary under section 112 (b) (6) does not by reason of the liquidation have to include any amount in income and make a distribution to stockholders in order to avoid the personal holding company surtax. Under the bill, however, the gain would have to be included in income as a dividend, which is personal holding company income, and section 545 (b) (3) provides that in computing undistributed personal holding company income the deduction for dividends received shall not be allowed. The result is that the personal holding company would have to make a distribution to its stockholders in order to avoid the personal holding company tax. Furthermore, the gain on a liquidation might be so great as to make a closely held corporation meet the gross income requirement portion of the definition of a personal holding company whereas otherwise the corporation would not meet such definition.

Apparently if either the parent or subsidiary corporation is a foreign corporation, section 358 of the bill, read together with sections 1001 and 1002, provides that the entire amount of the gain, measured by the difference between the fair market value of the assets and the cost of the stock, will be taxable to the parent

corporation upon the liquidation of the subsidiary unless a favorable clearance ruling is first obtained from the Secretary or his delegate. However, it is not clear whether such gain will be taxed as capital gain or as a dividend, and if the latter, what dividends-received credits, if any, would apply.

It is recommended that part II be changed to provide that if the parent has held its shares in a subsidiary for not less than 1 year, (1) no gain or loss shall be recognized to the parent upon the liquidation of the subsidiary; (2) the basis of the assets received by the parent shall be the basis which such assets had in the hands of the subsidiary; and (3) the parent will inherit the earnings (or deficit) of the subsidiary.

Clarification is recommended of the tax consequences where either corporation is a foreign corporation and a clearance ruling is not first obtained within the purview of section 358.

(14) Certain definitions

(*a*) *Partial liquidation.*—Section 336 (a) (2) as now drafted apparently requires that the liquidating corporation itself must have conducted the business being terminated for at least 5 years. It is recommended that the 5-year requirement be changed to give credit for the period during which the business was conducted by predecessor corporations.

(*b*) *Rights to income.*—Section 336 (d) (3) defines inventory assets as including "rights to income." This term is unclear and will give rise to difficult valuation problems. It is recommended that the term be confined to cases where there are no further services or capital to be furnished.

(15) Securities held by stockholders

Section 331 (d) (1) provides that securities of a subsidiary corporation held by its parent shall be treated as stock. This is to prevent tax to the subsidiary if it distributes appreciated assets to the parent.

It is recommended that section 331 (e) (1) be broadened to apply the same treatment to securities held by a shareholder other than a parent corporation, to the extent that the percentage which the shareholder's securities holding is of all securities issued by the corporation (based on principal amount of debt) is not in excess of the percentage which his holding of the corporation's participating stock is of the total outstanding participating stock of the corporation.

C. CORPORATE ORGANIZATIONS, ACQUISITIONS, AND SEPARATIONS (SECS. 351–359)

(1) Introduction

These sections make a number of most important improvements in the provisions of the present law relating to tax-free exchanges and reorganizations. In many respects the new provisions are more flexible, practicable, and realistic, and at the same time they eliminate several tax avoidance devices. Among the important improvements are: The elimination of the requirement of exact proportion in transfers to controlled corporations required by section 112 (b) (5) of the present law (sec. 351); clarification of the question under present law as to whose earnings and profits are looked to in determining the taxability of boot in a corporate acquisition or merger (sec. 352); liberalization of the spin-off provisions to eliminate the necessity for the creation of a holding company (sec. 353); relating the basis of stock acquired in a corporate acquisition of stock to the basis of the assets of the corporation whose stock is acquired rather than the basis to the transferors of their stock, thus eliminating the difficult practical problem of determining such basis and correlating the provision with that in the case of corporate acquisitions of property (sec. 355).

Other important improvements include: Elimination of a possible tax avoidance device where property subject to an indebtedness in excess of its cost basis is transferred in a tax-free reorganization (sec. 356); elimination of a possible tax avoidance device where a corporation is liquidated and subsequently its liquidating assets are transferred to a new corporation (sec. 357); permitting the distribution of limited amounts of boot in the case of corporate acquisitions of property (sec. 359); substituting a definite percentage of 80 percent as the amount of assets of a transferor corporation which must be acquired in a tax-free corporate acquisition of assets for the "substantially all" rule under the present law (sec. 359); treating as a tax-free acquisition a corporate acquisition of stock where after the transaction the acquiring corporation has control even though part of such stock was acquired in an earlier transaction (sec. 359); permitting assets acquired in a corporate acquisition of property to be transferred

to a subsidiary of the acquiring corporation, thus correcting the inequity in the present law involved in the Groman and Bashford cases[1] (sec. 359).

However, the basic change in approach and terminology adopted in part III results in a number of important substantive changes which it is not clear were intended and, as could be expected in a drafting job of such proportions, there are a number of technical errors which should be corrected.

(2) The spin-off provisions (sec. 353)

The committee report at pages 40 and A119 indicates that the intent of the amendment of the spin-off provisions was to liberalize them and make them more easy to administer. However, in several areas the proposed section appears to be unnecessarily and perhaps unintentionally restrictive.

(*a*) *Gross income requirement.*—Section 112 (b) (11) of the present law provides for a tax-free spin-off unless it appears that any of the corporations involved were not intended to continue the active conduct of a trade or business, or the spun-off corporation was used principally as a device for the distribution of earnings and profits. These provisions, of course, involved matters of judgment which the bill attempts to eliminate. The new section is entirely automatic in its operation, permitting the distribution of assets of any nature without limitation. To prevent the use of the spin-off as a device for distributing earnings and profits, however, the section defines the spun-off corporation as an "inactive corporation" unless it meets certain tests. One of these is that 90 percent or more of the gross income of such business for each year of the preceding 5 years was other than personal holding company income. If the business to be spun off does not meet this test, then any disposition of its stock within 10 years would result in ordinary income. This means that in the normal situation, the spin-off of a bona fide operating division would be impracticable.

For example, if in any 1 year the business to be spun off had incurred an operating deficit due to large inventory losses, and had a few dollars of income from the temporary investment of surplus funds, it would be classed as an inactive corporation if spun off. Such a severe requirement would not appear to be necessary to prevent tax avoidance. It is the committee's recommendation that the requirement of section 353 (c) (3) that "90 percent or more of the gross income" of the business must have been other than personal holding company income for each of the preceding 5 years be changed to "90 percent or more of the gross receipts."

(*b*) *Jointly created operating subsidiary.*—A second area in which the section is more restricted than present law is in the case of the spin-off of assets of a jointly owned subsidiary. It has not been uncommon in recent years for two unrelated corporations in different industries or types of business to combine their efforts through a jointly owned subsidiary in a new field of endeavor related to both businesses, but which neither one is properly equipped to carry on alone. Under the present law the stock of such a corporation can be spun off, whereas under the new provision the transaction is treated as if it were a tax avoidance device. There would seem to be no reason for denying the application of the spin-off provisions simply because the new business was created jointly by two or more corporations.

(*c*) *Working capital.*—A third question arises in connection with the nature of the assets spun off. Section 353 (c) (2) requires that separate books and records must have been maintained for "such business." Where the business to be spun off was operated as a department of the distributing corporation, it is quite likely that separate books and records were maintained for operating income and expense. However, upon the spin off it is probable that working capital will have to be spun off with the operating assets, for otherwise the spun-off corporation would not be able to stand on its own feet. The section is not clear as to whether the spinning off of such assets which were not strictly a part of the business will disqualify the transaction. It is our recommendation that the section be amended to expressly provide for the spinning off of "adequate cash working capital," even though not included in the books actually maintained for such business.

(*d*) *Sale of stock of both corporations.*—It is also our recommendation that the penalty provisions of section 353 imposing an ordinary income tax upon the disposition of the stock of the inactive corporation shall not apply if, at the same time or prior thereto, the stock of the distributing corporation with respect to which such stock was distributed is also disposed of.

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[1] *U. S. v. Groman* (302 U. S. 82 (1937)), and *U. S. v. Bashford* (302 U. S. 454 (1947)).

(3) Tax-free mergers and consolidations (sec. 354)

(*a*) *Publicly held distinctions.*—It is our understanding that the provisions of the bill limiting tax-free mergers and consolidations to publicly held corporations is being eliminated. We concur in this change, for there would seem to be no justification for drawing a line between publicly and closely held corporations as defined in the bill. It is quite possible that a large corporation with hundreds of stockholders would be classed as a privately held corporation under this concept, whereas a relatively small and unknown corporation with only several dozen stockholders might be deemed publicly owned.

(*b*) *Practical mergers.*—It is our recommendation that the section be liberalized in another respect. The use of the statutory merger or consolidation permits the acquisition of the assets of a corporation which has outstanding nonvoting preferred stock and securities by the issuance of similar securities of the continuing corporation. Except through merger or consolidation, only voting common or voting preferred stock can be used in acquisitions under present law. Frequently a merger or consolidation cannot be availed of because of the prohibitive cost of holding stockholders' meetings, the solicitation of proxies, the risk of appraisal rights under local law, etc. It is our recommendation that the bill give the tax consequences of a statutory merger to a practical merger, i. e., an acquisition of assets which is in all respects identical with a statutory merger under the local law except for the formalities of compliance with the statute. This could be accomplished by defining a merger as the acquisition by one corporation of all the assets of another corporation and the assumption by the acquiring corporation of all the liabilities of the transferor corporation followed by the immediate liquidation of the transferor corporation, whether or not pursuant to statutory merger provisions. The recommended change, in the words of the committee report, would "insure that the same tax consequences result from the different types of transactions which are available to accomplish substantially the same result" (p. 39).

(*c*) *Long-term securities.*—Under present law long-term securities can be received tax free in a merger or consolidation for stock provided a continuity of interest is maintained by the acquisition of stock as well. Under the bill, the rule has been changed. Securities may be exchanged tax free for securities, but neither preferred nor common stock may be exchanged for securities. No explanation of this change is made in the committee's report. It is our recommendation that long-term securities be permitted to be received in a merger tax free, provided that 25 percent of the consideration received by the shareholders of the transferor corporation is represented by stock of the acquiring corporation.

(*d*) *Continuity of interest.*—A related question arises under section 354 (b), which defines merger and consolidation. The subsection is ambiguous as to the amount of stock which is required to be received. The provision would seem to say that only a nominal amount of stock need be received and the balance of the consideration can be in the form of boot. However, it is possible to read the provision as requiring that the amount of the consideration which must be in the form of stock is the percentage of the stock of the transferor corporation which is required by applicable State law to approve the merger or consolidation (i. e., 50 percent or 66⅔ percent). If this was the intent of the section, it is our feeling that the requirement is too strict to be practical. This ambiguity should be clarified. We recommend that a merger should be tax free only if 25 percent of the consideration received by each stockholder of the disappearing corporation consists of stock of the acquiring corporation. We feel that in any situation where less stock than this is received by the stockholders there is in reality a sale and it should be taxed as such.

(4) Liquidation followed by reincorporation (sec. 357)

The basic operative provisions of section 357 are brief and are unclear in several respects.

It seems obvious under the statute that the new corporation would take a transferor's basis under section 355. However, it is not clear that the basis in the hands of the old corporation would be adjusted for the period during which the assets transferred to the new corporation were held by the stockholders of the old corporation.

The committee report states that in the event the assets retained are sold prior to the transfer of the remaining assets to the new corporation, the sales price of the assets sold shall constitute the fair market value of such assets as of the date of the transfer of the remaining assets. This should be brought out in the statute.

Section 357 (a) (2) is unclear on the point of which corporation is deemed to have made the distribution of the retained assets. The committee report states that ascertainment of the amount of earnings and profits for the purpose of applying section 301 is to be made by reference to earnings and profits of the old corporation. This is contrary to the general rule stated in section 352, and should be made explicit in the statute.

(5) *Corporate acquisitions of stock* (*sec. 359* (*b*))

(*a*) *Relative size rule.*—It is understood that the 25 percent to 400 percent rule will be eliminated from the bill. We approve of this change. There would appear to be no justification for restricting the application of the tax-free reorganization sections to situations where the parties are of approximately the same size, particularly where the corporations involved are both relatively small.

(*b*) *Acquisition for stock and boot.*—Section 359 (b) should be corrected to make it clear that stock may be acquired for participating stock, nonparticipating stock, securities or property. This was contemplated by the committee report (see pp. A85 and A119), but the bill does not appear to expressly so provide.

It is not clear, however, whether the transaction in which control is acquired must involve solely participating stock. For example, assume that 20 percent of the stock has been acquired in a previous transaction for stock or cash. In a subsequent transaction an additional 60 percent of the stock is acquired, 10 percent for cash and 50 percent for participating stock. It is not clear whether the intent was that the acquisition of the 50 percent interest for participating stock would be tax free or whether a minimum of 60 percent would have to be acquired for partiepating stock. The intent of the bill would appear to be satisfied so long as control is acquired in the single transaction with respect to which tax exemption is sought, any securities or property received in the transaction being taxed as boot, but the section should be clarified.

(*c*) *Acquisitions for nonparticipating stock.*—A further question is whether or not a tax-free acquisition should not be permitted for nonparticipating as well as participating stock. Under present law, a transaction is tax free so long as voting stock is used, whether common or preferred. The intent of section 305 of the bill is to permit the free exchange of equity interests. To be consistent, it would seem to be immaterial whether a corporate acquisition is for nonparticipating or participating stock. There would appear to be no reason for departing from present law in this regard.

(6) *Corporate acquisitions of property* (*sec. 359* (*a*))

(*a*) *Acquisition for nonparticipating stock.*—For the same reasons just stated with respect to corporate acquisitions of stock, section 359 (c) should be amended to provide for the taxfree acquisition of assets for nonparticipating as well as participating stock.

It is not clear whether the 80 percent referred to in paragraph (c) is 80 percent of the gross value of the properties acquired, less liabilities and claims, or 80 percent of the net value.

(7) *Suggested additional provisions*

(*a*) *Definition of "stock."*—In the sections relating to corporate organizations, acquisitions and separations, the term "stock" is frequently used, although it is not defined. A new subsection should be added in section 312 defining stock as participating stock and nonparticipating stock.

(*b*) *Change in place of organization.*—The bill includes no provision exempting from tax reorganizations which are mere changes in identity, form, or place of organization similar to that provided in sec. 112 (g) (1) (F) of present law. The committee report indicates that no exchange provision is needed because no realization is involved. It is our recommendation that to avoid any doubt in this respect a provision should be included in the bill expressly providing that such transactions will not result in either the realization or recognition of gain or loss. Since such a provision will be of general application, relating to procedural as well as substantive provisions, and to all tax attributes, including carrybacks, for example, as well as the carryovers provided in section 381, it should be included in section 7701 in the general definition of corporation or taxpayer, with appropriate cross-reference to part III.

D. CARRYOVERS IN CORPORATE ACQUISITIONS (SEC. 381)

(1) *Introduction*

Section 381 establishes an important new concept in the income-tax law. In substance, it provides that in most instances where one corporation takes over

the assets of another in a tax-free statutory merger, consolidation, corporate acquisition of property, or in a complete liquidation of a subsidiary by its parent, the acquiring corporation takes over many of the tax attributes of the corporation which goes out of business.

The section generally is excellent, and is a definite advance over present law, eliminating many inequities presently existing as well as many areas of litigation.

(2) Carryback on reincorporation

There is one definite inequity still existing which should be eliminated. In the instance where a corporation goes out of existence as part of a reorganization whereby the new corporation is, in substance, the same corporation as the old, the new corporation should have a right to carryback its net operating loss against the profits of the old. To give a precise actual example, corporation A had operated profitably for many years. As part of its growth and expansion, it moved its plant in 1945 from Long Island City, N. Y., to Trenton, N. J. It was decided to change from a New York corporation to a New Jersey corporation. In substance everything else remained the same. The change was accomplished by a tax-free reorganization. Because of severe inventory reversals and a strike at a supplier's plant which occurred within a matter of months after the reincorporation, large losses occurred. Working capital was wiped out. The corporation was thrown into bankruptcy, and many employees were thrown out of work. A quick net operating loss carryback would have saved the corporation. It was ruled, however, that since the new corporation was not the same taxpayer as the old corporation, no carryback from one to the other could be allowed.

This is the type of inequity which section 381 was designed to eliminate.

We therefore recommend that the following words be added to section 381 (b) (3):

"* * * except that when the acquiring corporation is a continuation of the distributor or transferor corporation as the result of a mere change in identity, form, or place of organization, however effected, the net operating loss of the acquiring corporation may be carried back to a taxable year of the distributor or transferor corporation."

E. EFFECTIVE DATE (SEC. 391)

Section 391 provides that subchapter C (secs. 301 to 391), shall be effective generally with respect to distributions or transfers occurring after March 1, 1954. Such an effective date can work great hardship in the case of transactions which had been entered into prior to that time without warning of the very fundamental changes being made in the bill.

It is our recommendation that subchapter C be effective only with respect to distribution or transfers occurring more than 90 days after the date of enactment of the act, except

(1) That part II, relating to liquidations, be effective only with respect to distributions made in pursuance of a plan of partial or complete liquidation adopted more than 90 days after the date of the enactment of the act, and

(2) That part V, relating to carryovers, be effective with respect to distributions and transfers made after March 1, 1954, as presently provided.

F. MISCELLANEOUS TECHNICAL CHANGES

Section 307 (a): Add "350 (d) (1)" following "351" in the fourth line.

Section 311 (a): Add at the end of the subsection the following, "or who is separated from the individual under a written separation agreement." (Compare sec. 71 (a).)

Section 352: The word "securities" should be added after the word "stock" in the third line.

Section 353: "c" in subparagraph (a) (2) should real "d."

Section 353: The meaning and purpose of the last sentence of (a) is not clear. It has been interpreted as denying the benefit of section 353 where a small interest in the controlled corporation was acquired through a transfer by an individual, or where a small amount of boot was involved. The language should be clarified.

Section 353: In view of the severe penalty which can be incurred as the result of a "disposition" under subsection (b), the term should be defined. In particular, the disposition by an in rem pledge, which is referred to in the committee

report (p. A122), should be expressly covered in the statute since this represents a substantial departure from current law as to what constitutes a taxable event.

Section 358: If stock of an inactive corporation is disposed of, and ordinary income realized, the basis of the stock should be added to the stockholder's basis for his stock in the distributing company.

Section 354 (b): Paragraphs (1) and (2) should be amended to provide for the receipt of stock, securities, and property.

Section 359 (b): In the fourth line the words "or corporations" should be added.

ection 359 (d): At the beginning of the third line the words "all or" should be inserted, and following the word "corporation" the words "or corporations" should be added.

Section 359 (d): In the last sentence the words "participating stock" should be eliminated and there should be inserted in lieu thereof "stock or securities."

Life Insurance and Annuities

A. Preface

The following section of the report has been prepared by the section's committee on life insurance and annuities which is principally comprised of attorneys specializing in that field. Their report relates not only to the provisions of H. R. 8300 dealing with life insurance and annuities but also to related sections such as those dealing with pension and profit-sharing trusts.

The new provisions in this area are very technical and involved. Even though clarified by amendment, it is recommended that the proposed various effective dates, insofar as applicable to the above subject matter, be extended generally to the year 1955. Such extension would give the general public and particularly businessmen, lawyers, and accountants, needed time to make themselves acquainted with the new code and to be able to comply with its provisions.

The section following, headed "Pension, Profit-Sharing and Stock Bonus Plans," is partially repetitive of some of the material covered in this section of the report on life insurance and annuities. The section following deals principally with the provisions governing qualifications of plans and the limitation of investments. By segregating all of the material on life insurance and annuities which falls within the specialized knowledge of members of our committee, it was believed that a greater contribution might be made since so far as we know no other group has analyzed the proposed code from this viewpoint alone.

B. Annuities; Certain Proceeds of Endowment and Life Insurance Contracts (Sec. 72)

(1) Investment in the contract

It is possible, and in fact may be quite common, that the "investment in the contract" will be a minus quantity. For example, take the case of an employee 10-year certain annuity which commenced January 1, 1950, and under which the employee's contributions were not returned during the 3-year period beginning on that date but have been returned tax free by the end of the year 1953. The "amount determined under paragraph (1)" is (applying subsection (f)) zero but paragraph (2) requires that the value of the refund feature be subtracted from the amount determined under paragraph (1), and as of January 1, 1954, this refund feature still has a value. Minus quantities could be produced in other situations, for instance, in noncontributory annuities with a refund feature. Clarification, therefore, on the foregoing point is needed. It is recommended that the following words "provided that the investment in the contract shall never be less than zero" be added at the end of the first sentence in paragraph (2).

(2) Employees' annuities

Paragraph (1) (B) refers to "the aggregate amount receivable by the employee." The committee report (p. A22) uses the language "if the employee or his beneficiary will recover * * *." Is this paragraph intended to apply to refund annuities certain, and, especially, to joint and survivor annuities? To answer this question there is a need for a paragraph specifically covering the tax treatment of amounts received by the beneficiary or a surviving annuitant under an employee annuity.

Moreover subsection (d) (1) in its present form could be deemed to apply to death proceeds of life insurance or endowment contracts. It should be expressly limited to amounts received as an annuity by the employee. Accordingly

the words "as an annuity by an employee" should be inserted after the word "received" in the next to the last line on page 15 of the bill and the word "so" should be inserted before the word "received" in the third line on page 16.

Furthermore it should be clearly provided in subsection (d) that payments received by a beneficiary or a surviving annuitant under an employee annuity contract should be taxed in the same manner as they would have been taxed, if received by the employee.

(3) Amounts not received as annuities

The phrase in subsection (e) "and if no other provision of this subtitle applies" in paragraph (1) is an objectionable provision. This quoted language should be deleted and the exceptions intended to be indicated by it should be carefully spelled out. Actually there appear to be no such exceptions other than in the case of the proceeds of a life insurance policy payable by reason of the death of the insured thereunder.

Paragraph (2) (A) of subsection (e) refers to an amount received "in full discharge of the obligation under the contract which is in the nature of a refund of the consideration." Presumably, therefore, such paragraph only applies to lump sum payments. Since subsection (e) (2) provides for an adjustment in "investment" where there is a refund feature, it seems obvious that refund annuity installment payments made after the death of the annuitant are not intended to be taxable to the beneficiary. Accordingly it is recommended that the words "whether in a single sum or otherwise" be inserted after the word "contract" in the first line of subsection (e) (2) (A) and the word "full" in the same line be deleted.

(4) Special rules for computing employees' contributions

Subsection (f) provides rules for computing employee contributions. It creates a question in the light of very recent rulings in respect to employer contributions made to a qualified annuity plan for nonresident citizens not subject during the period of nonresidence to United States income taxes. Under paragraph (2) of this subsection, employer payments in effect will be added to the cost base only when paid in taxable years during which the employee had a nonresident status. Often, particularly in the case of the purchase of past service annuities, the employer payments for the past service period of employment may be made to the insurer subsequent to such period of employment, and possibly such payments for past service annuities may be made at a time when the employee is a resident of the United States. The gearing of the time element for employer payments to years when the employee, while abroad, was not taxable because of foreign service, is unsound and inequitable. It should be made clear in this subsection that employer payments for foreign service should be treated as part of the employee cost base, irrespective of when the employer payments were made.

(5) Option to receive annuity in lieu of lump sum

Subsection (h) deals with the situation where the policyholder may, within 60 days aftr maturity of his contract, elect to receive an annuity in lieu of a lump sum. Apparently in the light of paragraph (1) it is intended that this liberal rule only apply to the case where an annuity option is contained in the contract. Often options of this nature, especially in old policies, are not contained in the contracts but are allowed by company practice or concession. To avoid discrimination it is recommended that paragraph (1) be amended by omitting the words "subject to an option to receive an annuity in lieu of such lump sum" and replacing the words "the option" in paragraph (2) by the words "an option to receive an annuity in lieu of such lump sum."

(6) Joint and survivor annuities

(a) Death before 1951.—What is to be the treatment of joint and survivor annuities where the employee or other original annuitant died before 1951? The failure to provide a rule with respect to this category appears to be a clear-cut oversight.

Subsection (i) does not make it clear the the expected return is determined by the life expectancy of the surviving annuitant on January 1, 1954, if that is the intention.

(b) Death after 1953.—It is believed that the present system of taxing joint and survivor annuities is much fairer than that proposed and should be retained. This is especially true in the case of employee annuities. In such cases the employee contributions, if any, are usually received within a short period after

commencement of annuity payments and the survivor would be taxable on the full amount of the annuity payments received under proposed subsection (j). While the bill also proposes an exemption from estate tax (sec. 2039) for the noncontributory portion of an employee annuity, this estate tax exemption is only of academic interest in the case where the gross estate is not large enough to result in payment of an estate tax. This situation would prevail in respect to most surviving annuitants under employee annuities. The provision in present code sections 113 (a) (5) and 22 (b) (2) (C), giving the survivor a "new start" for income tax purposes, provides relief that is far more significant and valuable to the great majority of surviving annuitants than the new proposals. Accordingly it is recommended that the present code treatment be retained, using the estate tax base as the consideration paid for the contract, for the purpose of taxing amounts received by the survivors. This could be done by eliminating the restriction in subsection (i) to cases where death of the first annuitants occurred in the years 1951, 1952, and 1953, and making such subsection (i) applicable generally. Subsection (j) could then be eliminated. New York State has this year adopted the "new starter" treatment of joint and survivor annuities in accordance with a suggestion made by this section of the New York State Bar Association (Chap. 363, New York Law of 1954). In addition, the State of Arizona in its Income Tax Act for the year 1954, chapter 65, enacted a similar provision.

(c) *Recommended changes in section 72 (j).*—If subsection (j) is to be retained there are certain matters that should be clarified. For instance, there is the question whether or not this subsection applies to employee annuities which are taxable under subsection (d). The pharse "in addition to the exclusion allowed by subsection (b)" seems to imply that this subsection applies only to annuities which are to be governed by the new general rule. On the other hand there is no express exception such as there is in subsection (b) for employee annuities. Contributory employee annuities are subject to estate tax under section 2039 and therefore the additional exclusion should be allowed in such a case.

Unlike the present rule, this subsection would allow the additional exclusion only if an estate tax is paid, and the amount of the additional exclusion would depend on the amount of the estate tax. This would produce whimsical results and in addition the rule appears to be unworkable in practice since the surviving annuitant in a typical case would be receiving periodic annuity payments for a period of more than a year, perhaps several years, before the amount of the estate tax is finally determined. In any event it seems undesirable that the additional credit resulting from the payment of an estate tax should be allowed for only a limited period, following which the originally determined exclusion ratio would be resumed. The additional exclusion should be permanent, that is, for the lifetime of the surviving annuitant, and accordingly it is suggested that the exception beginning in line 3 and ending in line 5, on page 18, of the bill be deleted.

C. EXCLUSION OF CERTAIN DEATH BENEFITS (SEC. 101)

(1) Proceeds of life-insurance contracts

As a matter of substance, the removal by subsection (a) of the exemption of life insurance proceeds payable under policies purchased by an employee's trust (except as they may qualify for the $5,000 exclusion) is objectionable.

(2) Employees' death benefits

Subsection (b) (1), providing for nontaxation within the limits of (b) (2) of amounts paid by or on behalf of an employer, is obviously not intended to be applicable to the extent that such amounts represent proceeds of life insurance payable under contracts issued to an employer directly or to a trust other than a pension trust, and when the benefits are directly paid by the insurer to employee beneficiaries. Accordingly it is recommended that there be added as a new sentence at the end of (b) (1) the following:

"This subsection shall not apply to amounts received under a life-insurance contract other than a contract to which section 402 (a) (4) applies."

The exemption in this subsection should probably be made applicable to death benefits paid under employee annuity contracts. Otherwise discrimination would exist as between insured annuity and noninsured trust or employee plans. Paragraph (2) (D) implies that it is applicable where the death benefit is paid as an annuity but it is not clear as to how it applies to a single sum payment.

It is also recommended that paragraph (2) (B) be amended so as to be expressly inapplicable to pension trusts in addition to a profit sharing or stock bonus trust.

There is a typographical error in paragraph (2) (B) where the first reference to section 501 (a) should be to section 501 (e).

(3) Payment of life insurance proceeds at a date later than death

Objection may be taken to the classes of preferred beneficiaries in subsection (d) of section 101 for purposes of the exemption because they do not include relatives who may have been dependent for support upon the insured. It is therefore suggested that the group of persons entitled to exclusions might be extended along the lines of the new definition of dependent contained in section 152.

It is not clear whether this subsection applies to the life insurance proceeds referred to in section 402 (a) (4) and in the last sentence of subsection (a) of section 101. Paragraph (2) seems to make it clear that there would be no prorated exemption in such a case but the significance of the question relates principally to whether or not the exemptions of $500 in the case of the surviving spouse or $250 in the case of other beneficiaries would be available.

Although the committee report is definite that the $500 and $250 exemptions are annual exclusions, the language of the bill itself does not seem wholly clear in this regard. Subsection (d) (2) refers to an amount held by an insurer "under an agreement provided in the life insurance contract." Often in the case of old policies provisions for installment payments are not contained therein. However, installment settlements are permitted by company practices, which practices should expressly be recognized in this provision.

Subsection (d) (4) states that this subsection shall not apply to any amount to which subsection (c) is applicable. Subsection (c) relates to amounts held at interest. In the case of a combination of an interest option and another option, e. g., proceeds left at interest for the life of the primary beneficiary then paid in installments to a secondary beneficiary, it is not clear how this provision would apply.

(4) Effective date of section 101

There appears to be a conflict in effective dates between section 101 and section 402 (a) (4). Subsection (f) that this section shall apply only where the death of the employee occurs after the date of enactment of this title, whereas section 402 appears to be effective, in accordance with the general rule in section 7851, with respect to taxable years beginning after December 31, 1953.

D. ACCIDENT AND HEALTH INSURANCE AND EMPLOYER ACCIDENT AND HEALTH PLANS (SEC. 104-106)

These sections are not well drawn and the provisions in section 105, particularly, relating to employer plan qualification and taxing of benefits, seem impracticable. We do not make specific suggestions for improvement since we understand that these sections are already being reconsidered by the Treasury Department and the staff of the joint committee with a view to Senate amendments.

E. MEDICAL, DENTAL, ETC., EXPENSES (SEC. 213)

(1) Amounts paid for accident or health insurance

Section 213 (e) defines the term "medical care" as meaning various amounts paid "including amounts paid for accident or health insurance." While to this extent the existing law is followed, clarification is needed because there is much confusion in the light of Internal Revenue Service rulings, tax return instructions, and adult practices, as to what is meant by health insurance for purposes of this deduction. It is recommended that the point be clarified by amending the definition so that it will be made clear that a broad application is permissible and that the types of accident or health insurance intended are not only those which provide for reimbursement for medical, hospital, surgical, etc., expenses, but also those which solely provide for periodical indemnity to a disabled person.

F. NONDEDUCTIBILITY OF CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS (SEC. 264)

(1) Interest paid on money borrowed for single premium insurance or annuity contract

Section 264 deals with prohibited deductions. In paragraph (2) there is a prohibition against deducting interest paid on borrowed money which may be deposited with an insurer "for payment of a substantial number of future premiums on the contract." The use of the words "substantial number of future premiums" is objectionable because of indefiniteness. If deposit arrangements with borrowed money are objected to, it is recommended that a specific period be prescribed, such as 5 or 10 years.

G. TAXATION OF EMPLOYEE ANNUITIES AND OTHER DEFERRED COMPENSATION (SEC. 401)

The phrase "balance to the credit of an employee" in section 401 (b) (2) and in section 402 (a) (3) is not completely apt to describe the death benefit under an annuity contract, although it apparently is intended to include such a death benefit, at least in section 401 (b).

H. TAXABILITY OF BENEFICIARY OF EMPLOYEE'S TRUST (SEC. 402)

(1) Proceeds of life insurance contracts

Section 402 (a) (4) provides that the proceeds of life insurance contracts purchased by an exempt trust under section 501 (a) are taxable under paragraph (1) of this subsection. This proposed rule is inequitable in the case of contributory plans where employees share in the premium cost, in some cases to the extent of one-half, or in any case where employee contributions are substantial. Under paragraphs (1) and (2) in effect credit would be allowed for an employee's contribution but such credit would not completely rectify this rule. It would be more proper to tax only such portion of the policy proceeds as is attributable to trust contributions and the remainder attributable to the employee's cost should be given tax-free treatment. This result could be reached by adding after the words "when distributed" in paragraph (4), the words "excepting, however, the portion of such proceeds attributable to the insured employee's contributions."

The last sentence of subsection (a) (4) also is obscure. Since the first sentence of the paragraph deals solely with the purchase of life-insurance contracts by an employees' trust exempt under section 501, this second sentence probably is intended to mean that the proceeds of group term insurance continue to be exempt, and also that no change is intended in the exclusion from income of the employee participants of group term insurance premiusm paid by the employer. Such results are very desirable. Group term insurance may be purchased directly by an employer or by a trustee under a life-insurance trust which need not qualify under section 501. It is therefore recommended that the nontaxing of both the premiums for and the death proceeds of group term insurance be made clear by appropriate amendments.

In order to clarify the result as to nontaxation of group life-insurance proceeds, it is recommended that the following words be added after the words "life-insurance contract" in the first sentence of section 101 (a): "including group term insurance contracts purchased by an employer or an employee's trust whether or not qualifying as a trust described in section 501 (e) or section 165 of the Internal Revenue Code of 1939."

In the absence of any action in accordance with the above recommendation, it is recommended that the last sentence of section 402 (a) (4) be retained as it now appears in the proposed code.

The first sentence of section 402 (a) (4) refers only to a trust described in section 501 (e) which is exempt from tax under section 501 (a). It is not clear whether life-insurance purchases by existing code section 165 trusts, not qualifying under 505 (e) and 501 (a) will receive the treatment prescribed in 402 (a) (4). It is recommended that the scope of 402 (a) (4) be expanded to include such trusts, so as to have a uniform rule in respect of these employees' trusts.

(2) Treatment of beneficiary of trust not exempt

Section 402 (b) taxes "the amount actually distributed or made available" to any distributee, as does subsection (a) (1). It would appear that the word "amount" is intended to embrace only cash which is actually distributed to a

distributee or made available to him, and not the value of property, such as an insurance policy or annuity contract, the ownership of which may be transferred to the employee. This intention is not clearly expressed. Accordingly, it is recommended that a separate paragraph (c) be added to section 402 reading as follows:

"Wherever the words 'received,' 'distributed,' or 'made available' are used in this subchapter, they are not intended to embrace a transfer of title of a life insurance, endowment, or annuity contract to an employee or his beneficiary."

I. DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEE'S TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN (SEC. 403)

(1) Employees' annuities

Section 403 (a) (2) provides a deduction for contributions "paid toward purchase of retirement annuities," where such purchase is part of a qualified plan and refunds of premiums, if any, are applied within the current or next succeeding taxable year toward the purchase of such retirement annuities. It is not clear, under this paragraph, whether employer contributions made to an insurance company under a deposit administration plan which does not result in the immediate purchase of retirement annuities are allowable deductions. Accordingly it is recommended that the words "toward the purchase of" be amended to read "for the purpose of purchasing."

Subsection (a) carries over the requirement of the present law that refunds of premiums must be applied in the current taxable year or next succeeding taxable year. It may be noted that the corresponding provision in section 401 (b) (1) (B) does not contain the requirement of application within the current taxable year or next succeeding taxable year.

In any event the provision requiring that refunds of premiums must be applied in the current taxable year or next succeeding taxable year is inadequate in many instances due to unusual adjustments which may be in excess of premiums required within a current year and the next succeeding taxable year. This difficulty could be overcome simply by providing that the words "next succeeding taxable year" be changed to "succeeding taxable years."

Furthermore, no express sanction is given for the purchase of "widows' " death benefits or annuities under employee plans.

(2) Deductions for contributions in case of nonqualified plans

Section 403 (a) (5) provides for a deduction when the "amount is actually distributed or made available to a distributee," if the plan is not a qualified one. It is not clear whether this paragraph would result in a deduction for the value of the insurance or annuity policy when the ownership of such a policy is transferred to a distributee. It is therefore recommended that this point be clarified.

It is also not clear whether the amount permitted as a deduction is the amount that may be payable by an insurance company under an insurance policy or annuity contract to a distributee, rather than either the amount paid by the employer in purchasing the insurance or annuity contract or the economic value of such contract at the time of transfer to the distributee. It is believed that the proper deduction for the employer should be the total amount paid by it for the contract, if the amount sought to be deducted is other than a cash payment by the employer to the employee under the plan and that a distributee should be taxed upon the payments as received from the insurance company as an annuity, the consideration for which is the amount contributed by the employee as specified in subsection (a) of section 402. Accordingly, it is recommended that the following words be added to the end of section 403 (a) (5): ", to the extent of the contributions paid by the employer."

(3) Contributions having effect of plan

Section 403 (b) dealing with contributions having the effect of a plan does not cover the purchase of retirement income life-insurance contracts as well as annuities. This subsection might well be extended to the employer contribution paid for the annuity or retirement element in a life- or endowment-insurance contract.

(4) Trusts exempt under section 165 (a) of present law

Section 403 (c) (1) continues the tax exempt status of presently qualifying trusts for contribution purposes. However, such trusts or plans apparently do

not continue to qualify for distribution purposes under sections 401 and 402, nor for income tax withholding purposes under section 3401 (a) (12), unemployment tax purposes under section 3306 (b) (5), or Federal insurance contribution purposes under section 3121 (a) (5). Moreover, the requirement that they meet the investment rules in section 505 substantially diminishes the value of section 403 (c).

Paragraph (2) provides that contributions to a presently qualifying trust exempt by reason of paragraph (1) shall be deductible under this section or section 23 (p) of the present code. Presumably this gives the taxpayer an option, but neither the bill nor the committee report is specific in this regard.

J. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC. (SEC. 501)

(1) Nondiscriminatory classification requirements

The percentage rules in section 501 (e) (3) are objectionable as written. In the first place, these percentage requirements must be met even if one of the categories in clauses (i) through (vi) is adopted (committee report, p. A-166). This means, for instance, that a plan covering all regular salaried employees would be discriminatory if more than 10 percent of the participants are key employees and the salaried employees number less than 25 percent of all regular employees. This condition would frequently exist in cases where an employer has a large percentage of hourly wage employees. Similarly, a plan with an age requirement and with no other eligibility requirement might be discriminatory if an employer had a large percentage of young employees.

Moreover, if an employer has two or more plans covering different classes of employees, it appears that each plan must qualify separately under these percentage requirements. Thus, a salaried employees' plan might be found to be discriminatory where there is a high percentage of wage employees, even though the employees are covered under another plan. Another example might be a life-insurance company which has separate plans for its home-office employees, its salaried field personnel, and its full-time agents.

The "30-percent stockholder" rule is open to objections similar to those applying to the "10-percent key employees" rule.

(2) Ratio of contributions and benefits

There are few, if any, plans that could comply with the literal requirements of section 501 (e) (4) (A). Where a unit-type benefit is provided, the contribution and the ratio of the contribution to compensation is dependent upon age, among other factors. Consequently, in such a plan the contributions would almost always bear a higher ratio to compensation for some highly paid employees than for some lower paid employees. Apparently the intent is to apply the ratio to contributions in a money-purchase-type plan and to benefits in a unit-benefit-type plan, but the subparagraph is defective in not including some such phrase as "with like service."

Moreover, "compensation" should be defined in respect to time—that is, it presumably is intended to relate to current compensation and not to average or total compensation over the period of employment or membership in the plan.

(3) Ratio of contributions and benefits under profit-sharing or stock-bonus plan

Section 501 (e) (4) (B) provides that the total allocation as a percentage of compensation to any covered employee under a plan in any year cannot exceed twice the minimum allocated to any other covered employee whose compensation is lower. Such limitation will prevent a profit-sharing plan from buying a unit of retirement benefit for each employee, regardless of age, which is a frequent practice under present profit-sharing plans. For instance, the annual premium for a retirement annuity of $1 per year beginning at age 65 for an employee age 30 approximates $4 as against an annual premium of $10 for a man just under 60. It would not be permissible to allocate an amount sufficient to purchase the same annuity for each individual, even though the salary of the man age 30 may be only minutely lower than the salary of the man age 60, since the amount allocated to the man age 60 would exceed twice the amount allocated to the man age 30. Such a result seems undesirable.

Moreover, it appears that if employees, age 30 and 60 respectively, had the same salary, there would be no limitation under either subparagraphs (A) and (B) of paragraph (4) since such paragraphs prohibit contributions only if they bear a higher ratio of compensation for any covered employee than for any other covered employee whose compensation is lower. No limitation is placed upon contributions with respect to employees whose contribution is the same.

Accordingly, it recommended that:

(a) The words "the same or" be inserted in subparagraphs (A) and (B) of paragraph (4) before the word "lower", wherever the word "lower" is used.

(b) The following words be added at the end of 501 (e) (1) (B): ", except that this section shall not prohibit the purchase of amounts of retirement annuities for all employees covered under the plan in any year which are a uniform percentage of compensation during such year for all such employees."

The sentence of paragraph (4), beginning "Any classification which meets the requirements of paragraph (3) * * *" (lines 2, 3, 4, p. 121 of the bill) is puzzling and should be clarified.

K. ALLOWABLE INVESTMENTS FOR EMPLOYEES' TRUSTS (SEC. 505)

(1) Allowable investments

Section 505 (a) rules out investment by pension or profit-sharing trusts in ordinary life policies or in any insurance company contracts other than annuity contracts and retirement income contracts in which the face amount does not exceed 100 times the monthly annuity payable at normal retirement age. This section overrules revenue rulings 54-51, 1954-8 Internal Revenue Board 9. It also rules out the so-called ordinary life and accumulation fund plan which is used by many companies. It also appears to eliminate the use of any type of retirement income contract in which the amount payable at death at any time exceeds 100 times the monthly annuity. This last feature may not be intended, but if it is not, the words "at issue" should be inserted after "face amount" in clause 3 of subsection (a).

(2) Additional rules applicable in case of allowable investments

In section 505 (b) (2) it is provided that the section shall only apply to investments made after March 1, 1954. This limiting date may create a special problem in relation to investments made between March 1, 1954, and the date on which the proposed code is approved. It might unduly penalize trusts for having made certain investments in good faith and therefore the date of March 1, 1954, should be carried forward. Moreover, this subsection should be amended so as to permit the continuation of premium payments on insurance policies bought under present provisions of law even though the purchase of such contracts may be forbidden under the proposed law.

L. COLLECTION OF INCOME TAX AT SOURCE ON WAGES

(1) Definitions (sec. 3401)

Section 3401 contains definitions of includible and nonincludible "wages" for purposes of income-tax withholding by an employer. It satisfactorily excludes in subparagraph (a) (12) various trust payments and also those made in connection with an employer annuity plan. However, there is no recognition of the rules contained in proposed sections 106 and 402 (a) (4), nor as to the group term life-insurance premiums. These items and perhaps others which are no doubt intended to be free from income tax should be expressly excluded in this section.

PENSION, PROFIT-SHARING, STOCK BONUS PLANS, ETC.

A. EXEMPTION FROM TAX ON EMPLOYEES' PENSION TRUSTS, ETC. (SEC. 501 (E))

(1) Nondiscriminatory classifications

Section 501 (e) (3) (A) sets forth seven nondiscriminatory classifications of employees and then in effect nullifies the use of such classifications by providing that any classification is acceptable only if it does not discriminate in favor of "key employees"; which term is defined as those employees whose total compensation places them in the highest paid 10 percent of the regular employees of the employer—up to a maximum of 100 of the highest paid employees. A classification is considered discriminatory if more than 10 percent of the participants are key employees unless certain percentages of employees are participants—50 percent in case of an employer not having more than 20 regular employees, and in the case of an employer having more than 20 regular employees, 10 of such regular employees or 25 percent or more, whichever is greater.

These limitations on otherwise nondiscriminatory classifications may prevent the establishment of certain plans which are commonplace today and which are not objectionable by today's standards. For example, an employer may be unable to set up a separate plan for his salaried employees since in all likelihood the salaried force would constitute less than 25 percent of the regular employees and more than 10 percent of the salaried force would be key employees. The result would follow even though the hourly employees were covered by a separate plan.

B. REQUIREMENTS FOR EXEMPTION (SEC. 503)

(1) Prohibited transactions

Section 503 (c) (1) provides that a pension trust will be denied tax exemption in the event that any part of its funds are loaned to the employer if the trust does not obtain "adequate security" and a "reasonable rate of interest." The meaning of the term "adequate security" is not clear and its requirement is inconsistent with the provisions of section 505 (a) (4) which permits investments to be made in securities of the employer without limitation. Since there is no restriction whatsoever on the purchase of the stock of the employer under section 505 (a) (4), it is incongruous to require "adequate security" on the purchase of a note or debenture of the employer under section 503.

(2) Effective date of section

The effective date of this section is March 1, 1954, even though its provisions were not disclosed to the public until March 9, 1954. To void those transactions consummated between these two dates and, as a consequence, to deny tax exemption for the entire taxable year results in a completely unwarranted penalty. In all fairness the effective date should be the date the section actually becomes law or preferably January 1, 1955.

C. DENIAL OF EXEMPTION (SEC. 504)

Section 504 denies tax exemption to pension trusts if the income which has been accumulated but has not been distributed during the taxable year is "unreasonable in amount" or not used or invested in such manner as to carry out the purpose for which the exemption was granted. The inclusion of pension and profit-sharing trusts under this section may be detrimental to their operation and serves no useful purpose inasmuch as (*a*) the income of such trusts is usually accumulated and in any event is taxed to the employees upon distribution, (*b*) no distinction is made in such trusts between principal and income, and (*c*) all of such trust funds, whether identified as principal or income, must be devoted to the exclusive benefit of the employees, as required by the provisions of section 501 (e) (1) and (2).

D. ALLOWABLE INVESTMENTS FOR EMPLOYEES' TRUST (SEC. 505)

(1) Enumerated investments

Section 505 introduces ironclad regulation into a field previously governed by broad general principles. If the test of a permissible pension trust investment is no longer to be whether it inures to the exclusive benefit of employees and is to be supplanted by an exclusive listing of allowable investments, it is of the utmost importance that the types of investments and conditions under which they can be made be clearly stated, eliminating, so far as possible, the need for supplementary regulations.

(*a*) Section 505 (a) (2) permits investment in Government securities without indication as to the scope of the term. It would appear to embrace even the securities of foreign governing bodies. The term should be expressly defined.

(*b*) Section 505 (a), in subdivisions (2), (4), (5), and (7) thereof, permits investments in certain types of securities, which in a strict sense, could mean only stocks and bonds, thus, eliminating, without justification, investments in oil, gas, and timber interests, oil payments, leaseholds, and other forms of property, all of which may be desirable and appropriate investments.

(*c*) Section 505 (a) (6) permits investment in real estate, leaving to speculation whether interests in the nature of real property, such as mortgages, leases, etc., are to be considered proper investments under this section.

(*d*) Life-insurance policies, group or otherwise, are not permissible investments although provision for the tax treatment of certain life insurance, ex-

cluding, however—and for no apparent reason—group term insurance, is made in section 402 (a) (4).

(e) Section 505 (a) (7) restricts investments in securities of any one issuer to 5 percent of the fund. This restriction is especially burdensome to small trusts and it is suggested that at the very least the restrictions should limit investments to 10 percent of the fund or a fixed dollar amount, whichever is greater. With respect to the larger funds this percentage limitation may well deprive the trust of an attractive investment in a particular industry merely by reason of the fact that such industry is dominated by one, two, or relatively few corporations and their subsidiaries.

Moreover, the limitation that a trust may not own more than 10 percent of the stock of a company prevents a trust from organizing a corporation of the type referred to under section 501 (c) (2) to carry out transactions which would otherwise comply with the requirements for investments. Such corporations are being increasingly used by corporate trustees to hold properties in other States.

(2) Valuation of investments

Section 505 (a) requires that at the close of each quarter of the taxable year all assets of the trust be of the type and fall within the percentage limitations set forth in subdivisions (1)–(7) of section 505 (a). This section does not indicate whether for the purpose of valuing the fund the current market value of the investments or cost (inventory values) must be used. If market value is intended, the burden of making an almost continual revaluation of the fund will be imposed upon the trustee. In addition, if the percentage must be complied with not only at the time of purchase but also on each such quarterly valuation date, liquidation of those securities which have proved to be good investments will necessarily result merely because they have appreciated in value to a point beyond the percentage of the fund which may be invested in such securities.

(3) Loss of exemption status

Section 505 (a) deprives the trust, as a penalty for failure of compliance with the aforementioned investment restrictions on any quarterly date, of the tax exemption for the entire taxable year. The penalty would appear to be unreasonably severe when it is considered that a violation may occur as the result of a mere clerical error over which the employer has no control or by reason of a mistaken calculation, though made in good faith, of the value of a trust investment, as for example, a security of a small company which has no readily ascertainable market value.

(4) Effective date of section 505

Section 505 (b) (2) provides that the provisions of this section shall be effective as of March 1, 1954. As mentioned with respect to a similar provision in section 503, such a provision may deprive a trust of tax exemption simply because certain investments were made after the proposed effective date without knowledge of its retroactive effect.

Since the several States in their supervision of trust investments make provision for "legal" investments for trust funds, it would seem that the provisions of section 505 should not be made applicable to trusts limited to legal investments. An exception should also be made for trusts whose investments are limited to securities authorized by a State for investment by life-insurance companies.

In any event, there is clearly no reason for the application of section 505 to corporate trustees who are subject to the supervision of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, or a State banking department.

E. IMPOSITION OF TAX ON UNRELATED BUSINESS INCOME OF EMPLOYEES' TRUSTS (SECS. 511–515)

Sections 511–515 impose on pension trusts the same restrictions in regard to investments in leasebacks as are imposed on charitable foundations. One of these is the subjection to income tax of that portion of the rent derived from real property under a lease for more than 5 years which the amount of any indebtedness incurred in connection with the acquisition or the improvement of the property bears to the adjusted cost basis of the property. In other words, if property subject to a lease of more than 5 years and subject to a mortgage is held in a pension trust, that portion of the rent attributable to the

mortgage indebtedness is taxable income. This provision should not be applied to pension trusts.

(*a*) There is a fundamental difference between a pension trust and a charitable organization in that the funds paid out of the pension trust are subject to taxation in the hands of the recipients whereas funds paid out by a charitable organization are not so taxable.

(*b*) The accumulation of profits of a leaseback subject to a mortgage indebtedness will reduce the future contributions to an actuarial pension trust and thus reduce the employer's tax deductions, whereas the accumulation of such profits in a charitable trust has no such effect.

(*c*) If sections 511–515 are to be retained, an exception should be made with respect to real estate transferred to the trust by the employer which is leased back to the employer. This practice is quite prevalent and has proven to be advantageous to the employee beneficiaries.

F. TRUSTS EXEMPT UNDER SECTION 165 (A) OF INTERNAL REVENUE CODE OF 1939 (SEC. 403 (C))

The proposed provisions regarding the continued qualification of trusts exempt under section 165 (a) of the Internal Revenue Code of 1939 do not state whether any amendments to such trusts or plans will cause them to lose their qualified status under section 165 (a) and thus necessitate qualification under the provisions of the new bill.

CORPORATIONS USED TO AVOID INCOME TAX ON SHAREHOLDERS

A. IMPROPER ACCUMULATION OF SURPLUS (SECS. 531–536)

(1) Introduction

Sections 531–536 of the proposed Internal Revenue Code of 1954 levy a tax on corporations improperly accumulating surplus. These sections correspond to section 102 of existing law and are still properly described as a penalty tax. Several amendments have been adopted in order to minimize the inherent threat where funds are accumulated for legitimate business purposes and to exempt small companies. The amendments are generally helpful, but they do not remove all of the inequities under section 102.

(2) Publicly held corporations

Under the bill, a "publicly held corporation" would be exempt from this tax. However, the definition restricts this classification to a corporation which can prove that on the last day of its taxable year no individual (including his relatives, partners, etc.) owned more than 10 percent of its stock. It is doubtful whether many large corporations could obtain the necessary information to satisfy this requirement. A corporation could obtain the facts about stock held by the directors who determine its dividend policy. Accordingly, it is recommended that this test be confined to directors. If it is necessary to apply some limit on the percentage of stock owned by individuals who are not directors, it is suggested that 25-percent ownership would be an adequate test.

(3) Tax on all-or-nothing basis

The tax still retains its penalty characteristic because it would be imposed on an all-or-nothing basis. If a corporation fails to prove that every dollar was accumulated for legitimate business purposes, it is taxed on the entire accumulation although the major portion may not be subject to any question. It would seem more equitable to restrict the tax to that part of the accumulated earnings found to be unreasonable.

(4) Burden of proof

The bill proposes to shift the burden of proof to the Secretary or his delegate in certain cases where the taxpayer has submitted a statement of the grounds on which it relies to establish that earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business. This is entirely proper in the case of a penalty tax. The burden of proof has been on the Government for many years when a fraud penalty is asserted.

Shifting the burden of proof to the Commissioner is strictly a change in procedure. It does not change the substantive law affecting a taxpayer's liability for the tax. This procedural relief should be applicable to all proceedings where there has been no hearing by the Tax Court prior to enactment of this bill. Shifting the burden of proof in cases involving civil fraud penalties

was a similar procedural change made by the Revenue Act of 1928. (See sec. 601 of the Revenue Act of 1928.) That change was made effective to any proceeding where there had been no hearing by the Board of Tax Appeals before the enactment of the Revenue Act of 1928.

It is believed that many pending cases would be dropped or settled if the new burden of proof rule were applied. If these cases would not have been initiated under the new law, it seems unfair that the taxpayers should be penalized because of an unfair procedural handicap which will now be discarded. The Ways and Means Committee report states: "It also appears probable that many small taxpayers may have yielded to a proposed deficiency because of the expense and difficulty of litigating their case under the present rules." This situation would be remedied if the new burden of proof procedure were applied in all pending cases. In the cases where this penalty tax should be applied, it is believed that the Government's case will not be jeopardized if it assumes the burden of proof.

(5) Subsidiary corporations

It is not clear under the new provisions whether a subsidiary (as defined in sec. 336 (b)) would be considered liable for the tax because its retention of earnings avoided the income tax with respect to its corporate shareholder. To eliminate this uncertainty the phrase "with respect to its shareholders or the shareholders of any other corporation" in section 532 (a) should be amended to read: "with respect to its individual shareholders or the individual shareholders of any other corporation."

B. PERSONAL HOLDING COMPANIES (SECS. 541–547)

The proposals contained in this section correspond generally to sections 500–511 of existing law. They impose a special tax on the undistributed income of personal holding companies. However, the proposals contain several amendments which, according to the report of the House committee, are designed to clarify and simplify certain provisions to relieve inequities and to provide for a more effective administration of the tax.

The draftsmen of the new legislation have apparently achieved their objective to a great extent. The proposed changes do eliminate inequities currently existing and inordinate complications presently found in the law.

TAXATION OF ESTATES, TRUSTS, AND THEIR BENEFICIARIES (SECS. 641–683)

A. DETERMINATION OF WHAT INCOME IS DISTRIBUTABLE

Section 643 (a) (4) gives conclusive effect to a finding by a fiduciary that a stock dividend or an extraordinary dividend constitutes principal rather than income. This principle should be extended to other items of taxable income as to which there may be doubt as to whether it constitutes income or principal for trust accounting purposes.

B. DISPUTE AS TO THE BENEFICIARY TO WHOM INCOME IS DISTRIBUTABLE

Income should not be considered as distributable within the meaning of sections 651 (a) (1), 652 (a), 661 (a) (1), and 662 (a) (2) (A) where there is dispute as to the beneficiary to whom it is payable.

C. THROWBACK RULE

The prime purpose of the throwback rule (sec. 665–8) is to prevent the use of discretionary trusts to enable a beneficiary to avoid the higher surtaxes which would be incurred if the income were currently distributed. In view of the complexity of the provisions it seems clear that the statute should be limited to the prevention of tax avoidance and should not be used to achieve equality between beneficiaries who currently receive income and those for whom income is accumulated and sporadically distributed. Accordingly, the provision should not be applicable where:

(1) Income which ordinarily would be currently distributable is withheld due to doubt or dispute as to whether it constitutes income or principal or because of doubt or dispute as to the beneficiary to whom it is distributable, or

(2) The tax which would be payable by the beneficiary under the throwback rule does not exceed by some reasonable amount the tax theretofore paid by the trustee.

In addition to all other exceptions, the statute should be made inapplicable upon proof that the major purpose of the accumulation and subsequent distribution was not to avoid income tax upon the beneficiary.

The present exception stated in section 665 (b) (2) is too broad and should be limited to income which is distributed to care for the needs of the beneficiary which exist at the time of distribution, but did not exist at the time of accumulation.

D. SECTION 672—ADVERSE PARTY

Although a person having a general power of appointment over property technically has no interest therein it is obvious that his power may be adversely affected by the grantor's exercise of a power over the property. Therefore, for the same reasons as motivated the enactment of section 2041 (b) (1) (C) (ii), section 672 (a) should be expanded to provide that a person having such a general power of appointment will be deemed to have an adverse interest in the trust.

E. CLIFFORD RULE—PROOF OF SUBSERVIENCY OF RELATED OR SUBORDINATE TRUSTS

Section 672 (c) provides that a related or subordinate trustee is presumed to be subservient to the grantor unless the taxpayer establishes by a clear preponderance of the evidence that the trustee is not subservient. The statute puts an extremely heavy burden upon the taxpayer since he is required to overcome a presumption and also to prove a negative by a clear preponderance of the evidence. This burden of proof would be almost impossible to carry where no occasion has arisen to test the extent to which the related or subordinate trustee would be actually subservient to the grantor. In seeking to tax the grantor because a trustee is claimed to be subservient, the Treasury necessarily takes the position that the trustee will act in fraud of his fiduciary duties. As in other cases of fraud, the Treasury should have the burden of proof that the related or subordinate trustee is in fact subservient.

F. CLIFFORD RULE—INDEPENDENT TRUSTEE

Under section 674 (c) the grantor will be taxed even though certain powers are exercisable only with the consent of an independent trustee, where more than one-half of the trustees are related or subordinate persons subservient to the grantor. Under the present regulations the grantor is not taxed if certain powers are exercisable only with the consent of an independent trustee. Where the trust instrument, as construed under applicable rules of local law requires unanimous action by the trustees, the rule of the statute is clearly incorrect, since one independent trustee can block action by any number of subservient trustees.

G. FAILURE TO MAKE EXCEPTIONS AS BROAD AS THOSE GRANTED BY THE CLIFFORD REGULATIONS

Section 674 in listing the exceptions to the rule that the grantor is taxable by reason of certain powers to affect beneficial interests, omits the provisions of section 39.22 (a)-21 (d) (2) (iv) (b) (3) of regulations 118 which provides the grantor is not taxable where there is a power to distribute or accumulate income to or for a beneficiary, provided such power is limited by an ascertainable standard. Section 674 (a) (6) (A) frees the grantor from tax where the beneficiary from whom any income was withheld has a general power of appointment over such income. Sections 39.22 (a)-21 (d) (2) (iv) (b) (5) of regulations 118 merely require that this be a broad limited power of appointment.

No reason is apparent for making the rules of section 674 stricter than the regulations, particularly where the trust may have been set up in reliance upon the exemptions granted under the regulations. The statute should either be conformed to the regulations or the statutory provisions which are more restrictive than those set forth in the present regulations should be made applicable only to trusts created after the date of the enactment of the act.

H. EFFECTIVE DATE

Section 683 (b) in effect provides that no deduction shall be allowed an estate or trust for any taxable year beginning before January 1, 1954, for distributions made in the first 65 days of the next succeeding taxable year. This change may impose greater taxes upon estates and trusts, and lesser taxes upon beneficiaries,

than would have been imposed under the 65-day rule of the 1939 code. That rule should not be changed after it is too late for taxpayers to protect themselves.

PARTNERS AND PARTNERSHIPS

A. GENERAL STATEMENT

In its own language the Ways and Means Committee undertook "* * * the first comprehensive statutory treatment of partners and partnerships in the history of the income tax laws" (p. 65 of the committee report). Codification of the revenue provisions with respect to partners and partnerships has been long overdue and the draftsmen of H. R. 8300 are to be commended for their efforts in this connection.

Most of the provisions of subchapter K of chapter I are declaratory of existing law as set forth in Bureau regulations and rulings and judicial decisions.

However, the bill makes some radical substantive changes in the treatment of partners and their interests in their partnerships. We disagree with a number of these changes. In some cases the treatment provided for in the bill was adopted "* * * because of its extreme simplicity as contrasted with any other alternative and because it conforms to the usual expectations of partners" (p. 66 of the committee report). We do not believe that radical changes in the treatment of partners should be made on the grounds of "extreme simplicity" particularly where that simplicity is likely to create inequitable situations and where the rule does not in fact carry out the usual expectations of partners.

In our opinion it is desirable to reenact the existing partnership provisions of the Internal Revenue Code of 1939 pending a further intensive study of the taxation of partners and partnerships. Some suggestions will be made below with respect to changes in particular sections of subchapter K but we feel that such treatment will result in a patchwork creation that will be less satisfactory than the existing law.

If subchapter K is not deleted then the modifications discussed below should be considered. These modifications relate only to the more important weaknesses in subchapter K. Other weaknesses may be developed in practice.

B. PARTNER'S DISTRIBUTIVE SHARE (SEC. 704)

This section permits a partner's distributive share of income and other items to be determined by the partnership agreement except as otherwise provided in the section. The principal restriction created by the section is contained in subsection 704 (c) which requires that income, gain, loss, etc., arising with respect to contributed property or property as to which there has been a change in basis as permitted by section 743, must be allocated among the partners in the same manner as items arising with respect to any other property acquired by the partnership. Stated in its simplest terms this means that partners cannot provide among themselves for adjustment of differences between basis of contributed assets and market value of those assets on the date of contribution.

Assume that A and B form a partnership in which each is to have a half interest. A contributes property having a basis of $50 and a fair market value of $150. B contributes cash of $150. If the property contributed by A is sold the partnership will realize a gain of $100. Under section 704 (c) A and B would each be subject to tax on one-half the gain or $50.

On the ultimate liquidation of the partnership the inequity created between A and B may be adjusted since B will then realize either a loss or a lower gain which will compensate him for the tax to which he has been subjected (assuming of course that B can use the loss). A will similarly realize a larger gain or a lower loss which will equalize the reduced tax to which he was subjected.

Under present law partners may agree upon the adjustment of differences between market value and basis of contributed assets. Problems arise only when the agreement is silent.

Section 704 (c) should be operative only in the absence of a provision in the partnership agreement.

Section 704 (b) (2) permits disregard of the partnership agreement as to distribution of income, etc., if the principal purpose of any provision in the agreement with respect to a partner's distributive share is the avoidance or evasion of tax. Experience has been had with tax laws which depend upon a subjective test. Section 102 of the Internal Revenue Code of 1939 is typical.

If the code is to cover the minutest detail there is no need for a provision requiring a subjective test. And if a provision which permits the disregard of the stated rules must be included, the standards of application should be objective and clearly expressed.

C. TAXABLE YEARS OF PARTNER AND PARTNERSHIP (SEC. 706)

This section requires no particular comment beyond pointing out that a partner's guaranteed salary may be taxed in the same year as his share of partnership profits in the first year in which the section becomes effective. This would happen since a partner's guaranteed salary is not allowable as a deduction to the partnership under present law. This situation can be remedied if a partner is permitted to include his guaranteed salary in his taxable year during which the fiscal year of the partnership ends.

D. DISTRIBUTIONS BY A PARTNERSHIP (SECS. 731-735)

These sections present an entirely new concept of taxation of distributions by a partnership.

Under existing law distributions in kind by a partnership do not give rise to recognized gains or losses in the hands of the distributee partners. Distributions of money will result in gain if they exceed the partner's basis for his partnership interest and may result in a loss if the amount of the distribution is less than the basis for the partnership interest and if his interest in the partnership is terminated.

In our opinion the existing rule for nonrecognition of gain or loss on distribution of assets in kind should be continued. The tax should be imposed only when the property distributed has been disposed of by the recipient. It is true that the mechanics of allocating basis of assets distributed in kind in the hands of the distributee partner under existing law is somewhat complicated. However, that complication is negligible when compared with the procedures required under the proposed new provisions.

Recognition of gain upon a distribution in kind from a partnership places an undue burden on the distributee. Assume that A receives improved real estate as a distribution in kind from his partnership. Assume further that under the provisions of section 731 and section 732 there is a gain recognized to A. In such event A will have to raise money for the payment of the tax on the recognized gain even though he has not disposed of the real property. It is true that when A ultimately disposes of the property he may have either an additional recognized gain or a recognized loss. If it is a loss he may be deprived of a tax benefit through inability to use the loss. In such a situation A has been placed at an unfair disadvantage and a tax has been collected where, in fact, no tax should have been payable.

It is also possible for a partner to have a recognized loss for tax purposes when no economic loss exists and to this extent the revenue would suffer from the new provisions. Such a situation would arise where a partner's adjusted basis for his interest exceeded the basis of property distributed to him in liquidation and where the basis of such property is substantially below fair market value on the date of distribution. For example, A's adjusted basis for his partnership's interest is $100. The partnership distributes property to A having a present fair market value of $200 and an adjusted basis to the partnership of $50. A would then have a recognized loss of $50 although in fact he has an economic gain. Of course, if A disposes of the property he will have an increased gain which will be subject to tax. However A might not dispose of the property promptly and in that event he would have obtained a tax loss of $50 to which he should not have been entitled. If A retains the property until his death there will be no tax on the amount of appreciation over the partnership basis.

We recommend that sections 731 to 735, both inclusive, be modified to permit distribution of property in kind without recognition of gain or loss at the time of distribution.

If it is deemed desirable to recognize gain or loss on distributions in kind, the proposal made by the tax committee of the Association of the Bar of the City of New York represents an improvement over the existing provisions of the bill. Under this proposal rules somewhat analogous to those laid down in connection with the liquidations of corporations are suggested.

E. PAYMENTS TO A RETIRING PARTNER OR A DECEASED PARTNER'S SUCCESSOR IN INTEREST (SEC. 736)

The proposal with respect to payments to a retired partner or to a deceased partner's successor in interest is a radical departure from existing practice and creates an arbitrary time limit on the period during which payments may be made to a retiring partner without adverse tax consequences to the continuing partners. In effect, section 736 provides that income payments made to a retiring partner within 5 years after retirement are taxable to the recipient and thereafter such payments are in effect taxable to the continuing partners. The committee report states that amounts paid to a retired partner after the expiration of the 5-year period will be treated as a gift to the recipient (Ways and Means Committee report, p. A231).

Partnerships are business organizations and it is inconceivable that in the ordinary case any partner or group of partners would make periodic gifts to a retired partner. No reason is given in the Ways and Means Committee report for this unusual and arbitrary treatment.

Generally speaking, periodic payments made to a retiring partner or to the successor in interest of a deceased partner are made in recognition of the contribution of the retiring or deceased partner to the production of the income from which such payments are made. If arbitrary time limits are incorporated in a provision such as this, the code becomes a strait-jacket and limits the proper scope of negotiation between partners engaged in a business venture. The period of time during which continuing partners are required to make distributions of income to a retired partner or the successor of a deceased partner and the amounts of such payments should be matters for unshackled negotiations between the partners.

In section 736 (b) (2) (B) it is provided that amounts paid for goodwill in excess of the fair market value of such goodwill to persons not members of the partnership shall not be considered as payments for an interest in the partnership. While this provision is an effort to close a loophole it may well cause more distress both to the Government and to the taxpayers than is justified by the amount of revenue which would escape taxation if the provision were not included.

Valuation of goodwill is at best a difficult matter and to apply, in effect, two standards of value is merely compounding the difficulty. Assume that A, B, and C have a partnership operating a retail store. The profits of the partnership are due to the merchandising ability of all three partners. So long as all three are engaged in the business substantial profits can be expected. The goodwill of the venture has a definite value to each partner and presumably they would take this factor into account in their negotiations with respect to the payments to be made by the partnership to a retiring partner. The proposed new provision however creates an entirely different standard of value than the value agreed upon between the partners. It uses as a standard the fair market value of the goodwill to a third party. This is an indefinite phrase and can only have the effect of confusing and making indefinite the rights of the partners in the event of the retirement of one of them.

F. TREATMENT OF CERTAIN LIABILITIES (SEC. 752)

Subsections (a) and (b) of section 752 provide respectively that an increase in a partner's share of liabilities of the partnership shall be considered as a contribution of money by the partner to the partnership and conversely, that any decrease in a partner's share of the liabilities of a partnership shall be considered as a distribution of money to the partner by the partnership. These provisions may have an unintended effect where a new partner is admitted to a firm which was in existence and had liabilities created prior to the effective date of the new bill.

Suppose that A and B have an equal partnership with assets of $230, liabilities of $180 and capital accounts of $25 each. C is to be admitted as an equal partner with A and B upon the payment of $25 in cash. If C is admitted after section 752 becomes effective then C will become liable for one-third of the liabilities of the partnership or $60. Under the provisions of subsection 752 (b) the reduction in A's and B's share of the liabilities (amounting to $30 each) would be treated as a distribution of money to them. Thus A and B would have a taxable gain of $5 each since the reduction in their liabilities, which is treated as a distribution of money, exceeds the basis of their interest in the partnership.

The fact is, of course, that neither A nor B have realized any gain and that they should not be subjected to a tax in these circumstances.

This strange result can be avoided if it is made clear that section 752 is not effective with respect to liabilities existing at or before the effective date of the enactment of the bill, or alternatively, if the scope of section 752 is restricted to contribution or distribution of assets subject to liabilities.

FOREIGN TRADE

The bill seeks to improve the competitive position of United States businesses in world markets by four principal means: (1) a 14-percent rate differential for some types of income from foreign sources; (2) a taxpayer election to have a foreign branch take on some of the United States tax attributes of a foreign subsidiary; (3) a new concept of principal tax qualifying for credit against United States tax; and (4) elimination of the overall limitation on allowance of foreign taxes as credits against United States tax on income from foreign source. There are also miscellaneous provisions concerning the appropriate balance between trade and taxes.

A. THE 14-PERCENT RATE DIFFERENTIAL (SECS. 923, 951)

(1) Compensation for technical, etc., services

Section 923 (a) (2) in conjunction with section 37 provides a 14-percent rate differential for compensation received by a domestic corporation from foreign sources for "the rendition of technical, engineering, scientific, or like services." Although the proposed code itself does not restrict the availability of this differential by reference to the medium of service or the form of payment, the report of the House Ways and Means Committee declares (p. A254) that "Rentals or royalties from patents, copyrights, and similar property are not deemed compensation for services rendered."

The limitation asserted by the report is undesirable.

It would hamper adaptation of commerce to divergent policies of various sovereigns. A particular foreign country may permit dollar exchange only for royalty payments, and not for technical services rendered without patent protection, or for dividends. Still again, the foreign country may permit dollar exchange for interest payments but not for other payments. Section 923 of the proposed code, with reference to which the report asserts the disqualification of patent and similar royalties, itself recognizes problems of adaptation, by providing that interest from a foreign subsidiary may have the benefit of the 14-percent differential as well as dividends.

The limitation asserted by the report is factually untenable.

The report's pronouncement that royalties "are not deemed compensation for services rendered" is similar to its further pronouncement (p. A255) that such royalties "would not qualify as income derived from the active conduct of a trade or business through a factory, etc. * * *."

An essential part of technical aid frequently is permission to use disclosures made in patents. That the disclosure has been found of such significance as to merit the ward of a patent should not disqualify the related payment from the rate differential accorded payments for disclosures which have not won similar recognition. And in many instances segregation of payments between the two elements would be impracticable.

Patent licensing may often be a very active business, involving continuing commitments of capital and personnel, and the practical necessity of keeping in the vanguard of technical development.

For these reasons, it is believed that the views of the report referred to are erroneous, and that the rate differential should be accorded all compensation which is in fact for technical service, regardless of the medium of service or the form of payment.

(2) Income from business conducted through foreign business establishment

Like present law, the proposed code provides for deferral of tax on income of a foreign corporation until distribution to a taxpayer subject to current United States taxation. The proposed code would also permit deferral of tax on income of a foreign branch of a domestic corporation meeting elaborate tests as to the nature and location of business activity, if the taxpayer so elects.

If the business of either a branch or a foreign corporation whose stock is owned in specified percentages by domestic interests meets the tests as to nature

and location referred to, the deferred tax will not be at usual rates, but with the benefit of a 14-percent differential. Sections 923, 951.

The tests which must be met to qualify for this importantly advantageous tax treatment are even more stringent and less certain than the tests for qualification as a Western Hemisphere trade corporation.

(*a*) *Nature and location of foreign business.*—Sections 923 (a) (3) (A) (ii) and 951 (a) (2) provide that the operation must have derived its "gross income * * * to the extent of at least 90 percent from the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business situated within a foreign country * * *."

For this purpose, "the term 'trade or business'" as defined in sections 923 (b) (1) and 951 (b) (1) does not include—

"(A) the operation of an establishment engaged principally in the purchase or sale (other than at retail) of goods or merchandise, or

"(B) the maintenance of an office, or employment of an agent, other than a retail establishment excepted from subparagraph (A) to import or facilitate the importation of goods or merchandise."

These provisions seem to have been drafted with a view to limiting the benefit of the new incentive rate to cases of "significant investment abroad"; and to disqualifying some types of operation—essentially export—which have qualified for the benefits accorded Western Hemisphere trade corporations. (House committee report, p. 75.)

They go on, however, and disqualify income of a wholesale establishment even though the establishment represents an investment heavier than would be required for an office or even a retail establishment. Since the proposed code would deny the credit for business income from foreign sources unless the income were derived from conducting business through a "factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business, situated within a foreign country," there would be an arbitrary and capricious discrimination against foreign income not qualifying under the narrowly defined category. The foregn operations of the automotive industry frequently could not come within such categories as illustrated by the following suppositious example which would be typical:

An American automobile concern operates a branch in foreign country X whose tax rates do not exceed 38 percent. The branch business does not justify the maintenance of a factory or other operation coming within the above-quoted language, and instead its functions consist of importing built up automotive units which would ultimately sell to dealers which are strategically located throughout country X. In addition to conditioning the units after their importation from the United States or other countries, sound business principles have dictated that this branch in its capacity as a wholesale distributor in foreign country X should also perform all the sales and service functions needed in order to accomplish a maximum penetration of the market in that country. In contrast to having only a paper organization or nominal investment abroad, the branch instead maintains office and storage buildings, shop, facilities, machinery, inventories, and related assets representing a very substantial investment.

The foreign income derived from these extensive and necessary investments should clearly qualify for the foregoing credits, but under the restrictive language above quoted, there would be a discrimination against such income in that under present rates it would presumably be taxed at 52 percent rather than the 38 percent rate which would be applicable respecting foreign income which satisfies the narrowly defined categories above quoted. Such a discrimination against wholesaling operations is especially shortsighted, since they are the normal antecedent of a factory operation if such is later found to be warranted.

Even assuming that the branch had a factory and combined manufacturing with wholesale distribution, the same discrimination might result, since the wholesaling function would still be present, and section 923 is ambiguous as to whether an enterprise with these combined functions would receive the above credits.

On the other hand, the proposed statutory listing of establishments which would qualify for this advantageous tax treatment is only illustrative. Thus, the House committee report says (p. A255) that a bank may qualify although not listed. And, by stating that "other like placed of business" may also "include * * * the operation of * * * an air transportation business," the report indicates (ibid.) that the business need not be confined to a fixed location, but may consist of a variety of activities over a wide geographical area.

The express exclusions from the term "trade or business," of an "establishment engaged principally in the purchase or sale (other than at retail) of goods or merchandise" and of a mere "office" seem to indicate, although with less clarity than would be desirable, that the "conduct of a trade or business through" a "factory," etc., may include incidental wholesaling activities, as where a factory assembles some articles and buys or imports, and sells, other articles at wholesale, in order to fill out its line and to provide replacement parts. The House committee report seems intended to bear this out by stating (p. A255) that:

"If the trade or business activities consist principally in the production or manufacturing and sale of goods or merchandise, and incidentally in the purchase and sale of goods or merchandise, such trade or business would not be excluded."

The House committee report seems to assume that income of a factory, etc., may be derived in part from technical services, but expressly states that royalties from patents or copyrights can disqualify an otherwise qualified operation. It says (p. A255):

"* * * items of income which would not meet the qualifying requirements are rentals or royalties from patents or copyrights since they would not qualify as income derived from the active conduct of a trade or business through a factory, etc., or other like place of business."

Here again, the report asserts an erroneous view of the role of patents or copyrights.

Neither the proposed code nor the report makes clear beyond doubt the status of a business operating in more than 1 foreign country, e. g., a manufacturing business with its plant in 1 foreign country and its customers and sales outlets in a number of foreign countries. Section 923 (a) extends the new incentive rate only "with respect to taxable income derived from sources within any foreign country"; and section 923 (a) (3) (A) (ii) refers to gross income from "the active conduct of a trade or business through a * * * place of business situated within a foreign country * * *." See also section 951 (a) and (a) (3). Conflicting inferences may be drawn from the further provision of section 952 (2), that "* * * the amount of branch income considered to be withdrawn pursuant to section 954 shall * * * be considered to be derived from sources within the foreign country in which such selected branch is situated."

The statement in the House committee report (p. A255) that income from operation of an airline business may qualify, referred to above, does seem to contemplate that income-producing activities may take place in more than one foreign country.

Qualification is expressly denied, however, if more than 25 percent of the gross income of the foreign corporation or branch is "derived from the sale of articles or products manufactured in a foreign country and intended for use, consumption, or sale in the United States" (secs. 923 (a) (3) (A) (iii); 951 (a) (3)). There is no similar disqualification in the cases of mines, oil or gas wells, or like places of business.

The proposed code does not provide that degree of assurance of the tax consequences of foreign transactions required for fulfillment of its broad purposes.

This inadequacy results in part from the method of drafting. As has been seen, the illustrative listing of qualified activities and specific listing of disqualified activities leaves in doubt numerous typical cases which could much better have been handled by a simple, straightforward test—such as conduct of business through a foreign permanent establishment—formulated with less detailed concern for taxes and more practical concern for trade.

It also results in part from the choice of particular ends to be served, which seems to reflect some inconsistencies in orientation toward problems of what may be called economic nationalism.

Thus, the provisions under discussion would foster what may freely be called exportation of technical information derived in domestic research and operations; but seek to prevent, at almost any cost in complexity, giving any advantage to exportation of goods manufactured in the United States except as such exportation may be incident to the operation of a qualified foreign establishment (such as a retail store). The proposed code would also foster importation of raw materials (with the possible exception of agricultural products), but would actually penalize foreign manufacturing with a view to importation into the United States by making it disqualify income otherwise qualified for favorable United States tax treatment.

The proposed code ties together two incentive devices used separately in present law; Deferral of United States tax (as in the case of operation through a foreign corporation) and a favorable rate differential (as in the case of a Western Hemisphere Trade Corporation).

On the one hand, the combination of these benefits falls considerably short of the complete exemption from United States tax of income from a foreign permanent establishment, often urged in the view that the country of the place of operation is the best judge of the appropriate tax burden. On the other hand, it considerably exceeds the benefits accorded operations qualifying for taxation as a Western Hemisphere Trade Corporation.

However drafted, tests for determining qualification for such combined benefits are subject to strain corresponding to the relative importance of qualification; and to compounded strains where the tests serve not only to determine whether particular income is qualified, but also whether receipt of such income will disqualify otherwise qualified income.

Problems of drafting and administration could be much simplified, and the broad purposes of the proposed code better served, by providing for the income of any foreign permanent establishment, the combined benefits now proposed; and by providing some, although less, tax relief for income derived from purely export operations. One method would be establishment of a new category of corporation having United States tax attributes corresponding generally to those of the so-called Canadian 4-k and similar foreign corporations now employed for some foreign operations—deferral of United States tax pending distribution to United States taxpayers, and a rate differential smaller than 14 percent.

Such treatment of export operations, regardless of whether conducted with benefit of the technical title passage abroad now required by the rituals for qualification as a Western Hemisphere Trade Corporation, would make much less difficult the problems of in-or-out classification necessarily presented by the proposed code; would foster what is typically the first step toward ultimate investment in a foreign permanent establishment; and would provide an objective test for qualification for the major incentive of deferral of United States tax, by making such deferral correspond to the tie-up of earnings, in the foreign venture. To the extent of deferral of tax, there will be correspondingly increased opportunity for foreign investments determined, as they should be, by foreign market considerations rather than overelaborate rubrics of United States law based on an oversimplified view of foreign operations such as found in the proposed code. Both sovereign and subject would abide the commercial outcome of the foreign venture, and both would benefit from freeing the subject of the burdens of frustration and uncertainty occasioned by present law.

Further discussion of the questions involved in such a proposal, based on extensive factual research, may be found in the very recently issued report on United States Tax Incentives to Direct Private Foreign Investment by Messrs. Barlow and Wender of the program in international taxation of the Harvard Law School.

(*b*) *Relationship of foreign business to United States.*—Section 923 (a) (3) (B) (i) refers, perhaps inadvertently, to ownership of "more than 50 percent" of the voting stock of a foreign corporation by a domestic corporation. It would seem desirable that this test be made to correspond to that of section 902 (b): "50 percent or more."

The proposed code should also be amended to make it clear that a domestic corporation may qualify for the new incentive rate accorded branch operations even though it actually has no "home office" in the United States.

B. ELECTION TO HAVE FOREIGN BRANCH TAKE ON SOME OF THE UNITED STATES TAX ATTRIBUTES OF A FOREIGN SUBSIDIARY (SECS. 923, 951)

Sections 923 (a) (1) and 951 accord the new incentive rate to branches meeting tests of kind and place of business discussed under A (2) (a), supra. The comments there are generally applicable here. For example, the statute leaves room for some doubt whether a branch may receive more than 10 percent of its gross income from technical services without disqualifying income from a factory. In this and other respects, both the provisions for income from foreign sources and elective treatment of foreign branches call for generally comparable clarification and amendment.

In most respects, the provisions for elective branch treatment cope adequately with the difficult technical problems of assimilating a branch to a foreign corporation.

Considerations of protecting the revenue would make it desirable, however, to provide for elected branch operations, policing provisions comparable to those of section 112 (i) of the present code. On the other hand, the at least arguably

correct view of the House committee report (p. A264) that loss on liquidation of a branch would have no United States tax consequence presents a real prospect of penalty for use of the elective branch treatment, in direct proportion to the amount of foreign investment—an astounding result in a measure which elsewhere goes to unnecessarily elaborate extremes to confine the benefit of the new incentive rate to cases of substantial foreign investment.

C. THE NEW CONCEPT OF "PRINCIPAL TAX" (SECS. 901 (B) (1) (B), 902 (A) (2), 903)

Sections 901 (b) (1) (B), and 902 (a) (2) and (b) (2) would allow an election to take credit for a "principal tax" of a foreign country and do away with the credit for tax in lieu of income tax provided by section 131 (h) of the present code.

Commendable in purpose as this may be, the results are surely unpredictable and quite possibly detrimental to the broad purposes of the proposed code.

Abolition of credit for tax "in lieu" would seem likely to cause the courts to revert to and perhaps extend their strict construction of what constitutes an "income tax," developed before credit was allowed for tax "in lieu."

At least until there is more experience with the novel and obscurely defined category of "principal" tax, it seems unwise to deny credit for taxes "in lieu." Such taxes should continue to qualify for credit, except where the taxpayer elects to take credit for a "principal" tax.

D. ELIMINATION OF "OVERALL" LIMITATION ON ALLOWANCE OF FOREIGN TAX CREDIT (SEC. 904)

Section 904 would eliminate the "overall" limitation and retain only the per-country limitation on the credit for foreign taxes.

Simplicity in administration, protection of the revenues, predictability of results, and concord with conventional commercial attitudes toward foreign operations, would best be served, however, by abolishing the per-country rather than the overall limitation.

The proposed code does not cure vexatious and in some instances wasteful aspects of present law concerning the allowance of credit against United States tax for foreign tax. It does not give assurance that contest of a foreign tax will not postpone accrual, nor does it alter the present discrepancy in the situations of the United States Government and the United States taxpayer in cases of adjustments of foreign tax—the United States Government is never barred by limitations from asserting a deficiency after refund of foreign tax; but the taxpayer may not get a refund of United States tax based on upward adjustment of foreign tax, after the expiration of the generally applicable period of limitations.

Correction of practical problems such as these should provide needed protection to the revenues, and bring to the administration of foreign taxes a good measure of that healthy rivalry between taxpayer and taxgatherer which has contributed so largely to the efficient administration of domesic tax affairs.

GAIN OR LOSS ON THE SALE OF PROPERTY

A. BASIS OF PROPERTY ACQUIRED FROM A DECEDENT (SEC. 1014)

Section 1014 (c) denied a basis to restricted stock options described in section 421 which remained unexercised at an employee's death. Insofar as this subsection operates to deny a basis for values taxed to an estate where such values ultimately represent ordinary income subject to an appropriate deduction under section 691 (c), it seems unobjectionable. With respect to restricted stock options, however, only the spread between 85 and 95 percent can constitute such ultimate ordinary income. Instead of merely denying a basis for such 85–95 percent spread for which a section 691 (c) deduction is allowable, the effect of section 1014 (c) is to deny any basis whatever for such option. It is believed that this treatment is too drastic. We therefore recommend that the estate or beneficiary of a deceased employee be allowed a date of death or optional valuation date basis to the extent that the value of the unexercised option represents potential capital gain and not ordinary income.

In this connection we also point out that a clerical error apparently exists in section 421 (d) (6) (B) where the bill refers to a person described in "paragraph (1)." This consequently should be changed to "subparagraph (A)."

B. SALE OR EXCHANGE OF RESIDENCE (SEC. 1034)

Section 1034, with some few changes, is substantially the same as section 112 (n) of the existing law providing under certain conditions for the postponement of gain on the sale of a taxpayer's principal residence where the proceeds of sale are used to purchase a new residence.

Section 1034 (b) (1) provides for the reduction of the amount realized on the sale of the old residence by the aggregate of certain expenses incurred to fix it up for sale. However, this reduction is limited by section 1034 (b) (2) to expenses "for work performed during the 90-day period ending on the day on which the contract to sell the old residence is entered into" provided such expenses "are paid within 30 days after the date of the sale of the old residence." This is a desirable feature and seems to fall within the spirit of the section. However, we believe that the time limitation for performing such work is too short. We therefore recommend that the reduction should be limited to expenses for any such work performed during the 180-day period ending on the day of entering into the contract to sell or if the 90-day period is to be retained that it commence to run only upon the completion of the last item of work that is done with an overall limitation of 180 days. It is believed that this additional time is necessary because it would be a very rare case, indeed, where the fixing-up work would be completed, the property listed for sale, the property actually sold, and a contract entered into all within 90 days.

Under section 1034, as under existing law, to qualify for nonrecognition of gain the new residence must be purchased within 1 year before or 1 year after the sale of the old residence except that the 1-year period after the date of sale of the old residence is extended 6 months to a period of 18 months if construction is commenced on a new residence during the 1 year after the sale. Both the new and the old sections provide that in determining the taxpayer's cost of purchasing the new residence there shall be included only so much of his cost as is properly attributable to capital account during the said periods. It is believed that the time limitation prior to the date of sale is too short in the case of the construction of a new residence. In the usual situation the old residence is not placed on the market for sale until the taxpayer is able to move into the residence that he is building. It is rare, indeed, that a taxpayer can, in the short period of 1 year, purchase a lot, obtain his plans and specifications, arrange his financing, let the contract for construction, complete the construction, move into the new residence, and then bring about and consummate the sale of the old residence. We, therefore, recommend that in the case of new construction the provisions of section 1034 be modified to allow the inclusion in the cost of the new residence of all items expended during an 18-month period prior to the date of sale of the old residence and, in addition, to allow the inclusion of the cost of the lot and any expenses incidental to its maintenance and improvement toward the construction of a residence if such items are expended within a period of 6 months prior to the commencement of the above recommended 18-month period for new construction.

C. CERTAIN EXCHANGES OF INSURANCE CONTRACTS (SEC. 1036)

Section 1036 provides for the nonrecognition of gain or loss on the exchange of various contracts issued by life-insurance companies. The definitions, however, contained in subsection (b) are too restrictive and probably their framers overlooked the vast varieties of insurance and annuity contracts issued by life insurance companies and all of which serve desirable purposes. For instance, in paragraph (1) of subsection (b) the definition of endowment contract would not include a noncommutable installment endowment contract which in accordance with its terms would not be payable in full in a single payment during an insured's life. The definition of an annuity contract in paragraph (2) of subsection (b) is defective in that it refers to an "insured" rather than the "annuitant." In addition, it restricts the annuity contract for this purpose to one payable during life as distinguished from an annuity for a period certain, which is now treated as an annuity in section 72.

Paragraph (3) of subsection (b) is also objectionable in that it limits the definition of life insurance contract to one which is not payable in full during the life of the insured. A life insurance contract may in various instances and especially at advanced ages, perhaps through the application of dividends, become payable during the lifetime of the insured and to him. This may be rule in a case where the policy cash value during the lifetime of the insured equals the face value of the contract.

Accordingly, we recommend that the definitions contained in section 1036 (b) be improved.

CONSOLIDATED RETURNS

A. CONSOLIDATED RETURNS FOR SUBSEQUENT YEARS (SEC. 1505)

(1) Consolidated returns required for subsequent years

Section 1505 (a) sets forth the rules under which separate returns may be filed by affiliated corporations which previously have elected to file a consolidated return. Paragraph (2) thereunder provides a new election after a code amendment has been made which renders the continued filing of consolidated returns substantially less advantageous to affiliated groups. In such event the effective date of the amendment is of no materiality. It appears to be contemplated that the new election must be made with the first return filed after the date of enactment although the year for which the return is filed is not affected by the amendment. On the other hand, no further election is available for the year or years for which the amendment becomes effective.

While this rule is consistent with a change made in 1951 by the Commissioner in his regulations, it differs from the practice which the Commissioner previously had followed in recognizing that when a new tax law was enacted imposing different tax burdens for different future years, affiliated corporations were entitled to a new election for each of those years. As the committee report shows, this provision means that if after the close of a tax year (1953) an amendment (H. R. 8300) is enacted which has no effect on returns for 1953, but which drastically changes the tax burden for later years, taxpayers will get a new election as to the one year (1953) which is not at all affected by the amendment and will not get a new election as to any of the later years which will be so vitally affected. The new rule seems unfair and results in depriving affected corporations of the freedom of elections for years to which changes are applicable.

Furthermore, the law should allow a new election whenever an amendment of the law takes effect which materially increases the tax burden of corporations, whether or not it affects consolidated returns more seriously than separate returns. A group of corporations might be willing to pay the extra 2 percent for the privilege of filing consolidated returns if that increased their tax from 38 percent to 40 percent, but not if it increased their tax from 52 percent to 54 percent.

It is suggested that section 1505 (a) be modified to allow a new election whenever an amendment to subtitle A of the code, which substantially increases the tax burden of affiliated corporations as a class becomes effective.

B. FAILURE TO INTEGRATE WITH PROVISIONS AS TO ADVANCE PAYMENT OF INCOME TAX

Under section 6016 most corporations with anticipated income tax in excess of $50,000 will be required to prepay a part of their tax. This new system for collecting taxes, if adopted, presumably should include affiliated groups as well as separate corporations. The proposed code does not appear to deal with the myriad questions which would arise with respect to affiliated groups. For example, does the $50,000 allowance apply to the group or to each corporation within the group; how are installments on estimates to be treated where the election to file consolidated returns follows payment; and how are they to be allocated where the election to file separate returns follows payment on a consolidated basis?

It appears that a good deal of work to achieve statutory integration is required in this area.

ESTATE TAX (SECS. 2001-2207)

A. POWERS OF APPOINTMENT—PREVIOUSLY TAXED PROPERTY

Section 2013 (a) should be amended so that "transfer" as used therein will include a situation where property subject to a power of appointment was included in the gross estate of the donee of the power. (Cf. sec. 2041 (a) (3) (B).)

B. ALTERNATE VALUATION

Section 2032 should be amended to eliminate the restriction that optional valuation will be permissible only if the gross estate declines in value by 33⅓ percent. In the case of large estates, this rule could wipe out the estate. In

the case of small estates it could work considerable hardship. The reasons advanced for the change do not seem sufficient to justify such a limitation.

The executor should have the right to elect to use alternate valuation during such period as a deficiency may be determined.

C. ANNUITIES [3]

(1) Distributed upon the termination of exempt plans

Section 2039 (c) (1) and (2) deny exemption to cases where annuities were received by an employee prior to the termination of his employment by reason of the termination of an exempt plan, merely because no plan is in existence to qualify under section 501 (e) at the date of the employee's eventual separation from employment. Section 2039 (c) (1) and (2) should be amended to allow the exemption if the trust or annuity meet the requirements of section 501 (e) at the date of the termination of the plan or at the time of decedent's separation from employment, whichever was earlier.

(2) Employees' annuities atrributable in part to employees' contributions

The sentence immediately following clause 2 in section 2039 (c) forbids any exclusion if the employee made any contributions toward the purchase of the annuity. This does not appear to be in accord with the intention of the draftsman (committee report p. A-315) nor does it accord with common sense. The sentence should be amended to accord with the intent expressed in the committee report.

(3) Presently exempt plans not qualifying under section 501 (e)

Section 2039 (c) should be amended to provide for exclusions in cases where the employees' plan qualifies under section 165 (a) even though it does not qualify under section 501 (e).

(4) Lump-sum annuity death benefit

Section 2039 should be amended to make it clear that an exclusion is to be given in the case where a lump-sum annuity death benefit is provided and the beneficiary exercises the privilege, first or otherwise available to the employee, of making the benefit payable in installments for life or a period certain.

(5) Valuation

(*i*) *Comparable cost.*—Section 2039 should be amended to set forth a clear rule of valuation. It is recommended that the harsh rule of comparable cost (the cost of a new annuity at current rates as otherwise sold upon the death of the decedent by the same insuring company) should not be adopted.

(*ii*) *Actual facts differing from actuarial assumptions.*—The statute in providing for the valuation of annuities should take into account the fact that the surviving annuitant is not in good health or even if in good health, died shortly after the death of the first annuitant without a recovery of payments even equal to the tax imposed upon the transfer.

D. INSURANCE—REVERSIONARY INTEREST

Section 2042 (2) provides for the inclusion in the gross estate of a policy of insurance if the decedent had a reversionary interest therein exceeding 5 percent of the "value of the policy." This raises problems where the policy has little or no cash value. The test should be whether the decedent has a reversionary interest of 5 percent "in the policy."

E. INSURANCE—TRANSFERS FOR INSUFFICIENT CONSIDERATION

Section 2043 does not refer to transfers of insurance for a partial consideration and thus should be amended to refer to section 2042.

GIFT TAX (SECS. 2501-2542)

A. PRESENT INTEREST IN INCOME WHERE REMAINDER MAY BE ACCELERATED

Section 2503 should be amended to provide that an exclusion is allowable for the actuarial value of an income interest, computed without regard to the fact that the remainder may be accelerated and delivered to the income beneficiary. Cf. *Sensenbrenner* v. *Commissioner*, 134 F. (2d) 883.

[3] See earlier discussion under Annuities—sec. 72 (j).

B. JOINT AND SURVIVOR ANNUITIES

Section 2039 exempts from estate tax the portion of the value of a survivor's annuity which is attributable to the contributions made by an employer under a plan which is exempt under section 501 (e). Similar exemption should be granted for gift tax purposes.

PROCEDURE AND ADMINISTRATION

A. ADVANCE PAYMENTS OF CORPORATE INCOME TAX (SEC. 6016)

Section 6016 will require most large corporations to prepay a portion of their tax through the utilization of a declaration of estimated tax to be filed pursuant to section 6074 on or before the 15th day of the 9th month of the taxable year. It is provided that estimated tax shall be the excess of anticipated income tax less credits over $50,000. It is apparent, therefore, that the advance payment will be required only of corporations with substantial income.

There would seem to be no problem with respect to the ability to collect taxes from large and stable corporations. Consequently, this new requirement can have as its purpose only an acceleration in the collection of taxes.

Many large corporations conduct a diversified business through divisions, branches, and subsidiaries. Some have foreign branches or subsidiaries. The books and records of the separate divisions ordinarily must be separately maintained. The requirement of section 336 (defining partial liquidation) that books and records for a terminated business be separately maintained may induce even a greater breakdown in accounting for the income and disbursements of large corporations in the future. Furthermore, the ultimate taxable income of many large corporations depends on business decisions or elections which may not be taken until the end of the year. For example, decisions as to withdrawal of income from a foreign branch could affect taxable income considerably in view of the election to be made available under subtitle A, chapter I, and subchapter N, part IV.

The estimated tax is payable in 2 installments pursuant to section 6154 and penalties determined at the rate of 6 percent per annum on underpayments are provided for by section 6655.

It seems questionable whether the acceleration in the collection of taxes (which would not even have the effect of changing the Government's fiscal year of collection) warrants the mandatory imposition of such additional burdens as will be placed on certain large corporations to comply with the new provisions requiring advance payments.

B. LIMITATIONS ON CREDIT OR REFUND (SECS. 6513 AND 6072 (B))

(1) Time return deemed filed and tax paid

For purposes of determining the period of time within which claims for refund may be filed, section 6513 sets forth rules as to the time when the tax is considered as paid. Subsection (b) thereof states that any amount paid as estimated income tax shall be deemed to have been paid on the 15th day of the 4th month following the close of the taxable year. This is proper insofar as individuals are concerned in view of section 6072 (a), fixing the date of their final returns as the 15th day of the 4th month. It fails to integrate into the limitation provisions the new requirements with respect to estimated income taxes paid by corporations, the final returns of which continue to be due on the 15th day of the 3d month following the close of the year as provided in section 6072 (b). If the advance-payment provisions relating to corporations are not eliminated, an appropriate provision should be inserted in this subchapter of the code.

C. INSTALLMENT PAYMENTS OF ESTIMATED INCOME TAX BY INDIVIDUALS (SECS. 6073 AND 6153)

(1) Declarations and payments of estimated tax

Section 6073, dealing with the time for filing declarations of estimated income tax by individuals and section 6153, dealing with the payments of installments would move to April 15 the declaration and first installment payment date, but retain the current law provisions of June 15, September 15, and January 15 of the succeeding year for the remaining installments. The change from March 15 to

April 15 for the declaration of estimated tax coincides with the similar change respecting final returns for the prior year.

Section 6015 (f) permits a taxpayer to file a return on or before January 15 of the succeeding taxable year which shall be considered as a declaration or the amendment of a declaration previously filed, as the case may be. It is believed that if the date for the fourth installment were deferred an additional month many taxpayers would be enabled to file their returns and pay the balance of their taxes on the last installment date. It is therefore suggested that the above sections be appropriately amended to provide for the declaration and payment of estimated tax dates for individuals by April 15, July 15, October 15, and February 15 of the succeeding year.

Section 6153 (c) provides that where an amendment of a declaration is filed, the remaining installments shall be ratably increased or decreased to reflect the increase or decrease in the estimated tax by reason of such amendment. This follows current law. Section 6654 contains new rules dealing with the penalty for the failure by individuals to pay estimated income tax. In certain circumstances interest will be payable where the individual has underestimated his tax and, hence, underpaid the earlier installments. Section 6153 (c) should be modified to provide flexibility with respect to the payments to be made in connection with amended declarations, in order that a payment in an amount sufficient to eliminate interest on an underpayment can be made.

D. DEFINITION OF DEFICIENCY (SEC. 6211)

Section 6211 (b), which lays down rules for the application of subsection (a) defining the term "deficiency," provides in effect that in determining a deficiency, no account is to be taken of payments of estimated tax. Current law is the same in this respect.

The application of this rule has given rise to cases where deficiencies were determined in amounts which admittedly represented a sum greater than actual unpaid tax liabilities when advance payments through the filing of declarations of estimated tax were taken into consideration.

Section 6215 (a) provides that the entire amount redetermined as a deficiency by the Tax Court will be assessed and paid upon notice and demand. There appears to be no requirement that the Secretary or his delegate should credit against the deficiency so determined any part of the payment of estimated tax. On the contrary, section 6402 (a) states that in the case of any overpayment, he may credit such amount against any liability in respect of an internal revenue tax and this is meant to include any kind of a tax levied by the code on income or otherwise. Subsection (b) of 6402 authorizes the Secretary or his delegate to prescribe regulations providing for the crediting against the estimated income tax for any year of the amount determined by him to be an overpayment of the preceding year. A new provision of law, contained in section 6513 (d), provides that if any overpayment of our income tax is, in acordance with section 6402 (b), claimed as a credit against estimated tax for the succeeding year, such amount shall be considered as a payment for the succeeding year and no claim for credit shall be allowed for the taxable year in which the overpayment arises. These last-mentioned sections presuppose there to have been an overpayment. However, since on the hypothesis the Tax Court has determined a deficiency, it would appear that no overpayment exists as that term is defined in section 6401.

This confusing situation which can result in the collection of excessive interest from a taxpayer where the Government actually has had the use of his money seems to be emphasized by reason of 6402 (b) and the provisions which will entail advance payments by corporations. It is submitted that appropriate provisions should be inserted in the code to prevent this result.

E. OMISSION FROM GROSS INCOME (SEC. 6501)

Section 6501 (e), dealing with omission from gross income of an amount in excess of 25 percent of that stated in the return, will eliminate a controversial point which has arisen under its counterpart in the current law. It does this by defining "gross income" as meaning total receipts from the sale of goods or services before reduction by cost of such sales or services. It further provides that an amount shall not be deemed to have been omitted where a disclosure has been made in the return.

It is desirable that these provisions be made effective with respect to returns for prior years where settlement has not been had by virtue of a final determination or closing agreement.

F. VALIDITY OF LIENS AGAINST MORTGAGEES, PLEDGEES, AND PURCHASERS (SEC. 6323)

Section 6323 (c) provides that tax liens shall be valid against any mortgagee, pledgee, and purchaser who had notice or knowledge of the existence of such lien, notwithstanding the fact that notice thereof has not been filed.

This provision places an undesirable burden upon financial institutions and others participating in commercial loans. Furthermore, it may encourage laxity on the part of the Secretary or his delegate in filing notice and may promote controversy on the question of the extent to which implied notice or knowledge should be imparted to the mortgagee, pledgee, and purchaser. For example, should a financial institution employing thousands of persons be held to have notice of the existence of a lien because proof is established that one employee has such notice, although such employee has no connection with the making of the loan?

G. PETITION FOR REVIEW (SEC. 7843)

Section 7843 gives to the Secretary (or his delegate) or the taxpayer an additional month within which to file a petition for review of a Tax Court decision where "an adverse party" has taken an appeal. This provision would seem to promote "nuisance appeals" on issues which should have been laid at rest by the Tax Court's decision. It therefore seems an undesirable change in the law.

If, however, this provision is to remain in the law, it should also cover instances in consolidated proceedings where two or more taxpayers or groups of taxpayers are really adverse parties. This can occur, for example, where the Government has taken inconsistent positions with respect to the taxation of income paid by a partnership to a retired partner and the cases are consolidated for trial. The word "adverse," as used in this section, should be changed to "any other" so as to permit any party to the consolidated proceeding to file a cross proceeding within the extended period where one party has taken an appeal.

Respectfully submitted.

SECTION ON TAXATION, NEW YORK STATE BAR ASSOCIATION,
RALPH M. ANDREWS, *Chairman.*

MEMORANDUM OF RAILROAD SECURITY OWNERS ASSOCIATION URGING REVISION OF SECTIONS 275 AND 312 (C) AND 312 (D) OF H. R. 8300

This memorandum is submitted for the purpose of urging that sections 275 and 312 (c) and 312 (d) of H. R. 8300 be revised to eliminate the adverse effect such provisions would have upon railroad credit by denying a deduction from gross income of the interest paid on railroad income bonds.

Railroad Security Owners Association is a nonprofit membership corporation organized under the membership corporation law of New York. Its membership consists of institutional holders of railroad bonds, principally insurance companies and savings banks, whose operations are for the benefit of their depositors and policyholders. They are interested both in preserving the integrity of their present holdings in railroad securities which include both income and fixed interest bonds and in preserving railroad credit for the future investment of their fiduciary funds.

H. R. 8300, through the provisions of section 275 and 312 (c) and 312 (d) thereof, appears to eliminate the present deductibility of interest on railroad income bonds of which many millions in principal amount have been issued with the approval of the Interstate Commerce Commission.

The report of the Ways and Means Committee on section 275 states that "this section provides that no deduction shall be allowed for any amounts paid with respect to nonparticipating stock, as defined in section 312 (d), such as those income debentures which are not true debt obligations of the issuer * * *." It is evident, therefore, that the proposed sections are not intended to eliminate the traditionally accepted deduction for true interest, but are doubtless designed to prevent such deduction from becoming available in the case of securities which, though disguised as debt obligations, in fact have all the incidents of equity ownership. Railroad income bonds have no characteristics that fall within this category, and their apparent inclusion within the class of securities described in the proposed sections could not have been intended, and should not be permitted.

The issuance of railroad bonds, whether in connectoin with an original borrowing or in connection with some form of railroad reorganization under the Bank-

ruptcy Act, requires the approval of the Interstate Commerce Commission in accordance with the provisions of section 20 (a) of the Interstate Commerce Act. No railroad income bonds could have been issued since the passage of that section or can be issued in the future unless the Interstate Commerce Commission found or finds that "such issuance is compatible with the public interest" and "necessary or appropriate for or consistent with the proper performance by the carrier of service to the public as a common carrier." It is evident from this alone that railroad income bonds are securities whose issuance is governed by sound economic policy and is not and cannot be made the subject of mere tax-saving expediency.

Railroad income bonds are true debt obligations in every possible sense. They are secured by mortgages which are in all respects similar to those securing fixed interest bonds. They represent, as to principal, obligations which must be met at maturity and which can be enforced by suit, not only upon maturity but upon the occurrence of any one of the numerous events of default set forth in the mortgages. They are usually fully cumulative to the extent earned, i. e., payment of the interest is mandatory if income is available therefor under the terms of the indenture. Unlike preferred stock, income mortgage bonds have a claim in case of bankruptcy prior to that of general creditors. In the case of some railroads, where there are no fixed interest bonds, they represent a first lien on the property. The bonds are publicly held by bona fide arms-length creditors, with all the rights of lien creditors, e. g., to appointment of receivers in case of default. The income bondholders are true creditors with a contract right to payment of interest contingent only on the available earnings. Their principal is not at stake. They are in no respect analogous to stockholders.

Where income bonds represent an original bond issue by the railroad, they are issued to provide funds for the conduct of its business and a promise is made to pay at a specified rate for the use of the funds whenever earnings are available. This rate of payment differs from fixed interest merely in the fact that it is payable only when the earnings of the company are sufficient for the purpose. Clearly such payment, like fixed interest, is a cost of borrowing money to the borrowing corporation. A fortiori, where income bonds are issued solely as the result of a railroad reorganization and replace by operation of law an obligation to pay fixed interest which an essential public utility has been unable to meet, the new interest obligation is likewise a cost of borrowing money. Such cost has long been regarded as a proper deduction from gross income and this basic concept does not appear to be questioned in the proposed law.

The legitimate importance of income bonds in the general railroad financial structure and the maintenance of railroad credit is illustrated by the fact that a considerable proportion of the outstanding income bonds originated in bankruptcy reorganization proceedings where in all instances they were issued in place of previously existing fixed interest bonds. In each instance the plan of reorganization was approved by the Interstate Commerce Commission and by the Federal district court. The theory underlying the issuance of income bonds was that the position of the bondholders as creditors should be protected but that future financial difficulties should be minimized by preventing a large accumulation of unearned interest which might drag the reorganized company into subsequent bankruptcy proceedings. In another type of case, also approved by the Interstate Commerce Commission, carriers have effected readjustments under section 20 (b) of the Interstate Commerce Act as a result of which interest has been put on a contingent basis. The use of income bonds in these reorganization or readjustment proceedings has been approved by the courts and the Commission in the public interest in order to insure against future costly reorganization proceedings resulting in operation of the properties by the courts and diminished ability of the carriers to provide adequate and efficient public service.

If the proposed enactment is not modified to permit the deduction of interest on income bonds issued by railroads, it will have a serious adverse effect on the railroad credit position which has long been of much concern to the railroad industry and to the Interstate Commerce Commission. The heretofore unforeseen increase in the amount of taxes payable would not only reduce the earnings coverage of interest, and possibly result in lack of earnings sufficient to cover contingent interest on the income bonds. It would also reduce the earnings coverage for fixed interest bonds which in most instances underlie the income bonds, and as a further consequence, would adversely affect the dividend position of the company's preferred and common stock. Inasmuch as interest coverage is an important factor in determining the value of a bond, the reduced cov-

erage would reduce the value of the underlying fixed interest bonds, thereby resulting in a consequent loss to the holders of those bonds, as well as to the holders of income bonds and other railroad securities. The net result would be a serious impairment of railroad credit in the case of carriers having outstanding income bonds which, because of the large number of carriers involved and the large amount of securities affected, might well result in an adverse effect upon railroad credit generally.

The adverse effect of the proposal contained in H. R. 8300, if unchanged, would not be confined to situations involving income bonds already in existence. The proposal would have an equally serious effect on the issuance of income bonds in the future. Several important carriers, such as the Missouri Pacific Railroad Co. and the Florida East Coast Railway Co., are still in reorganization. Proposals for the issuance of income bonds in those cases would undoubtedly be adversely affected by eliminating the deductibility of contingent interest for tax purposes. This will inevitably lead to pressure for the substitution of fixed interest bonds to a degree otherwise unwarranted, thus inviting future financial difficulties for the railroads concerned. An equally important problem may arise with respect to proceedings under section 20 (b) of the Interstate Commerce Act, which is designed to facilitate readjustments of carriers without the more drastic reorganizations under section 77 or in equity receiverships. The availability of this procedure has been hailed as a forward step in minimizing the possibility of prolonged and costly reorganization in the future. However, its usefulness will be sharply curtailed if carriers and creditors are unwilling to agree upon the issuance of contingent interest-bearing securities because of a resulting increase in the tax burden. The consequent reluctance of management and creditors to avail themselves of this remedy may result in a postponement of action to the point where more drastic reorganizations become necessary. Thus the beneficial effects of the enactment of section 20 (b) of the Interstate Commerce Act may be thwarted.

The bearing of this question upon railroad credit has a very direct relationship to the ability of the Nation's railroads to maintain adequate facilities for serving the public, both in normal times and in times of national emergency. The making of essential improvements is a day-to-day necessity for most carriers, for which funds must be obtained from retained earnings or from borrowing. Any impairment of credit is necessarily reflected in the cost of borrowing money and in ability to perform adequately the transportation services required in the public interest.

Clearly, therefore, the elimination of the deduction of income bond interest cannot be intended or desired by the committee. Where, as here, there is an absolute obligation to pay back borrowed principal similar in all respects to that of fixed interest bonds; where, as here, the holders are bona fide public creditors who are not only not subordinated but are usually prior to other creditors; where, as here, interest must be paid if any income is available, the corporate management notwithstanding, then clearly the obligation is a true debt obligation of the type referred to in the Ways and Means Committee report.

It is, therefore, respectfully requested that the provisions of clause (2) of subsection (c), quoted above, be revised so as to permit the deductibility of interest on railroad income bonds.

RAILROAD SECURITY OWNERS ASSOCIATION, INC.,
OLIVER & DONNALLY, *Attorneys.*

MEMORANDUM ON SECTION 1233 OF PROPOSED INTERNAL REVENUE CODE OF 1954 AND ARBITRAGE IN SECURITIES SUBMITTED BY BRACH, GOSSWEIN & LANE, CERTIFIED PUBLIC ACCOUNTANTS, NEW YORK, N. Y.

Subsection 117 (1) of the present Internal Revenue Code as presently interpreted in Revenue Ruling 154 (I. R. B. 53-17),[1] produces a result which obviously

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[1] Revenue Ruling 154 reads as follows:

"Certain bonds traded in on the New York Stock Exchange are convertible, at the option of the holder, into common stock of the issuing corporation. The market price of the bonds tends to fluctuate in direct relation to the market price of the stock. At times, however, there is a slight difference in the relative market prices of the bonds and the stock. When the price of the bonds is down, in relation to the price of the stock, members of the exchange buy the bonds at the market price and as nearly simultaneously as possible sell the stock into which the bonds are convertible. The bonds purchased are then converted and the stock so received is used to close the sale. Held, sales of stock in the manner described constitute short sales within the purview of sec. 117 (1) of the Internal Revenue Code."

was not intended by Congress. Such unintended result is that if a taxpayer invests in a convertible security and within 6 months thereafter buys another convertible security of the same issuer for arbitrage purposes, selling as soon after such second purchase as possible the stock to be obtained by converting his second purchase, the taxpayer thereby loses his holding period for the security he has been holding for investment. Section 1233 of the proposed Internal Revenue Code of 1954 continues the various provisions of subsection 117 (1) with certain modifications not here in point. Therefore, if section 1233 is enacted in its present form and Revenue Ruling 154 is sustained, the unintended result described above will be continued and will have the effect of discouraging arbitrage in convertible securities.

These peculiar results follow from treating the arbitrage sale as a "short sale" and thus setting into operation certain rules or sanctions provided in subsection 117 (1), which were designed to prevent an abuse by which short-term gains could, prior to the enactment of that subsection in 1950, be technically brought into the long-term classification by means of short sales. Revenue Ruling 154 holds that, where a taxpayer buys convertible bonds and as nearly simultaneously as possible sells the stock into which such bonds are convertible, such sales of stock constitute short sales within the purview of subsection 117 (1). At the same time the regulations[2] hold that the convertible bonds are regarded as property "substantially identical" to the stock sold. Such combination of circumstances then brings into operation the following rules under subsection 117 (1): (1) If substantially identical property has been held by the taxpayer on the date of a short sale for not more than 6 months, a portion of such property equivalent in amount to the short sale loses its holding period. (2) The portion of property thus affected shall be determined in the order of dates of acquisition. As a result, the convertible bond held for investment loses its holding period rather than the convertible bond purchased as part of the arbitrage transaction.

To illustrate further the impact of Revenue Ruling 154 and the rules of subsection 117 (1): Taxpayer purchases for investment $100,000 of bonds, which are convertible into 1,000 shares of common stock of the issuing corporation. Within 6 months of such purchase taxpayer, in a separate account, makes an arbitrage in which he purchases $100,000 of convertible bonds of the same corporation, immediately thereafter sells 1,000 shares of stock of that corporation, converts the bonds purchased for the purpose of the arbitrage into 1,000 shares of stock and uses such stock to close the sale. The holding period of the bonds purchased for investment would be lost. The bonds purchased for investment are the ones first acquired and, therefore, it is the holding period of these bonds which is changed and not the holding period of the bonds acquired for the purpose of the arbitrage. If, within 6 months of the initial investment, the taxpayer makes another arbitrage, the beginning of the holding period for the investment position will again be moved forward to the date on which the sale in connection with the second arbitrage is closed. A taxpayer regularly making arbitrages would, for practical purposes, never attain a 6-month holding period on the bonds held for investment, and hence any gain on the sale of such bonds could not be a long-term capital gain.

It is suggested that this situation can be remedied by adding to subdivision (e) of section 1233 of the proposed new code, which subdivision contains the rules for the application of the section, a new rule dealing with sales in arbitrage transactions. A suggested wording of such rule is as follows:

"Where a taxpayer enters into two securities transactions in the same arbitrage account, the first a purchase of a security by which, at that time he is, or presently, within 61 days, will be entitled to acquire another security or securities and the second a sale of the latter security or securities, and such sale is subsequently closed by delivery of a security or securities acquired by virtue of the security purchased in the first transactions, such sale shall not be regarded as a 'short sale' within the purview of subsections (b) and (d) of this section and the sale shall be deemed completed on the contract date of the sale and the resulting gain or loss shall be considered as a gain or loss on the sale of a capital asset held for not more than 6 months."

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[2] Regulations 118, sec. 39.117 (1), contains the following statement:

"(c) Other rules for the application of sec. 117 (1): (1) Substantially identical property * * *. Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, in certain situations, as, for example, where the preferred stock or bonds are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical property."

The suggested provision is so worded that it will apply only to situations in which the arbitrage purchase is made before the offsetting sale, and in which the sale would not normally be classed as a short sale if ownership of the purchased security were recognized as the ownership of the securities obtainable therefrom. It will apply both to situations where the securities sold are immediately obtainable by virtue of the security purchased and also to situations in which they are obtainable within 61 days of the purchase date.

The reason for specifying a period of 61 days is that the rules of the New York Stock Exchange, which treat arbitrage sales in a manner different from ordinary short sales, apply only where the offsetting purchase is convertible at the time of purchase or within 60 days thereafter. A period of 61 days, rather than a period of 60 days, has been used to make certain that the provision would cover an arbitrage in which the security purchased would become convertible on the 60th day after the date of purchase.

The reason for the use of the phrase "another security by virtue of which he is, or presently * * * will be entitled to acquire another security or securities" is that such phrase corresponds to the wording of the ruling of the Securities and Exchange Commission (subdivision (d) (7) of rule X-10A-1 under section 10 of the Securities and Exchange Act of 1934)[8], which exempts arbitrage sales from certain restrictions applicable to short sales.

THE INTENT OF CONGRESS IN ENACTING SUBSECTION 117 (1) OF THE INTERNAL REVENUE CODE OF 1939

Subsection 117 (1) of the Internal Revenue Code of 1939 was added to the code by section 210 of the Revenue Act of 1950. The purpose of the new subdivision was explained in the report of the House Committee on Ways and Means (subdivision (T) of pt. III), as follows:

"(T) SHORT SALES.

"At the present time it is possible for an investor in stocks to realize a capital gain in less than 6 months and obtain long-term capital gain tax treatment on it by making a short sale which will assure his gain on his original investment, and then defer closing out the short sale until he has held his original stock investment for more than 6 months. The operation of the short-sale device in the stock market may be illustrated by the following examples:

"Example 1: On January 1 the taxpayer buys 100 shares of stock at $10 per share for a total of $1,000. Five months later, on June 1, when the stock has risen to $16 per share, he sells short 100 shares at $16 per share for a total of $1,600. On July 2 (6 months after the original purchase) he delivers the 100 shares he bought on January 1 to the lender of the stock used to effect the short sale.

"Actually, the taxpayer has a short-term gain of $600, realized on June 1 when he sold 100 borrowed shares for $1,600 in a short sale, but by deferring delivery of the stock he already owned until he has held it for 6 months the short-term gain is converted into a long-term gain, so that $300 instead of $600 is included in taxable income.

"Example 2: On January 1 the taxpayer buys 100 shares of stock at $10 per share for a total of $1,000. On June 1, he sells short 100 shares at $16 per share for a total of $1,600. If the price of the stock thereafter rises to $18 per share, on July 2 he sells the 100 shares he bought on January 1 at $18 per share for a total of $1,800. He then buys 100 shares at $18 per share for a total of $1,800 and delivers them to cover the short sale he made in June.

"As in example 1, the true result is a short-term gain of $600, since the taxpayer realized a $600 gain when he made the short sale in June and the purchase of 100 shares for $1,800 and the sale of 100 shares for $1,800 on July 2 merely cancel each other out. However, under existing law the 4 transactions are

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[8] Subdivision (d) (7) of rule X-10A-1 of the Securities and Exchange Commission issued under sec. 10 of the Securities and Exchange Act of 1934 reads as follows:

"(d) The provisions of par. (a) hereof par. (a) contains the restriction as to the price at which a short sale may be made shall not apply to:

* * * * * * *

(7) any sale of a security for a special arbitrage account by a person who then owns another security by virtue of which he is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold; provided such sale, or the purchase which such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned and that such right of acquisition was originally attached to or represented by another security or was issued to all the holders of any class of securities of the issuer";

viewed as: First, the purchase of 100 shares in January and their sale in July with a long-term gain of $800; and, second, a short sale in June, closed by purchase and delivery in July with a short-term loss of $200. This results in the inclusion of $200 in taxable income instead of $600.

* * * * * * *

"Your committee's bill provides that capital gains and losses will be deemed long-term gains and losses if the property sold or exchanged has been held more than 3 months. This would increase the possibility of utilizing the short-sale device as a method of tax avoidance.

"Section 210 of your committee's bill provides, in effect, that where a sale of 'substantially identical' property is made, and thereafter simultaneous 'long' and 'short' positions are maintained so as to give an actual short-term transaction the appearance of a long-term transaction, gains and losses shall be treated for tax purposes as short-term gains or losses. On the other hand, where securities have been held for more than 3 months, and thereafter a short sale is made, any loss on the short sale shall be treated as a long-term loss, offsetting the long-term gain so that 50 percent of both will be taken into account, and not as a short-term loss 100 percent of which would be taken into account."

The wording of the portion of the report of the Senate Committee on Finance dealing with the new short sale provision was almost identical with that of the House committee, quoted above. (See sec. X A (5) of Report, CB 1950-2, p. 515.)

It is clear, therefore, that the intention of the committees was that a taxpayer should not be permitted to extend his holding period in respect of a capital asset after he had by means of a short sale actually realized and determined his profit.

In the situation described in this memorandum, the taxpayer does not by the sales made in its arbitrage operations realize or establish any profit in respect of the bonds held in its investment portfolio. The so-called short sale made in connection with the arbitrage transaction is not made for the purpose of converting what would otherwise be a short-term capital gain into a long-term gain. Instead, it is made for the purpose of making a profit from a current difference between the market price of the bonds simultaneously purchased and the market price of the stock.

The investment transaction and the arbitrage transaction have nothing to do with one another. It could be carrying out the obvious intent of Congress to amend section 1233 of the proposed Internal Revenue Code of 1954 to make it clear that the arbitrage transaction shall not change the holding period of securities held for investment.

WOULD THE SUGGESTED AMENDMENT WITH RESPECT TO SECURITY ARBITRAGE CREATE ANY OPPORTUNITY FOR TAX AVOIDANCE?

The suggested amendment should not create any opportunity for tax avoidance.

Under the suggested amendment, if the taxpayer should fail to carry out his original intent of converting the bonds into stock and delivering the stock received on such conversion to close the sale, the transaction would not come within the suggested exception and the sale would then be classed as a "short sale." If the taxpayer does complete the arbitrage so that the transaction comes within the suggested exception, no other security position is affected and thus there is no tax avoidance.

The situation is very similar to that resulting from an arbitrage in commodities, which has been dealt with in the same section of the code. There has never been any question that the provision relating to arbitrages in commodities created any opportunity for tax avoidance.

THE EXCEPTION FOR COMMODITY ARBITRAGE PRESENTLY CONTAINED IN SUBSECTION 117 (1)

When Congress was engaged in the drafting of what is now subsection 117 (1) of the present Internal Revenue Code, its attention was called to certain types of transactions in commodity futures. It was pointed out that such transactions involve short sales and that the application of the proposed short-sale rule might result in discouraging arbitrage in commodities.

Accordingly, subsection 117 (1) when enacted contained a provision, paragraph (C) of subdivision (3), which reads as follows:

"Where the taxpayer enters into two commodity futures transactions on the same day, one requiring delivery by him in one market, and the other requiring

delivery to him of the same (or substantially identical) commodity in the same calendar month in a different market and the taxpayer subsequently closes both such transactions on the same day, this subsection shall have no application to so much of the commodity involved in either such transaction as does not exceed in quantity the commodity involved in the other."

This provision has been continued in section 1233 of the proposed new code as paragraph (3) of subdivision (e).

The type of transaction covered by this provision is, of course, an arbitrage, as expressely stated in the committee report and in the regulations. The purpose of the above exception was to prevent a sale which was made as part of an arbitrage, offsetting a concurrent purchase, from destroying the holding period of a prior, and unrelated, purchase of the same commodity.

The suggested amendment to section 1233 of the proposed new code would add a similar rule applicable to arbitrage in securities.

REASON FOR PRIOR FAILURE TO PROVIDE EXCEPTION FOR SECURITY ARBITRAGE

The question may properly be asked why Congress, in enacting subsection 117 (1) of the present code, did not include an exception for security arbitrage similar to that which it was including for commodity arbitrage. The answer to this question is that neither Congress nor those engaged in the security arbitrage business then thought that the sales made in connection with security arbitrage transactions would be classified as short sales. Ordinarily a sale is deemed to be a short sale if, at the time of the sale, the taxpayer does not possess the property sold and expects to purchase such property at a later date and at a lower price for the purpose of closing the sale. The sales in connection with the arbitrage transactions above described were not thought to be short sales because, at the time of making such sales, the arbitrager had purchased bonds convertible into stock sold. He therefore considered himself to be the owner of the stock which he was selling. It was not until the Commissioner of Internal Revenue ruled that such sales were short sales that the necessity for any exception in the statute with respect to security arbitrage became apparent.

ECONOMIC FUNCTION OF ARBITRAGE

The arbitrage operations here in question serve a useful purpose, and therefore are encouraged by the securities exchanges and the Securities and Exchange Commission, receiving preferential treatment under their rules.

Moreover, Congress itself has recognized the valid purpose of arbitrage in securities by providing in section 16 (d) of the Securities Exchange Act of 1934 that, unless the Commission ruled otherwise, arbitrage transactions would not be deemed to give rise to insiders' profits.

The arbitrage operations enable the holder of a convertible bond who desires to dispose of it to obtain a better price and to receive his cash at an earlier date than he otherwise would. If certain members of the securities exchanges did not conduct these arbitrage operations, there would develop substantial differences between the market price of convertible bonds and the market price of the stocks into which they are convertible. A holder of the bond would then have his choice of either selling the bond at a market price less than the market price of the corresponding stock or of turning in his bond for conversion, waiting several days until he receives the stock and then selling the stock, paying a broker's commission on the sale. If he elected to convert, he would run the risk that by the time he sold the stock, its market price would be less than that which had prevailed at the time he converted the bond. Because of the activity of the arbitrager (as one who performs the arbitrage operations is called) the average investor can sell his bond, save himself the time and expense of actual conversion and receive immediately the full market value of the stock into which the bond is convertible, less the arbitrager's small profit.

If the situation hereinbefore described continues, the taxpayers who both conduct arbitrage operations and hold for investment, in an entirely separate account, securities which are substantially identical to those involved in the arbitrage, will have to decide which of the two activities they wish to continue; they cannot continue both without a serious tax disadvantage. Since arbitrage operations are conducted on a relatively small spread and with a relatively small profit per transaction, some taxpayers may well decide to discontinue their arbitrage operations. If they do so, this would tend to deprive the market of a stabilizing influence.

REVENUE RULING 154

As above indicated, the suggestion in this memorandum for a change in section 1233 of the proposed new code is made necessary because of the situation created by the issuance of Revenue Ruling 154.

It is possible, and indeed quite probable, that the Commissioner's ruling that the sales in arbitrage transactions are short sales under subsection 117 (1) is incorrect. If such sales are not short sales and the Commissioner were to concede such fact by issuing a new ruling to such effect and revoking Revenue Ruling 154, there would be no need for any provision in the code dealing with the type of arbitrage transactions here under consideration.

Indeed, there seems to be an inconsistency in Revenue Ruling 154. To bring the sanctions of subsection 117 (1) into play, the Commissioner holds that the convertible bond is substantially identical to the stock into which such bond is convertible; but the sale of the stock is called a short sale on the theory that possessing the convertible bond is not equivalent to possessing the stock.

However, since Revenue Ruling 154 is presently in force, a reenactment of subsection 117 (1) without modification by an exception for security arbitrage might be misconstrued as reflecting an approval by Congress of the Commissioner's ruling as a proper interpretation of the existing statute. Therefore, unless Revenue Ruling 154 is revoked before Congress enacts the proposed new code, the suggested amendment of section 1233 is necessary.

There is submitted with this memorandum an appendix which contains the following:

Section A: Rules of the Securities and Exchange Commission, the New York Stock Exchange and the Board of Governors of the Federal Reserve System as to short sales and sales in arbitrage transactions.

1. A statement of the rules of the Securities and Exchange Commission as to short sales, the background of such rules and the special treatment accorded sales in arbitrage transactions.

2. A statement of certain rules of the New York Stock Exchange which accord sales in arbitrage transactions a treatment differing from that accorded short sales.

3. A statement of a rule of the Board of Governors of the Federal Reserve System which accords sales in arbitrage transactions a treatment differing from that accorded short sales.

Section B: A statement as to the meaning of the words "short sale" in the financial community, under the Law Merchant and in court decisions relating to tax law.

APPENDIX TO MEMORANDUM ON SECTION 1233 OF PROPOSED INTERNAL REVENUE CODE OF 1954 AND ARBITRAGE IN SECURITIES

SECTION A—RULES OF THE SECURITIES AND EXCHANGE COMMISSION, THE NEW YORK STOCK EXCHANGE AND THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM AS TO SHORT SALES AND SALES IN ARBITRAGE TRANSACTIONS

PART 1—A STATEMENT OF THE RULES OF THE SECURITIES AND EXCHANGE COMMISSION AS TO SHORT SALES, THE BACKGROUND OF SUCH RULES AND THE SPECIAL TREATMENT ACCORDED TO SALES IN ARBITRAGE TRANSACTIONS

In 1934 Congress had come to the conclusion that one of the causes of the great decline in security prices which took place between October 1929 and March 1933 was the unrestricted use of short sales (i. e. sales of stock, which the seller did not own and which he hoped to buy at a lower price at a later date) to disorganize an already dangerous and panicky market. Accordingly, Congress gave the newly created Securities and Exchange Commission (hereinafter referred to as the "SEC") the authority to regulate short sales. Under this authority, the SEC issued rule X-10A-1. The first three paragraphs of this rule are as follows:

"(a) No person shall, for his own account or for the account of any other person, effect on a national securities exchange a short sale of any security (1) below the price at which the last sale thereof, regular way, was effected on such exchange, or (2) at such price unless such price is above the next preceding different price at which a sale of such security, regular way, was effected on such exchange. In determining the price at which a short sale may be effected after a security goes ex-dividend, ex-right or ex-any other distribution, all sales prices prior to the "ex" date may be reduced by the value of such distribution.

"(b) No member of a national securities exchange shall, by the use of any facility of such exchange, execute any sell order unless such order is marked either 'long' or 'short'.

"(c) No member of a national securities exchange shall mark a sell order 'long' unless (1) the security to be delivered after sale is carried in the account for which the sale is to be effected, or (2) such member is informed that the seller owns the security ordered to be sold and, as soon as is possible without undue inconvenience or expense, will deliver the security owned to the account for which the sale is to be effected."

The sales of stock made in connection with the arbitrage operations described above do not qualify as "long" sales under rule X-10A-1 for the reason that they do not meet the requirements in paragraph (c) thereof. While the arbitrager owns bonds which are convertible into the stock being sold he does not own "the security" being sold nor is such "the security" carried in the account for which the sale is effected. It would seem, at first glance, that since the sales are not "long" sales they must be "short" sales.

Such, however, is not the case. When the ruling was being drafted, the SEC conferred with representatives of the various exchanges. These representatives called to the attention of the SEC that there were a number of types of sales which could not meet the requirements of paragraph (c) as "long" sales but which were not "short" sales within the meaning given to the term "short sales" by the financial community. The SEC thereupon added to rule X-10A-1 an additional paragraph, paragraph (d), which stated that the provisions of paragraph (a) relative to the prices at which short sales may be made should not apply to certain designated classes of sales. Among the exempt classes were sales in connection with arbitrage transactions of the kind herein described. The wording of paragraph (d) is as follows:

"(d) The provisions of paragraph (a) hereof shall not apply to—

(1) any sale by any person, for an account in which he has an interest, if such person owns the security sold and intends to deliver such security as soon as is possible without undue inconvenience or expense;

(2) any member in respect of a sale, for an account in which he has no interest, pursuant to an order to sell which is marked 'long';

(3) any sale of an odd-lot;

(4) any sale by an odd-lot dealer to offset odd-lot orders of customers;

(5) any sale by an odd-lot dealer to liquidate a long position which is less than a round lot, provided such sale does not change the position of such odd-lot dealer by more than the unit of trading;

(6) any sale of a security on a national securities exchange effected with the approval of such exchange which is necessary to equalize the price of such security thereon with the current price of such security on another national securities exchange which is the principal exchange market for such security;

(7) any sale of a security for a special arbitrage account by a person who then owns another security by virtue of which he is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold; provided such sale, or the purchase which such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned and that such right of acquisition was originally attached to or represented by another security or was issued to all holders of any class of securities of the issuer;

(8) any sale of a security on a national securities exchange effected for a special international arbitrage account for the bona fide purpose of profiting from a current difference between the price of such security on a securities market not within or subject to the jurisdiction of the United States and on such national securities exchange; provided the seller at the time of such sale knows or, by virtue of information currently received, has reasonable grounds to believe that an offer enabling him to cover such sale is then available to him in such foreign securities market and intends to accept such offer immediately; or

(9) any sale of a security on a national securities exchange effected in accordance with a special offering plan declared effective by the Commission pursuant to paragraph (d) of rule X-10B (2).

For the purpose of clause (8) hereof a depositary receipt for a security shall be deemed to be the same security as the security represented by such receipt."

Subdivision (7) covers sales in connection with arbitrage operations of the kind described in the memorandum.

The rules of the New York Stock Exchange require that the sell orders for sales falling within certain of subdivisions of paragraph (d) of SEC rule X-10A-1, including paragraph (7), shall be marked "short exempt." (New York Stock Exchange Rules, p. E643, item 12.)

In effect, therefore, rule X-10A-1 and the New York Stock Exchange rule relating thereto creates three classes of sales (1) "long" sales, (2) "short" sales, and (3) "short exempt" sales.

PART 2—A STATEMENT OF CERTAIN RULES OF THE NEW YORK STOCK EXCHANGE WHICH ACCORD SALES IN ARBITRAGE TRANSACTIONS A TREATMENT DIFFERING FROM THE TREATMENT ACCORDED SHORT SALES

There are a number of rules of the New York Stock Exchange which accord to sales in arbitrage transactions a treatment differing from that accorded to short sales. Two of these rules are as follows:

(a) Permission to "fail" instead of borrowing

In the case of a true short sale the seller is not permitted to "fail" but must "borrow" stock to consummate the short sale. On the other hand, in the case of a "short exempt" sale the seller may "fail" and is not required to "borrow." Since the terms "fail" and "borrow" are technical terms some explanation of their meaning is necessary. Under the rules of the New York Stock Exchange contracts for the sale of securities are required to be satisfied by delivery of the securities to the purchaser on the third full business day following the day of the sale. In some instances the seller of long stock may be unable to make delivery on the settlement day—let us say because the security is in the seller's safe deposit box and the seller is unable to get to the safe deposit box in time. In such cases the seller's broker is permitted to advise the purchaser that he will not make delivery on the settlement date or in other words that he will "fail to deliver". The purchaser usually consents to such "fail" for the reason that at some other time he may find himself in the position of needing a similar favor from the seller's broker. The only penalty for the "fail" is that the seller does not collect the selling price until he delivers the stock. In consenting to the "fail" the purchaser reserves the right to call upon the seller for delivery and if delivery is not made to buy in the security in the open market. A "fail" will normally be open for only a short period of time.

Where a seller sells "short" a security he consummates the sale by borrowing the security from some other holder and delivering the borrowed security to the purchaser to consummadte the sale. If there is a large "short" position outstanding the lenders of securities may demand and receive compensation for the loan of their securities. This compensation is known as a premium.. The borrower must also pay a stamp tax. The borrower must also deposit with the lender 100 percent of the value of the stock borrowed. This deposit is adjusted up and down with the changes in the market value of the stock. If a short seller were to be left free to "fail" it would be unnecessary for him to borrow and he might save the cost of the premium and the stamp tax and avoid the necessity of a deposit equal to the market value of the stock. Consequently, the New York Stock Exchange has ruled that there may be no "failing" on a short sale. The exact working of the ruling (which appears at p. E-464) is as follows:

"*Deliveries against short sales.*—No member or member firm should "fail to deliver" against a short sale of a securities exchange until a diligent effort has been made by such member or firm to borrow the necessary securities to make delivery."

The exchange does, however, permit "failing" on "short exempt" sales. This difference in treatment is evidence that the exchange considers that a "short exempt" sale is not, in reality, a "short sale."

(b) Capital requirements

Under the rules of New York Stock Exchange, member firms are required to have a certain ratio of capital against every security position. If a member firm is both long and short the same security it must have capital to cover *both* positions. But, if a member firm engaged in an arbitrage operation has purchased convertible bonds and has sold the stock into which the bonds are convertible, it is deemed to have no open position and hence has no capital requirements. The rule of the exchange on this point, which appears on page E-230 of the Exchange Rulings, reads as follows:

"In the case of securities which are exchangeable or convertible, a security sold may be considered as a sale of a security held, after adjustment of the cost

or proceeds of such securities for any money to be paid or received in connection with such exchange or conversion provided the security held is, without restriction other than the payment of money, exchangeable or convertible into the security sold within a period not exceeding thirty days." [1]

PART 3. A STATEMENT OF A RULE OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM WHICH ACCORDS SALES IN ARBITRAGE TRANSACTIONS A TREATMENT DIFFERING FROM THAT ACCORDED SHORT SALES

The Board of Governors of the Federal Reserve System has the right to regulate the use of credit for the purpose of purchasing or carrying securities. Under this power the Board has issued Regulation U. Loans by Banks for the Purpose of Purchasing or Carrying Stocks Registered on a National Securities Exchange. Section 1 of this regulation states a general rule which limits the amount which may be loaned by a bank on securities. Section 2 contains the exceptions to the general rule and reads, in part, as follows:

"SECTION 2. EXCEPTIONS TO GENERAL RULE.

Notwithstanding the foregoing, a bank may make and may maintain any loan for the purpose specified above, without regard to the limitations prescribed above, if the loan comes within any of the following descriptions:

* * * * * * *

(j) Any loan to a member of a national securities exchange for the purpose of financing his or his customers' bona fide arbitrage transactions in securities; * * *

SECTION B—THE MEANING OF THE WORDS "SHORT SALE" IN THE FINANCIAL COMMUNITY, UNDER THE LAW MERCHANT AND IN COURT DECISIONS RELATING TO TAX LAW

(NOTE.—The material in this section is taken from a memorandum, dated June 5, 1952, submitted by Brach, Cosswein & Lane of 1328 Broadway, New York 1, N. Y., in support of an application for a ruling that sales made in connection with security arbitrage transactions are not short sales within the purview of subsec. 117 (l) of the present Internal Revenue Code.)

PART 1. THE MEANING OF THE WORDS "SHORT SALE" IN THE FINANCIAL COMMUNITY

The financial community, i. e., those who buy and sell securities as a business, regards the words "short sale" as meaning a sale of a security which the seller does not own. If the seller owns the same security as he is selling, the sale will be regarded as a "short sale" only if, at the time of the sale, the seller intends not to use the security which he owns to complete the sale. If the seller owns the same security as he is selling, the fact that, at the time of the sale, he knows that the security he owns will not be available for delivery against the sale at the time delivery must be made under the rules of the exchange on which the sale is made does not make the sale a "short sale" if it is his intention that as soon as he can do so he will use the security which he owns to complete the sale or to repay the security which was borrowed to make delivery against his sale.

Nor will the fact that the seller does not own the security sold, but instead owns a security which is convertible into the security sold make the sale a "short sale" provided that, at the time of sale, it was his intention to forthwith convert the security owned into the security sold and to use the security received on conversion to complete the sale or to repay the security temporarily borrowed to make delivery on the sale.

In support of the statements in the two preceding paragraphs there is submitted:

(a) An affidavit of Frederick S. Todman (exhibit A). Mr. Todman is a certified public accountant who, for more than 30 years, has specialized in the audit of accounts of members of the New York Stock Exchange and New York Curb Exchange. He has been a partner in a firm which was a member of the New

[1] Upon application by members the exchange has extended this rule to situations where the security held was not exchangeable or convertible for 60 days. Thus, in the case of a recent issue of bonds of American Telephone & Telegraph Co. which were not convertible until a date several months after the date of issuance, the exchange permitted the rule stated above to apply to arbitrages made 60 days before the date on which the bonds became convertible.

York Stock Exchange. He is the author of a textbook on Wall Street Accounting. He has expressed the opinion that a sale made under the following circumstances would not be regarded by the financial community as a "short sale":

"Under the practice prevailing prior to February 1938, would a sale of stock made under the following circumstances be a long sale or a short sale? A member of the New York Stock Exchange purchases bonds which are currently convertible into stock of the issuing corporation. Shortly after such purchase the member makes a sale of stock of the issuing corporation in a quantity equal to the number of shares he will receive upon the conversion of the bonds he has purchased. The purpose of the member in making such sale of stock is to realize a profit based upon the current difference between the cost of the bonds, adjusted for all payments to be made on conversion and the selling price of the stock. It is his intention that the shares of stock received upon the conversion of the bonds shall be applied to complete the sale. To carry out this intent he gives oral instructions to those of his employees who are charged with the receipt and delivery of securities that upon the receipt of the bonds from the vendors thereof, they are to be sent to the transfer agent of the issuing corporation for conversion and that upon receipt of the stock from the transfer agent, the stock is to be used forthwith to complete the sales of stock theretofore made. At the time the sale of stock is made the member is aware of the fact that the vendor of the bonds will be obligated to deliver the bonds to him on the same day that he is obligated to deliver stock to the vendee of the stock and that it will take a day or more after the receipt of the bonds to convert the bonds into stock. He therefore instructs his employees that if, at the time that he is obligated to deliver stock to the vendee, they have no stock received on conversion of the bonds available for delivery, they should fail to deliver the shares to the vendee-broker until the stock is received from the transfer agents in exchange for the convertible bonds heretofore deposited, or they should borrow stock temporarily to make delivery and later apply the stock received on conversion to liquidate the previous borrowing of the shares. The instructions so given are executed by the employees of the broker who made the sale of the stock against the convertible bond."

Mr. Todman states:

"It is my opinion that sales made in the manner described above would be long sales and not short sales. My reasons for this opinion are as follows:

"Historically, a short sale of a security is a sale of a security that the seller does not own at the time of sale. Thus, on page 41 of Brokerage Accounts, I said 'By the expression "short" is meant the selling of shares not previously purchased or held, but sold with the expectation of realizing a profit through the decline in value of such shares.' I repeated this definition on page 28 of Wall Street Accounting. Since I wrote these texts, it has been recognized that a person may make a 'short sale' of a security in which he has a 'long' position. However, where a person has a long position in a security and makes a sale of the same security, the sale will not be regarded as a 'short' sale unless he indicates clearly at the time of the sale that he has no intention of currently using his long position to complete the sale. The mere fact that at the time of the sale, the long security is held in such a manner that it will not be available for delivery at the time delivery against the sale must be made, does not make the sale a 'short' sale. A very common instance is where the vendor owns the security which he has sold but such security is in a safe deposit box to which he does not have access until after settlement date fixed by the rules of the exchange on which the sale is made. The broker making the sale must 'fail to deliver' or 'borrow' the shares. But such 'failing' or 'borrowing' does not convert the sale into a short sale.

"The fact that at the time of the sale, the vendor does not own the security which he has sold, but does own a security which is convertible into the security sold, does not change the situation. For all purposes, I would regard the ownership of security A which is convertible into security B, as being the ownership of security B.

"Where a person is long a security and makes a sale of the same security, the major factor in determining whether the sale is a 'short' sale or a 'long' sale is intent. Such intent is evidenced by the vendor's actions both before and after the sale. On the basis of the facts stated in the question, it is clear that the vendor's intention was to make a sale of securities which he had purchased and not to make a short sale."

(*b*) An affidavit of Max Jacquin, Jr.: Mr. Jacquin was an official of the New York Stock Exchange from 1920 to 1946. His last office was that of assistant vice president of the exchange. He is particularly familiar with arbitrage

transactions and with the practice of the financial community with respect to the designation of sales of securities as "long sales" or "short sales." He expresses the opinion that a sale of a security made under circumstances identical with those stated in Mr. Todman's affidavit would be a "long sale" and not a "short sale." He further states:

"Where an individual owns a security and makes a sale of the same security he may be making a long sale or a short sale. Which it is, will depend on his intent. If at the time he makes the sale he intends to use his long stock to complete the sale, the sale will be a long sale and not a short sale. For example, if the stock which he is long is in a safe deposit box and he cannot get to such box in time to make delivery of the stock at the time delivery must be made under the rules of the stock exchange, he has nevertheless made a long sale. The fact that he fails to make delivery on delivery date or borrows stock to make such delivery, does not make the sale a short sale. Likewise, if an individual owns a convertible bond and he makes a sale of stock into which the bond is convertible, he may be making either a long sale or a short sale. If at the time he makes the sale it is his intention that the bonds which he owns are to be converted into the stock and the stock received upon the conversion is to be used to complete the sale, he is making a long sale and not a short sale. Obviously, the individual's future conduct is a fact to be taken into consideration in determining his intent. If, upon making the sale of the stock, he forthwith takes the steps necessary to convert the bonds into the stock and actually uses the stock received upon the conversion to complete the sale, such facts will be evidence of his intent to make a long sale."

(c) An affidavit of Richman Proskauer: Mr. Proskauer has been a member of the New York Stock Exchange for 28 years. In 1938 he was a member of a committee of members of the New York Exchange who conferred with the Securities and Exchange Commission with respect to the application of rule X-10A-1 to sales of the type here under consideration. He says, "The gist of the argument made by the committee was that the financial community had not previously regarded sales of the kind herein described as short sales in that, if the seller was long security A and security A was convertible into security B, he was, in effect, the owner of security B."

PART II. THE MEANING OF THE WORDS "SHORT SALE" UNDER THE LAW MERCHANT

The definitions of "short sale" in common-law cases uniformly embody the concept that a "short sale" is a sale of property which the seller does not own at the time of the sale and which he expects to purchase at a later date and at a lower price. Definitions of short sales taken from cases cited in Words and Phrases, Corpus Juris and textbooks are as follows:

(a) From Words and Phrases, first series, vol. 7, page 6497:

(1) "A sale of stock short means a sale of stock which the seller does not at the time possess, but which, by the future date or time agreed upon for its delivery to the purchaser under the terms of the contract, the seller must in some way acquire for the purpose of such delivery" (*Boyle* v. *Henning*, 121 Fed. 376, 380).

(b) From Words and Phrases, second series, vol. 4, page 576:

(2) "An authority to brokers to sell stock 'short' is authority to sell on plaintiff's account stock which he did not have, and which the brokers would be compelled to borrow for him" (*Armstrong* v. *Bickel*, 66 ATL 326, 327, Pa. 173).

(3) "'Short sale' is usually applied to sales of stocks and bonds where the seller has not the stock he assumes to sell, but borrows it and expects to replace it when the market value has declined" (*Hurd* v. *Taylor*, 78 N. E. 977, 181 N. Y. 231).

(4) "A sale of stock 'short' by a broker on his own account does not necessarily imply a conversion by the broker of stock purchased for a customer; a short sale being of that which the vendor has not at the time but which he expects to acquire subsequently for delivery at a lower price" (*Lamprecht* v. *State*, 95 N. E. 656, 659; 84 Ohio St. 32).

(c) From Dos Passos on Stock Brokers and Stock Exchanges, vol. 1, second edition (1905):

(5) "In *Knowlton* v. *Fitch* (52 N. Y. 288) Mr. Justice Rapallo defined a 'short sale' as follows:

'The nature of these sales has, in the many litigations which have come before the courts concerning them, has been frequently proved, and is again explained in

the testimony in this case. It is proven to be a sale before purchase with a view of purchasing at a future time at a lower price.'"

(*d*) From Corpus Juris, vol. 58, page 700:

(1) "'Short' in financial and stock exchange parlance is a term of common use in the stock and produce markets. * * * so that when used in relation to a sale of stock it refers to a sale in which the seller does not at the time possess the stock sold but which, by the future date or time agreed upon for its delivery to the purchaser under the terms of the contract, the seller must in some way acquire for the purpose of such delivery." (Cases cited same as those in Words and Phrases.)

PART III. THE MEANING OF THE WORDS "SHORT SALE" IN COURT DECISIONS RELATING TO TAX LAW

The Board of Tax Appeals, predecessor to the Tax Court, on numerous occasions has passed on the question of whether or not certain sales were short sales and a number of the Board of Tax Appeals decisions have been reviewed by the various circuit courts of appeal. In all of these cases the taxpayer owned the same security that he had sold. In some cases it was to the interest of the Commissioner to contend that the sale was a long sale and to the interest of the taxpayer to contend that the sale was a short sale. In other cases the positions were reversed and it was the taxpayer who contended for a long sale and the Commissioner for a short sale. Each case was decided on its facts. The determining fact was the intent of the taxpayer. If the evidence showed that the taxpayer intended to sell his own stock the sale was held to be a long sale. The fact that the taxpayer was unable to deliver his own stock at the time delivery to the vendee was required to be made with the result that borrowed stock was delivered to the vendee has been held to be immaterial. The fact that as soon as could be done conveniently the seller used his own stock to replace the borrowed shares was held to be proof of intent even though such use of the sellers own stock took place after the sale. The foregoing statement is based upon an analysis of the following decisions:

(*1*) *C. B. Ferree* v. *Commissioner* (*32 BTA 725* (*1935*) *Affd. CCA* (*3d*) *84F* (*2d*) *124* (*1936*) *17 AFTR 1260*)

The facts were:

On August 26, 1929, the petitioner bought 1,000 shares of Continental Can for $86,950, took the certificates and put them in his safety deposit box. December 19, 1929, he sold 200 of these shares and delivered certificates to the broker on December 20, retaining certificates for 800 shares. December 27, 1949, petitioner instructed broker "to sell for him the 800 shares of Continental Can Co. stock represented by the certificates which remained in his safe deposit box." December 30 the broker sold 200 shares for $9,957, and December 31, 600 shares for $29,286. Petitioner, however, did not deliver the certificates and they continued to remain in his box.

January 31, 1930, petitioner, through the same broker, bought 500 shares, and February 3, 1930, he bought 1,000 shares. On February 4, the broker delivered certificates for 700 shares, which petitioner put in his box with the aforesaid certificate for 800 shares. The petitioner treated the sales of December 27 and December 30, 1929, as being sales of the remaining 800 shares purchased in the preceding August, and deducted $30,317 as the resulting loss. This the Commissioner disallowed.

The issue was whether the December 1929 sales were short sales or long sales. The Board held that the sales were long sales saying: "But the evidence shows that the petitioner intended to sell the 800 shares which he owned, that he instructed the broker to sell such shares, and in view of the fact that the broker promptly sold 800 shares the conclusion is inescapable that the broker was carrying out the instructions and sold the shares he was directed to sell. There is not the slightest reason to believe that either the petitioner or the broker was considering a short sale and the mere failure of petitioner to deliver the certificates is no alone sufficient to esablish one."

The decision of the Board of Tax Appeals was affirmed by the Circuit Court of Appeals, Third Circuit. Said the court:

"The broker, acting as agent of the petitioner, was authorized to sell the 800 shares identified and was not authorized to sell short. Upon completing the sale, he had a right to demand these identical shares. However, the broker substituted other shares of equal value which was in no way objectionable to the

purchaser. The broker still had the right to demand the original 800 shares. However, when the petitioner purchased 1,500 shares of the same stock through him, he merely withheld 800 shares. As the original intention is controlling these subsequent substitutions do not change the original transaction."

(2) *Dee Furey Mott, 35 BTA 195 (1936)*

The facts were:

On December 30, 1930, taxpayer instructed her broker to sell 200 shares of stock. At the same time she informed the broker that the stock was in her safety-deposit box and that she would deliver it immediately after the holidays. The stock was sold through the broker on December 30, 1930. Petitioner did not take the certificates from her safety-deposit box and deliver them to the broker until January 2, 1931. Petitioner claimed a deduction for the loss on the sale in her 1930 return. Here the question was whether the loss was deductible in 1930 or in 1931. It was held that the loss was deductible in 1930. Obviously, if it had been the law that the mere failure to deliver made the sale a short sale the loss would have been a 1931 loss.

(3) *Ruml* v. *Commissioner, 31 BTA 534, reversed 83 F. (2d) 257 (CCA 2d 1936), 17 AFTR 958*

The facts were:

In December 1928 the petitioner owned 4,000 shares of the capital stock of North Central Texas Oil Co., which he had purchased in that year, and which were deposited with the Guaranty Trust Co. as collaterial for a loan. He desired to sell that stock at the then market, and instructed his broker to do so, advising him how the shares were held as collateral, and telling him that there might be some delay in making delivery. His broker informed him that the stock would be sold, and that petitioner might make delivery to the broker at his convenience when he paid off the loan or substituted other collateral to release the shares.

The broker sold 4,000 shares of such stock in December, and credited the petitioner's account with the proceeds, which were less than what the petitioner had paid for the shares he owned. Petitioner obtained from the trust company 1,500 of his shares, and delivered them to the broker in December 1928. That part of this loss sustained on the sale of those shares has been allowed as a deduction. In February 1929 the petitioner paid the trust-company loan, obtained the remaining 2,500 shares, and delivered them to the broker. The Commissioner refused to allow the loss attributable to the sale of those shares in 1928 on the ground that it was not sustained until 1929.

On January 1, 1929, the petitioner received a statement from the broker indicating that he was being carried short 2,500 shares of the stock, and upon inquiring what that meant, was told, "That is simply the way we carry it until you deliver it."

Said the court in holding that the loss was deductible in 1928:

"The petitioner neither intended to make what is known as a short sale nor instructed his broker to do so, though he did direct his broker to sell the shares, leaving the broker free to make the sale as he might.

"It is clear that the petitioner intended to sell the specific shares he owned and only those."

*(4) *Commissioner* v. *Dashiell (36 Bta 313, affd. 100 F. (2d) 625 (CCA-5, 1938), 22 AFTR 163)*

The facts were:

On December 30, 1931, the taxpayer, who was in Florida on that date, was the owner of 500 shares of Vanadium stock which he had purchased on March 30, 1931, at a cost of $36,062.50. The certificates for these shares were in a safety deposit box in Chicago. The taxpayer telephoned to his broker in Chicago on December 30, 1931, and instructed him to sell for him the 500 shares of stock. He and the broker agreed that he would deliver the shares upon his return to Chicago in January 1932. The Chicago broker sold the 500 shares of Vanadium for the taxpayer through a New York broker on the New York Stock Exchange on December 31, 1931, for $6,417.50. On that date the New York broker delivered certificates for 500 shares to the purchaser. The shares which were thus delivered to the purchaser were in the possession of the New York broker and were loaned by him for the purpose of consummating the sale in accordance with the rules of the New York Exchange. The New York broker on December 31, 1931, credited the proceeds of the sale and charged the 500 shares to the Chicago

broker. On the same date, the Chicago broker credited the proceeds of the sale and charged the 500 shares to the taxpayer. The taxpayer delivered his certificates for 500 shares of Vanadium to his broker on January 30, 1932.

The taxpayer deducted his loss of $30,245 on his return for 1931. The Commissioner disallowed the claimed loss on the theory that the transaction was a short sale and was not closed until the delivery of the certificates in 1932.

The Board of Tax Appeals and the court held that the sale was not a short sale and that the loss was deductible in 1931.

Said the court:

"It may be true, as asserted by petitioner, that the taxpayer in the instant case by violation of the legal obligation which had been created before the end of December 1931, could have avoided delivering the stock which he had authorized his broker to sell. But on December 31, 1931, the loss had become certain and ascertainable in amount, both in fact and in law. *Furthermore, we are at liberty to consider, and should consider, that the transaction relating to the sale was in fact carried out and that the shares in question were actually delivered to the New York broker.*" [Italics ours.]

(5) Alice Dupont Ortiz, 42 T. C. 173 (1940), reversed 124 F. (2d) 156 (CCA-3d 1941), 28 AFTR 624 and again reversed 316 U. S. 164 (1942), 28 AFTR 1264 (as Wilmington Trust Co. v. Helvering)

In this case the taxpayer had several long accounts and a short account with the same broker. Taxpayer made sales in the long account of the same securities of which she was long in her long accounts. On her books of account she treated the sales in the short account as short sales. Nevertheless, on testimony that the broker regarded all accounts as a single unit and felt free to use stock in the long account to make deliveries against sales in the short account, the Board of Tax Appeals held that sales in the short account were "long sales." The circuit court reversed, relying on the manner in which the transactions were entered on the taxpayer's books. The Supreme Court affirmed the Board of Tax Appeals (and reversed the Circuit Court of Appeals) saying:

"The true character of the 'short' account is a question of fact to be determined in the light of the outward or manifested intention of the taxpayer and the way in which the account was actually managed. The designation of the accounts, the fact that as a matter of bookkeeping sales made through the 'short' account apparently were not reflected in the 'long' accounts, the method of reporting gains or losses are some evidence to support the conclusion of the court below. But there are numerous other circumstances which look the other way. They are embraced in the several subsidiary findings which the Board made and which we have enumerated. Those findings are supported by substantial evidence and are abundant justification for the Board's ultimate finding that the sales made through the 'short' account were ordinary sales."

(6) Henry F. Dupont, 38 B. T. A. 1317

Taxpayer, through his broker, made many short sales of stock when he had in long accounts with the same broker equivalent amounts of the shares sold short. Some of the short sales were closed out by purchases and others by transfer of stock from the long account. In holding that the sales in the short account were "short sales" the Board of Tax Appeals reviewed its decisions in the C. B. Ferree, Dee Furey Mott, and Dashiel cases, which we have cited above and distinguish them from the case before it, saying:

"In all of the above cases where it was held that the sales were not short sales the evidence showed that at the time of the transaction the taxpayer had a clear intention to sell the specific shares which he then held, and so instructed his broker. No such facts obtain in the proceeding at bar."

But it should be noted that three members of the Board dissented, saying:

"I realize fully that a short sale may be made by one who actually owns securities of the kind he sells (*Francis Bartow Farr, Executrix*, 33 B. T. A. 557, 561). But a sale of the same kind of securities is not the same as a sale of the specific securities. The latter is a long sale, even though delivery of the certificates is temporarily delayed."

From these decisions it is clear that intent is the controlling factor. Where the taxpayer sells securities of the same kind as those which he owns, the intent not to sell the long shares must be clear before the courts will hold that there has been a short sale.

The concept that a taxpayer makes a short sale if the certificate for the stock that he intends to sell will not be available for delivery at a time when, under

the rules of the exchange, delivery must be made, appears in the decision of the United States Supreme Court in *George D. Provost* v. *U. S.*, 269 U. S. 443, 5 AFTR 5681, which contains the following statement:

"The loan of stock is usually, though not necessarily, incidental to a 'short sale.' As the phrase indicates, a short sale is a contract for the sale of shares which the seller does not own *or the certificate for which are not within his control so as to be available for delivery at a time when, under the rules of the Exchange, delivery must be made.*" [Italics ours.]

In determining the weight that should be given to this definition, it should be borne in mind that the question at issue in the Provost case was one of stamp-tax liability and not one of income-tax liability. The question before the Court was whether certain transfers of stock in connection with borrowings by vendors who were unable to make delivery on settlement date were subject to the stamp tax imposed on transfers of stock. For this purpose it gave a definition of "short sale" which included every situation in which there would be a borrowing of stock.

While the decision in the Provost case has sometimes been cited in income-tax cases, an examination of such cases will show that the citation was for the first part of the definition re "the sale of shares which the seller does not own." The income-tax cases cited in this memorandum that failure to make timely delivery does not of itself make a sale a "short sale" and that as we have pointed out, intent is the controlling factor.

EXHIBIT A

STATE OF NEW YORK, *county of New York, ss:*

Frederick S. Todman, being duly sworn, deposes and says:

I am a certified public asscountant and I am the senior member of the public accounting firm of Frederick S. Todman & Co. with offices at 60 Beaver Street, New York, N. Y.

I have been a certified public accountant for more than 30 years. A substantial part of my practice has consisted of the auditing of accounts of members of the New York Stock Exchange and New York Curb Exchange. At the present time my firm acts as accountants for more than 50 members, or member firms, of these exchanges. For a number of years I was a partner in a member firm of the New York Stock Exchange.

I am the author of a textbook titled "Brokerage Accounts," published in 1916 and issued in 1921 in a revised and enlarged form under the title "Wall Street Accounting" and have written numerous articles on various accounting problems of members of security exchanges.

I am thoroughly familiar with the practice of members of the New York Stock Exchange and of other persons in the financial community who trade in securities with respect to the treatment of sales of securities as long sales or as short sales, as such practice existed prior to the promulgation of Securities and Exchange Commission rule X10A–1 in February 1938. I have been asked the following question:

Under the practice prevailing prior to February 1938, would a sale of stock made under the following circumstances be a long sale or a short sale? A member of the New York Stock Exchange purchases bonds which are currently convertible into stock of the issuing corporation. Shortly after such purchase the member makes a sale of stock of the issuing corporation in a quantity equal to the number of shares he will receive upon the conversion of the bonds he has purchased.

The purpose of the member in making such sale of stock is to realize a profit based upon the current difference between the cost of the bonds, adjusted for all payments to be made on conversion and the selling price of the stock. It is his intention that the shares of stock received upon the conversion of the bonds shall be applied to complete the sale. To carry out this intent, he gives oral instructions to those of his employees who are charged with the receipt and delivery of securities that upon the receipt of the bonds from the vendors thereof, they are to be sent to the transfer agent of the issuing corporation for conversion and that upon receipt of the stock from the transfer agent, the stock is to be used forthwith to complete the sales of stock theretofore made. At the time the sale of stock is made, the member is aware of the fact that the vender of the bonds will be obligated to deliver the bonds to him on the same day that he is obligated to deliver stock to the vendee of the stock and that it will take a day

or more after the receipt of the bonds to convert the bonds into stock. He therefore instructs his employees that if, at the time that he is obligated to deliver stock to the vendee, they have no stock received on conversion of the bonds available for delivery, they should fail to deliver the shares to the vendee-broker until the stock is received from the transfer agents in exchange for the convertible bonds heretofore deposited, or they should borrow stock temporarily to make delivery and later apply the stock received on conversion to liquidate the previous borrowing of the shares. The instructions so given are executed by the employees of the broker who made the sale of the stock against the convertible bonds.

It is my opinion that sales made in the manner described above would be long sales and not short sales. My reasons for this opinion are as follows:

Historically, a short sale of a security is a sale of a security that the seller does not own at the time of sale. Thus, on page 41 of Brokerage Acounts, I said "By the expression 'short' is meant the selling of shares not previously purchased or held, but sold with the expectation of realizing a profit through the decline in value of such shares." I repeated this definition on page 28 of Wall Street Accounting. Since I wrote these texts, it has been recognized that a person may make a "short sale" of a security in which he has a "long" position. However, where a person has a long position in a security and makes a sale of the same security, the sale will not be regarded as a "short" sale unless he indicates clearly at the time of the sale that he has no intention of currently using his long position to complete the sale. The mere fact that at the time of the sale, the long security is held in such a manner that it will not be available for delivery at the time delivery against the sale must be made, does not make the sale a "short" sale. A very common instance is where the vendor owns the security which he has sold but such security is in a safe deposit box to which he does not have access until after settlement date fixed by the rules of the exchange on which the sale is made. The broker making the sale must "fail to deliver" or "borrow" the shares. But such "failing" or "borrowing" does not convert the sale into a short sale.

The fact that at the time of the sale, the vendor does not own the security which he has sold, but does own a security which is convertible into the security sold, does not change the situation. For all purposes, I would regard the ownership of security A which is convertible into security B, as being the ownership of security B.

Where a person is long a security and makes a sale of the same security, the major factor in determining whether the sale is a "short" sale or a "long" sale is intent. Such intent is evidenced by the vendor's actions both before and after the sale. On the basis of the facts stated in the question, it is clear that the vendor's intention was to make a sale of securities which he had purchased and not to make a short sale.

FREDERICK S. TODMAN.

Subscribed and sworn to before me this 28th day of May 1952.

AUGUST WILLS,
Notary Public, State of New York.

Term expires March 30, 1953.

EXHIBIT B

STATE OF NEW YORK,
County of New York, ss:

Max Jacquin, Jr., being duly sworn, deposes and says:

From June 1929 until April 1946, I was associated with the New York Stock Exchange in various capacities. I served as secretary of a number of its committes, including the committee on arbitration, the committee on foreign business, and various special committees which included supervision of the conduct of domestic and foreign arbitrage transactions of members. I was successively assistant secretary and assistant vice president of the exchange. My duties included working with members of the exchange, public officials and legislators in the solution of problems of stamp tax and income tax liabilities which were common to a substantial portion of the membership of the exchange.

In the course of my work, I became thoroughly familiar with the practice of members of the exchange and of other members of the financial community with respect to the designation of sales of securities as long sales or short sales, par-

ticularly insofar as arbitarge transactions are concerned. I have been asked the following question:

Under the practice prevailing prior to February 1938, would a sale of stock made under the following cirmumstances be a long sale or a short sale?

A member of the New York Stock Exchange purchases bonds which are currently convertible into stock of the issuing corporation. Shortly after the purchase of the bonds, the member makes a sale of stock of the issuing corporation in a quantity equal to the number of shares he will receive upon the conversion of the bonds he has purchased. The purpose of the member in making such sale of stock is to realize a profit based upon the current difference between the cost of the bonds, adjusted for all payments to be made on conversion, and the selling price of the stock. It is his intention that the shares of stock received upon the conversion of the bonds shall be applied to complete the sale. To carry out this intent he gives oral instructions to those of his employees who are charged with the receipt and delivery of securities that upon the receipt of the bonds from the vendors thereof they are to be sent to the transfer agent of the issuing corporation for conversion and upon the receipt of the stock from the transfer agent the stock is to be used forthwith to complete the sales of stock theretofore made. At the time the sale of stock is made, the member is aware of the fact that the vendor of the bonds will be obligated to deliver the bonds to him on the same date that he, the member, is obligated to deliver stock to the vendee of the stock and it will take a day or more after the receipt of the bonds to convert the bonds into stock. He therefore instructs his employees that if, at the time that he is obligated to deliver stock to the vendee they have no stock received on conversion of the bonds available for delivery, they should endeavor to obtain the consent of the vendee's broker to a failure to make delivery and, if they cannot obtain such consent, they shoud borrow stock temporarily to make delivery and apply the stock received on conversion to satisfy the borrowings. The instructions given are carried out.

It is my opinion that the sales made under such circumstances would be long sales and not short sales.

Where an individual owns a security and makes a sale of the same security he may be making a long sale or a short sale. Which it is will depend on his intent. If at the time he makes the sale he intends to use his long stock to complete the sale, the sale will be a long sale and not a short sale. For example, if the stock which he is long is in a safe deposit box and he cannot get to such box in time to make delivery of the stock at the time delivery must be made under the rules of the stock exchange, he has nevertheless made a long sale. The fact that he fails to make delivery on delivery date or borrows stock to make such delivery does not make the sale a short sale. Likewise, if an individual owns a convertible bond and he makes a sale of stock into which the bond is convertible, he may be making either a long sale or a short sale. If at the time he makes the sale it is his intention that the bonds which he owns are to be converted into the stock and the stock received upon the conversion is to be used to complete the sale, he is making a long sale and not a short sale. Obviously, the individual's future conduct is a fact to be taken into consideration in determining his intent. If, upon making the sale of the stock, he forthwith takes the steps necessary to convert the bonds into the stock and actually uses the stock received upon the conversion to complete the sale, such facts will be evidence of his intent to make a long sale.

I am familiar with the fact that in 1938 the Securities and Exchange Commission promulgated a ruling known as rule X-10A-1, the purpose of which was to regulate short sales. This ruling required all orders for sales of securities executed by members of the national securities exchange to be designated as either long or short. The provisions in this rule as to the conditions which must be met before a sale could be marked long were such that the sale of stock against a long position in bonds convertible into the stock could not be designated as long sales. Members of the exchange who in the course of their business made such sales formed a committee which appeared before the Securities and Exchange Commission and urged a change in the requirement for designation of sales as long sales so as to permit the sales of the kind herein referred to, to be designated as long sales. I knew the members of this committee and discussed their problem with them, their associates, and their counsel. Their position was that such sales were not short sales within the generally accepted meaning of the term "short sales" and in this position I concurred with them.

I understand that, for the purpose of facilitating the administration of its rule relating to short sales, the Securities and Exchange Commission decided not

to change its requirements for the designation of sales as long sales. Instead, it provided that certain sales which were required to be marked short sales would be free from the restriction applicable to other short sales as to the price at which the sale could be made. Since, at the time this question arose, the only consequence of the designation of a sell order as a short sale was to restrict the price at which the sale could be made, it was felt that there was nothing to be gained by pressing the Securities and Exchange Commission to have its requirements for designation of the sales herein discussed as long sales, as long as the Commission itself exempted such "short" sales from the restriction.

EXHIBIT C

STATE OF NEW YORK,
County of New York, ss:

Richman Proskauer, being duly sworn, deposes and says:

I have been a member of the New York Stock Exchange since 1924. I am now a partner in the firm of Rosenbaum, Proskauer and Russhon, a member firm of the New York Stock Exchange, with its office at 160 Broadway, New York, N. Y.

In 1938 I was a member of a committee of members of the New York Stock Exchange which conferred with the Securities and Exchange Commission for the purpose of obtaining a revision of rule X-10A-1 of the Securities and Exchange Commisison. The facts concerning the work of this committee were as follows:

In the early part of 1938, the Securities and Exchange Commission had promulgated a ruling, designated as rule X-10A-1, which was to become effective on February 8, 1938. Such rule provided that "(a) no person shall, for his own account or for the account of any other person, effect on a national securities exchange a short sale of any security (1) below the price at which the last sale thereof, regular way, was effected on such exchange, or (2) at such price unless such price is above the next preceding different price at which a sale of such security, regular way, was effected on such exchange * * *; (b) no member of a national securities exchange shall, by the use of any facility of such exchange, execute any sell order unless such order is marked either 'long' or 'short'; (c) no member of a national securities exchange shall mark a sell order 'long' unless (1) the security to be delivered after sale is carried in the account for which the sale is to be effected, or (2) such member is informed that the seller owns the security ordered to be sold and, as soon as is possible without undue inconvenience or expense, will deliver the security owned to the account for which the sale is to be effected."

A number of firms who were member firms of the New York Stock Exchange carried on operations which involved the purchase of convertible securities and the sale almost immediately thereafter of the security into which the security purchased was convertible. The sales made in such transactions could not qualify as long sales under the restrictions in subdivision (c) of the rule for the reason that the security sold was not "carried in the account for which the sale is to be effected" nor could it be said the seller "owns the security ordered to be sold." The result was that the orders for such sales would have to be marked "short" and would be subject to restriction as to the price at which the sale could be made.

Such member firms appointed a committee, of which comittee I was a member, to confer with the Securities and Exchange Commission for the purpose of obtaining such change in the wording of subdivision (c) as would permit selling orders of the kind herein described to be marked "long." The committee spent 2 days in Washington conferring with members of the Commission and members of its staff. The gist of the argument made by the committee was that the financial community had not previously regarded sales of the kind herein described as short sales in that, if the seller was long security A, and security A was convertible into security B, he was, in effect, the owner of security B.

The Commission declined to amend subdivision (c). It did, however, agree to add to subdivision (d) of rule X-10A-1, which subdivision contained a list of sales to which the price restriction of subdivision (a) would not apply, a new item which would also exempt sales of the type in question from the price restriction. Such exemption was later embodied in subdivision (7) of subdivision (d) which became effective on April 3, 1938. While the members of the committee would have preferred a change in subdivision (c) so as to permit the sales to be made as long sales, the Commission's solution had the same effect,

i. e., the sales could be made without restriction as to price. Consequently, the committee accepted the Commission's solution.

At that time (i. e., in 1938), once the restriction on selling price was removed, it was immaterial to the members of the committee and to the member firms they represented whether the sales were marked as "long" or as "short" exempt. I am certain that, had there been any unfavorable tax consequence from the designation of the sales as "short" exempt, the members of the committee would have adhered to their position that the sales were not short sales and would have insisted on such change in subdivision (c) as would have permitted the sales in question to be marked "long." I know that I, for one, would have done so.

RICHMAN PROSKAUER.

Subscribed and sworn to before me this 3d day of June, 1952.

LOUIS A. KATZ,
Notary Public, State of New York.

Term expires March 30, 1954.

PEERLESS CEMENT CORP.,
Detroit 26, Mich., April 20, 1954.

Hon. CHARLES E. POTTER,
Senate Office Building,
Washington, D. C.

DEAR SENATOR POTTER: I have recently been advised that during the current session there is a House bill, H. R. 8361, having to do with rapid amortization of machinery and equipment for elimination of air and water pollution by industry. I understand this bill was introduced by Representative Kersten of Wisconsin as an amendment to the 1954 revenue bill now in the Senate.

Anything you may be able to do toward legislation furthering the program of rapid amortization of capital investment of this kind, I believe, would be for the best interests of the public because it would encourage industry to provide capital for this.

I hope the amendment will be passed by the House.

Sincerely,

W. C. RUSSELL.

CHICAGO, ROCK ISLAND AND PACIFIC RAILROAD CO.,
Chicago, April 14, 1954.

Hon. EUGENE D. MILLIKIN,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: I know that the Finance Committee has a tremendous task before it in studying and reporting upon H. R. 8300; and consequently it is with some hesitation that I make the request that consideration be given to a change in one of its provisions.

Section 309 imposes a corporate tax which has no counterpart in the present law. Obviously, it is intended to serve the entirely laudable purpose of preventing stockholders in closely held corporations from converting income into capital gain by the device of issuing preferred stock to themselves instead of declaring a dividend. Such tax avoidance is not, and ordinarily cannot be, practiced by stockholders of corporations whose stock is publicly held; and therefore, I believe that the House bill goes too far in making section 309 applicable to such corporations.

The redemption of preferred stock is frequently desirable from the standpoint of good corporate management. It would be very unfortunate if such redemptions were to be placed under the cloud of possible exposure to this confiscatory tax merely in order to eliminate the possibility of tax avoidance by the stockholders of closely held corporations. Surely it is not necessary to close the door so hard that the whole house falls down.

Section 309 (a) provides five exemptions from the tax. These are not sufficient to eliminate from the possibility of its application many preferred stock redemptions by publicly held corporations, which are entirely proper and completely free from any taint of tax avoidance abuses. I believe that the purposes of the section could be fully effectuated if its application were confined to closely held corporations, and consequently I suggest that there be added a sixth exemption reading as follows:

"(6) NONPARTICIPATING STOCK ISSUED BY PUBLICLY-HELD CORPORATIONS.—If the transfer is in redemption of nonparticipating stock issued by a publicly held corporation as defined in section 359 (a)."

Yours very truly,

J. D. FARRINGTON.

ROOTS-CONNERSVILLE BLOWER,
Connersville, Ind., April 15, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Finance Committee of the Senate,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: We note that the Revenue Code of 1954 which has been completely revised, contains certain provisions which we feel should be given further consideration. This has been a very busy time of year for us and we have not had adequate time to thoroughly review the new code, but feel that you would be interested in receiving our comments. It is our opinion that such an important law which has been completely rewritten and perhaps passed, should receive adequate review by the taxpayers of this country. It is our understanding that your committee is now starting hearings on this subject. We earnestly suggest that these hearings be continued until after responsible organizations and taxpayers have had time to review the law and have had opportunity to be heard on this subject.

We do not feel that the revised code in general, should be criticized and we agree that the long existing present code was in need of a general revision. Changes are being made however, in the existing law which we cannot help but feel, are unwise. In reading the provisions with reference to corporate reorganizations, we find a substantial change has been made.

The existing law under section 112 treats any statutory merger or consolidation as a tax-free reorganization. This is when one corporation acquires substantially all the assets or 80 percent of all stock of another, in exchange solely for shares of its own voting stock.

Under section 359 of the new code this rule would be changed by treating the transaction as a taxable exchange unless the stockholders of the acquired corporation receive at least 25 percent as much stock in the acquiring corporation as the old stockholders of the acquiring corporation had before the transaction. In other words, the transaction is taxable unless the stockholders of the acquired corporation wind up with at least 20 percent of the stock in the merged venture. The exception to this rule would be where both corporations are "publicly held", as the term is defined. Corporations in which members of 10 families own as much as 50 percent of the stock, are not considered as publicly held, therefore, the exception applies principally to transactions between corporations which have their stocks listed on an exchange.

It is our opinion that the insertion of the 25-percent rule would penalize the owners or shareholders of smaller corporations. Many times a company manufacturing a certain line of products finds it to their advantage from an economic viewpoint to become merged with a larger company offering a wider line of products to enable them to compete with other concerns. In addition, certain companies may find it advantageous to become integrated with companies manufacturing similar products in a wider area. Accordingly to the present law, shareholders of smaller corporations end up with stock in a continuing venture with a real continuity of interest.

The new revisions of the law would compel shareholders of smaller corporations to sell a part of his stock in order to pay the capital-gains tax. This particularly would be burdensome where neither corporation was widely held and there may be no ready market for sale of the shares in the continuing corporation. The net effect of this change would discourage transactions of this type and the result which we believe is unwarranted, would not be a sound economic basis for mergers of this kind.

A distinction has been drawn between those corporations which are "publicly held" and those which do not meet this definition. Such distinction is without merit. The House committee report seeks to justify this distinction based on the grounds that acquisitions between corporations which are not publicly held are sometimes made with the view of minimizing the stockholders' tax. We do not believe that this is an accurate analysis of most past reorganizations.

In most cases we believe you will agree with us that reorganizations are established, based on a genuine business purpose. The method of reorganizing is then

chosen to minimize taxes on the transaction. Most of these tax-free transactions are not what could be defined as tax avoidance, but are merely a deferment of tax payments until after an economic gain has been realized.

We sincerely hope that your committee will oppose this change in the reorganization section and will permit time for review and discussion of the many changes in the proposed Revenue Code of 1954.

Yours very truly,

R. R. NEWQUIST, *President.*

APRIL 16, 1954.

Re H. R. 8300, the Internal Revenue Code revision bill.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Committee on Finance,
Senate Office Building, Washington, D. C.

DEAR MR. CHAIRMAN: The American Society of Travel Agents, Inc., representing over a thousand travel agents and businessmen in allied fields, wishes the Senate Committee on Finance to record its strong support of the proposed amendment to section 4261 of H. R. 8300 urged by the Air Transport Association of America. This proposed amendment would redefine domestic transportation as used in section 4261, aforesaid, to prevent the present, large-scale loss of revenue derived from the tax on the transportation of persons and to remove the existing discrimination against those American travel agents doing business near the Mexican and Canadian borders.

The American Society of Travel Agents, Inc., participated, by counsel and members, at the hearings held by the House Committee on Ways and Means on H. R. 91 on August 10, 1953, and supported at that time the same change now sought.

As it now stands, the law imposes a tax on the transportation of persons where the transportation begins and ends in the United States. As pointed out by Mr. Kenneth G. Traux, a member of this society who testified in its behalf at the August hearings, persons living near an international border of the United States who desire to purchase transportation for travel wholly within the United States will buy their tickets in Canada or Mexico where, by also buying a bus ticket from the point of purchase across the border to their point of origin in the United States, they avoid having to pay the Federal tax on transportation.

And, as stated by Mr. Thomas J. Tavano, many people from points inland also avail themselves of this loophole. If the proposed amendment is enacted there will be a substantial tax saving to the United States. This is one way that the administration can help prevent the deficit from getting any worse.

At the same time, this amendment will result in American travel agents having more business, making more money, and, in turn, paying more in income taxes to the Federal Government.

By adopting the amendment proposed by the Air Transport Association of America, your committee will achieve two desirable results. Federal revenues will be increased and a segment of a widespread American business will be strengthened. For the foregoing reasons, the American Society of Travel Agents, Inc., requests your favorable consideration of the proposed amendment.

I am,

Respectfully yours,

HARRY A. BOWEN,
Counsel for the American Society of Travel Agents, Inc.

LAW OFFICES, MORRIS LAVINE,
Los Angeles, Calif., April 5, 1954.

Senator WILLIAM L. LANGER,
Senate Office Building,
Washington, D. C.

MY DEAR SENATOR: Since the new tax bill has been referred to the Senate and to your Judiciary Committee for consideration, I desire to call your attention to some matters that I believe are vital and should be in the bill from the standpoint of the citizens and from a practical standpoint of the operation of the law.

(1) The proposed new law extends the statute of limitation with reference to criminal penalties from 3 years to 6 years. This extension would be very

burdensome on a great many business people who neither keep records nor can remember 6 years back. Can you?

The 3-year statute of limitations has been in existence for many years and has been perfectly satisfactory in the operation of criminal cases. The Government has ample protection in the civil penalties and sanctions which it now has and which now covers a penalty of 50 percent in cases of fraud and 25 percent in cases of negligence, together with other penalties with interest, etc. These, it would seem, would be ample to protect the Government without the prolonged period which is now being sought to be injected into the bill.

There is also a section in connection with the bill which provides for criminal prosecution for 6 years, instead of 3 years, "for willful failure to pay any tax or make a return, for making false statements, intimidating United States officers, etc." The bill does not define what constitutes "making a return." Recently I had a case in the Tax Court which involved the question whether the fact that the taxpayer himself did not sign the return was a failure to make a return, although the return was signed by the accountant who made out the return and was working under the direction of the taxpayer.

The item of "making false statements" is now covered by section 1001 of title 18 of the United States Code, and there is no need to put it in specially in the tax bill.

Also, there should be some definition of what constitutes false statements and whether the testimony of an intelligence officer of the Internal Revenue Department needs corroboration as in the case of perjury. Otherwise, it makes a person liable by pitting his word against that of an agent.

There also ought to be a provision in the law providing that the Federal Rules of Civil Procedure, which now govern the courts of the United States in all other courts, should govern the Tax Court in all proceedings in relation to taxes.

Under the present rules of the Tax Court, the lawyers throughout the United States are required to follow the rules of the District of Columbia as they existed in equity cases prior to 1938. But, where do we find this law and what law library throughout the country, except in Washington, D. C., and some of the major cities, has the rules therein? As long as the tax bill is being modernized, why not bring it up to date and make it uniform with the laws of the district courts of the United States.

There also ought to be some provision in the bill for voluntary disclosure. This was a policy which was carried out by the Department for many years and until its troubles arose 2 years ago, and brought in many hundreds and thousands of dollars to the Department. The voluntary disclosure procedure was, in effect, a provision that if a taxpayer voluntarily disclosed his error prior to the commencement of prosecution he would not be prosecuted criminally and could settle his liabilities without fear of prosecution, having made a voluntary disclosure. Since the upheaval in the Tax Department a few years ago, the Department has abandoned this policy and procedure and it is the opinion of various accountants, tax lawyers, and persons that I have talked to about it that this has resulted in considerable loss to the Government. The provision should be codified so that the Internal Revenue Department would feel free to act under it as well as the taxpayer, and the lawyer to feel free to advise his client that that is the best thing to do, and the client feel free that if he does so he will not face a criminal charge.

These are some of the suggestions I hope you will have the entire committee consider and adopt in the revision of the tax bill.

Yours very truly,

MORRIS LAVINE.

JOHNSON MACHINE WORKS, INC.,
Chariton, Iowa, April 13, 1954.

HON. GUY M. GILLETTE,
United States Senate,
Washington, D. C.

DEAR SENATOR GILLETTE: It has just been brought to my attention that the depreciation proposal as contained in H. R. 8300 does not permit accelerated depreciation on capital equipment manufactured prior to January 1 of this year.

If this is true, I believe that this proposal is very unfair. I feel that it is particularly unfair to smaller manufacturers, such as ourself, who because of limited capital cannot afford the luxury of buying new equipment at all times.

As I see it, the only people that would benefit by such a proposal would be manufacturers of capital goods and the larger or well-financed firms who do not need to be so careful in their cash outlays.

I would greatly appreciate your checking into this matter and advising me as to your thoughts regarding it.

Yours very truly,

RUSSELL S. JOHNSON.

CHICAGO & EASTERN ILLINOIS RAILROAD,
Chicago, Ill., April 15, 1954.

HON. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: We have given careful consideration to H. R. 8300, the proposed Internal Revenue Code of 1954, as it relates to the financial structure of this company. The bill contains several provisions which, if adopted, will not only have a serious effect on this company, but also, in our judgment, will have far-reaching effects on many other companies in the railroad industry.

This company, like many other companies, was reorganized under section 77 of the Bankruptcy Act, the present company having taken over the properties of its predecessor on January 1, 1941. The predecessor company, Chicago & Eastern Illinois Railway Co., owed approximately $30 million of fixed interest bonds secured by a general mortgage on the property. These bonds were in default from 1932 until the reorganization plan went into effect on January 1, 1941. The reorganization plan gave to the holders of the fixed interest bonds of the predecessor company income bonds totaling approximately $15 million, and preferred stock totaling approximately $15 million. Thus, both the income bonds and the preferred stock represent debt of the predecessor company. The indenture under which the income bonds were issued contemplates maintenance of a sinking fund looking to eventual retirement of the debt at the maturity of the income bonds on January 1, 1997. The income bonds are redeemable at their face value that is, $100. Retirement of the preferred stock also is contemplated, the company's certificate of incorporation containing a provision that the preferred stock may be redeemed at par; that is, $40 per share.

Section 275 of H. R. 8300 would preclude this company from deducting interest paid on the income bonds for the first time since the reorganization plan went into effect, on January 1, 1941. Section 275 would impose upon this company an additional tax burden of approximately $300,000. Section 275, if adopted, thus would throw out of balance the carefully thought out plan of reorganization approved by the Interstate Commerce Commission and the courts, and conceivably might have serious consequences for this company. Further, section 275, if adopted, would subvert the other laudable objectives of Congress in adopting the Bankruptcy Act and the Interstate Commerce Act, by impairing provisions of law designed to permit hopelessly insolvent carriers to reorganize on a basis that would permit them to continue to render service to the public under private management.

Section 309 of H. R. 8300 also would have an impact upon this company almost as severe as the newly proposed section 275. As we interpret section 309, applied to our presently outstanding income bonds and our obligations with respect to them, the transfer tax proposed by section 309 would require this company to pay $171.61 for each $100 income bond redeemed by the company. This results from the fact that the fixed interest bonds of the predecessor company were selling on the market for approximately $15 and thus the 85 percent transfer tax would apply to $84.25, the difference between the redemption price of $100 and the credit of 105 percent of the fair market value of the fixed interest bonds surrendered for income bonds, given by section 309. Moreover, the indenture under which said income bonds were issued compels the trustee thereof to redeem the income bonds at the redemption price—that is, $100—whenever it is unable to purchase for less than their face value an adequate amount of income bonds for sinking fund purposes on the open market. Accordingly, this company might be required to pay the exorbitant penalty tax proposed to be imposed by section 309 under circumstances completely beyond its control.

Furthermore, section 309 would preclude this company from redeeming its preferred stock as its business improves. It should be readily apparent that as the cash position of this company improves, its preferred stock will move to par

and thus the company will be required to exercise the redemption privilege if it desires to retire its preferred stock. In that event, this company would be required to pay substantially the same exorbitant penalty tax proposed to be imposed under section 309 as it would be compelled to pay in connection with redemption of its income bonds. Thus, section 309 is extremely harsh, in that it subverts the objective of the reorganization plan—that is, the eventual retirement of this company's preferred stock—in order that the holders of the fixed interest bonds of the predecessor company eventually might receive 100 cents on the dollar for their investment.

Although this company is now in good shape and we hope that it will remain in that condition, it seems to us that for Congress to adopt drastic provisions which would effectively prevent future reorganizations and recapitalizations under the supervision of the Interstate Commerce Commission would be completely inconsistent with the intent of Congress as expressed in the provisions of law concerning reorganizations and recapitalizations contained in the Bankruptcy Act and the Interstate Commerce Act. We all hope that it will not be necessary for railroad companies to again require reorganization or recapitalization, but it seems to us that it would be extremely unwise for Congress to assume at this stage that the need for the reorganization and recapitalization provisions of law has ended. In fact, it is our understanding that several proposed reorganizations and recapitalizations now pending before the Interstate Commerce Commission cannot be consummated if H. R. 8300 becomes law in its present form. Moreover, many of the reorganization plans previously approved by the Commission require revision in the light of actual experience or subsequent developments and railroad companies should not be hampered in their efforts to work out such reorganizations and recapitalizations under conditions which the Interstate Commerce Commission finds to be required by the public interest.

It is our understanding that the Association of American Railroads will recommend the complete elimination of section 275. This company deems such elimination to be imperative. It is also our understanding that Mr. John P. Farrington, president of the Rock Island, has proposed an amendment to section 309, which, in substance, would make section 309 inapplicable to publicly held corporations within the meaning of a publicly held corporation as defined in section 359 (a) of H. R. 8300. We have examined this proposed amendment and concur in Mr. Farrington's recommendation that it be adopted. We also understand that Mr. Donald B. Fraser, president of Missouri-Kansas-Texas Railroad Co., will submit for consideration a proposed amendment to H. R. 8300 which would enable the M-K-T to solve the serious financial problems peculiar to that company. We have examined the provisions of this proposed amendment and heartily concur in Mr. Fraser's recommendation that it be adopted.

As we view the matter, H. R. 8300 poses a serious problem for all railroads and for Congress to adopt H. R. 8300 in its present form not only would seriously affect railroad companies in their present form, but also would create a further problem in connection with future reorganizations and recapitalizations required by the public interest.

We request that this letter be included in the record on H. R. 8300.

Respectfully submitted.

C. M. RODDEWIG, *President*.

J. NEILS LUMBER CO.,
Klickitat, Wash., April 12, 1954.

Hon. WARREN G. MAGNUSON,
Senate Office Building,
Washington, D. C.

HON. SENATOR MAGNUSON: The Senate is now or will be soon considering the proposed technical revision of the Internal Revenue Code passed by the House as H. R. 8300 on March 18, 1954.

We call your attention to section 631 and 272 of H. R. 8300. Section 631 is a reenactment of section 117 (k) with one very important change contained in the second sentence of 631 (a), which reads as follows:

"If such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the fair market value of such timber, and the adjusted basis for depletion of such timber in the hands of the taxpayer *plus the deductions disallowed under section 272.*" Section 272 is a new section to the code which provides "that where the cutting of

timber is considered to be a sale or exchange of such timber under section 631 (a), no deduction shall be allowed on account of certain expenses of the taxpayer incurred in connection with the holding and quantity measurement of the timber cut * * * It is intended that only that portion of such expenses allocable to the timber cut will be disallowed as a deduction."

The effect of the foregoing is to reduce the capital gain arising under section 631 (a) from the cutting of timber and to increase the amount taxable as ordinary income by the amount of the disallowed expenses.

We believe that this is undesirable for the following reasons:

(1) Capital gain from the cutting of timber was first enacted as a relief measure under section 117 (k) (1). The proposals under new sections 631 (a) and 272 would drastically reduce the amount of such relief at a time when the industry is hard put to keep afloat in a period of declining prices and still increasing costs, and

(2) The enactment of these provisions will create complicated burdensome problems expense allocation and materially widen the area of possible disagreement as between Treasury Department officials and taxpayers, thereby resulting in further unnecessary litigation.

We thank you for the privilege of writing you in this manner and ask only your consideration of this proposed change in the law.

Yours very truly,

W. H. RATHERT, *General Manager.*

PENINSULA PLYWOOD CORP.,
Port Angeles, Wash., April 6, 1954.

Hon. WARREN A. MAGNUSON,
United States Senate,
Washington, D. C.

MY DEAR SENATOR: We have made a concentrated study of certain features of H. R. 8300, as recently passed by the House of Representatives and now being considered by the Senate Finance Committee. We are particularly concerned as to the manner in which this bill might cause revision of section 117 (k) of the Internal Revenue Code.

We believe that section 117 (k) of the present code was intended to relieve forest owners of discriminatory and inequitable taxation and to serve as an incentive for conserving, protecting, and assuring future timber resources; that acting in good faith upon its representations to Congress in 1943, and in reliance upon the benefits of section 117 (k), as now provided, private forestry has made great progress; and that the language of sections 631 and 272 of H. R. 8300 would create new discriminations and inequities that would impede or retard the progress that has been made under section 117 (k).

We respectfully request that you make careful study of this proposed legislation with particular consideration as to its effect on the timber industry in the West.

We trust that you will use your fullest influence to urge the Senate Committee on Finance to amend section 631 of H. R. 8300, as passed by the House, by restoring the language of section 117 (k) of the present code insofar as timber is concerned, and to strike out the references to timber in section 272. This may necessitate dividing subsection (b) of section 631 into two subparagraphs which would treat timber and coal separately.

Sincerely yours,

C. J. HOPKINS,
Manager, Timber Department.
EINAR ERICKSON,
General Manager.

TUCSON TITLE INSURANCE CO.,
Tucson, Ariz., April 14, 1954.

Re H. R. 8300.

Senator CARL HAYDEN,
Senate Office Building,
Washington, D. C.

DEAR SENATOR HAYDEN: I am enclosing herewith a copy of correspondence and opinion written by Mr. Joseph D. Peeler on behalf of the California Land Title

Association. This trade association represents 15 California title insurance companies as well as 3 Arizona title insurance companies, namely, Phoenix Title & Trust Co., Phoenix; Arizona Title Guarantee & Trust Co., Phoenix; and Tucson Title Insurance Co., Tucson.

The opinion enclosed clearly states our position relative to certain phases of H. R. 8300.

We sincerely feel that including title insurance companies along with other insurance companies is unsound, illogical, and discriminating.

It appears to me, after having studied the opinion and the law that is attempted to be made, that there was clearly an oversight on the part of the proponents based upon their failure to recognize the type of business that title insurance is.

As usual, we feel that we can count upon you for a correction of this erroneous inclusion.

With kindest personal regards, I am,

Yours very truly,

J. B. O'Dowd.

Musick, Peeler & Garrett,
Los Angeles, April 7, 1954.

Re H. R. 8300.

Mr. Colin F. Stam,
Chief of Staff, Joint Committee on Internal Revenue Taxation,
1011 House Office Building, Washington, D. C.

Dear Mr. Stam: Enclosed herewith for your consideration and for presentation to the Senate Finance Committee is a memorandum suggesting amendments to sections 34 (c) (1) and 246 (a) (1) of the proposed Internal Revenue Code of 1954, together with a statement of the reasons why such amendments should be made. It is believed that the sections now proposed are defective from a technical standpoint and cover corporations not intended to be covered.

This presentation is made on behalf of the California Land Title Association, a trade association representing 15 California title insurance companies.

Respectfully,

Joseph D. Peeler.

Memorandum Re Proposed Amendments to Sections 34 (c) (1) and 246 (a) (1), H. R. 8300, Relative to Dividends Paid on Stock of California Title Insurance Companies

I. Proposed Amendments

It is submitted that the following provisions should be substituted for the provisions proposed under H. R. 8300 for the following subsections:

"SECTION 34. DIVIDENDS RECEIVED BY INDIVIDUALS.

"(c) No Credit Allowed for Dividends From Certain Corporations. Subsection (a) shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following), unless (*a*) its tax is computed as provided in section 11, and (*b*) its net income as computed under subchapter L is not substantially different from its net income as computed without reference to subchapter L."

"SECTION 246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED.

"(a) Deduction Not Allowed for Dividends From Certain Corporations. The deductions allowed by sections 243, 244, and 245 shall not apply to any dividend from—

"(1) an insurance company subject to a tax imposed by subchapter L (sec. 801 and following), unless (*a*) its tax is computed as provided in section 11, and (*b*) its net income as computed under subchapter L is not substantially different from its net income as computed without reference to subchapter L."

II. Reasons for the Proposed Amendments

(a) Purpose of provisions

As explained in the House committee report the general purpose of section 34 is to afford some relief from the double taxation of corporatio ndividends. The

purpose of subsection (a) of section 34 is explained on page 6 of the report as follows:

"The relief offered by the dividend-received credit is limited to situations in which double taxation actually occurs. Accordingly, the dividend-received credit is not allowed with respect to dividends paid by foreign corporations or tax-exempt domestic corporations. Thus, it does not apply to dividends of exempt farm cooperatives or to distributions which have been allowed as a deduction (in effect treated as interest) to a mutual savings bank, cooperative bank, or building and loan association. Moreover, the dividend-received credit is not available to nonresident alien individuals not subject to the regular individual income tax."

Section 34 contains provisions not in the present law, allowing to individual stockholders a dividends-received credit for part of the dividends received from corporations subject to the regular tax rates. Sections 243, 244, and 245 contain provisions, similar to those in section 26 (b) of the present law, allowing to corporate stockholders deductions for a portion of the dividends on stock received from corporations subject to the regular tax rates.

Undoubtedly, it was for the purpose stated in the above quotation that the House committee inserted in section 34 (c) (1) and in section 246 (a) (1) the limitation regarding "an insurance company subject to a tax imposed by subchapter L (sec. 801 and following);"

As will be shown clearly below, however, the language used is too broad in its operation and will include insurance companies which are subject to the income-tax and surtax rates applicable to corporations in general and whose dividends presently are subject to double taxation.

(b) Taxation of insurance companies

Subchapter L of chapter 1 contains the provisions for taxation of insurance companies, under four separate parts, as follows:

Part I covers life insurance companies and in general continues for 1 year the present provisions of the law.

Part II covers mutual insurance companies (other than life or marine or fire insurance companies issuing perpetual policies) and in general continues the present provisions of the law.

Part III covers other insurance companies and in general continues the present provisions of the law.

Part IV covers provisions of general application and in general continues the present provisions of the law.

Under the present law and under the House bill, insurance companies which are covered by parts I and II, in general life insurance and mutual companies, are not subject to the regular corporation income-tax rates. On the other hand, section 831 of the House bill provides as to "other companies" covered by part III as follows:

"(a) IMPOSITION OF TAX. Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company (other than a life or mutual insurance company), every mutual marine insurance company, and every mutual fire insurance company exclusively issuing either perpetual policies or policies for which the sole premium charged is a single deposit which (except for such deduction or underwriting costs as may be provided) is refundable on cancellation or expiration of the policy."

Section 11 covers the tax imposed on "corporations in general." Accordingly, insurance companies covered by part III pay the regular corporation tax rates.

(c) Title insurance companies

These companies are covered by part III and pay the regular corporation tax rates. Section 832 provides, as does the present law, that the gross income of such companies shall include (A) the gross amount earned during the year from investment income and from underwriting income, (B) gain during the year from the sale or other disposition of property, and (C) all other items constituting gross income under subchapter B. Deductions are allowed for losses incurred, expenses incurred, and other deductions comparable to the deductions allowed to ordinary corporations.

By reason of the nature of their business, title insurance companies in the State of California operate in the same manner as corporations in general. They maintain extensive title records and before a title policy is issued a careful search of the record is made. A single premium is charged for the policy and the entire amount immediately constitutes taxable income. A title policy is not renewable at stated intervals, like most insurance policies, but continues in

force indefinitely. Accordingly, there is no problem of "unearned premiums."

Because of the extensive research in connection with each title policy, the largest item of expense is labor, in common with corporations in general. As a result of this and efficient title practices, losses rarely exceed 2 percent of annual premiums and thus do not present any unusual accounting problems. California title insurance companies do not use reserves in determining loss deductions for the purpose of computing net income. A loss deduction is determined on each separate situation in the light of the particular facts, and is taken only when the amount is definitely ascertained.

Accordingly, the net income of a California title insurance company, as computed under section 832 of the House bill (which is substantially the same as section 204 of the present Internal Revenue Code), would be the same if its income were determined under other provisions of the law applicable to corporations in general.

California title insurance companies do not receive any special tax benefits or favored treatment; their income tax burden is fully as heavy as that of corporations in general. They do not receive any special benefits such as, for example, percentage depletion deductions afforded to natural resource companies.

Any fair-minded survey of the facts will disclose clearly that title insurance companies in the State of California bear their full share of the Federal income tax burden. They definitely present a situation "in which double taxation actually occurs" and there is no sound basis in logic or equity for discriminating against them, as the House bill does.

(*D*) *Title insurance & trust co.*

The California Land Title Association, on whose behalf this memorandum is filed, is a trade association with membership including 15 California title insurance companies. To illustrate the impact of this legislation on the title industry in California, it will be helpful to examine in some detail its effect on one company, the Title Insurance & Trust Co. of Los Angeles. This company is the largest title insurer in California, but it differs from the other companies chiefly in its size, and it may be regarded as representative. Title Insurance & Trust Co. is a California corporation, located at 433 South Spring Street, Los Angeles 13, Calif. Its activities include a title insurance business in southern California, a trust and escrow business, and the ownership and operation of a large office building in Los Angeles. The principal source of revenue is derived from its title insurance business. In addition, it owns stock of other corporations, some of which are engaged solely in the title insurance business and from which it receives substantial dividends. Accordingly, it is vitally concerned with the provisions of the House bill here considered, both as a corporate stockholder of title insurance companies and on behalf of its many stockholders to whom it pays regular dividends.

A review of this company's Federal income tax returns for recent years discloses clearly that its income tax burden would have been substantially the same if its taxable net income had been determined under the provisions of the law relating to "corporations in general" instead of the provisions of section 204 of the present code relating to other insurance companies. Since, as stated on on page A240 of the committee report, the provisions of section 832 of the House bill "correspond without change of substance" to the present provisions of the law, there is every reason to assume that in the future its tax burden under the proposed new law would not be reduced by treatment as an insurance company.

Accordingly, if no change is made in the provisions here in question, this company will continue to be subject to double taxation in the same manner as corporations in general, without any relief whatever to its stockholders. We respectfully submit that this treatment would be grossly inequitable and discriminatory and, we believe, would be contrary to the real intention of the legislators.

In this connection, it should be noted that under the present law this company is allowed a dividends-received deduction for dividends received from its title insurance subsidiaries while under the proposed House bill it would be allowed no deduction. Accordingly, the House bill not only would deny the new dividends-received credit to its shareholders, but would add a very great tax burden on the company itself which is not imposed by the present law.

This is not a situation in which a taxpayer is afforded tax relief by electing to be taxed as an insurance company. Under the House bill, as well as under the present law, it has no choice but must compute its net income under subchapter L as an insurance company, even though it obtains no tax benefit from such treatment.

As an alternative, in the event that the provisions here in question are not changed so as to remove this discrimination, title insurance companies, including this company, should be permitted to elect whether to be taxed under the provisions of subchapter L (with the corresponding burdens relative to dividends received from other title insurance companies and relative to dividends paid to its shareholders) or whether to be taxed under the general provisions relating to corporations in general. Without the right to make such an election, a title insurance company is forced to file its returns in a manner which affords it no tax benefits or relief, while at the same time subjecting it and its stockholders to tax burdens which do not apply to corporations in general.

CONCLUSION

It is respectfully submitted that the provisions of sections 34 (c) (1) and 246 (a) (1) of House bill 8300 would result in unjust discrimination as to California title insurance companies and should be amended. It is believed that their inclusion in the exceptions was due to a misunderstanding or to an oversight.

Respectfully,

JOSEPH D. PEELER.

FIRST NATIONAL BANK OF NEVADA,
Reno, Nev., April 10, 1954.

Hon. GEORGE W. MALONE,
United States Senate, Washington, D. C.

DEAR SENATOR MALONE: There is now being considered by the Senate Finance Committee tax legislation (H. R. 8300), pertaining to employees' pension plans. This legislation will restrict all investments to not more than 5 percent of the total assets held under a pension trust.

You can readily appreciate that many pension trust plans are now being administered by smaller institutions, and some of these will not exceed $100,000 in total value. We feel that such legislation will impose an unreasonable restraint on the trust, inasmuch as no piece of real estate or mortgage loan, for example, on a $100,000 trust, could be acquired in excess of $5,000, in view of the proposed limitations under the pending legislation. This, we feel, is undesirable, as it may be possible to secure attractive, well-secured loans or real estate that would be a desirable investment under the present proposed legislation.

Unless you feel the pending legislation desirable, your support in the modification of the act to provide that smaller pension funds may make larger real estate investments or mortgage loans would be appreciated.

Kind regards.

Sincerely,

E. J. QUESTA, *President.*

RENO, NEV.

GEORGE W. MALONE,
United States Senate, Washington, D. C.:

Have been requested by Mr. Frank Belgrano, president Transamerican Corp. Call your attention certain provisions in tax bill H. R. 8300 now under consideration in Senate Finance Committee which changes existing law. If enacted would result in serious financial loss to corporation. These changes relate (1) to the taxability of dividends received by corporate stockholders from insurance companies; and, (2) to the gain or loss and basis provisions in the case of corporate liquidations. Both of the above would, if enacted in their present form, cause considerable loss to Transamerica Corp., and believe other corporations as well. I would appreciate anything you may do.

E. J. QUESTA,
President, First National Bank of Nevada.

THE CLEVELAND-CLIFFS IRON CO.,
Cleveland, Ohio, April 16, 1954.

Senator EUGENE D. MILLIKIN,
*Senate Finance Committee, United States Senate,
Washington 25, D. C.*

DEAR SIR: We wish to call to your attention an extreme, and we believe, highly inequitable, penalty which would be imposed upon the Cleveland-Cliffs Iron Co.

if section 309 of the Internal Revenue Code of 1954 were enacted in the form in which it is set forth in H. R. 8300. That section would require our company to pay an 85 percent tax on sinking fund purchases and redemptions in the normal operation of our business with respect to our $41,600,000 of preferred stock, which has been outstanding since 1929.

Our company is a publicly held company with 2,266,838 shares of common stock listed on the Midwest Stock Exchange and owned by some 8,100 shareholders, and $41,600,000 of preferred stock which is actively traded over the counter and is held by some 2,500 shareholders.

In 1929 the Cleveland-Cliffs Iron Co., operating one of the largest iron ore mining businesses in the United States, issued 500,000 shares of preferred stock (redeemable at $102.50 per share) as a distribution to its stockholders, who then numbered about 300. This was a preliminary step in the setting up of the Cliffs Corp. which was being organized by a group of Cleveland industrialists to acquire stock in a number of steel and iron-ore companies. After the issuance by the Cleveland-Cliffs Iron Co. of the preferred stock, the common stock was transferred to the Cliffs Corp. for part of its common stock, and control of the company passed to the Cliffs Corp.

In 1947 the Cleveland-Cliffs Iron Co. and the Cliffs Corp. were consolidated into the present corporation, under the name of the Cleveland-Cliffs Iron Co. The holders of 455,237 shares then remaining outstanding of the preferred stock received $45,523,700 par amount of new preferred stock together with 455,237 shares of common stock, and the holders of common stock of the Cliffs Corp. received 1,811,601 shares of common stock. Since that date the outstanding preferred stock has been reduced as a result of purchases by the company to $41,684,000.

Only about $10,500,000 of the preferred stock distributed in 1929 is still held by the holders who received it, or their families. Less than one-fourth of the total preferred stock now outstanding is held by holders in any way related to the original holders. The balance is held by some 2,000 stockholders, most of whom own little or no common stock.

In the normal operation of our business our company would expect to purchase from time to time some of this preferred stock for retirement and the sinking fund provisions of the stock, effective beginning in the year 1956, require us to do so. As we understand the provisions of H. R. 8300, section 309 would require us to pay a tax of 85 percent upon all amounts used for such purposes (except in those cases, if there should be any, where the holder of the purchased preferred stock owned 1 percent or more of our common stock). This would be true even where we had to make the purchases in order to avoid default under the legal requirements of the preferred stock.

We believe the application of this penalty tax with respect to our normal business transactions relating to this stock which has been outstanding for 25 years could hardly have been intended, and we urge the appropriate changes be made in H. R. 8300 to avoid that inequitable result.

Respectfully yours,

H. S. HARRISON, *Vice President.*

BOSTON BAR ASSOCIATION,
Boston, April 16, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: At a meeting of the committee on Federal taxation of the Boston Bar Association held on April 13, 1954, the attention of the committee was directed to a recommendation submitted by George B. Lourie, Esq., relative to amendment of the provisions presently contained in section 461 (c) (2) of H. R. 8300 which is presently being considered by the Senate Finance Committee.

Section 461 provides for a change in the method of taking deductions for Federal income-tax purposes on account of local real-estate taxes. It provides that in the future, such taxes shall be deducted ratably over the period for which they are assessed, instead of being deducted in their entirety upon the assessment date. Section 461 (c) (2) as presently written provides that in the period of changeover from the old to the new system, no such real-estate taxes may be deducted if they had been deducted on a previous return. It was pointed out that this rule will work a substantial practical hardship upon all fiscal year

taxpayers owning real estate in Massachusetts and in other States similarly situated in relation to the date of local tax assessment.

To prevent this substantial practical hardship, Mr. Lourie recommends that instead of denying a property tax deduction in the changeover period to the extent that the tax was allowable as a deduction for a prior year under the 1939 code, the deduction should be allowed in full, but the basis of the property against which the taxes are assessed should be reduced to the extent of what would otherwise constitute a double deduction.

After a full consideration of this recommendation, the committee unanimously voted to endorse the same and to communicate such endorsement to the chief of staff of the Joint Committee on Internal Revenue Taxation, to the chairman of the Senate Finance Committee, which is presently considering H. R. 8300 and to the Senators from Massachusetts who will consider the bill after it is reported by the committee.

This communication is forwarded to you in accordance with the above-described vote of the Committee on Federal taxation.

Very truly yours,

WILLIAM A. PARKS.

BOSTON BAR ASSOCIATION,
Boston 8, Mass., April 16, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: The Committee on Federal Taxation of the Boston Bar Association does herewith submit a proposed amendment to the provisions now contained in section 212 (3) of H. R. 8300 which is presently being considered by the Senate Finance Committee.

Section 212 (3) provides for the deduction by an individual of all ordinary and necessary expenses paid or incurred "in connection with the determination, collection, or refund of any tax." The report of the House committee accompanying H. R. 8300 discloses that the provisions of this section, although in some aspects broader than the present law, may be construed to be limited to cases of contested tax liability. This would in some instances deprive taxpayers of rights to deductions available under existing law. The committee believes that this provision should be broadened so as to include expenses incurred in connection with estate planning and similar situations where advice is given and service is rendered with regard to uncontested or future tax liabilities. To bring about this change, the committee believes that a provision substantially similar to the following should be substituted for the present section 212 (3):

"(3) In connection with the ascertainment or determination by such individual of future or current liability for any tax, or in connection with the determination, collection, or refund of any tax."

After full consideration, the committee unanimously voted to endorse the above amendment and to communicate such endorsement to the chief of staff of the Joint Committee on Internal Revenue Taxation, to the chairman of the Senate Finance Committee, which is presently considering H. R. 8300, and to other interested parties.

This communication is forwarded to you in connection with the above described vote of the Committee on Federal Taxation.

Very truly yours,

WILLIAM A. PARKS.

SERENE, KOSTER & BARBOUR,
CERTIFIED PUBLIC ACCOUNTANTS,
Los Angeles, April 16, 1954.

Hon. EUGENE D. MILLIKIN,
Senate Office Building,
Washington, D. C.

Dear Senator MILLIKIN: We have a number of clients who are confronted with unnecessary litigation and fear of litigation because of a difference of opinion between the Internal Revenue Service and the courts with regard to the interpretation of the phrasing in connection with alimony and separate maintenance payments "under a written instrument incident to such divorce or separation."

In the recent decision of the tax court *Raoul Walsh* v. *Commissioner Docket 32317*, March 31, 1954, 21 Tax Court, No. 120 Opinion by Judge Black, the Tax Court has definitely stated its opinion that contracts made subsequent to divorce are contracts which are "incident to such divorce or separation." The Internal Revenue Service in the past has refused to accept this interpretation and probably will continue to refuse to follow the Tax Court decision. It is believed that a simple clarification in the code would solve this problem without unnecessary further litigation.

We received a letter from one of our clients who is concerned with this problem which we feel gives a very good picture of the problem and we are, therefore, passing it on to you with the hope that something can be done about it in the proposed Revenue Code of 1954.

The following is a copy of this letter:

"Has it ever occurred to you that there are many divorced women in this country today trying to eke out an existence based on alimony payments established prior to inflation or during the depression, which payments are now entirely inadequate? That in many of these cases ex-husands recognize the depreciated buying power of today's dollar, and would in fairness increase the amount of the original alimony commensurate with today's prices. This realistic approach, however, is prevented and deterred for the reason that such increases his alimony would not be deductible unless the entire divorce proceedings be rehashed in court, which most people refrain from doing.

"My suggestion is simply this; that existing contracts providing for alimony payments be subject to amendment without the requirement of court action. Section 71 (a) (1) of the proposed tax bill may provide for this but clarification is necessary. I suggest that the words "and subsequent amendments" be added.

"It is an obvious injustice to make it impossible for divorced wives to keep pace with the present day cost-of-living, and for fair-minded husbands to be prevented from doing the so-called right thing by this oversight in the law. It is unthinkable that the law should provide as the only alternative an open court procedure with all of the attendant publicity, bringing to light skeletons long since closeted and reopening wounds long since healed. When children are involved, the justice is compounded."

We sincerely trust that you will be able to correct this legislation to take care of this problem.

Very truly yours,

SERENE, KOSTER & BARBOUR.
By J. E. RAWLINSON.

(Whereupon, at 1:10 p. m., the committee recessed, to reconvene at 10 a. m., Wednesday, April 21, 1954.)

THE INTERNAL REVENUE CODE OF 1954

WEDNESDAY, APRIL 21, 1954

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

The committee met, pursuant to recess, in room 312, Senate Office Building, at 10:05 a. m., Senator Frank Carlson presiding.

Present: Senators Millikin, Martin, Flanders, Carlson and Byrd.

Senator CARLSON. The committee will please come to order.

I have a letter this morning addressed to Senator George, stating that we have with us this morning the director of training of the international program in taxation at the Harvard Law School, Mr. Herrick K. Lidstone. And I understand that he has some tax people here with him this morning.

Mr. Lidstone, are you in the audience? We are very happy to have you here, and I would be happy if you would just introduce some of the folks that are with you here this morning for the record.

Mr. LIDSTONE. I would like to introduce Abdel Moneim Abd Rabbo, Inspector of Taxes, Department of Taxation, Egypt; Massud Azam Zanghenah, Commissioner of Taxation of Iran; Mr. Miguel Amat, Chief Auditor, Tax Section of Panama; Alban Lataste, Economic Adviser to the Minister of Finance, Chile; and Sylvain Plasschaert, of Belgium.

The international program is designed to do two things: We went to do a little investigation of the problems in taxation, both United States taxation in foreign business, and foreign taxation, and to conduct a training program for tax revision.

These gentlemen are here as a result of our first year's work.

Senator CARLSON. Mr. Lidstone and gentlemen, we appreciate your presence at the committee this morning, and I assume they have tax problems in other countries besides the United States.

The first witness this morning is Mr. Henry P. Isham of the Clearing Industrial District, Inc.

While Mr. Isham is coming up, for the record I would like to submit to Mr. Stam a proposed change in section 172, in regard to the carryover of losses to reflect the carryback date from the date that is in the present bill, December 31, 1953, to October 31, 1953. I am submitting to Mr. Stam a statement on that.

Mr. Isham, we are very happy to have you present this morning, and you may proceed in any way you care to.

STATEMENT OF HENRY P. ISHAM, PRESIDENT, CLEARING INDUSTRIAL DISTRICT, INC., CHICAGO, ILL.

Mr. ISHAM. Mr. Chairman, my name is Henry P. Isham. I am president of the Clearing Industrial District, Inc., Chicago, Ill. My company is usually considered the first in the field of industrial real-estate planning.

Over the years a discrimination has crept into the administration of of the income-tax laws. This discrimination operates at a disadvantage to individuals and corporate dealers in the liquidation of investments in real estate. It is difficult for the dealer-investor in real estate, in contrast with the dealer-investor in other forms of equity, to be taxed on a capital gains basis instead of a current income basis.

The report of the House committee on the proposed Internal Revenue Code of 1954 clearly recognizes this difficulty and, in particular, the discrimination against a real-estate dealer in contrast to a security dealer, in establishing the fact that he purchased a piece of property as an investment and not as stock in trade held for sale to customers in his regular course of business.

Section 1237 of the proposed code recognizes that a dealer can also be an investor, but corporations are excluded from any benefit thereunder. This does not seem fair. Corporations are almost a necessity in any large long-time investment in real estate. This is because of the large amount of money involved, not only in the original purchase, but in carrying for years nonproductive property and paying the real-estate taxes thereon, and because of the difficulties otherwise encountered upon the inevitable death of individuals.

I have a fundamental objection both to section 1237 and 1238. Under these sections absolutely on one is entitled to the capital gains treatment, no matter what he bought the property for or how long he held it, if at any time during his ownership any substantial improvement to the property was made by him or even by a city or a public utility.

Let me drive home the injustice of this prohibition and the harm it will do to our economy, which is so largely based upon the investment of savings of the people in real estate.

Senator CARLSON. The chairman has now arrived and I relinquish the chair.

The CHAIRMAN. Sit still, Senator. Go ahead.

Mr. ISHAM. I just got to my punchline, Senator.

The famous Hetty Green owned a square mile of land halfway between the center of Chicago and its southwest limits. She owned it from approximatley 1870 to 1915. For these 40 years she blocked all special assessments for city streets, sewers or water mains through or around her property. This left this property for 40 years a vacant field and a trash dump. This action on her part also paralyzed any growth or proper use of the property on the area outside of it.

Sections 1237 and 1238 say that by such actions and by such action only she is entitled on sale of the property to treatment on a capital gains basis. Now, in contrast, my grandfather and some of his friends in 1898 organized a company now known as the Clearing Industrial District, Inc. They purchased 8 square miles of poor and largely unused farmland adjacent to the city limits. This purchase was clearly an investment in the future growth of the city of Chicago.

Like Hetty Green, we paid real-estate taxes thereon for years. Like Hetty Green, we received no revenue therefrom for years. Unlike Hetty Green, we not only cooperated with the city in its normal growth, but we installed at our own expense a sewer system to drain the property, roads to reach part of the property, made water available, and permitted public utilities to extend their gas mains and electric transmission lines so their services would be available. This we deemed advisable regardless of the eventual disposition of the property.

Now, in contrast to Hetty Green, both under existing law and under section 1237, we seem to be faced with a tremendous burden in establishing our right to a capital-gain treatment on the sale of all or any part of this investment which we have owned for 56 years.

Senator CARLSON. Mr. Isham, this Clearing Industrial District, Inc., is that a corporation or an investment trust of real property?

Mr. ISHAM. It is a corporation. Under Illinois law for a while a corporation couldn't own real estate. For that period of our ownership we had a land trust.

Can anyone seriously contend that all of this property retained under 1 ownership for 56 years is stock in trade or property held primarily for sale to customers in the ordinary course of trade or business?

The CHAIRMAN. What is the answer to that?

Mr. SMITH. The Ways and Means Committee is having a conference on this, and we are looking into it.

Mr. ISHAM. In addition to the exclusion of corporations, there is this very basic hurdle of the prohibition of improvements.

The CHAIRMAN. Please tell us about the rest of the hurdles.

Mr. ISHAM. Can anyone seriously contend that the sales price of a vacant piece of land is current income to anyone who has paid carrying charges on it for 56 years?

The CHAIRMAN. Mr. Smith, I would like to have that explained pretty carefully in executive session.

Mr. ISHAM. It may be a little out of line, but if you held property for 56 years, you may have bought it for $100 an acre; 56 years later you sell it for $10,000 an acre; $9,900 is considered current income, and if you don't get the capital-gains treatment, you pay 52 percent of that $9,900.

The CHAIRMAN. That seems strange to me. But, go ahead. I am not your counsel. Go ahead.

Mr. ISHAM. Why, merely because the investor is a corporation or because he installs a sewer to convert swampland into dry land, should there be any doubt about his right to the eventual capital-gains treatment after holding property for a period of 56 years?

In a country such as ours, investment of the savings of the people has played a most important part in its growth. These savings have found their way into real property in greater volume than in all the other forms of equity ownership. Investment in real estate should be encouraged, not discouraged.

You are now rewriting the income tax law. One of the stated purposes is to take out those inequities which are discriminating in some way on one group or another. I hope I have demonstrated convincingly one of these inequities, an inequity that is not in the public interest. I hope you can find some way of correcting it. All I am

asking is that an investor and a dealer in real estate be accorded substantially the same treatment as investors and dealers in other forms of property.

Senator CARLSON. Thank you very much.

Mr. ISHAM. May I ask permission to file for the record a prepared statement?

Senator CARLSON. The statement will be put in the record, I assure you.

Senator FLANDERS. Mr. Chairman?

Senator CARLSON. Senator Flanders.

Senator FLANDERS. I would like to make one remark. First, I find this Hetty Green situation very embarrassing because she was a citizen of the State of Vermont.

Mr. ISHAM. She lived in Chicago for quite a while, but, Senator, in a parody of the popular song, "You can have her—she's too tight for me."

Senator FLANDERS. She had her residence in Bellows Falls and she didn't keep up her property any better there than she did in Chicago.

Now, one thing that I hope we can make out of this point, which seems prima facie to be well taken, is whether it introduces or whether it clarifies that sort of a no-man's land in the holding of real estate which exists between that applicable for capital-gains treatment and that applicable for current profits.

Senator CARLSON. We thank you, Mr. Isham.

(The prepared statement of Mr. Isham follows:)

EXPLANATION OF SECTION 1237 OF H. R. 8300 RELATING TO INVESTMENTS IN REAL ESTATE BY DEALERS IN REAL PROPERTY, SUBMITTED BY HENRY P. ISHAM, PRESIDENT, CLEARING INDUSTRIAL DISTRICT, INC., CHICAGO, ILL.

This memorandum explains that impact and injustice of section 1237 of H. R. 8300, the pending Internal Revenue Code of 1954, upon the Clearing Industrial District, Inc., a corporation which purchased about 4,000 acres southwest of Chicago in 1898. A major portion of this large tract of land, together with other land subsequently acquired, has been held for investment, and the gradual increment in value over a long period of years would appear to be the kind of income for which capital gain treatment was intended. Yet, section 1237 of the bill offers no assurance that gain or loss upon the liquidation of this investment will be treated as capital gain or loss.

Dealers in other types of property, including dealers in securities, may make investments in property like that which they hold for sale or for use in their business, but dealers in real estate are subjected to an ever-increasing burden of administrative controversy with the Internal Revenue Service and litigation in the courts to establish their claim to capital gain treatment for real property held by them for investment. Section 1237 prescribes rules under which an unincorporated dealer in real estate will be recognized to have an investment in real property and, upon sale or exchange, to have any loss and that part of any gain in excess of 5 percent of the selling price subject to the general provisions of subchapter P of the new code, relating to capital gains and losses.

The report of the Committee on Ways and Means suggests that the purpose of section 1237 is to insure that real estate dealers should be given opportunities to segregate investments in real estate from any real estate business activities and to receive capital gain treatment on the disposition of such investments in much the same manner that dealers in securities now receive capital gain treatment on securities identified as held for investment purposes. The avowed beneficial purpose of the bill, however, is nullified by the following major defects in section 1237:

(1) *Exclusion of corporations.*—Section 1237 is inapplicable to investments by incorporated dealers in real property although corporations and individuals are generally accorded roughly the same treatment under other capital gain provisions of the Internal Revenue Code.

(2) *Prohibition against improvements.*—Capital gain treatment under section 1237 would not be available in regard to real property upon which any "substantial" improvement is made during the period held by the taxpayer. Apart from the uncertainty as to what would be a substantial improvement either to raw land or land upon which a building or facility has been constructed prior to acquisition by the taxpayer, it is questionable tax policy to preclude the addition of improvements to property which should be made without regard to the ultimate disposition of the premises.

(3) *Penalty requiring treatment of capital gain as ordinary income.*—Although the taxpayer meets all the other restrictive requirements of section 1237 (b) as to identification, holding period, and failure to make substantial improvements—so there can be no question about his having a bona fide capital asset investment—he is required to treat as ordinary income any gain upon disposition to the extent of 5 percent of the selling price. This penalty applies forever, even though the taxpayer may hold the property for 10, 15, or 20 years from the date of identification and even though the property may, on the date of disposition, clearly come within the definition of capital asset or property used in the trade or business under sections 1221 or 1231 of H. R. 8300.

While the primary business of Clearing Industrial District, Inc., is the construction, management, and leasing of improved industrial property, it has also held, solely for investment, land owned for many years by Clearing. On some of the land held for investment there have been no improvements whatsoever. In some cases improvements have included some or all of such betterments as sewers, roads, utilities, and similar additions which an owner of real estate might make without regard to the ultimate use which will be made of the land. It is our view that the capital gain provisions of the Federal tax laws were intended to apply to the liquidation of such investments. Otherwise the taxpayer who sells a tract of industrial real estate would not be allowed to retain sufficient capital to reinvest in other real estate which he thinks may be a good, long-term investment today.

The limitations of section 1237 are as onerous in their terms as the burden under existing law of convincing internal revenue agents that a real estate dealer can have bona fide investments in real property. It is our recommendation, therefore, that capital gain treatment should be applicable to gain or loss from disposition of real estate held for a period of time, whether it be 6 months or 5 years, without regard to identification, improvements made prior to the prescribed holding period, or other restrictions or limitations. Surely any gain accruing over a period of several years should be entitled to capital gain treatment. This would be accomplished under attached alternative draft A.

If this is not feasible, we urge that section 1237 be stricken from H. R. 8300 so that the staffs of the joint committee and the Treasury Department may consult further with the taxpayers whose interests would be adversely affected by its passage. If even this is asking too much, we respectfully suggest that section 1237 be clarified at least to leave real estate dealers in no worse position than they are today with regard to investments in real estate held by them. This would be accomplished under attached alternative draft B.

ALTERNATIVE DRAFT A—SUGGESTED AMENDMENTS TO SECTION 1237 OF H. R. 8300 RELATING TO DEALERS IN REAL PROPERTY

Section 1237 of H. R. 8300 (relating to dealers in real property) is hereby amended to read as follows:

"SEC. 1237. DEALERS IN REAL PROPERTY

"(a) GAINS AND LOSSES.—In the case of a dealer in real property, gain or loss from the sale or exchange of real property shall, notwithstanding the provisions of section 1221 and section 1231, be considered gain or loss from the sale or exchange of a capital asset or of real property used in the trade or business, as the case may be, if such real property was held by the taxpayer for more than [any period from 6 months to 5 years], and if no substantial improvement was made in such real property during the period it was held by the taxpayer or members of his family (as defined in section 267 (c) (4)), by a corporation controlled by the taxpayer, or by a partnership which includes the taxpayer as a partner.

"(b) DEFINITION OF SUBSTANTIAL IMPROVEMENTS.—As used in this section, the term 'substantial improvements' shall not include any improvement completed more than [whatever holding period is provided in subsection (e)] before the

sale of such real property; or any improvement resulting from clearing, leveling, grading, paving, or drainage operations; or any improvement (other than connection of facilities to, or their installation in, any building or structure above ground level) necessary to make generally available throughout such real property services of a type customarily provided by a governmental agency or a public utility.

"(c) EFFECTIVE DATE.—This section shall apply only with respect to sales or exchanges of property occurring after the date of enactment of this title."

ALTERNATIVE DRAFT B—SUGGESTED AMENDMENTS TO SECTION 1237 OF H. R. 8300 RELATING TO DEALERS IN REAL PROPERTY

Section 1237 of H. R. 8300 (relating to dealers in real property) is hereby amended as follows:

1. By amending subsection (b) (1) to read as follows:

"(b) REQUIREMENTS WITH RESPECT TO THE PROPERTY.—SUBSECTION (a) SHALL APPLY TO REAL PROPERTY IF—

(1) After the date of enactment of this title, but before the expiration of the 30th day after the date of its acquisition or before the expiration of the 90th day after the date of enactment of this title, whichever is the later, the taxpayer has elected to have the gain taxed in accordance with the provisions of this section and such real property has been clearly identified (such election and identification to be made in the manner prescribed by the Secretary or his delegate or, in the absence thereof, in the taxpayer's records) as real property held for investment; and."

2. By adding as subsection (f) the following:

"(f) EFFECT OF FAILURE TO IDENTIFY.—In case of the sale or exchange of property as to which the taxpayer has not made the election and identification prescribed by the provisions of subsection (b) (1), none of the provisions of this section shall apply to the determination of taxable gain or deductible loss."

3. By redesignating subsection (f) as subsection (g) and amending it to read as follows:

"(g) EFFECTIVE DATE.—This section shall apply only with respect to sales or exchanges of property occurring after the date of enactment of this title."

Senator CARLSON. The next witness is Miss Patricia McGerr. We are happy to have you with us this morning, and you may proceed in your own way.

The CHAIRMAN. Off the record.

(Discussion off the record.)

Senator CARLSON. Proceed, Miss McGerr.

STATEMENT OF PATRICIA McGERR, MYSTERY WRITERS OF AMERICA, INC.

Miss MCGERR. My name is Patricia McGerr and I represent the Mystery Writers of America. I would like to explain first that while we are an organization of about more than 400 members, with about 325 of these professional writers, which sounds like a relatively small organization, what we have to say about this bill, about the economics of writing in general and the inequities to which we object, applies equally to the authors of books in other fields. So that in speaking for ourselves, we are actually, I think, speaking for the authors of all books.

Our immediate concern, of course, is with section 107 (b) of the present Internal Revenue Code, and the new section 1301 of H. R. 8300, which provides that an author who has spent 36 months on 1 work and receives 80 percent of the income from that work in a single year may, for income tax purposes, spread that income over the same number of years he has spent in writing this particular work.

Now, there are many inequities in this section, but two of them are our chief concern in this present statement. First, very few professional writers spend as much as 36 months on the production of a single work. Too few writers receive 80 percent of the income from a single work in 1 year. While we actually realize the difficulties of estimating accurately the amount of time an author may spend on a single book, it is of course obvious that no author may work for 1 year, much less the 3 years specified by the existing law, on 1 book without outside means of subsistence earned either at other forms of writing or at a salaried job. Moreover, a book may consume only a certain number of months of an author's writing time, but may require years of research for which the author receives no recompense and which may cut into his income-earning hours.

To specify 36 months as the amount of time which must be consumed by an author in writing a single work before he is allowed a modicum of relief in the payment of income tax is, in the opinion of Mystery Writers of America, Inc., an inequity, and works hardship on the great majority of authors who do not take 36 months for the production of a single work.

Mystery Writers of America, Inc., believes that there is inequity in the percentage of income allowed an author in 1 year, under the present tax law, before he may spread this income for the purposes of income-tax payment. Few authors receive 80 percent of their income from 1 work in a single year. An author may sell a book as a magazine serial in 1 year, as a book and to a reprint house in a second year, to a motion-picture company in a third year, and in each of these years receive less than the specified 80 percent of the total income he earns from the book.

An author's income while he is writing a book may be, and frequently is, low. If he sells the book well, with multiple sales, his income may reach astral proportions, with a subsequent astral tax, in 1 year, decline the next year, fall to almost nothing the third year, and abruptly, through a motion-picture sale, soar again in a fourth year. Because of this fluctuation of income the author will be penalized in the payment of income tax to a degree not suffered by a salaried person whose income, over the same period of time, may exceed his own.

Of the writing of books there is indeed no end. In 1953, according to an estimate made by one publisher, 260 million copies of paperbacked books alone were sold in America, not counting sales of hardcover books. This figure comprises all kinds of books: Classics written by men long dead; novels and nonfiction; books of songs and books for children; cook books, religious books, and books on politics; books on how to prepare one's income tax report—and, regrettably, a certain number of lurid tales which were better left unwritten. The great majority of these 260 million books, however, formed a contribution to American letters and thought, and are written by a relatively limited number of living authors.

Because the number of those engaged in the writing of books is small compared with those employed in other professions, and because authors are bound together in no one organization or union, it is easy to underestimate their importance in American life. The fact is, however, that no other single group contributes more than authors

to the upholding of American ideals and the protection of American tradition.

Many authors must in 1 year earn next year's income. The books they are writing today may not be published until 1956. Except in unusual cases, an author's income is lower than that of most salaried workers. Few books are best sellers; even fewer are sold to the movies for $25,000 and up. But even unspectacular sales may raise the writer's income for 1 or 2 years to a bracket where the payment of income for that year will work considerable hardship on him.

Mystery Writers of America, Inc., demands no special privileges for its members; it asks no remittance of any legitimate tax on income derived from the writing of books. It does ask that the importance of all authors, not merely the authors of mysteries, be recognized in relation to the whole of American thought and letters; it does ask that the unique problems of a writer's income receive close and careful consideration, even to the introduction of a resolution before the Congress calling for a change in the whole law covering the income tax to which writers are subject.

As such a change in the entire law would seem to be impossible of achievement at this present time, however, Mystery Writers of America, Inc., therefore respectfully proposes that two changes be made in the present Internal Revenue Code, section 107 (b), new section 1301, H. R. 8300:

1. That the specified time which an author must devote to the writing of a single work be lowered from 36 to 24 months;

2. That the specified percentage of income from that work which the author shall receive in 1 year before he may spread the income for tax purposes be lowered from 80 percent to 50 percent.

The CHAIRMAN. Mr. Smith, what is the matter with that? Why shouldn't we give these people some relief?

Mr. SMITH. We looked into this, and it is just a question of how far we want to go in extending capital-gains treatment.

The CHAIRMAN. Take a good look at this, will you? We have it again and again, but we don't solve it. I think we ought to give more relief to writers.

Miss MCGERR. All we are asking, Senator, is that we spread our income over the years we are working on the book. If we write a book for 2 years, a man who is collecting a salary is earning during those 2 years. We don't start to collect until the book starts collecting royalties, and then if we get a sudden windfall——

The CHAIRMAN. You spend it quick, and when the year comes around you don't have anything to pay taxes with.

Miss MCGERR. That is right.

The CHAIRMAN. Off the record.

(Discussion off the record.)

Miss MCGERR. We would like you to rewrite the whole tax law in our favor, but what we are really asking for is, instead of having to work on a book for 3 years to take this spread, if we write a book for 2 years, which many of us do, and collect 50 percent in 1 year, we would be able to spread our income over 2 years.

Senator CARLSON. Miss McGerr, I followed the text of your release that you have up here on the desk, and you skipped over 2 words in reading your statement. You said something about the great majority

of these 260 million books form a contribution—and you said "not a detriment." Is it possible that some of these are a detriment?

Miss McGERR. There is talk of some of them being a detriment. None of those written by our members, of course, but some of the 260 million may be.

Thank you very much.

The CHAIRMAN. You didn't read your last paragraph.

Senator CARLSON. We will make that a part of the record.

(The prepared statement of Miss McGerr follows:)

STATEMENT BY MYSTERY WRITERS OF AMERICA, INC., NEW YORK, N. Y., RE A REVISION OF THE TAX LAW AFFECTING THE AUTHORS OF BOOKS

Under section 107 (b) of the International Revenue Code now in force (new sec. 1301 of H. R. 8300) an author who has spent 36 months on 1 work and who receives 80 percent of the income from that work in 1 year may, for income tax purposes, spread the income over the same number of years he has spent in writing this particular wook.

The following statement, pointing out the inequities of the above provision concerning the authors of books, is made at the behest of the board of directors of Mystery Writers of America, Inc., an organization of more than 400 members, of which some 325 are professional writers. The organization was founded in New York in 1945 and now comprises branches in the midwest, southern California and northern California. The inequities to which we object, however, apply equally to the thousands of authors of book titles published annually in America in fields other than that which is the particular concern of Mystery Writers of America; in speaking for ourselves we speak for all authors of books.

OBJECTIONS TO THE PRESENT LAW

For the professional writer of books this section 107 (b) of the present Internal Revenue Code, and new section 1301 of H. R. 8300, holds many inequities, of which 2 are our chief concern in this present statement:

(1) Very few professional writers spend as much as 36 months on the production of a single work.

(2) Few writers receive 80 percent of their income from a single work in 1 year.

(1) Mystery Writers of America, Inc., fully realizes the difficulties of estimating accurately the amount of time an author may spend on a single book. It is, of course, obvious that no author may work even for 1 year, much less the 3 years specified by the existing law, on 1 book without outside means of subsistence earned either at other forms of writing or at a salaried job. Moreover, a book may consume only a certain number of months of an author's writing time, but may require years of research for which the author receives no recompense, and which may cut into his income-earning hours.

To specify 36 months as the amount of time which must be consumed by an author in the writing of a single work before he is allowed a modium of relief in the payment of income tax is, in the opinion of Mystery Writers of America, Inc., an inequity, and works hardship on the great majority of authors who do not take 36 months for the production of a single work.

(2) Mystery Writers of America, Inc., believes that there is inequity in the percentage of income allowed an author in 1 year, under the present tax law, before he may spread this income for the purposes of income-tax payments. Few authors receive 80 percent of their income from 1 work in a single year. An author may sell a book as a magazine serial in 1 year, as a book and to a reprint house in a second year, to a motion picture company in a third year, and in each of these years receive less than the specified 80 percent of the total income he earns from the book.

An author's income while he is writing a book may be, and frequently is, low. If he sells the book well, with multiple sales, his income may reach astral proportions, with a subsequent astral tax, in 1 year, decline the next year, fall to almost nothing the third year, and abruptly, through a motion picture sale, soar again in a fourth year. Because of this fluctuation of income the author will be penalized in the payment of income tax to a degree not suffered by a salaried person whose income, over the same period of time, may exceed his own.

Of the writing of books there is indeed no end, even in these days of television. In 1953, according to an estimate made by one publisher, 260 million copies of paperbacked books alone were sold in America, not counting sales of hard-cover books, and 260 million copies, even in paper jackets, is a lot of books. This figure comprises all kinds of books: Classics written by men long dead; novels and nonfiction; books of songs and books for children; cookbooks, religious books, and books on politics; books on how to prepare one's income tax report—and, regrettably, a certain number of lurid tales which were better left unwritten. The great majority of these 260 million books, however, form a contribution, not a detriment, to American letters and thought, and are written by a relatively limited number of living authors.

Because the number of those engaged in the writing of books is small compared with those employed in other professions, and because authors are bound together in no one organization or union, it is easy to underestimate their importance in American life. The fact is, however, that no other single group contributes more than authors to the upholding of American ideals and the protection of American tradition.

Many authors must in 1 year earn next year's income; the book they are writing today may not be published until 1956. Except in unusual cases an author's income is lower than that of most salaried workers. Few books are best sellers; even fewer are sold to the movies for $25,000 and up. But even unspectacular sales may raise the writer's income for 1 or 2 years to a bracket where the payment of income tax for that year will work considerable hardship on him.

SUGGESTED REMEDIES

Mystery Writers of America, Inc., demands no special privileges for its members; it asks no remittance of any legitimate tax on income derived from the writing of books. It does ask that the importance of all authors, not merely the authors of mysteries, be recognized in relation to the whole of American thought and letters; it does ask that the unique problems of a writer's income receive close and careful consideration on the part of our lawmakers, even to the introduction of a resolution before the Congress calling for a change in the whole law covering the income tax to which writers are subject.

As such a change in the entire law would seem to be impossible of achievement at this present time, however Mystery Writers of America, Inc., therefore respectfully proposes that two changes be made in the present Internal Revenue Code, section 107 (b) (now sec. 1301, H. R. 8300):

(1) That the specified time which an author must devote to the writing of a single work be lowered from 36 to 24 months;

(2) That the specified percentage of income from that work which the author shall receive in 1 year before he may spread the income for tax purposes be lowered from 80 percent to 50 percent.

In other words, if an author spends 24 months or longer on the writing of a single work, and receives at least 50 percent of the income from that work in 1 year, he may be allowed, for income tax purposes, to spread that income over the same number of years which he has spent in the production of the book.

Senator CARLSON. The next witness is Mr. James F. Oates, of the Peoples Gas Light & Coke Co. You may proceed in your own way, Mr. Oates.

STATEMENT OF JAMES F. OATES, JR., CHAIRMAN, THE PEOPLES GAS LIGHT & COKE CO., CHICAGO, ILL.

Mr. OATES. Thank you, Mr. Chairman.

I am chairman of the Peoples Gas Light & Coke Co., in the city of Chicago, which is a gas distributing utility in that community.

I welcome the opportunity to appear today about the peculiarly precarious position of operating public utilities. I refer to the allowance of the expense of depreciation, in the light of the reduced purchasing power of the dollar, both from the standpoint of fixing rates by the local regulatory agencies and commission, and also from the stand-

point of the deductibility of the expense of depreciation, in the computation of Federal taxes on corporate income.

Depreciation is well recognized as an expense, a contemporaneous, current, continuing expense. It represents the expenditure each year of the service capacity of the plant that is being consumed that year in the rendering of public service. It comes from wear and tear and obsolescence.

Many years ago it was recognized that the problem of measuring the expense of depreciation, which of course continues over the life of the property, was a difficult one. There was devised as a method to measure the expense of depreciation what has been called the amortization of original cost. That was good method, as long as the dollar which represented the investment in the plant remained approximately the same in its purchasing power. But when the dollar changed in its purchasing power, the method no longer was a good one in measuring the current expense of depreciation.

The CHAIRMAN. Mr. Chairman, may I ask the witness what has happened as the dollar has decreased in value? What has happened to your rates?

Mr. OATES. The rates have not been adjusted to reflect what we regard to be the actual increase in the expense of depreciation, in terms of dollars. And the reason, Senator Millikin, why the regulatory agencies—and some of them have expressed this quite recently—have not granted as an expense an increased dollar charge over amortization of original cost, is because they know that any excess above amortization of original cost will not be deductible in the computation of Federal taxes on income. Consequently, they do not wish, in their own language, to saddle the consumers, the rate-payers, with a payment of an additional corporate income tax.

In other words, if a regulatory agency, say the Illinois Commerce Commission, were to increase the rates of our company to provide for an actual increase in depreciation expense because of the reduced purchasing power of the dollar, they would have to double the amount of excess above amortization of original cost in order that the tax could be paid.

Now, actually, of course, what is happening is that the capital of utilities is being eroded through this process. Unregulated industry has to a degree, and I think rather generally, compensated for the effects of inflation by increasing their prices, which they are free to do because they are not subject to regulation. Also, unregulated industry, many of the trades of the Nation, do not have such a very large percentage of their capital assets represented in the plant that was constructed so many years ago.

Take the Peoples Gas System. We have 3,600 miles of 6-inch mains in the city streets of Chicago, the great bulk of which were installed long prior to the period of inflation. Eighty percent of our assets are in long-lived property. Our suggestion is that the Internal Revenue Code should be amended to provide that in those cases where a regulated utility, as defined in the preferred stock section—the same definition—where a regulated utility has been successful in obtaining an allowance for rate purposes by their own regulatory commission, in excess of the orthodox amortization of an original cost, then and in that event only should the excess be deductible in the computation of the taxes on income.

Now, the reason why we submit that there is justification for singling out the utility industry is twofold: First, a very large percentage of their plant is represented in long-lived assets, so they are the worst hurt; and second, because they are not free to raise their prices to compensate for this increased expense, which unregulated industry is free to do.

Now, there is precedent for recognizing the situation the utility is in, as a regulated industry. Very recently, in the 1950 excess-profits-tax law, which permitted the regulated utilities to fix their credit for excess-profits tax, based upon the books of account kept under the direction of their local regulatory agencies. Now, ideally I think, the utility industry would assert that Congress should say, "You are permitted to deduct in the computation of your tax an expense of depreciation computed upon amortizing an adjusted original cost, to take into account the purchasing power of the dollar." That would be ideal. We are not making that suggestion, because we feel that Congress perhaps would prefer to leave to the local agencies the determination of what the expense of depreciation should be for rate purposes, and then, following that determination, adopt it for tax purposes.

Just two more thoughts, if the committee pleases:

First, in the House, the current tax bill provided a method of depreciation which is known as the declining balance. Under that provision, as you know, for investments made after 1953, two-thirds of the cost can be depreciated over one-half the life of the property. Now, that provision does not deal, nor does it purport to deal, with the problem we are talking about. We are talking about the continued amortization of plant installed long prior to the period of inflation, at a percentage of the then original cost, although the actual investment in terms of original capacity, the real wealth invested in that plant before inflation, can only be described in an increased number of dollars, because the dollars themselves have lost their purchasing power.

Then, the final observation is one of rather fundamental policy, which I will attempt to express as I feel it. The savings of the American people must go into the expansion and development of utility plant throughout the Nation—the gas companies, the electric companies and the telephone companies.

Now, unless the regulatory agencies and Congress, for tax purposes, permit the utility companies to recapture the actual wealth invested in their plant during the process of its consumption, and not simply recapture the nominal dollars which are now no measure of that wealth, the utilities will be required to seek the savings of Americans through the sale of securities, not to expand the public service but to simply keep the utilities where they are and maintain the same service capacity which they had before.

Now, this is not an effort to grant a windfall. Our concept is that any excess allowed for rate purposes and allowed for tax purposes must be reserved in a capital account, similar to the depreciation account, where it will remain and be available for the replacement of the plant. Nor, do we suggest that the utility industry should be permitted to escape paying any tax they are now paying. It is our concept that if the utility is able to get a larger allowance than orthodox amortization of original cost for rate purposes and, therefore, a larger

allowance for tax purposes, the rates of the utility will correspondingly go up and the net effect for tax purposes will be the same. The Federal tax paid by the utilities will be the same.

So, we are not seeking to avoid the payment of any tax that we are now paying.

Thank you very much, indeed.

Senator CARLSON. If there are no questions, we thank you very much, Mr. Oates.

Mr. OATES. I would like to file a statement, if I may, for the record.

Senator CARLSON. Your statement will be made a part of the record.

(The statement referred to follows:)

STATEMENT OF JAMES F. OATS, JR., CHAIRMAN, THE PEOPLES GAS LIGHT AND COKE COMPANY, OF CHICAGO, ON ADEQUATE TAX DEPRECIATION FOR PUBLIC UTILITIES

I am James F. Oates, Jr., chairman of the Peoples Gas Light & Coke Co., Chicago, Ill. Our company is one of the largest gas distributing companies in the country, serving approximately 1 million general customers in the city of Chicago.

The problem which I would like to call to the attention of your committee deals with depreciation. I have prepared a memorandum which discusses this matter in detail and contains a statutory amendment which I would recommend for inclusion in the current tax bill. I would like to have this memorandum inserted in the record as a part of my testimony, but in order to meet the time limitations, I will summarize our position.

1. Depreciation is a current, contemporaneous expense. It is the expense sustained by a business as the result of the continuing consumption of the service capacity of the plant. The consumption is, of course, caused by wear and tear as well as by obsolescence.

2. Early in the administration of the income-tax law it became accepted as fact that a practical and sound method of measuring the expense of depreciation for tax purposes was to ascertain that amount which should be charged each year in order to amortize over the service life of the plant in question its value as represented by the cost incurred in acquiring it. This method was incorporated into gas and electric utility accounting systems somewhere around 1935–40.

3. The amortization of original cost therefore is a method adopted to ascertain and determine the expense of depreciation. It is a good method but its accuracy is based on the assumption that the dollar, which is the measure of the plant investment or cost, will not change appreciably or permanently in its average purchasing power during the total period of amortization.

4. It is common knowledge that the dollar has changed drastically in its purchasing power and there is no reasonable expectation that it will return to the levels existing prior to World War II. Many signs point in the opposite direction.

5. The amortization of original cost, that is, the recapture of the nominal dollars invested in plant, is now no longer a sound or practical method of measuring the expense of depreciation. Those who claim that depreciation is only the amortization of nominal dollar cost are confusing a method adopted to ascertain or measure the expense with the expense itself.

6. The only reason why depreciation is deducted in ascertaining net earnings is that it is an "expense." Like all expenses, depreciation must accordingly be determined in terms of the current dollar. Since the amortization process is no longer sound, because of the change in the purchasing power of the dollar, another method must be found or the amortization process adjusted to meet the changed circumstances. Such a method must be designed to determine the actual economic expense of current wear and tear in terms of the current dollar.

7. Public utilities, whose rates are regulated by public authority, are in a uniquely precarious situation if they are unable over a long period of time to charge rates adequate to cover the actual economic expense of depreciation and, in addition, meet all other expenses and taxes and pay a fair rate of return. Because unregulated industry is free to, and generally speaking has, increased its prices to meet its increased expenses including the expense of economic

depreciation, this problem of recognizing the full expense of depreciation is primarily one of regulated industry.

8. Certain utility companies are now endeavoring to persuade regulatory authorities that the recapture of nominal dollars, through the amortization of unadjusted original cost over the average service life of plant, is not an adequate provision for the actual expense of economic depreciation. It is contended that the recapture of the same number of nominal dollars as originally invested, will necessarily be inadequate since the investment made in actual service capacity has increased in terms of dollars, because the dollar itself has decreased in purchasing power during the intervening period.

9. The ability of utilities to persuade regulatory agencies to allow an adequate expense of economic depreciation is greatly prejudiced and impaired by the fact that only a charge to amortize original cost is now regarded as deductible in the computation of Federal taxes on corporate income. Regulatory agencies are reluctant to grant an adequate depreciation expense because the excess above amortization of original cost is now taxable, with the result that the regulators must grant twice the amount of the excess in order to accord the relief which the utility seeks and requires. An adequate recognition of the existence of increased depreciation expense requires both the inclusion as an expense of the excess above amortization of original cost in the utility's rates and the deductibility of such excess in the computation of the Federal tax on income.

10. It is not our purpose to seek any exemption from present taxes on income for the utility industry. We merely urge that in those cases where utility companies are able to persuade a regulatory agency to allow an amount in rates, as the expense of depreciation, in excess of amortization of original cost, the utilities should be allowed to deduct such an amount as an expense in the computation of the Federal tax on corporate income.

11. At the end of the service life of property, at which point the unadjusted original cost thereof will have been amortized, no further depreciation allowances will or can be requested with respect to such property, even though there may be a substantial deficiency in full recovery of economic depreciation due to the reduced purchasing power of the dollar in years prior to the recognition of the need for adjustment.

12. The capital invested in the enterprise, being the service capacity of the plant, is the wealth represented by the purchasing power of the dollars at the time they were invested. Certainly it is not economically sound to permit the invested capital, as so defined, to be eroded. It is believed, moreover, that Congress should affirmatively permit the deduction of all actual and legitimate depreciation expenses in the computation of a regulated utility's corporate income tax, otherwise the income tax is a capital levy in disguise.

The savings of the American public being invested in the securities of utilities should be used for the expansion of production and other plant and should not be diverted to keeping the existing plant at its present productive or service capacity.

13. It is not believed that Congress in the enactment of income-tax revisions desires to exercise jurisdiction over the regulation of utilities. It is for this reason that the suggestion is made that the test of deductibility for tax purposes might be the action of the regulatory agency.

We agree that the ideal approach to a solution of the tax aspect of the problem would be to revise the code to provide that the depreciation base shall be adjusted from time to time to reflect changes in the current purchasing power of the dollar. It may be, however, that it is not practicable to seek this objective initially and without reference to the actions of regulatory agencies. Accordingly, as a minimum relief at this time, we are asking that utilities be allowed to deduct for tax purposes the depreciation allowance provided by the appropriate regulatory body.

14. If a public utility elects, under the amendment, to deduct for tax purposes the amount of depreciation fixed by the regulatory body, then it ought to continue on such a depreciation system even if the purchasing power of the dollar should increase in the future to such an extent that the allowance granted by the regulatory body might be less than the amortization of original cost.

It is agreed that the full amount of depreciation allowed under the amendment should be placed in a special account and not simply put into surplus from which it could be distributed as a dividend to stockholders. The preservation of the full allowance is necessary in order to serve the actual objective we seek; namely, the protection of the integrity of the capital invested in the enterprise.

RECOMMENDATION TO PROVIDE ADEQUATE TAX DEPRECIATION FOR PUBLIC-UTILITY PROPERTIES; PRESENTED BY THE PEOPLES GAS LIGHT & COKE CO.

(Prepared by its attorneys, Ross & O'Keefe, Chicago)

The Peoples Gas Light & Coke Co., Chicago, Ill., one of the largest retail gas distributors in the country, with approximately 1 million customers in the city of Chicago, urges the enactment of legislation to provide for more adequate tax depreciation for public utilities. This legislation is necessary for the following reasons:

1. With the decline of the dollar within the last 15 years to one-half of its former value, the present allowance for depreciation provided in the Internal Revenue Code has become a wholly inadequate measurement of current wear and tear of depreciable property acquired prior to such period. For example, in the case of property purchased in 1940 and still in use, the annual depreciation allowance for tax purposes represents only one-half of the property actually being consumed each year in the process of production.

2. As a result of the inadequate depreciation allowance, the corporation income tax has become, in part, a capital levy, because it taxes a part of the recovery of the taxpayer's capital. To continue such a tax without corrective amendment would erode, and eventually destroy, the invested capital of private enterprise.

3. Public utilities are most seriously affected by the present inadequate depreciation allowances because of the concentration of their investment in long-lived depreciable property. Many of their fixed assets have useful lives in excess of 50 years, and much of their investment in such properties was made prior to 1940.

4. Public utilities cannot voluntarily adjust their prices to meet increased costs (including actual depreciation) without the approval of the regulatory commissions. The regulatory commissions will not grant adequate depreciation for ratemaking purposes, because, to the extent that depreciation allowed by the regulatory commission exceeds that allowed for tax purposes, it will be taxed as income by the Federal Government and 52 percent of it will be taken away.

For the above reasons, public utilities are not only deprived of adequate tax depreciation, but are also prevented from getting sufficient revenue through their service rates to provide for the recovery of the capital investment in plant and equipment. The result is an unmistakable erosion and destruction of the capital of public utilities.

Accordingly, it is urged that this serious inequity in the Internal Revenue Code be eliminated by an amendment which would give the same depreciation allowance for tax purposes as is granted by the appropriate regulatory commission for ratemaking purposes. This amendment would have these desirable effects:

1. The regulatory commissions could fix depreciation for ratemaking purposes with the knowledge that such amount would be accepted for tax purposes.

2. The full amount of depreciation determined by the regulatory commissions to be necessary for maintenance of the capital investment of public utilities would be able to be retained by the utilities as a part of their reserves without being taxed as "income" under present law.

3. There would be no revenue loss to the Federal Government as a result of the enactment of the amendment, because any increased depreciation allowed for tax purposes would first have to be allowed by the regulatory commissions for ratemaking purposes and such increased depreciation would necessarily be accompanied by additional revenue to offset the added expense of depreciation.

Finally, it should be particularly noted that the revenue-revision bill, H. R. 8300, now before the Senate Finance Committee, contains no provision which is directed at this particular depreciation problem. The liberalization of depreciation, called the declining-balance method, found in section 167, does not help solve the problem facing public utilities for 2 reasons: (1) it is restricted to new properties; and (2) it does not adjust depreciation allowances for substantial changes, past or future, in the value of the dollars invested in utility properties.

The following memorandum explains in further detail the need and justification for the requested amendment. At the end, there is attached a draft of the legislative language which would provide a solution to this serious problem of inadequate depreciation. The draft is so prepared that the amendment may be made a part of H. R. 8300.

I. DEPRECIATION IS A COST OF PRODUCTION

The net income of a business cannot be determined without first allowing for the recovery of all expenses incurred. Depreciation is a very important one of these business expenses. It represents the gradual consumption or use of physical assets, such as plant and machinery, in the process of production. It is just as real a current cost of doing business as wages and salaries paid to employees on the production line. The only difference between depreciation and other current costs, such as wages and salaries, is that depreciation is spread over the useful life of the property and thus deducted proportionately in successive accounting periods.

Since the beginning of the income tax, the Internal Revenue Code has recognized this principle providing for the recovery of capital invested in productive property before arriving at net income. The present tax provision, section 23 (1), allows as a deduction, in computing taxable income, "a reasonable allowance for the exhaustion, wear and tear * * * of property used in the trade or business." This provision has worked satisfactorily in the past, when the dollar was a reasonably stable measure of cost, for it permitted the taxpayer to recover over the life of the property the full investment without subjecting any part of such recovery to the income tax. The original investment of the taxpayer was measured in the dollar cost to him of the property, and he was allowed through depreciation a tax-free recovery of an equal number of dollars over the useful life of the property. As long as the current dollars which are taken as a depreciation deduction are approximately equivalent in value to the dollars which were originally invested in the property, the objective of the allowance for depreciation is achieved. That was generally true up to World War II. While, of course, the value of the dollar fluctuated during that earlier period, it moved up as well as down; the decline of the value of the dollar in one period offset its appreciation in another period.

II. DEVALUATION OF THE DOLLAR HAS MADE THE PRESENT ALLOWANCE FOR DEPRECIATION SERIOUSLY INADEQUATE

Since 1940, however, the dollar has dropped in value continuously. For the year 1953, the dollar has declined in value to 52 cents when compared to its purchasing power in the 1935–39 period, according to the Department of Commerce statistics. And its value may still be declining. Furthermore, it is quite clear that it will not return to anything like its former value.

The effect of this decline in the value of the dollar on tax depreciation, as allowed under the Internal Revenue Code, is that the depreciation allowance is greatly understated for tax purposes, with the result that the investment in depreciable property is not allowed to be fully recovered tax-free. For example, assume a public utility purchased a piece of equipment in 1940 for $200,000. If this equipment has a useful life of 20 years, the utility company is allowed to take a depreciation deduction of $10,000 for each of those 20 years in which the property is used in the business; this is intended to represent the proportionate consumption of the property. Under the present law, this depreciation deduction remains fixed at $10,000 even in the later years when the value of the dollar had declined far below its value at the time the investment was made. Thus, in 1953, a depreciation allowance of only $10,000 is permitted under present law, although that $10,000 does not by any means represent a one-twentieth part (which is the proportionate part of the property worn out in that year) of the utility's real investment in the property. Due to the decline in the value of the dollar to approximately one-half its value since the investment was made in 1940, the $10,000 depreciation deduction represents a recovery of only one-half of the capital consumed during the year. Accordingly, at the end of the life of the equipment in 1960 the utility will have recovered during the life of the property only a part of its original investment. It is true that it will have deducted against its income $200,000 over the 20-year period: but during the last half of the period the value of the dollar had declined to the point where it would take approximately 2 current dollars to equal each of the 1940 dollars which were originally invested in the property. The dollar yardstick for measuring the depreciation had so changed since the original investment was made that the original dollar value may not be used, without substantial adjustment, to express the amount of depreciation sustained in the later years. In order to give the utility appropriate recovery of its 1940 investment which is being consumed in 1953 and subsequent years, the dollar amount of depreciation for those years must be

stated with reference to the 1940 investment in dollars of current purchasing power; in other words, the proper amount of depreciation to be taken by the utility in 1953 would be $20,000 (on the assumption that the 1940 dollar had declined to 50 cents), representing a one-twentieth part of the 1940 investment (stated in equivalent purchasing power) actually used up in 1953.

This example is typical of what is actually happening in industry today. It is estimated that, for the electric, gas, and telephone utilities, the present method of basing depreciation allowances wholly upon unadjusted original dollar cost results in underdepreciation to the extent of approximately $500 million annually; this overstates for tax purposes their actual net income by an equal amount, resulting in over half of the amount by which the depreciation allowance is understated being taken away in taxes. This is the drain which so seriously concerns the utilities at this time; for whenever tax depreciation fails to accurately state true depreciation, the amount by which true depreciation exceeds tax depreciation is taxed as income, although the entire amount of true depreciation is simply the return of real capital invested by the taxpayer.

III. WITHOUT ADEQUATE DEPRECIATION, THE CORPORATE INCOME TAX BECOMES A CAPITAL LEVY

With the decline of the dollar to one-half its value in the last 15 years, the corporate income tax has become, in part, a capital levy due to the failure of the Internal Revenue Code to provide a depreciation allowance which adequately measures the current consumption of properties used up in the production of goods and services. The understatement of depreciation produces an overstatement of taxable income, with an accompanying tax on fictitious profits. With the corporate tax as high as 52 percent, the overstatement of true income is extremely detrimental to the welfare of business in general, and particularly to public utilities. Its significance is that a tax which was originally imposed to share with the Government the profits of a business is now taking a part of the very capital which is so essential to the continued operation of that business. As such a tax continues over a period of years, the injury to business deepens, for more and more of the capital vitally needed for production is drained away. This erosive process cannot go on unchecked without real harm resulting to private enterprise.

IV. REGULATED UTILITIES ARE MOST SERIOUSLY AFFECTED BY THE PRESENT INADEQUATE DEPRECIATION ALLOWANCES

While this understatement of tax depreciation due to the decline in the purchasing power of the dollar affects most businesses, the burden falls most heavily upon those industries which have a concentration of long-lived depreciable property. The utility companies are foremost among those industries whose investments in such assets are high in relation to their total capital and to their annual revenues. Their generators, their gas production plants, their pipelines, their transmission and distribution facilities, and other installations, all have long lives, extending as much as 50, sometimes even, 100 years. With their substantial investment in such long-term assets, the utilities are seriously affected when the tax allowance for depreciation falls far below the amount necessary to permit a tax-free recovery of their investment. In our own company, the Peoples Gas Light & Coke Co., a typical gas-distribution utility, 80 percent or more of its total capital is invested in depreciable assets. On the other hand, there are many industries, such as those engaged in the wholesale or retail trades, in light manufacture, in the processing of goods, and in the construction business, which have relatively little or no investment in long-lived depreciable property. Their capital may be largely invested in inventories, raw materials, goods in process, or in depreciable property with relatively short useful lives. With respect to these industries, of course, there is no major problem as to the inadequacy of tax depreciation resulting from the change in the value of the dollar.

In addition to the fact that public utilities generally have a greater proportion of their investments in long-lived depreciable assets than most businesses, they are more seriously affected by the present inadequate depreciation allowance because they are not free to adjust voluntarily the prices of their products or services to meet their actual costs in a period of inflation. These costs include depreciation based upon the real investment of the public utilities, and not merely the tax depreciation which at present is limited to the historical cost

of the physical assets measured by the nominal dollar amount invested in the property. Industry which is not subject to regulation may adjust its prices at will to meet these actual costs; thus, to a large extent, unregulated industry may protect itself through its own pricing policies from the effects of inflation on tax depreciation. Furthermore, competing firms in unregulated industry are subject generally to the same pressures with respect to their costs in a period of inflation, and therefore they will tend to adjust their pricing upward on a more or less uniform basis in order to meet the rising costs to which all members of the industry are equally subject. Public utilities, however, being regulated as to their rates, are not free to meet these higher costs except upon the approval of the regulatory commissions; and the regulatory commissions are extremely reluctant to approve realistic depreciation rates which are not fully allowable for tax purposes.

V. WHILE UTILITY COMMISSIONS REALIZE THE INADEQUACY OF TAX DEPRECIATION, THEY CANNOT SOLVE THE PROBLEM ALONE

A number of the public commissions have realized that the tax allowances for depreciation have become wholly inadequate by reason of inflation, and a few have tried to meet the problem to some extent by granting larger allowances in the ratemaking process. For example, in the rate case of *The Peoples Gas Light and Coke Company* (97 P. U. R. (N. S.) 33 (1953)), the Illinois Commerce Commission granted over $500,000 additional depreciation (above tax depreciation) in view of "the changes which have occurred in economic conditions." The Commission went further and allowed some $100,000 in additional rates to cover in part the income taxes which would be levied upon that part of its allowance for current depreciation which would not be deductible (being in excess of the corresponding original-cost depreciation) in computing the company's income taxes. However, as a general proposition, extreme reluctance is uniformly shown on the part of the regulatory bodies to provide adequate allowance for actual depreciation due to the fact that the excess of such allowance over the amount of depreciation permitted under the tax laws must be split with the Federal Government for income taxes. In other words, the amount by which actual depreciation exceeds tax depreciation is not permitted to remain in the reserves of the public utility, but is taxed as income, 52 percent of it being thereby drained away into the Federal Treasury. This aspect of the problem was specifically commented upon by the Utah Public Service Commission in the application of the *Mountain States Telephone and Telegraph Company* (99 P. U. R. (N. S.) 1 (1953)), for additional depreciation for ratemaking purposes. In denying the applicant's request for depreciation based upon "the consumption of real capital devoted to the business," the Commission stated: "Under existing Federal tax laws it would be necessary for the applicant to collect in excess of $2 from its customers for each $1 it could retain * * * to provide the extra depreciation allowance contended for." In view of the adverse effect which the Federal taxing provisions now have upon any effort to provide for actual depreciation sustained by the public utilities, the reluctance of the regulatory bodies to increase consumers' rates for such purpose is understandable.

In a more recent rate case (*Re Southwestern Bell Telephone Company* (2 P. U. R. 3d, 1, 22)) before the Arkansas Public Service Commission, the following statement was made by the Commission in the course of denying the application of a utility company for an increase in rates to provide for adequate depreciation accruals:

"We are acutely aware of this problem in utility regulation, and we recognize that depreciation expense computed on original cost during this period of inflation may not maintain the capital committed to the utility service. The problem is currently under consideration by various regulatory bodies, and proposals have been made to change the Uniform System of Accounts to allow for additional depreciation expense.

"However, until some definite action has been taken to modify the Uniform System of Accounts, we do not feel that we can allow this expense for ratemaking purposes. Moreover, depreciation expense in excess of amortization of original cost is not recognized by the Federal Government for income-tax purposes at this time, although hearings have been held to consider proposals to modify the present law. Pending a revision of this law, an allowance for additional depreciation expense would require an increase in revenues of more than twice the amount of the required expense to provide for additional income taxes. We feel that it is unreasonable to expect the ratepayer to bear this excessive burden."

Unregulated industry is not so seriously involved with this problem, for it may voluntarily raise its prices to cover necessary costs (such as actual depreciation), even though the taxing provisions do not give full recognition of all such costs. Moreover, the vast wartime and postwar expansion of the property of unregulated industry has lessened the significance of their prewar properties in respect of the total of all plant and equipment now in use.

VI. CONGRESS HAS RECOGNIZED THE ADVERSE EFFECTS INFLATION HAS UPON TAXATION

With respect to taxpayers who have a substantial part of their investment in inventories, the Congress has provided for the use of the last-in-first-out (LIFO) inventory method, under section 22 (d) (2) of the Internal Revenue Code. Under this method, the income which would otherwise result from repricing at higher current costs the same physical quantities of materials initially carried in inventories at lower costs, commonly called inventory profits, may be largely eliminated by using as the cost of goods sold the most recent purchases of goods. The fictitious income thus attributable to inventories in periods of inflation is thereby excluded from taxable income. This problem which the Congress cured in 1939 for industries with large inventories, such as metal fabricators, tanneries, and also retail and wholesale establishments, by recognizing the LIFO inventory method is very much the same as that which confronts the public utilities today with respect to their depreciation charges for plants and facilities. Fictitious income similarly arises from the inadequate depreciation allowed under the present tax laws.

In 1951, the Congress recognized the tax burden resulting from inflationary gains in the sale of residential properties. Out of concern for the fact that many homeowners were paying income taxes on gains from the sale of their homes simply because the purchasing power of the dollar had dropped substantially since acquiring their homes, the Congress provided in the Revenue Act of 1951 that no such gain would be taxable if the homeowner reinvested with reasonable promptness the proceeds in a new home. In this way, they, too, were protected from having a part of their capital taken away in the form of income taxes.

VII. EMERGENCY AMORTIZATION DOES NOT PROVIDE A SOLUTION TO THE PROBLEM OF INADEQUATE DEPRECIATION

The amortization deduction for emergency facilities which was enacted in 1950 to encourage the development of essential plants in connection with the Korean crisis is not a solution to the tax problem of the public utilities. While the emergency amortization provision gives much earlier (and larger) deductions for certified facilities, it is applicable only to plant expenditure made since the major share of the present inflation took place. Even so, the provision continues to use as the basis for the deduction the original cost measured in dollars which are not adjusted for any change in their purchasing power since the acquisition of the property. Accordingly, if the dollar should drop substantially further in the value between the time when the property was purchased and the year in which the depreciation or amortization deduction is taken, the deduction figure will still be an inadequate representation of the cost of the investment to be recovered.

Similarly, the liberalization of the depreciation allowance under section 167 of the current revenue revision bill (H. R. 8300), wherein there is provided the declining-balance method for measuring depreciation, does not solve the problem confronting utilities. This provision would permit a taxpayer to write off two-thirds of the original cost of the property during the first half of its life. This version of accelerated depreciation will be of very little use to the utilities in meeting their present problem for two reasons. First, it applies only to new properties acquired after 1953. Second, it is still tied to original cost dollars unadjusted for any change in the purchasing power of the dollar. Thereunder, if the dollar fluctuates in value between the time the property was acquired and the period for which depreciation is computed, the allowance under that method in the bill will be either under or over stated, just as it would be under the present method of computing depreciation.

VIII. RECOMMENDED SOLUTION IS THAT PUBLIC UTILITIES BE GIVEN AS TAX DEPRECIATION THE AMOUNT ALLOWED BY THE REGLATORY COMMISSIONS

In order to prevent the income tax from taking part of the capital of public utilities through wholly inadequate depreciation allowances, it is urged, as a

minimum solution at this time, that public utilities be permitted to take as a deducton the amount of depreciation determined to be currently necessary and essential by the regulatory bodies in their ratemaking procedure. Tax depreciation and depreciation for ratemaking purposes are intended to accomplish the same thing; both are designed to provide for the recovery of the investment in depreciable property consumed in the business operations in a given period prior to the determination of net profits. It is believed that the appropriate agency to make a fair determination of necessary and proper depreciation would be the regulatory body having jurisdiction over the public utility. The regulatory agency has the obligation to see not only that the public utility is allowed sufficient reserves to maintain its capital at an efficient operating level for the future but also that the rates for its services to the public are as low as possible consistent with reasonable earnings for the investor. These pressures are counterbalancing and would tend to produce a fair and equitable depreciation allowance; the amount allowed would not be too large because that would increase unduly consumer rates, nor too small because in that event the utility could not adequately maintain its productive capacity. Although traditionally the Internal Revenue Service has had the initial authority over tax deductions, in appropriate cases the Congress has made use of determinations made by other governmental agencies for tax purposes. For example, in the Excess Profits Tax Act of 1950, public utilities were permitted, under section 448, to compute their excess profits tax, credits by reference to the corporate books of account kept by the utilities under the direction of the appropriate regulatory agencies.

The amendment which is attached to this memorandum specifically provides that the amount to be taken for current depreciation is not to be limited by the original dollar cost of the depreciable property as specified under section 113 (b), because it is intended by the amendment to permit the regulatory bodies, if they find it necessary and appropriate, to determine the depreciation allowance by reference to the original dollar investment adjusted to reflect the changed purchasing power of the dollar. Thus, in such instances the total number of dollars charged as depreciation may exceed the number of dollars of greater purchasing power originally invested by the particular utility; but in no case will the value of the depreciation charges ever exceed the value of the investment made. The objective of the amendment is to permit the regulatory bodies to provide an adequate allowance for the full tax-free recovery of the real value of the wealth invested in the physical plant and equipment, and no more. The present law merely permits the taxpayer to recover over the life of the property the same number of dollars which he originally invested in the property; due to the very substantial drop in the value of the dollar during the last 10 years, the taxpayer is not permitted a full tax-free recovery of his investment.

The amendment is made wholly elective, so that no public utility will be forced to use this method for measuring depreciation; those companies which desire to pursue the present depreciation practice may continue to do so undisturbed by the amendment. In addition, the amendment would not allow any public utility to use both this adjusted cost method and the declining balance method prescribed in section 167 of H. R. 8300. While it is felt that utilities generally will find little or no help in the declining-balance method, they should not in any event be permitted to take both accelerated depreciation (which is what the declining-balance method really is) and adjusted-cost depreciation.

Attention should probably be called to the effect and prospective treatment of an offsetting factor in connection with inflation, and that is long-term indebtedness which may be a part of the capital structure of the utility company. To the extent of the borrowed capital, there is a builtin protection against the effects of a rise or fall in the purchasing power of the dollar insofar as the measurement of depreciation is concerned. Thus, to the extent, both as to amount and period of time, that the dollar is stabilized through the hedging effect of long-term indebtedness, the original cost depreciation works satisfactorily. This partial hedge against the decline in the value of the dollar is one of the factors which the regulatory commissions would certainly be expected to take into account in determining the appropriate depreciation allowance for ratemaking purposes. Indeed, in the recent rate case of the Peoples Gas Light & Coke Co., previously referred to, the company itself took the position that it was entitled to depreciation based upon original cost adjusted to the current purchasing power of the dollar only with respect to the equity interest in its depreciable property.

IX. NO SUBSTANTIAL REVENUE LOSS FROM PROPOSED AMENDMENT

While the cost to the revenues of enacting the proposed amendment would be difficult to estimate with accuracy, it is believed that in any event it would not be substantial, for the following reason: The regulatory commissions have at the present time almost uniformly refused to grant more depreciation for ratemaking purposes than that allowed for tax purposes. Therefore, immediately upon enactment of the proposed amendment, there would be no immediate revenue effect. However, with the enactment of the amendment, public utilities could be expected to, and most certainly would, apply to the regulatory commissions for service rates which would reflect adequate depreciation allowances. At that time, the commissions would be no longer deterred from giving full depreciation allowances because of the tax laws; they would be able to grant adequate depreciation allowances in the fixing of service rates with the knowledge that no part of such allowances will be taken from the utilities in the guise of taxes on income. The increases in the depreciation allowances so granted by the regulatory bodies would thus be reflected simultaneously in rate increases fully offsetting the drop in the taxable income of the public utilities which would otherwise result from the increase in depreciation allowances alone. For example, if the regulatory commission in its ratemaking process gave an increase in the depreciation allowance of $500,000, the commission could only do so effectively by increasing the revenues of the utility to make up for the added expense. Accordingly, there would be no actual decline in the taxable income or the income tax of the public utility. However, the depreciation accumulations by the utility would thereby be restored to an adequate level for continued maintenance of its service capacity and capital investment.

For this reason it is doubtful that the revenue cost of the enactment of the proposed amendment could be substantial.

APPENDIX A. AMENDMENT TO PROVIDE ADEQUATE DEPRECIATION FOR PUBLIC UTILITIES

Add the following new subsection at the end of section 167 of the Internal Revenue Code of 1954, as contained in H. R. 8300:

"(i) DEPRECIATION FOR PUBLIC UTILITIES.—For taxable years ending after December 31, 1953, at the election of a public utility (as defined in sec. 247 (b)) the term 'reasonable allowance' as used in subsection (a) shall be an allowance computed according to the method and in the manner prescribed for ratemaking purposes by the appropriate regulatory agency or appellate body with respect to the utility property held by such taxpayer. The election of such method shall be made in accordance with such regulations as the Secretary or his delegate may prescribe, and shall be irrevocable for the taxable year in which it was made and for all subsequent taxable years, unless a change to a different method is approved by the Secretary or his delegate. The allowance under this subsection shall not be limited to the adjusted basis of the property under section 1011. In computing the adjusted basis of property with respect to which an election has been made under this subsection, the adjustment for exhaustion, wear and tear, obsolescence and amortization required under section 1016 (a) (2) for taxable years to which such election is applicable shall be determined under subsection (b) (1). For taxable years to which an election under this subsection is applicable, the taxpayer shall not be entitled to use the method prescribed by subsection (b) (2) or (3). In no case shall this subsection apply to that part of any property with respect to which the taxpayer is entitled to take an amortization deduction for an emergency facility under section 168."

Senator CARLSON. The next witness will be Mr. Sherlock Davis, United States Cuban Sugar Council.

Mr. Davis, we appreciate your appearance before the committee, and you may proceed in any way you care to.

STATEMENT OF SHERLOCK DAVIS, GENERAL COUNSEL, UNITED STATES CUBAN SUGAR COUNCIL

Mr. DAVIS. My name is Sherlock Davis. I am general counsel of the United States Cuban Sugar Council.

The United States Cuban Sugar Council consists of a group of companies producing sugar in Cuba, which are publicly owned and the majority of stockholders of which are American citizens.

We have a large investment in Cuba, and therefore, we are particularly interested in those sections of this bill which are designed to encourage new American investment abroad, because the encouragement of new American investment abroad naturally depends in a substantial measure on the welfare of existing American foreign investments. We are, therefore, particularly interested in sections 901, 903, and 923 of this bill.

I have prepared a statement which is before the committee, with suggested amendments to the bill, and with your permission I will merely say a few words here, in the interests of conserving your time this morning.

Senator CARLSON. We appreciate very much your trying to conserve our time, and your statement will be made a part of the record.

(The statement referred to follows:)

STATEMENT BY SHERLOCK DAVIS, GENERAL COUNSEL, UNITED STATES CUBAN SUGAR COUNCIL

The United States Cuban Sugar Council, which I represent, is composed of a group of companies which own or operate sugar properties in Cuba, the stockholders of which are predominantly United States citizens. The securities of 11 of these companies are listed on securities exchanges in the United States, and their shares are widely distributed among investors in this country. These companies account for approximately 40 percent of the total output of sugar in Cuba. The names of the companies are listed at the end of this statement.

Under the present United States sugar legislation, Cuba is granted a quota of sugar which may be sold in the United States markets. This quota amounts at present to about 40 percent of the total Cuban production. Every sugar mill is allotted by the Cuban Government a portion of that quota. Thus, in a general sense, part of the raw sugar and part of the refined sugar extracted by every mill and refinery in Cuba may be intended for use or sale in the United States. (Any mill is free to sell its United States export permits or certificates to another mill in exchange for that other mill's permits to export to some other destination).

As our companies have large investments in Cuba in the form of plantations, sugar mills, storage and transportation facilities, and refineries, they are interested in the provisions in the revenue bill which are intended to encourage American investments abroad, particularly the following:

Section 901, which allows a credit for Cuban taxes against the United States tax; and

Section 923, which allows a rate reduction of 14 percent on dividends received by a domestic corporation from a Cuban corporation, or income withdrawn by a domestic corporation from a branch in Cuba, under conditions specified in the bill.

CREDIT FOR CUBAN TAXES

The Cuban counterpart of the United States income tax on companies producing sugar is composed of at least three separate taxes, as follows:

1. The municipal tax on net income (renta liquida) determined on a statutory basis, with additional percentages of the tax for the benefit of the municipality and province, and a national tax on the same basis as the municipal tax.

2. A tax levied by reason of extraordinary war profits, but measured by 16 cents per bag of sugar; and

3. A national profits tax on net income in determining which of the two previous taxes are allowed as deductions.

At present our companies are allowed to take credit in the United States for only the greatly reduced income tax—reduced as the result of deducting the other taxes. This leaves an excess of the United States rate over the Cuban effective rate.

In 1942 the Senate Finance Committee sponsored an amendment in subsection (h) to section 131 of the Internal Revenue Code of 1939, which was intended to extend the scope of the section and allow a credit for taxes measured; for example, on gross income, gross sales, or the number of units produced which are imposed in lieu of an income tax otherwise generally imposed. This implied a broad interpretation of section 131 so as to give a more adequate relief from international double taxation.

We thought that the first two taxes enumerated above would be covered by the amendment. The municipal taxes are imposed on a statutory definition of income under which gross income is computed by multiplying the number of units produced by the official price per unit, and net income is determined by deducting 80 percent representing costs of growing and processing if the mill grinds cane grown on its own lands, or 60 percent representing costs of processing if it grinds cane bought from farmers. The formula gives a net income which corresponds to net income as computed under American concepts. It seems to us that credit should be allowed for such a tax as an income tax under subsection (a) of section 131, or as a tax in lieu of the income tax generally imposed, especially as corporations in general have been allowed a credit for the same tax on net income under another subsection of the same section of the Cuban law. (*Havana Electric Railway, Light & Power Co.*, 34 B. T. A. 782).

Likewise, to avoid administrative difficulties, the Cuban extraordinary war-profits tax is reduced to the simplest terms of 10 cents per bag of sugar produced. Nevertheless, it takes the place of a war-profits tax such as might be imposed by the United States. It was introduced during World War I when income-tax administration in Cuba was very underdeveloped and, in fact, the administration has not made much progress since toward attaining the high proficiency of our internal revenue service. However, American taxpayers should not be penalized by not being allowed to credit these taxes as foreign income taxes. Full details concerning these two taxes can be supplied if desired.

The justice of this contention was recognized in a letter dated May 29, 1952, from Senator Walter F. George, chairman of the Finance Committee in 1942, when section 131 (h) was sponsored by your committee, and still in 1952, when the letter was written and published in the Congressional Record June 27, 1952.

Senator George protested against the restrictive regulations issued by the Treasury, enunciated certain criteria for carying out the intent of Congress as shown in the statement on section 131 (h) in the Senate Finance Committee report on the 1942 bill (S. Rept. 1631, 77th Cong., 2d sess., pp. 131, 132), and cited these two taxes as within the purview of the section.

Instead of liberalizing the regulations, the Treasury has brought forth a new concept known as a principal tax, which is to be allowed as a credit as an alternative to the income tax, so that if a corporation took a credit for such a tax it would lose the credit for the income tax. Furthermore, the principal tax is to be measured in terms of the amount paid as such tax by the taxpayer as compared with the amounts paid as other taxes. The principal tax may not be, on the one hand, an income tax or a social-security tax, or, on the other hand, a sales, property, turnover or excise tax which is generally imposed. These terms are broad enough to cover every conceivable type of tax, but the House report says that one of these latter taxes may be allowed as a credit if selectively imposed on a particular industry.

We are concerned because these taxes we have described are generally imposed on sugar companies, and, therefore, we hesitate to rely on the qualification of selectively imposed because the Treasury is not likely to grant the credit unless the criterion is in the law itself. Moreover, it seems to us that this criterion is too indefinite.

As the former chairman of this committee has advised the Treasury in his letter of May 29, 1952, that the original intent of section 131 (h) was to cover taxes such as these, we urge that the provisions in section 131 (h) of the Internal Revenue Code of 1939 be clarified to carry out this original intent and be incorporated in the proposed Revenue Code of 1954. The attached draft of an amendment suggests that the provision allow a credit for taxes imposed wholly or partially in lieu of an income tax and define the types of taxes intended to be covered as indicated in the letter from Senator George.

In order to carry out the original intent as expressed by Senator George, the credit would include these two empirical income taxes together with the profits tax, subject only to the limitation of the amount of the United States tax on income from Cuba, found in section 904 of the bill.

SUGAR MILLS SHOULD BE ENTITLED TO 14 PERCENT TAX REDUCTION

The bill contains in section 923 a provision for granting a 14 percent reduction in tax for income of certain classes, including dividends from a foreign corporation and income withdrawn from a branch which elects the deferral of income, provided in either case that it derives 95 percent of its gross income from sources without the United States, and 90 percent or more of its gross income from the active conduct of a trade or business, and not more than 25 percent from the sale of articles or products manufactured in such foreign country and intended for use, consumption or sale in the United States.

The foreign corporation or elected branch must derive at least 90 percent of its earnings from the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business, but not through an establishment engaged principally in the purchase or sale of goods other than at retail, or through an office or agent to import or facilitate the import of goods or merchandise into a foreign country.

Perhaps the principal American investment in Cuba is in sugar plantations, mills, and refineries. None of these terms is found in the recital of establishments which qualify. Yet any one of them might be assimilated to a factory so as to qualify for the 14 percent credit. Sugar is manufactured by nature and is in the cane through the action of sun and moisture. A raw-sugar mill separates, but not completely, the sugar from other materials and ingredients which make up a stalk of cane. A sugar refinery carries the cleaning process further so that what is left is practically 100 percent sugar.

Such operations all involve a considerable investment and should therefore entitle the domestic corporation receiving the income to the reduced rate thereon. However, a given establishment might sell raw or refined sugar at wholesale.

Furthermore, more than 25 percent of the sugar produced is usually intended for use or consumption in the United States. The House report on page A255 says that the latter requirement is confined to manufacturing and would not apply, for example, to the mining or processing of metals or the extraction or refining of oil for consumption, use or sale in the United States. Surely the production of raw and refined sugar should be similarly treated.

RECOMMENDATION

Sections 923 and 951 should be amended so as expressly to allow the 14 percent credit to domestic corporations deriving dividends from a Cuban corporation, or income withdrawn from an elected branch situated in Cuba, which grows cane on a plantation, extracts raw sugar at a mill, or pure sugar at a refinery in Cuba and sells it wholesale in Cuba, or for consumption use or sale in the United States.

MEMBERS OF THE COUNCIL

Central Altagracia Sugar Co.
Central Hormiguero Sugar Co.
Central Violeta Sugar Co.
Cuban Atlantic Sugar Co.
Guantánamo Sugar Co.
Manatí Sugar Co.
Miranda Sugar Co.
Punta Alegre Sugar Corp.
The American Sugar Refining Co.
The Cuban-American Sugar Co.
The Francisco Sugar Co.
The New Tuinucú Sugar Co.
United Fruit Co.
Vertientes-Camagüey Sugar Co.

SUGGESTED AMENDMENTS TO SECTIONS 901 (b), 902, 903, AND 955, H. R. 8300

(1) Amend section 901 (b) (1) to read:

"(1) CITIZENS AND DOMESTIC CORPORATIONS. In the case of a citizen of the United States and of a domestic corporation the sum of—

"(A) the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to a foreign country or to a possession of the United States; and

"(B) the amount of any principal taxes described in section 903 for each separate trade or business of the taxpayer paid or accrued during the taxable year to a foreign country or possession of the United States."

(2) Amend section 902 to read:

"SEC. 902. CREDIT FOR CORPORATE STOCKHOLDER IN FOREIGN CORPORATION.

"(a) TREATMENT OF TAXES PAID BY FOREIGN CORPORATION. For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting

stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of the sum of the following taxes as the amount of such dividends bears to the amount of the accumulated profits of such foreign corporation from which such dividends are paid:

"(1) any income, war profits, or excess profits taxes paid or accrued by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to such accumulated profits; and

"(2) at the election of the domestic corporation, for each year involved in the computation of the credit permitted by this section, any principal taxes described in section 903 for each separate trade or business paid or accrued during such year to the government of any foreign country or any possession of the United States by such foreign corporation, but only in the proportion of such principal taxes which the accumulated profits of such foreign corporation for such year bear to its gains, profits, or income for such year; and not exceeding an amount computed by multiplying such foreign corporation's accumulated profits for such year by a percentage equal to the sum of the normal tax rate and the surtax rate prescribed in section 11 which apply to the taxable income of the domestic corporation for the taxable year of the domestic corporation in which such dividends are includible in its gross income; and

"(3) the taxes deemed to have been paid by such foreign corporation under subsection (b), but only in the proportion specified in paragraph (2) of this subsection.

"(b) FOREIGN SUBSIDIARY OF FOREIGN CORPORATION. If such foreign corporation owns 50 percent or more of the voting stock of another foreign corporation from which it receives dividends in any taxable year, it shall be deemed to have paid the same proportion of the sum of the following taxes as the amount of such dividends bears to the amount of the accumulated profits of the corporation from which such dividends are paid:

"(1) any income, war profits, or excess-profits taxes paid or accrued by such other foreign corporation to any foreign country or to any possession of the United States, on or with respect to such accumulated profits; and

"(2) at the election of the domestic corporation, any principal taxes paid or accrued by such other foreign corporation to the government of any foreign country or of any possession of the United States, under the circumstances and subject to the limitations described in subsection (a) (2), but as if such other foreign corporation were the foreign corporation described in such subsection."

(3) Amend section 903 to read:

"SEC. 903. DEFINITIONS.

"(a) TAXES IN LIEU OF INCOME, ETC., TAXES.

"(1) For the purpose of section 131 (h), Internal Revenue Code of 1939, as amended, and sections 901, 902, and 955 and section 164 (b) (6), the term "income, war profits, and excess-profits taxes" shall include a tax paid wholly or partially in lieu of a tax upon income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

"(2) In determining whether a tax is wholly or partially in lieu of an income tax such as, for example, by reason of being imposed on a statutory definition of income, or by being based on gross income, gross sales, or the number or price of units produced, or by including in its base the assets which produce the income, or by being allowed as a credit or deduction in computing an income tax, or in any way reducing the amount or the rate of such tax, or although replacing the general profits tax is supplemented by an income tax, and whether or not such tax is shown by its legislative history to reach income in its broad sense, the Secretary or his delegate shall take into account the terms of the law of the country which imposes the tax.

(b) PRINCIPAL TAX. For purposes of this subtitle, the term "principal tax" means any tax paid or accrued during the taxable year to the government of a foreign country or of a possession of the United States which is attributable to the operation of a trade or business regularly carried on by the taxpayer and which constitutes a principal source of tax revenue to such government from such trade or business, except that

"(1) no general sales or real property tax imposed by such government, and,

"(2) no income, war profits, or excess profits tax shall be included as a principal tax or be considered for the purpose of determining such principal source of tax revenue."

"(c) FOREIGN COUNTRY OR POSSESSION. For the purpose of sections 901, 902, 903, and 955, the term 'foreign country or any possession of the United States' includes any political subdivision of such country or possession."

(4) Amend section 904 to read:

"SEC. 904. LIMITATIONS ON CREDIT

"(a) LIMITATIONS. The amount of the credit in respect of all taxes, including those defined in section 903, paid or accrued to any country shall not exceed the same proportion of the tax against which such credit is taken (computed without regard to the credit under section 37 relating to credit with respect to business income from foreign sources) which the taxpayer's taxable income from sources within such country (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year. In the case of a corporation allowed a credit under section 37, the amount determined under the preceding sentence shall be reduced by the amount of such credit in respect of income from sources in such country."

(5) Amend section 955 to read:

"SEC. 955. FOREIGN TAX CREDIT

"For purposes of section 901, a domestic corporation which has withdrawn branch income from an elected branch under section 954 for any taxable year shall be deemed to have paid the same proportion of the sum of the following taxes as the amount of such branch income withdrawn bears to the amount of the branch income (as determined under section 954 (c)) from which such branch income is withdrawn—

"(1) any income, war profits, or excess profits taxes or accrued by such branch to any foreign country or to any possession of the United States, on or with respect to such branch income; and

"(2) at the election of the domestic corporation, for each year involved in the computation of the credit permitted by this section, any principal taxes described in section 903 for such trade or business paid or accrued during such year to such government by such branch, but only in the proportion of such principal taxes which the branch income of such branch for such year bears to such branch income (computed without the deduction for any income, war profits, and excess profits taxes paid or accrued to any foreign country or to any possession of the United States) allocable to such branch for such year; and not exceeding an amount computed by multiplying the branch income of such branch for such year by a percentage equal to the sum of the normal tax rate and the surtax rate prescribed in section 11 which apply to the taxable income of such domestic corporation for its taxable year in which such branch income withdrawn is includable in its gross income."

The reference to the opening sentence of the proposed amendment to section 903 (a) (1) inserts the language "For the purpose of section 131 (h), Internal Revenue Code of 1939, as amended" so as to indicate with maximum clarity and directness the retroactivity of the restored provision. As an alternative to such method of showing retroactivity, a similar result could be achieved by amending section 7851 (a) (1) A to read as follows (additional language indicated by italics):

"(A) Chapters 1, 2, 4, and 6 of this title shall apply only with respect to tax able years beginning after December 31, 1953, and ending after the date of enactment of this title, and with respect to such taxable years, chapters 1 (except sections 143 and 144) and 2, and section 3801, of the Internal Revenue Code of 1939 are hereby repealed, *except that section 109 of such Code is clarified by section 921 of Subtitle A and section 131 (h) of such Code is clarified by section 903 (a) of Subtitle A of the Internal Revenue Code of 1954.*"

Mr. DAVIS. Now, Mr. Chairman, the President, in several messages to Congress, notably his message on the budget and his message on foreign economic policy, has pointed out the desirability of encouraging American investments abroad. And he has stated that one method of encouraging this form of investment is by relaxing the provisions of the tax law pertaining to tax credits in the United States for taxes paid by American companies abroad to foreign governments.

Testifying before this committee, the Secretary of the Treasury has pointed out that, in his opinion, H. R. 8300 is designed to effectu-

ate this policy. In our opinion, the language employed in sections 901, 903, and 923, as they probably will be interpreted by the Bureau of Internal Revenue, will fail to accomplish the desired result. As I have said, our suggested changes in these sections have been submitted to the committee.

I should merely like to point out that section 901, which allows credit for certain Cuban taxes against the United States tax, seems even more restrictive than the present 131 (h) of the Internal Revenue Code of 1939, which in itself merely gave us credits for a small proportion of the taxes which we actually pay in Cuba. In this connection, I should like to suggest to the committee that the strongest argument in favor of the justice of our position was a letter written by Senator George, under date of May 29, 1952, and published in the Congressional Record of June 27 of that year, on the subject of section 131 (h).

In this letter Senator George protested against restrictive regulations issued by the Treasury, and enunciated certain criteria for carrying out the intentions of Congress in the administration of this section. This letter, in our opinion, completely supports our position, and we do not intend to go beyond the four corners of Senator George's position.

Finally, we would like to say in this section that the new concept of a principal tax will present very serious problems of interpretation. Now, section 923 of the bill provides for the granting of 14-percent reduction in tax for income of certain classes, including dividends from foreign corporations and income withdrawn from a branch, which elects the deferral of income. Such corporation or branch, however, must derive at least 90 percent of its earnings, and I quote—

> from the active conduct of a trade or business, through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business, but not through an establishment engaged principally in the purchase or sale of goods other than at retail.

We think it should be made clear that sugar refineries and sugar mills fall within that definition. We think it also should be made clear that our companies are not deprived of the 14-percent tax reduction because more than 25 percent of the gross income may be derived from the sale in the United States of sugar extracted from sugar cane in Cuba.

It is our respectful suggestion to the committee that these sections be referred, with our recommended changes, to the technicians of the staff for review. I would like the indulgence of the committee to read into the record one 3-line proposed amendment, which has occurred to me since our statement was prepared. With your permission, Mr. Chairman, we should like to suggest the following amendment to section 923 (b) (3):

> (3) The term "articles or products manufactured" shall not include products or commodities which have been processed in such foreign country from the agricultural products or the natural resources thereof.

I thank you very much, Mr. Chairman.

Senator CARLSON. If there are no questions, we thank you.

The next witness will be Mr. Laurence A. Crosby, American Chamber of Commerce of Cuba. We are happy to have you with us, Mr. Crosby. You may proceed.

STATEMENT OF LAURENCE A. CROSBY, CHAIRMAN, TAX COMMITTEE, AMERICAN CHAMBER OF COMMERCE OF CUBA

Mr. CROSBY. My name is Laurence A. Crosby. I am an American citizen, a resident in Cuba, and chairman of the tax committee of our American Chamber of Commerce in Habana.

Our chamber of commerce includes American firms or representatives of American firms in the aggregate number of about 170. It has been established for more than 35 years.

We are, of course, very much interested in the foreign tax credit provisions of the bill, and particularly sections 901, 903, and 923, to which Mr. Sherlock Davis referred in his testimony.

I have filed a written statement with the committee, for the record.

Senator CARLSON. It will be made a part of the record.

Mr. CROSBY. And I do not intend to take the time repeating statements that are set forth therein.

Senator CARLSON. Do I understand, Mr. Crosby, that you are in complete concurrence with the statements made by Mr. Davis?

Mr. CROSBY. Yes, I am, Mr. Chairman. And I would like to be permitted to endorse the statements which he has made, and to add this further thought—and I am particularly anxious to add it because I happen myself to be in the sugar business in Cuba, the production of raw and refined sugar. I speak for a wider field than just the sugar industry in Cuba. I speak for our members of the chamber of commerce, who are representatives of many American corporations engaged in other business and trade in Cuba, who are also equally interested.

We have in Cuba establishments of the principal American rubber companies, establishments of drug companies, establishments of soap companies, establishments of oil companies, and they are all interested in the scope and application of section 923 and desirous of its clarification, as suggested by Mr. Davis.

They are also interested in the point which he made, that section 131 (h) of the existing Internal Revenue Code, should not be narrowed or omitted from the law as revised by the proposed bill, through the adoption of the principal tax concept suggested by section 901 and 903.

I thank you, Mr. Chairman.

Senator CARLSON. We thank you very kindly.

(The prepared statement of Mr. Crosby follows:)

STATEMENT OF LAURENCE A. CROSBY, CHAIRMAN, TAX COMMITTEE, AMERICAN CHAMBER OF COMMERCE OF CUBA

The American Chamber of Commerce of Cuba welcomes the declared intent to encourage American investments in Cuba in the pending reform of the Internal Revenue Code, but is deeply concerned over two of its features because they may nullify its intended benefits.

SECTION 131 (H) SHOULD BE RETAINED AND CLARIFIED

The first is the repeal of the credit for taxes in lieu of income taxes in section 131 (h), Internal Revenue Code of 1939, as amended, and replacing it by a credit for a new and uncertain concept of "principal tax," which is defined so as to exclude a sales, property, turnover, or excise tax—in other words, every conceivable tax—which is generally imposed (sec. 903, H. R. 8300). Contrary to the statement in the President's budget message of January 21, 1954, to the

effect that the credit should be broadened, this measure would narrow the credit in two ways:

(1) The principal tax would be allowed as a credit only as an alternative to the national income tax so that if credit were taken for it, the taxpayer would lose the credit for the income tax.

(2) Whereas under section 131 (h) credit is allowable for an in-lieu tax generally imposed, under the "new concept" credit would be allowed only for a principal tax which is not generally imposed—or, as the House report says, which is selectively imposed, e. g., on a particular industry.

The report also indicates that a reason for adopting the new concept is that it should avoid inducing foreign countries to increase thier income-tax rates so as to absorb the full allowable credit. However, the principal tax concept may induce foreign governments to adopt any kind of tax not related to income which is selectively imposed on industries belonging primarily to Americans—thus placing them in a worse position than they are now.

In any event, the American Chamber of Commerce of Cuba urges the retention of section 131 (h) in the Internal Revenue Code of 1954, with a retroactive clarifying amendment to carry out the original intent of this provision as set forth in the Senate Finance Committee report on the 1942 bill, and as further interpreted in the letter of May 29, 1952 (Congressional Record, June 27, 1952), sent to the Treasury by Senator Walter F. George, chairman of the Finance Committee, when the subsection was enacted in 1942, and when he wrote the letter. He suggested certain criteria that would be incorporated in the regulations and mentioned three Cuban taxes that should come within the subsection, as follows:

1. Municipal and national taxes paid by sugar mills which are based on a statutory definition of income, whereby gross income is computed by multiplying the number of units produced by the officially fixed price per unit, and net income by deducting a percentage of 80 percent or 60 percent representing costs;

2. A tax levied on sugar companies by reason of extraordinary war profits but measured by 10 cents per unit produced;

3. A tax which is levied on certain other enterprises at so much per unit produced in lieu of the profits tax, but is supplemented by a special income tax.

The letter from Senator George states that all three of these taxes were within the original intent of Congress on the scope of section 131 (h), as they come within the examples of taxes measured by gross income, gross sales, or the number of units produced which are levied in lieu of an income tax that would otherwise be imposed.

The Treasury, however, embodied in the regulations only one type of tax, namely, a tax at a fixed rate on gross income in complete substitution for a tax at a higher rate on net income, which had been held even prior to the enactment of section 131 (h) to be an income tax allowable as a credit under subsection (a) of section 131. (*Seatrain Lines, Inc.*, 46 B. T. A. 1076.) Hence, the regulations did not extend the scope of the section.

However, it has been recognized in the Internal Revenue Service that credit should be allowed for a tax partially in lieu of an income tax. This should mean that it would cover a tax whether allowed as a credit or a deduction.

RECOMMENDATIONS

The foreign tax credit provisions of section 901, etc., in H. R. 8300, should be amended by including in the credit with retroactive effect the existing provisions in section 131 (h), IRC of 1939, but with the insertion of "wholly or partially" before "in lieu of," and possibly other clarifying language to cover the indicated Cuban taxes. It should be made clear that the credit is allowable for the aggregate of such taxes in addition to the income tax, so as to realize the original intent of section 131 (h) as shown in the Finance Committee report on the 1942 bill and the letter from Senator George to the Treasury.

DISCRIMINATION IN THE 14-PERCENT REDUCTION SHOULD BE REPEALED

The American Chamber of Commerce of Cuba is composed of subsidiaries and branches of United States corporations which are competing with Cuban-owned companies as well as subsidiaries and branches of various European countries which pay only the Cuban taxes. The Cuban tax system is composed of several levies of different kinds—some dating back to the period of Spanish sovereignty—and includes empirically determined income taxes, taxes on a unit basis in lieu of profits taxes or by reason of extraordinary war profits, profits taxes,

a combination of excess-profits tax and capital stock tax, and a remittance tax. However, by and large, the effective rate is perhaps about the same as that applicable to western hemisphere trade corporations, i. e., 38 percent.

Hence, the proposal to reduce to 38 percent the rate for dividends from Cuban corporations and income withdrawn from elected branches in Cuba was welcomed with enthusiasm until the conditions were fully understood (sec. 923 of H. R. 8300). The restriction that the reduction could not be enjoyed if the income of the subsidiary corporation or branch was derived to the extent of more than 10 percent from wholesale transactions appears sufficient to deprive many of the parent corporations of the benefit. The sales establishments in Cuba represent considerable investments, yet for some unknown reason they would continue to be subjected to the competitive disadvantage suffered from having to bear the excess of the United States rate over the credit allowed against the United States tax for Cuban taxes.

Very few American-owned establishments in Cuba sell at retail, as that business belongs almost entirely to Cubans. Many American-owned establishments in Cuba do sell at wholesale to distributors in Cuba, whether the goods are imported into Cuba or produced in whole or in part in Cuba. A number began by importing finished products from the United States, and, because of tariffs or competitive conditions, changed to importing parts and assembling them in Cuba, or using local materials in manufacturing there. Few, if any, American-owned factories have been set up in Cuba to manufacture for sale in the American market.

The American-owned sugar mills extract raw sugar from cane grown in Cuba. Refineries buy the raw sugar and refine it into pure sugar. The raw sugar mills and refineries sell wholesale in part to Cuban distributors or users, in part to American importers, and in part to importers of third countries.

Will the fact that, before selling wholesale, a sugar mill first produces raw sugar, or that a refinery produces pure sugar, be sufficient to qualify the recipient of the income for the 14-percent credit because of deriving income from a factory?

Or, as the same establishment both produces and sells wholesale, will there have to be some arbitrary allocation as between the part of the profit attributable to wholesale activities? If so, what will be the measure? One can be sure that, as a 14-percent differential in rate is involved, the Treasury will try to decide the question against the taxpayer.

RECOMMENDATIONS

In short, we urge that this arbitrary discrimination against wholesaling in sections 923 and 951 of H. R. 8300 be removed and that the 14-percent reduction be granted wherever there is involved an investment in the form of a permanent establishment of any kind in Cuba, or of substantial equipment or machinery used by an engineering or construction company. Only in this way can American-owned enterprises in Cuba be placed in a position of competitive equality with the enterprises of Cuba and of third countries.

Moreover, will the Treasury classify as "articles or products manufactured" in Cuba and "intended for use, consumption, or sale in the United States," the two principal natural products of Cuba, namely, sugar and tobacco. Neither ought to be considered "manufactured" in the proper sense of that term. But it is highly important that this legislation be clear and unambiguous, and nondiscriminatory. Therefore, we urge the Senate to delete the limitation in sections 923 and 951 that an American corporation may not enjoy the 14-percent rate reduction if its Cuban subsidiary or elected branch derives more than 25 percent of its gross income from the manufacture of goods for use or consumption in the United States.

Senator CARLSON. Is Mr. Maytag in the committee room?

Mr. MAYTAG. Yes, sir.

Senator CARLSON. Mr. Maytag, we are very happy to have you present this morning, and you may proceed.

STATEMENT OF FRED MAYTAG, CHAIRMAN, TAXATION COMMITTEE, NATIONAL ASSOCIATION OF MANUFACTURERS, ACCOMCOMPANIED BY JOHN C. DAVIDSON, DIRECTOR, GOVERNMENT FINANCE DEPARTMENT OF THE NAM, AND DONALD H. GLEASON, MEMBER, SUBCOMMITTEE ON GENERAL TAX REVISION OF THE NAM

Mr. MAYTAG. My name is Fred Maytag. I am president of the Maytag Co., Newton, Iowa. I am a director and chairman of the taxation committee of the National Association of Manufacturers, and appear here in behalf of the association. I ask that this statement and attached exhibits be accepted for the record.

Senator CARLSON. It will be made a part of the record.

Mr. MAYTAG. Thank you, sir.

If I may, I would like to introduce two associates. Mr. John C. Davidson, director, Government finance department of the National Association of Manufacturers, and Mr. Donald H. Gleason, general tax executive, Corn Products Refining Co., of New York, and member of the subcommittee on general tax revision of the National Association of Manufacturers Taxation Committee, which has made a general study of this bill.

Senator CARLSON. We are pleased to have them with us.

Mr. MAYTAG. We appreciate this opportunity to present our views in connection with H. R. 8300, which will become the Internal Revenue Code of 1954. This legislation is of tremendous importance to American taxpayers, individual and business. A rewriting of the Internal Revenue Code is long overdue. We congratulate and applaud those who have brought this legislation to its present state: Chairman Reed and his associates on the House Ways and Means Committee, the fine staff of the Joint Committee on Internal Revenue Taxation which so ably serves both this committee and the House committee, and the officials of the Treasury Department concerned with tax policy. We heartily endorse the statement of Secretary of the Treasury Humphrey before this committee:

> * * * that a modernization of our tax structure, as provided in part by the present tax revision bill, is something which this Nation must have for continued growth and prosperity.

In short, we give our enthusiastic support to this bill as a whole. In doing so, we know that those who have framed it, and members of this committee, are most anxious to provide the fairest and soundest tax structure possible, consistent with the present revenue needs of the Government. Therefore, we think it appropriate for our association to suggest changes, revisions, or additions where we are convinced improvement in the substance or operation of the law will result.

The tax policies of the National Association of Manufacturers are incorporated in a Federal tax program, the specific recommendations from which are attached as exhibit A.

We covered many of these recommendations in our presentations to the House Ways and Means Committee last summer, and I will not repeat them here, except as necessary to make clear our attitude in regard to specific provisions of H. R. 8300. For example, we then stated our hope that a proper solution to the problem of double taxation of corporate income would be found.

Now, we are happy to give our support to the method included in section 34 of the bill as a first step in dealing with this problem.

Our program is concerned with the fundamentals of tax philosophy, and rests on the belief that the fairest tax system is the best tax system; and that fairness in taxation assures the least impediment to individual initiative and advancement, to maintenance and expansion of the Nation's productive forces, and to the continuous achievement of the maximum levels of economic well-being for all citizens.

One of the fundamental criteria which our program lays down for determining tax policy is that "tax rates should be moderate at all points." While changes in tax rates, except for postponement for 1 year of the 5-percentage-point reduction in the corporate rate scheduled for April 1, 1954, are not provided in H. R. 8300, I think it important to note that many of the problems and inequitable situations with which this bill deals stem in large part from excessive rates of individual, corporate and death taxes. Such rates provoke resistance and evasion: they lead to burdens on some which are ruinous; and they induce wasteful use of human resources in the search for mitigating devices. Above all, such rates are a serious threat to the preservation of a competitive economic system in which everything depends on adequate rewards for individual ambition and initiative.

I emphasize these points, Mr. Chairman, as background for endorsing and commending the objectives, first stated in the President's January tax message, and since repeated by him, by Secretary Humphrey, and by other leaders in the Congress and the administration, that, after this tax legislation has been enacted, "further reductions in expenditures can be applied to our two objectives of balancing the budget and reducing tax rates."

I will now address myself to specific provisions of H. R. 8300.

The corporate rate: Section 11 postpones to April 1, 1955, the 5-percentage-point reduction in the corporate tax scheduled to take place on April 1, 1954. We accept this postponement, on the basis of revised policy initiated at a meeting of our taxation committee on March 26 and approved at a meeting of our board of directors on April 14. However, we strongly urge that there be no further postponement.

We are well aware that the revenue gained during the next fiscal year from extension of the corporate rate is approximately the same as will be lost under other provisions of H. R. 8300, many of which can have little effect on incentives and capital formation.

The House Ways and Means Committee states in its report that this bill will "reduce tax barriers to future expansion of production and employment." On the whole, we concur, but we do wish to point out that these tax reforms are in no way a substitution for the rate reduction job which lies ahead. The following statement from the House report merits the most sober reflection:

> The restrictive effects of the present law on economic growth have been obscured and somewhat offset during the past decade by the inflationary pressures of the war and postwar periods.

Experience under the tax laws and rates in effect since World War II indicates that economic growth and expansion cannot be expected in the future, in the absence of substantial moderation of the tax burden where it penalizes economic motivation and where it taxes away the potential sources of new capital. This conclusion has been well

documented in a study entitled "Major Tendencies in Business Finance," prepared by the research department of the National Association of Manufacturers. This careful analysis of business financial experience since World War II shows that excessive corporate and individual rates have been, and will be, a serious impediment to our long-term economic development. Summary conclusions from the study are attached as exhibit B.

Depreciation: Section 167 dealing with depreciation represents, within present budgetary limitations, a commendable step in the direction of liberalizing depreciation allowances and reducing the number of disputes in this area. While it stops short of returning authority to management to deduct the cost of depreciable property in accordance with its judgment as to useful and competitive life, which would mean repeal of Treasury Decision 4422 and Bulletin F, we believe this goal might be within reach after a few years of operation under a more liberal policy.

However, we do suggest a few changes in section 167 to better implement the intent, without seriously affecting revenue. These are discussed in exhibit C, and are summarized as follows:

(1) Remove arbitrary restriction on use of depreciation methods, and specifically provide for use of the "sum of the digits" method as well as the straight-line and declining balance methods.

(2) Provide terminal writeoffs and a minimum depreciation allowance under the declining balance method.

(3) Allow a variance of 25 percent—instead of 10 percent—from Internal Revenue determinations of useful life of property.

(4) Permit application of the new rules to property completed after December 31, 1953, regardless of when begun.

Now, the accumulated earnings tax: In regard to the accumulation of earnings beyond the reasonable needs of a corporation, we are happy to note the nominal shift in the burden of proof provided in section 534. We say "nominal" because the parenthetical clause "together with facts sufficient to apprise the Secretary or his delegate of the basis thereof" included in section 534 (c) could be used to nullify this shift in burden of proof. We therefore strongly advocate the deletion of this parenthetical clause.

We are disappointed also to find that section 531 continues to apply the penalty tax to all accumulated taxable income, as defined in section 535. We recommend that the penalty tax apply only to that part of undistributed income which is proven to have been unreasonably accumulated.

Declaration of estimated tax for individuals: We recommend that sections 6073 and 6153 be amended to extend the filing date of the final declaration of estimated tax, and payment of the fourth installment on the declaration, from January 15 to January 31, which is the final date for placing W-2 forms in the hands of employees.

This would enable and indeed encourage many more taxpayers to file final returns in January in lieu of amended estimates. Paperwork would be reduced for both taxpayers and the Government, the Treasury's workload would be spread more evenly, and there would be some offset for the delay in revenue receipts which will result from extending the final return date from March 15 to April 15.

The provisions of H. R. 8300 dealing with corporate organizations, acquisitions, and separations, have created great concern in business

circles, as they would serve to prevent legitimate transactions which, in many cases, would result in business and job expansion. Our views on this subject are set forth in exhibit D. Our overall recommendation is that the provisions in question be amended to permit without tax the legitimate reorganization of corporate structures by statutory merger, consolidation, or by practical merger and liquidation, without reference to the size of the corporations involved. In this connection, there should be no discrimination against corporations which are not "publicly held," as defined in the bill.

Moreover, to the extent that the bill when revised and perfected changes present rules for corporate reorganizations, parties affected should have the opportunity to elect in respect to any 1954 transactions whether they shall be taxed under the provisions of the 1939 code or the 1954 code.

Preferred stock bail out: There is attached a short statement, exhibit E, on section 309 dealing with redemption of nonparticipating stock. We strongly recommend that the penalty tax not apply to stock issued for adequate consideration.

As a minimum, we believe that section 309 (e) must be amended so that the presumptive issue date of January 1, 1954, applies only to stock issued for an inadequate or for no consideration.

Redemptions of stock to pay death taxes: Section 303 of the bill supplants section 115 (g) (93) of the existing code, enacted in 1950 to prevent death taxes from forcing the liquidation at a loss of closely held family corporations.

However, the protection afforded by the original provision, and included in the pending bill, does not extend to situations where there is, after the death of the owner, a substitution of stock for the stock owned at the date of death. To make the law consistent with its avowed intent, it is recommended that section 303 be amended to apply equally to substitute stock held in the decedent's gross estate. A fuller explanation of this proposal is included in exhibit F.

Accrual of real property taxes: Section 461 (e) represents a desirable step toward the determination of taxable income in accordance with generally accepted accounting principles. However, in making the new rule for accrual of real property taxes mandatory, a taxpayer who has been keeping his books in accordance with existing law may entirely lose his deduction for real property taxes during the transition year.

This situation, and alternative solutions, are explained in exhibit G.

Reserves for estimated expenses: Section 462 also brings tax accounting into closer conformity with generally accepted accounting principles. It leaves open the question, however, whether a taxpayer would be allowed to deduct actual expenses during the transition year, as is provided in present law for bad-debt reserves.

This section should be clarified so as to leave no doubt on this score. A fuller explanation is given in exhibit H.

Penalty taxes on intercorporate dividends and on consolidated returns: For many years, nearly all business groups, including the NAM, have recommended elimination of the tax on 15 percent of intercorporate dividends and the 2-percent penalty tax on consolidated returns.

The President's tax message proposed removal of these penalty taxes over a 3-year period, but such removal is not provided in H. R.

8300. We do not see how the purposes of this legislation can be accomplished without the complete elimination of injustices of this character. We therefore recommend that the President's proposals be carried out.

In this connection, the purpose of allowing a credit for intercorporate dividends is defeated in the case of corporations having a net operating loss. The result is that the corporation pays tax on 100 percent of the dividends received in the loss year. As explained in exhibit I, we recommend elimination of this discrimination against corporations with fluctuating incomes which receive dividends from other corporations.

Prepayment of corporate taxes: Mr. Chairman, I now come to a provision which is of the most serious concern to many corporations; namely, the requirements of declaration and payment of estimated tax provided in sections 6016, 6074, and 6154. It is conceded that these provisions would not be harmful in the case of corporations whose working capital position is such that they are able to set aside tax accruals in cash and perhaps buy tax anticipation certificates.

In other cases, however, corporations need all cash available for current working purposes. The operations of many such corporations have already been adversely affected by the speedup in corporate tax payments effected in the Revenue Act of 1950. We do not believe there is any method by which the further speedup can be confined to corporations which would not be financially embarrassed by its application, whether they be large or small.

We don't accept the idea that the elimination from this provision of a certain amount of income satisfactorily solves that problem. Accordingly, we strongly oppose any change in law which would require payment of any part of the corporate tax in advance of the 15th day of the 3d month following the end of a taxpayer's taxable year.

Additional reasons for taking this strong stand are: First, the fact that prepayment would have but slight effect on the amount of revenue received by the Government in any fiscal year, and second, the problem of imbalance in the revenue flow as between the first and second 6 months of the Government's fiscal year can be partially solved by excluding tax anticipation certificates from the statutory debt limit.

As we have previously suggested, the problem of imbalance was intensified by the speedup in corporate tax payments enacted in 1950, and cure should not be sought by compounding the hardship thus inflicted on corporate taxpayers.

This completes my testimony. I have not touched on many of the points included in our specific recommendations—some of which have, and some of which have not, been incorporated in the bill. We believe all of our recommendations are well-founded and merit your sympathetic consideration.

We would not want our testimony, in which we have proposed changes in H. R. 8300, to be construed as any lack of confidence in this legislation as a whole. Our only aim in appearing here is to aid the Congress in arriving at the best possible solutions of some very difficult problems. I hope that this testimony and accompanying material will serve that purpose.

Thank you, sir.

The CHAIRMAN. Thank you very much.

(The exhibits of Mr. Maytag follow:)

EXHIBIT A

SPECIFIC RECOMMENDATIONS FROM FEDERAL TAX PROGRAM OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

(As approved by the association's board of directors October 29, 1953, and revised February 4 and 5, 1954, and April 14, 1954)

I. THE CORPORATION INCOME TAX

(a) *Rate revision.*[1]—Although the National Association of Manufacturers has opposed continuation of the 52 percent combined corporate rate beyond March 31, 1954, it now recognizes that some continuation is necessary in view of budget conditions and to permit needed tax reforms. However, the 5-percentage-point reduction in the normal corporate rate which was scheduled to take effect on March 31, 1954, should not be postponed for more than 1 year.

(b) *Excess-profits tax.*—So-called excess-profits taxation is now almost universally recognized to be unsound in principle and inequitable in application. With expiration of the present tax on December 31, 1953, such a tax should never again be enacted regardless of fiscal emergencies.

(c) *Rates on smaller corporate income.*—The present high level of corporate tax rates makes imperative some differential in favor of corporations with small incomes as an aid to the beginning and development of business. To this end, the exemption of $25,000 from surtax in present law is approved, but there should be no increase of this exemption and no further graduation of the corporate tax.

(d) *Intercorporate dividends.*—The credit for dividends received from corporations subject to the Federal income tax should be increased from 85 to 100 percent.

Computation of the net operating loss deduction should not discriminate against corporations with fluctuating incomes receiving dividends from other corporations.[2]

(e) *Consolidated returns.*—The additional tax of 2 percent on the net income reported in consolidated returns should be eliminated.

(f) *Undistributed earnings* (*sec. 102*).—The policy with respect to retained earnings shoud be changed so as to accept the decisions of management regarding the proportion of earnings to be retained for valid business reasons.

Specifically:

(1) The burden should be upon the Government to prove that the taxpayer was formed or availed of for the purpose of preventing the imposition of surtax rates upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed.

(2) The tax should apply only to that part of the undistributed net income which is unreasonably accumulated.

(3) Dividends paid within 75 days after the close of its taxable year should, at the taxpayer's election, be deducted in computing section 102 net income for such year.

(g) *Payment date.*[3]—The payment of any part of the corporate tax should not be required in advance of the 15th day of the 3d month following the end of the taxpayer's taxable year.

(h) *Profit-sharing and stock bonus plans.*[1]—That the tax treatment of profit sharing and stock bonus plans permit recognition of length of service and employee contributions, in addition to wages, as the basis for allocation of employer contributions to participants in such plans.

(i) *Corporate reorganization.*[4]—Tax law with respect to corporate distributions and changes in corporate organization and ownership should not penalize nor discourage legitimate business transactions.

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[1] Revised April 14, 1954.
[2] Added April 14, 1954.
[3] Added February 4, 1954.
[4] Added April 14, 1954.

II. THE INDIVIDUAL INCOME TAX

(a) *Rate reduction and range of progression.*—Following the scheduled rate reduction as of January 1, 1954, the first emphasis should be on narrowing the range of progression and the second on further reduction of the first bracket rate. The first step in narrowing the range of progression should be a 25-percent reduction of the progressive element of each bracket rate. As budget requirements permit, there should be additional percentage reductions of the progressive element, and further reductions of the first-bracket rate. The goal should be a limited range of progression. The proposed constitutional amendment outlined in section VII sets a range of 15 percentage points whenever the top-bracket rate exceeds 25 percent.

(b) *Personal exemptions.*[5]—There should be no increase in personal exemptions, as such action would further narrow the base of the individual income tax, concentrate the burden of the tax on fewer citizens, and postpone perhaps indefinitely the opportunity for rate reduction.

(c) *Double taxation.*—The present high tax rates on individual and corporate income intensify the impact of double taxation. Resolution of this problem should have high priority in the list of needed tax reforms.

(d) *Withholding.*—The extension of withholding of tax to forms of income other than wages and salaries would cause serious hardships to thousands of small-income recipients by collection of money as taxes when there is no tax liability in fact, and hence should not be authorized.

(e) *Installment payment date.*—The time for payment of the fourth installment on the declaration of estimated tax should be extended from January 15 to January 31.

III. ESTATE AND GIFT TAXES

Estate and gift taxes should be removed from Federal use. Pending such action, rates of tax should be reduced, levies on transfers between spouses should be eliminated, and the rules of application should be designed to avoid hardships or inequities to estates consisting principally of stocks of closely held corporations.[6]

In addition, the following rules with respect to survivors annuities under pension should be adopted:

(1) The value of pension benefits and any death benefits paid to a survivor-beneficiary through exercise of a joint and survivor annuity option, under any qualified or previously qualified pension plan, should not be subject to estate tax.

(2) There should be no gift tax by reason of the employee exercising his right under a qualified or previously qualified pension plan to choose a joint and survivor option.

IV. EXCISE TAXES

(a) Excise-tax law, regulation, and administration should be designed to achieve equity consistent with revenue goals, and to minimize enforcement and compliance burdens and costs.

(b) Except for the alcoholic beverage and tobacco taxes, the present system of Federal excises should be replaced by a uniform excise tax preferably at the manufacturers' level to be levied on all end products of manufacture, including those produced and sold by any Government owned or operated facility, except food for human and animal consumption; drugs; seeds, fertilizers, insecticides, fungicides, and defoliants; books, pamphlets, and music in raised print used exclusively for and by the blind; and religious articles. There should be no other exceptions to the end-product rule not required as a matter of administrative procedure. This replacement should be made as quickly as possible, but no later than April 1, 1954, the time when the excise tax increases included in the Revenue Act of 1951 are scheduled to expire, and the rate should be set so as to maintain the existing level of excise tax revenues.[7]

(c) The rates of tax on alcoholic beverages and tobacco should be reduced to those in effect prior to the last World War II increases.

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[5] Revised April 14, 1954.
[6] Revised April 14, 1954.
[7] Revised February 5, 1954.

V. REFORMS AFFECTING ALL TAXPAYERS

In addition to the specific recommendations relating to particular taxes, there are matters of concern to all taxpayers, whether incorporated or not, which should be included in a general program of recommendations. These are presented here.

(*a*) *Business net income.*—Greater recognition should be given to the results of business accounting in the determination of business net income. That is, where management is following accepted, standard accounting procedures, modified consistently in some cases to reflect the taxpayer's own operating experience, the results should be conclusive as to the net income.

(*b*) *Depreciation.*—There should be establishment of adequate and realistic provision for depreciation and obsolescence. TD-4422 and bulletin F nullify this principle and should be rescinded as soon as possible in favor of a policy which will eventually authorize the taxpayer to deduct the cost of depreciable property in accordance with his judgment as to its useful and competitive life. The depreciation claimed by the taxpayer, if computed in a consistent manner, shall be accepted, unless the Government proves that it has no reasonable relationship to the useful and competitive life of the property. To minimize the short-run impact on revenue, this goal could be achieved by a series of steps. Nothing in the foregoing shall be construed as denying the taxpayer the right to deduct accelerated amortization of emergency facilities.

In moving toward the goal set forth above, there should be no arbitrary restriction on the use of depreciation methods. Specifically, provision should be made for use of the "sum of the digits method" as well as the declining balance and straight-line methods.[8]

(*c*) *Major repairs, etc.*—Taxpayer's consistent policy of expensing major repairs, intangible research, development and exploration costs, tools, jigs, dies, and fixtures, shortlived capital assets, and the like should be accepted for tax purposes.

(*d*) *Current reserves.*—Reasonable additions to reserves created to fulfill future obligations arising from current operations, such as reserves for product warranty, cash discounts, self-insurance, inventory losses, and advertising commitments, should be recognized for tax purposes.[9]

(*e*) *Depletion.*—The high levels of production and consumption of our natural resources impose a heavy burden of exploration and development upon our extractive industries. The policy of percentage-depletion allowances should be continued.

(*f*) *Capital gains and losses.*—Experience with capital-gains taxation proves that the revenues produced are not commensurate with its discouraging and harmful effects upon production and the investment and reinvestment of risk capital. Pending the complete elimination of capital-gains taxation, it is recommended that—

(1) The rate of tax be reduced; and

(2) Excess of capital losses over capital gains should be deductible. The maximum tax benefit should be limited to the maximum rate applicable to long-term capital gains.

(3) Relief provision with respect to disposition of business assets should be so amended as to allow its benefits to apply to self-insurors in whose respect casualty losses largely sterilize the benefits.[10]

(*g*) LIFO. The last-in, first-out (LIFO) method of inventory pricing should be modified to provide for the use of cost or market, whichever is lower. Whenever the market value is lower than LIFO cost at the end of a year, this lower market value should become the new LIFO cost base for the succeeding taxable year.

(*h*) *Retroactive taxation.*—A retroactive imposition of increase of taxes cannot be justified under any circumstances, and is vigorously opposed.

(*i*) *Tax favoritism.*—

(1) Federal taxation of all competitive enterprise should be fair and equal, and no tax favoritism should be shown any competitive group, whether it be private, corporate, cooperative, or association.

(2) In the case of corporations not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual, the Federal income-tax exemption privilege should be eliminated with

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[8] Added April 14, 1954.
[9] Revised April 14, 1954.

respect to that part of their net income which is derived from the actual operation or management of business enterprise.

(*j*) *Income from foreign sources.*—The reduced tax rate now afforded to Western Hemisphere business income should be extended under similar terms and conditions to business income from all foreign sources.[10]

VI. THE ADMINISTRATION OF THE TAX LAWS

(*a*) Treasury interpretative regulations shou'd be submitted, before promulgation, to the Joint Committee on Internal Revenue Taxation for comment and criticism.

(*b*) To the limits of practicality, obligations and rights of taxpayers should be established by the Congress in the statutes. Both statutes and necessary suporting regulations should be designed to improve the administration, collection, enforcement, and appellate procedures for the purpose of minimizing and penalizing tax evasion and corrupt practices on the part of taxpayers and their representatives and of Government officials.

(*c*) Such laws and regulations should not penalize or harass conscientious taxpayers by presumptions of guilt, unreasonable burdens of proof or by onerous information and recordkeeping requirements.

VII. CONTROL OF THE FEDERAL POWER TO TAX BY CONSTITUTIONAL AMENDMENT

(*a*) The most conspicuous case of excessive tax rates and the inequality resulting therefrom is in the income taxes. The 16th amendment to the Constitution was ratified by the States in 1911 and 1912 on the assurance of its proponents that the rates of tax on income would never be excessive.

These assurances have not been kept. On the contrary, Federal rates of tax on income have been advanced to exorbitant levels, in consequence of which the Federal tax structure is seriously unbalanced; thrift, initiative, and enterprise are heavily penalized; the survival of the middle-income groups is threatened by the leveling-down process; and the long-range capacity of the economy to provide jobs and advance its standard of living is endangered. Moreover, the discriminatory rates of income tax have created a dangerous disunity among taxpayers, have had a serious effect on taxpayer morale, and increasingly encourage a general disrespect for tax laws and administration.

In view of these conditions, the time has come to impose a limitation, by constitutional amendment, on the Federal power to tax income. This should be done by limiting the power of Congress to impose taxes to a maximum top rate of 25 percent, with power, however, by vote of three-fourths of all the Members of each House, to fix a maximum top rate in excess of 25 percent, if such rate so fixed does not exceed the lowest rate by more than 15 percentage points. There should also be a provision to the effect that the determination of income subject to tax shall be by uniform rules of general application which shall not vary with the size of the income.

(*b*) Such amendment should also deprive the Federal Government of the power to impose death and gift taxes and leave that field of taxation exclusively to the States.

EXHIBIT B

MAJOR TENDENCIES IN BUSINESS FINANCE[1]

SUMMARY AND INTRODUCTION

The process of business finance in the period since 1945 has posed what seems to be an incomprehensible mystery. On the one hand both businessmen and economists have been deeply concerned over the shortage of venture capital. They have warned that the consequences of this dearth would be either to restrict our economic growth or to pile up a dangerous burden of business indebtedness. On the other hand business has, to all appearances, been through a period

[10] Added April 14, 1954.

[1] Prepared by George G. Hagedorn, assistant director of research, National Association of Manufacturers, and published in January 1953 as No. 57 in the association's economic policy division series.

of unprecedented prosperity and growth. Although business debt has increased, the present level of indebtedness does not seem really serious in relation to other economic magnitudes.

The apparent record of business health and business growth in recent years has been so impressive that warnings about "the venture capital shortage" have not been taken very seriously. It has been felt that there could be nothing much wrong with a business system which is able to spend between 20 and 30 billion dollars a year for new plant and equipment. The small amount of new equity investment is (according to this view) perhaps regrettable, but its place has been taken by the enormous sums retained out of profits.

The original purpose of the present study was simply to compile the statistical record of the process of business finance, in its very broadest outlines. It was quickly realized that an accurate picture would require certain adjustments and addenda to the generally accepted figures, since customary accounting methods do not make full allowance for the effects of rising prices. The wholly unanticipated results of this analysis was a completely new perspective on the pattern of business finance since 1945. The commonly accepted generalizations turns out to be false or only partially true. The real key to the mystery of business growth amidst a shortage of venture capital lies elswhere than has been supposed.

The new conclusions are so important that they have been drawn out of the body of the study, and are summarized briefly here:

1. It is true that business has invested between 20 and 30 billions of dollars annually, in recent years, in new plant and equipment. But, about four-fifths of this amount has been required to replace the capital values currently used up. Only about one-fifth of business expenditures for fixed assets represents net expansion. This hasn't been generally understood, partly because one of the effects of inflation is that allowances made for depreciation in business accounts are less than the actual cost of replacing the capital consumed.

2. It is true that the increase in the book value of business inventories has been at a rate of greater than $10 billion annually in certain years, and has averaged $8 billion annually since 1945. But, approximately half of this increase represents the additional cost of carrying the same physical volume of inventory at a higher price level. Only half represents a genuine increment to stocks of goods held by business.

3. It is true that the retained profits of corporations, as reported, have averaged about $10 billion a year since 1945. But, two-thirds of this reported amount have been needed simply to maintain the tangible assets of corporations since, as a result of the rising price level, adequate provision for such maintenance is not charged in current costs. Only about $3 billion annually have been available from this source for the net expansion of corporate assets.

4. Even this small surplus of undistributed profits has been made possible only at the expense of a reasonable level of dividends. If dividends were increased so as to be the same percentage of national income as in the 1930's, the surplus of profits available for net expansion would be wholly wiped out.

5. The new capital supplied by stock issues has amounted to less than $2 billion annually in the postwar period.

6. The book increase in owners' equities in unincorporated business has averaged less than a billion dollars annually since 1945. This is less than the amount needed to make up for the failure of charges to current cost to provide fully for the maintenance of assets.

7. Although business accumulated large amounts of liquid assets during the war years, on balance these have not been drawn on, to any substantial extent, as a source of funds in the years since 1945. Apparently business has considered it necessary (or at least advisable) to maintain a substantial degree of liquidity.

8. The chief source of funds for expansion in the postwar period has been borrowing. Corporate debt has increased from $85 billion at the end of 1945 to $150 billion at the end of 1951.

9. One of the effects of inflation has been to reduce progressively the real burden of the outstanding business indebtedness. Business has borrowed large sums each year, but at the same time the process of inflation has reduced the relative burden of the already existing debt. The net effect has been to make the cumulation of indebtedness tolerable. This of course has occurred at the expense of the creditors of business.

These conclusions, taken together, lead to a drastically revised appraisal of the soundness of recent business financial operations. We cannot be as complacent

about them as we had thought. The usual incomplete statistical analyses have created an exaggerated idea as to the extent of business expansion and a false idea as to the manner in which it has been financed. The shortage of venture capital has had serious effects on the health of the economy, but inflation has suppressed the symptoms of the disease.

Exhibit C

Section 167—Depreciation

Section 167 of the bill represents, within present budgetary limitation, a commendable step in the direction of liberalization of depreciation allowance and reduction of the number of disputes in this area. The provisions of the bill are, however, in our opinion still too restrictive in several respects and could be made more practicable without further significant loss of revenue.

TERMINAL WRITEOFFS UNDER THE DECLINING BALANCE METHOD

Under the declining balance method permitted by the bill, a terminal writeoff of any undepreciated balance is permitted in the year when disposition is made of the last remaining asset of any particular year's acquisition of any class. In order to be able to take advantage of this terminal writeoff, the taxpayer must maintain detailed records of cost and year of acquisition of each asset. Many taxpayers do not maintain, and should not be required to maintain in order to take advantage of the declining balance method, such records with respect to assets of relatively small individual value. In cases where such records are not maintained, however, any particular year's acquisitions must, under the declining balance method, continue to be depreciated, in progressively reducing amounts, ad infinitum. A similar objection can be made to the use of the declining balance method as proposed in the bill in the case of assets for which detailed records of cost and year of acquistion are maintained, in that, as long as a single asset of any year's acquisition remains in service, it is necessary for the taxpayer to continue recording a constantly reducing depreciation allowance which might eventually be measured in pennies.

The terminal writeoff provision as presently contemplated must be made less restrictive. The problem could be met in any of several ways, two of which are the following:

1. Any remaining undepreciated balance might be written off in the last year of estimated useful life;
2. A minimum depreciation allowance might be provided under the declining balance method equal to a specified percentage (e. g., 3 percent) of the cost of any year's acquisitions of any class, with possibly a limitation that the minimum allowance might in no case exceed the annual straight-line depreciation allowance.

"SUM OF THE DIGITS" METHOD

Consideration should also be given to permitting the use of the "sum of the digits" method of computing depreciation, which has somewhat the same effect as the declining balance method, but has an advantage over the latter method, particularly as proposed to be applied under H. R. 8300, in that it results in complete depreciation of a group of assets at the end of their estimated useful life. Under the "sum of digits" method of computing depreciation, the digits beginning with 1 and ending with the number of years of estimated useful life are first totaled. Then to compute the first year's depreciation allowance, a fraction is applied to the cost of the assets which has as its numerator the years of useful life and as its denominator the "sum of the digits." The numerator used in the second year represents the years of useful life minus one, and so on.

For example, if an asset or a group of assets has an estimated life of 10 years, the numbers 1 to 10 are added together and found to total 55. In the first year ten fifty-fifths of the cost would be written off, in the second year nine fifty-fifths and so on until in the 10th year the remaining one fifty-fifth of the cost would be written off. A comparison of this method with the declining balance method proposed under H. R. 8300 for a $10,000 assets having an estimated life of 10 years is shown below.

Year	Declining balance depreciation		"Sum of the digits" depreciation	
	For the year	Cumulative	For the year	Cumulative
1	$2,000	$2,000	$1,818	$1,818
2	1,600	3,600	1,636	3,454
3	1,280	4,880	1,455	4,909
4	1,024	5,904	1,273	6,182
5	819	6,723	1,091	7,273
6	655	7,378	909	8,182
7	524	7,902	727	8,909
8	419	8,321	545	9,454
9	335	8,656	364	9,818
10	268	8,924	182	10,000

DISPUTES AS TO USEFUL LIFE

The 10-percent limitation on the Secretary with respect to the correction of taxpayer's estimates of useful life is designed to eliminate costly and time-consuming disputes concerning differences which have little or no effect on the revenue. Since factors such as obsolescence, which bear on the problem, differ greatly between taxpayers, and differ from year to year with each taxpayer, this limitation is so small as to render it largely ineffective, in accomplishing the desired purpose of avoiding disputes. It is therefore recommended that this limitation be increased to at least 25 percent. If this is considered undesirable, subsection (e) should be eliminated entirely.

CONSTRUCTION BEGUN BEFORE AND COMPLETED AFTER DECEMBER 31, 1953

Subsection (c) provides that the methods provided in subsection (b), which include the declining balance method, shall apply, in the case of property constructed after December 31, 1953, only to that portion of the basis of the property which is attributable to construction after December 31, 1953. Since depreciation normally starts when a building or other structure is completed and placed into service, it is suggested that, in the case of property construction of which is completed after December 31, 1953, the declining balance method be permitted with respect to the entire cost of the property.

EXHIBIT D

SECTIONS 351 THROUGH 359, CORPORATE ORGANIZATIONS, ACQUISITIONS, AND SEPARATIONS

Two general purposes expressed by the Ways and Means Committee on the changes to the reorganization provisions are as follows:

(1) "Your committee has revised existing law in conformity with its objective of making it sufficiently definite to permit taxpayers to ascertain in advance the tax consequences of their actions." [1]

(2) "Your committee's bill is designed to insure that the same tax consequences result from the different types of transactions which are available to accomplish substantially the same result." [1]

The introduction of the "distribution" approach to the taxation or exemption of transactions which are fundamentally exchanges or rearrangements of corporate interests and are not distributions at all, hardly encourages attainment of the first purpose. Moreover, the vastly greater complexity of the text will assuredly add uncertainty in many areas for a considerable time which are quite certain under the 1939 code.

Some improvements may be noted in the implementation of the second purpose. However, in the effort to plug loopholes or alleged loopholes in the present provisions regarding mergers, new and distinctly arbitrary tests have been set up which do considerable violence to the second purpose, to wit, that transactions, essentially the same in substance, should produce the same tax results.

The drafters show official concern at the use of mergers as a device by which corporate earnings are distributed at capital gain rates.[1] Accordingly, new con-

[1] P. 39, committee report.

cepts have been set up which produce different tax results in respect of essentially similar transactions. Meeting the new statutory tests to a great extent depends on size, or more particularly, difference in size. These tests bear more heavily on the small than on the large corporations, and result in intolerable discriminations.

The committee report strongly reaffirms the general principle that corporate simplification with its concomitant improvements and economies should be encouraged when it states that:

"* * * Your committee's bill is designed to provide for nonrecognition of gain or loss in cases which involve a mere rearrangement of the corporate structure or other shifts in the form of the corporate enterprise which do not involve any distribution of corporate assets to shareholders."[1]

"As long as a shareholder's interest remains in corporate solution, there is no appropriate occasion for the imposition of a tax."[2]

However, in plugging the alleged loopholes afforded by the present merger provisions, where it is contended that profits might be distributed at capital gains rates, H. R. 8300 violates the foregoing avowed principles, and taxes a shareholder's interest though it still remains in "corporate solution," not at the ordinary income tax rates at which such "disturbed" profits should be taxed, if indeed there has been a distribution, but at capital gains rates, the rate of tax which will be collected in any event upon the eventual disposition of the stockholder's interest.

It has been argued that the owners of a small company who receive stock in a large company upon a merger or a consolidation have received something so different from what they had before the exchange that they should be taxed upon the exchange. These arguments are generally grounded on differences in marketability and differences in essential business or investment characteristics.

It is strongly urged, that the violence done to the fundamental principles set forth by the committee itself, to wit, equal results for similar transactions, is far more important than the postponement of a capital gains tax to the shareholder of a small company, and indeed it's only a postponement. That the capital gains tax is in some instances avoided through transfers at death, is to a considerable extent offset by the estate tax on the capital gains tax which was avoided.

It is further strongly urged that the new provisions be so amended as to permit without tax the legitimate reorganization of corporate structures by statutory merger, consolidation, or by practical merger and liquidation, without reference to the size of the corporations involved.

Transactions should be effected as best suits the circumstances of the State corporation law and State tax law, and the business considerations involved. If this is not done, many transactions beneficial to business, labor, and consumers, and potentially productive revenue which could be accomplished tax free under the 1939 code may never be effected.

Specific criticism at this time is directed to the following provisions:

SECTION 359 (A)

This subsection defines a publicly held corporation as any corporation, except one with 10 or fewer stockholders owning more than 50 percent of the outstanding stock. Statutory mergers without tax incidence to any parties are permitted to only publicly held corporations. Thus, a corporation with a 51-percent stock interest in another corporation cannot merge tax free with such corporation, while 1 with a 40-percent stock interest can so merge, assuming no 9 other shareholders own more than 10 percent of the stock in the aggregate (Reference: Secs. 359 (a), 354 (b) 352, 305 (a) and (b)).

The arbitrary distinction between transactions involving corporations with more than 10 and 10 or less stockholders is untenable and should be eliminated.

SECTION 359 (C)

The only tax-free avenue for integration with respect to corporations which are not publicly held is the practical merger. This may be done only by corporations relatively equal in size. The tendency must be, then, for some larger corporations to substantially increase in size, and smaller corporations are

[1] P. 34, committee report.
[2] P. 35.

destined to remain relatively small corporations (Reference: Secs. 359 (c), 354 (a), 362, and 305 (a) and (b)).

Frequently business considerations such as the legal title to a franchise in the continuing corporation dictates that any integration must be accomplished by statutory merger or a consolidation. This is denied in the case of corporations which are not publicly held by the provisions of section 359 (c) (2) which require a liquidation. The liquidation concept is not inherent in mergers or consolidations. Moreover, under certain State tax laws, liquidations are subject to State taxes while mergers and consolidations are not. There is no valid reason for denying this useful device to other than publicly held corporations.

Conversely, the practical merger device is denied to publicly held corporations unless they satisfy the relative size test in section 359 (c) (1). Moreover, some State laws do not permit statutory mergers and consolidations of their charter corporations with those of other States. There is no valid reason for this denial.

EFFECTIVE DATE

Finally, many transactions which have required time-consuming negotiation and planning are presently under consideration. H. R. 8300 changes the rules and the concepts of reorganizations to such an extent that, even after essential correction the effects of its provisions should be applied gradually. Therefore, in respect of any of the transactions which would be affected by these sections, the parties involved should be permitted to elect whether they shall be taxed under the provisions of the 1939 or the 1954 code in respect of any transactions occurring in 1954.

EXHIBIT E

SECTION 309. TAX ON REDEMPTION OF NONPARTICIPATING STOCK

The stated purpose of this section is "to eliminate the preferred stock bail out," whreby certain taxpayers have substituted for full income rates capital gain rates on ordinary profit distributions. The purpose of the section is highly commendable.

At least two amendments to H. R. 8300 appear to be indicated however:

(1) Sections 531 through 536 provide for the surtax on improperly accumulated surpluses. A deduction for any tax paid under section 309 should be provided for in section 535 (b) in the computation of net income taxable under section 531.

(2) The final paragraph (sec. 309 (c)) provides that the issue date of nonparticipating stock is deemed to be the later of its issue date or January 1, 1954. This provision is entirely arbitrary and will unjustly penalize legitimate redemptions in many cases. Among these are presently operating sinking fund redemptions of nonparticipating stock at call prices in excess of 105, which will continue to operate regardless of the 10-year rule, and the purchase in the open market of noncallable nonparticipating stock issued many years ago for adequate consideration.

It is submitted that as a fundamental proposition the penalty tax should not apply to stock issued for an adequate consideration, for where legitimately issued nonconvertible nonparticipating stocks are selling substantially in excess of their issue prices the reasons are not found in profit distribution motives, but in the financial stability of the issuing corporations and, most important, in the changes in long-term money rates.

As a minimum, the final paragraph providing for the presumptive issue date of January 1, 1954, should be applied only to stock issued for an inadequate or no consideration.

EXHIBIT F

SECTION 303. DISTRIBUTION IN REDEMPTION OF STOCK TO PAY DEATH TAXES

Section 303 of the proposed code is the successor to section 115 (g) (3) of the present law. There is one important area which section 115 (g) (3) does not cover, and this omission is continued in section 303. It is therefore proposed that section 303 be revised to supply the coverage of the important area now omitted, as described below.

Section 115 (g) (3) was enacted in 1950 to effectuate the purpose of Congress that the impact of death taxes upon owners of closely-held family corporations would not result in the forced sale, liquidation or loss of control of such corporations. Congress expressly recognized the inequity and injustice of such corporations being wrecked by the necessity of payment of estate taxes and also the undesirability to the economy of owners of small businesses being forced to sell out to big business in order to prepare for or pay estate taxes. Accordingly, Congress added section 115 (g) (3) providing in substance that if the interest owned in a corporation constituted a certain percentage of the value of the taxable estate, the stock representing such ownership could be sold to the corporation free from the hazard that the proceeds would be taxed as an ordinary dividend and largely wiped out by such a dividend tax. However, section 115 (g) (3) and now the proposed section 303 of H. R. 8300 do not provide this protection in situations where there is, after the death of the owner, a substitution of stock for the stock owned at the date of death. For example, if a merger, recapitalization or reorganization takes place after the death of the stockholder, the new stock received by the estate in exchange for the stock held at the date of death does not qualify under section 115 (g) (3) or proposed section 303. Accordingly, the estate could not turn in such stock for redemption without grave risk of the proceeds being wiped out by the taxing of them as a dividend. The same undesirable result accrues in the case of an exchange of common for new common in a stock split occurring after death. Similarly, where the decedent held his stock of the operating business in a personal holding company, which was liquidated after his death and the stock of the operating company received by the executors in exchange for the holding company stock.

Obviously, the purpose of Congress is defeated in such situations by mere technicalities in the purely evidentiary form of ownership of the business interests. The situations described can meet all the requirements of section 115 (g) (3) and come 100 percent within its spirit and purpose, and yet by a mere technical change in form of stock ownership be deprived of the relief intended by Congress. It is therefore recommended that section 303 of the proposed code be amended to read as below in order that this defect in the law and discrimination between taxpayers be eliminated.

It is also pointed out that the separation of section 115 (g) (2) and section 115 (g) (3) of the present law into section 303 and section 304 of the proposed code deprives taxpayers of a right existing under present law. This is the right to sell stock of a parent corporation to the controlled subsidiary under the protection of section 115 (g) (3) from dividend tax. It is submitted that this right should be reinstated in the proposed code by a revision of section 304 to the effect that said section does not apply if the parent corporation stock sold to the subsidiary would qualify under section 303 if sold directly to the parent corporation.

"SEC. 303. DISTRIBUTION IN REDEMPTION OF STOCK TO PAY DEATH TAXES.

"(a) IN GENERAL. A distribution of property by a corporation to a shareholder in redemption of participating stock, the value of which is included in determining the gross estate of a decedent in accordance with section 2031 which is not in excess of the sum of—

"(1) the estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of such decedent's death, and

"(2) the amount of funeral and administration expenses allowable as deductions to the estate under section 2053 (or under section 2106 in the case of the estate of a decedent nonresident, not a citizen of the United States)

shall, subject to the limitations provided in subsection (b), be treated as a distribution in full or part payment for such stock.

"(b) LIMITATIONS ON APPLICATION OF SUBSECTION (a). Subsection (a) shall apply only—

"(1) to an amount which is distributed after the death of the decedent and—

"(A) within the period of limitations for the assessment of estate tax provided in section 6501, determined without the application of any other section, or within 90 days after the expiration of such period, or

"(B) if a petition for redetermination of a deficiency in such estate

tax has been filed with the Tax Court within the time prescribed in section 6213, at any time before the expiration of 60 days after the decision of the Tax Court becomes final,

"(2) to amounts distributed with respect to all or part of the stock of a corporation the value of which for estate tax purposes comprises either—

"(A) more than 35 percent of the value of the gross estate of such decedent, or

"(B) an amount equal to more than 50 percent of the taxable estate of such decedent.

For purposes of this paragraph, stock of two or more corporations, with respect to each of which there is included in determining the value of the decedent's gross estate more than 50 percent in value of the outstanding stock, shall be treated as the stock of a single corporation."

(Following Is New)

"(c) SUBSTITUTE STOCK.—A distribution of property by a corporation in redemption of stock received with respect to or in exchange for stock described in paragraph (a) and paragraph (b) (2) shall be deemed to be a distribution in redemption of and with respect to such stock, if—

"(1) the stock so received was received by the shareholder without inclusion of any amount in the income of or recognition of gain or loss to such shareholder under section 305 or section 371, or

"(2) the stock so received was received by the shareholder in a distribution in partial or complete liquidation as defined in section 336 of a personal holding company as defined in section 542 and was stock of a corporation of value—

"(A) more than 35 percent of the value of the gross estate of such decedent, or

"(B) more than 50 percent of the taxable estate of such decedent.

For the purposes of this paragraph, stock of two or more corporations, with respect to each of which there is received in a liquidation 50 percent or more in value of the outstanding stock, shall be treated as the stock of a single corporation."

EXHIBIT G

SECTION 461 (C) ACCRUAL OF REAL PROPERTY TAXES

The provisions of section 461 (c) represent a desirable step toward the determination of taxable income in accordance with generally accepted accounting principles. In making the new rule mandatory, however, this section creates a serious problem for taxpayers who have been keeping their books in accordance with existing law. The problem can best be illustrated by an example.

Court decisions have specified the lien date as the proper accrual date, but the Internal Revenue Service for ease of administration usually uses assessment as the determining event absent a court decision relating to the specific tax in question. Assume, then, that under present law a tax imposed for the calendar year 1954 has been deemed to accrue on July 1, 1953, its assessment date. Under section 461 (c) (1), this tax would be deductible in 1954. Under the special rules provided in section 461 (c) (2), however, if the tax were allowable, as it is in this example, as a 1953 deduction under the 1939 code, the tax is not allowable as a 1954 deduction. This provision is apparently considered necessary to prevent the deduction of the same tax twice.

The taxpayer in this example is assumed to have been keeping his books in accordance with the present tax rule. To avoid distortion of operations, he will undoubtedly wish to continue to accrue real property taxes on the same basis, as otherwise his operations for the transition year would not include any charge for real-estate taxes. Section 461 (c) (2), however, would not permit a deduction in the transition year for the real-estate taxes which consistent accounting practice would require the taxpayer to accrue.

Section 461 (c) will be very helpful to taxpayers who have been keeping their books by the method contemplated in that section. Clearly, however, taxpayers who have been keeping their books on a basis consistent with present tax law should not be required to make a change. Section 461 (c) should be made elective rather than mandatory.

Another possible solution would be to permit the taxpayer to deduct in 1954 the tax which applies to that year despite the fact that this tax was also deducted in 1953. Since only 1 year's tax would be deductible in any 1 year, it makes little practical difference whether the 1954 deduction represents the tax applicable to that year or the tax based on an assessment date which falls in that year. Many taxpayers in the past have changed their accounting practice to deduct property taxes in accordance with the requirements of rulings and court decisions rather than in the period to which the taxes are generally considered to apply. In connection with this transition, up to a full year's property-tax deduction has been completely lost, although a full year's property tax was paid in every year. For example, in computing 1941 income there might have been substituted for the tax applicable to the year 1941 the tax which applied to the year 1942 which was based on a 1941 assessment. The tax applicable to the year 1941 would not have been deducted in any year inasmuch as the 1940 deduction would have represented the tax applicable to 1940 based on the 1939 assessment. The taxpayer was not particularly concerned with this theoretical loss of a year's deduction because he had a property-tax deduction in each year and it made little difference whether for any year the deduction represented the tax based on assessment in that year, or the tax which applied to that year based on assessment in the preceding year.

For the same reason, the Government should not be particularly concerned that a specific tax is deducted in more than 1 year as long as only 1 tax is deducted in each taxable year. Revenues are not affected.

Another point which deserves consideration is the fact that section 461 (c) as written applies only to real property taxes. There would seem to be no reason why the same principle should not be made applicable to personal property taxes or any other taxes which relate to a definite period of time.

EXHIBIT H

SECTION 462. RESERVES FOR ESTIMATED EXPENSES

Section 462 is a very important step toward the conforming of tax accounting to generally accepted accounting principles. It is assumed that in the year when a reserve for estimated expenses is first taken into account in computing taxable income, the taxpayer will be able to deduct, in addition to the reserve provision, the actual expenses incurred during the transition year; i. e., that the taxpayer will not be required merely to substitute the reserve provision for the deduction of all or a part of the actual costs and expenses which would have been allowed under present law.

To take a very simple example, assume that:

1. Cash discounts allowed in 1954 with respect to 1953 sales amount to	$10,000
2. Cash discounts allowed in 1954 with respect to 1954 sales amount to	100,000
3. Cash discounts to be allowed in 1955 with respect to 1954 sales are estimated to amount to	12,000

Section 462 would permit the taxpayer to establish a tax-deductible reserve at the close of 1954 in the amount of $12,000 (item 3 above). The question is, however, as to the amount of deduction for cash discounts which the taxpayer will be permitted to claim for the entire year 1954. Would it be $122,000, the sum of all three of the amounts listed above, or would it be only $112,000, the sum of items 2 and 3. The allowable deduction for the transition year should include item 1 inasmuch as no previous deduction has been allowed with respect to this item. It is conceivable, however, that regulations might provide that only items 2 and 3 are allowable deductions in the transition year since only these items relate to 1954 sales.

Under present law when a taxpayer is permitted to change from the actual loss method to the reserve method of deducting bad debts, he is allowed to deduct actual losses during the transition year as well as the provision for future losses. The same rule should apply under section 462, but it would be highly desirable to spell this out in the statute.

EXHIBIT I

SECTION 172. NET OPERATING LOSS DEDUCTION (DIVIDENDS RECEIVED CREDIT)

One of the basic principles of our system of taxation is that double taxation is to be avoided wherever possible. Recognizing this principle, the Internal Revenue Code, provides for a credit against net income of 85 percent of dividends received by one corporation from another. A provision of similar import has been contained in all the revenue acts as far back as 1917. The purpose of these provisions is and has been to eliminate double taxation of corporate earnings prior to their distribution to the individual shareholders. (H. R. 8300, the Internal Revenue Code of 1954 bill, would extend this principle of the elimination of double taxation even further, by granting certain exemptions and deductions to individuals with respect to their dividend income.)

Another basic principle of our system of taxation is that taxpayers which are equally situated are to receive equal treatment for income-tax purposes. Recognizing this principle, the Internal Revenue Code provides for a net operating loss deduction under which the taxpayer is allowed a 7-year period within which to offset the loss of 1 year against the income of other years. This provision is intended to provide assurance that the same aggregate income tax will be paid on the same aggregate net income earned over a period of years, whether it is the result of several years of steady profits of flows from the uneven pattern of both profit and loss years.

Under existing law, however, a corporation which receives dividend income and also suffers a net loss from operations in some years finds that these provisions, far from giving the relief for which they were enacted, actually result in the imposition of a double tax on the dividend income, and that the corporation having some loss years may pay more taxes on the income earned over a period of years than would be paid by another corporation earning the same income over the same period, but having a profit in each of those years. H. R. 8300 attempts to give at least partial correction to this inequitable and chaotic arrangement, but the provisions of that bill fall far short of the relief needed. The provisions of this bill will be considered in more detail later, but in order that they may be understood, it is necessary first to examine in more detail the provisions of existing law.

Under present law corporations which receive dividend income include the full amount of these dividends in their gross income. Pursuant to the provisions of section 26 (b) of the code they are permitted to take as a credit against net income 85 percent of the amount of these dividends. In other words, it is the general intent of this section that taxable income should include only 15 percent of the amount of dividends received. The same provision of the code, however, limits the credit for dividends received to 85 percent of net income. Consequently, in a loss year, when there is no net income, a corporation is entitled to no dividends-received credit. The full amount of dividend remains in income without any offset. Under present law, a net operating loss is defined to be the excess of deductions over gross income. Under such a simple and restrictive definition, it is at once apparent that no allowance is made therein for any dividends-received credit on the part of a corporation suffering a loss. Consequently, the corporation cannot have an operating loss under the present statute unless its deductions exceed its gross income computed by including therein 100 percent of the dividends received in the year of the loss. This definition of the net operating loss is of crucial importance in the matter with which we are dealing, since it is the net operating loss which must be carried over to another year as an offset against the income of that year, in order to determine the average income for the period upon which the taxpayer will ultimately pay income tax. Bearing this principle in mind, it is to be seen that while the corporation with a history of steady profits includes as income and pays tax upon only 15 percent of the dividends which it receives, a corporation which has suffered a loss and which is seeking tax equality under the net operating loss provisions by averaging the income of its profit and loss years, must include in income, and pay tax upon, 100 percent of the dividends received in the loss year. Clearly, this result frustrates to a great extent the policy of the net operating loss provisions.

As an illustration, let us suppose that each of 2 corporations receives $1 million as dividend income in a particular year. Corporation X makes a profit in that year, whereas corporation Y sustains a loss. Since corporation X has net income, it may take as a credit against that net income 85 percent of the dividends it has received, and pay tax only upon the remaining 15 percent. At the

current 1952 present rate, this would mean that corporation X would pay a tax of $78,000 on $1 million of dividends. Corporation Y on the other hand, since it has sustained a loss, is entitled to no dividends-received credit, with the result that ultimately, through the use of the net operating loss provisions, it must pay a tax upon the full amount of the dividend income, totaling at present rates, $520,000. In other words, the corporation with the loss pays $442,000 more in tax than is paid by a corporation with steady profits, upon the same amount of dividend income. The injustice of such a situation is clear, and should be remedied by appropriate legislation.

The discrimination under existing law against a corporation receiving dividends and suffering a loss extends still further. Let us assume by way of explanation that corporation Y, in the previous example, has determined its operating loss and now desires to offset that loss against the income of another year. Let us assume further that the net operating loss so computed amounts to $850,000 and that the income of the year against which the loss is to be offset amounts to $2 million of which $1 million has dividend income. Under present law, the net operating loss must be reduced by the amount of the dividends-received credit applicable to the profit year to which the loss is carried. Under the example, the dividends-received credit applicable to the $1 million dividend income would be $850,000. Since the net operating loss is the same amount, $850,000, it is completely wiped out by the dividends-received credit in the profit year. From another point of view, the dividends-received credit in the profit year is entirely forfeited. In other words, the loss corporation has given up its credit not only in the loss year, but also in the profit year to which the loss was carried.

H. R. 8300 would provide partial relief from this unjust and illogical situation. Under the provision of that bill, it would no longer be necessary for the loss corporation to forfeit its dividend received credit applicable to the profit year to which the loss is carried. In the committee report, at page 27, the House Ways and Means Committee notes that this provision would "lessen the differences in tax treatment of firms with fluctuating and those with stable incomes." Thus, the committee has recognized that discrimination exists under present law. It recognizes further that it has not removed this discrimination, but is only attempting to grant partial alleviation. It is submitted that there is neither logical reason nor justifiable excuse for the continuation of any part of this discriminatory treatment, and it should be moved in its entirety. The situation could be easily and completely corrected simply by converting the present dividends received credit into a fully allowable deduction.

Under present law, the taxable status of a corporation receiving dividends depends upon whether it makes a profit or sustains a loss, with a severe penalty placed upon the corporation unfortunate enough to sustain a loss. This is contrary to our whole system of taxation. If the profit corporation is entitled to a deduction for its dividend income, a loss corporation has an equal right to such a deduction. Indeed, it would seem that the equities should be in favor of the loss corporation, since that corporation is more greatly in need of favorable tax treatment in order to regain its place in the economic community. With the continuation of existing high rates, the full availability of a loss carryover is essential. A business with fluctuating income cannot hope to survive unless there is available some method of averaging its income over an extended period of years, to the end that it shall be placed in an exactly equal situation taxwise with the corporation with a steady level of income.

The net operating loss provisions can and should afford a means of providing a strong and economic incentive during periods of decreased business activity; in the face of declining profits it is unreasonable to expect business to go forward with expenditures for maintenance and expansion of its plant, or to keep employment at a high level, measures which are necessary on the part of all to maintain a stable and dynamic economy, unless it is assured that any losses which may be suffered can be fully offset against the taxable profits of other years. Otherwise, a company may be compelled to curtail such expenditures at a time when inaction would be most harmful to the country as a whole.

It is therefore recommended that—

1. The dividends received credit allowable under existing law should be converted into a fully allowable deduction from gross income.

2. The ded[illegible]ion for dividends received authorized by H. R. 8300 should be made fully a[illegible]able from the gross income of the taxpayer, without regard to the existence or absence of net income.

The first recommendation would require the following amendments to the Internal Revenue Code:

Add to section 23 of the code the following new subsection:

"(gg) DEDUCTION FOR DIVIDENDS RECEIVED BY A CORPORATION.—In the case of a corporation, 85 percent of the amount received as dividends (other than dividends described in section 26 (b) on the preferred stock of a public utility) from a domestic corporation which is subject to taxation under this chapter."

Section 26 (b) should be amended technically to remove the present subsection (1) which now allows a credit for dividends received from domestic corporations.

To accomplish the second recommendation, H. R. 8300 should be amended as follows:

Amend section 172 (d) (5) to read:

"(5) SPECIAL DEDUCTION FOR CORPORATION.—No deduction shall be allowed under part VIII (except sec. 243 (a) and 248) or under section 922 (relating to Western Hemisphere trade corporations)."

Amend section 246 (b) by deleting therefrom the first reference to section 243.

(The following letter was subsequently received for the record:)

NATIONAL ASSOCIATION OF MANUFACTURERS,
New York, N. Y., April 23, 1954.

Hon. EUGENE D. MILLIKIN,
Chairman, Committee on Finance,
United States Senate, Washington, D. C.

DEAR SENATOR MILLIKIN: At the time of testifying before your committee on April 21, our subcommittee on taxation of foreign income under the chairmanship of Mr. Malcolm G. Stewart, general counsel of the Gillette Co., Boston, Mass., had not completed its analysis of the relevant sections of H. R. 8300. Accordingly, I did not go into our current policy in this area, although, as quoted below, it was included as item V (j), of our specific recommendations attached as exhibit A.

"The reduced tax rate now afforded to Western Hemisphere business income should be extended under similar terms and conditions to business income from all foreign sources."

Yesterday this subcommittee met and developed the attached implementing statements on specific sections, which I hope may be included in the record as additional exhibits to my testimony. Also attached are two additional statements dealing with other sections of the bill which I likewise hope may be included as exhibits. I will be most grateful if you would extend to us this further courtesy.

Sincerely yours,

FRED MAYTAG,
Chairman, Committee on Taxation.

EXHIBIT J

SECTION 923. BUSINESS INCOME FROM FOREIGN SOURCES

SECTION 951. INCOME WHICH MAY BE DEFERRED

The association's policy on taxation of income from foreign sources, as adopted by its board of directors on April 14, 1954, on recommendation of its taxation committee, reads as follows—

"The reduced tax rate now afforded to Western Hemisphere business income should be extended under similar terms and conditions to business income from all foreign sources."

H. R. 8300, in its present form, falls far short of implementing this policy, which has been recommended by many other groups as well. By way of illustration, the bill, as now written, excludes from the 14-point credit all wholesale business conducted outside the United States without regard to whether the articles sold or distributed originated outside the United States, or are sold or distributed by the manufacturer or others, and regardless of the fact that there may be substantial investment in a foreign country or countries.

EXHIBIT K

SECTION 954. DETERMINATION OF WITHDRAWAL OF BRANCH INCOME

Under section 954, it should be made clear that, in the case of a corporation organized in the United States and engaged in carrying on an eligible trade or business in a foreign country, all of its assets and liabilities will be elected branch assets and liabilities, respectively, if and to the extent acquired or incurred, as the case may be, to establish or operate its business in such foreign country.

EXHIBIT L

SECTION 904. LIMITATIONS ON CREDIT

The limitations on foreign tax credit provided in section 904 should be amended to allow the taxpayer to elect annually whether per country or overall limitation shall apply.

EXHIBIT M

SECTION 923 (A) (3) (A) (III). SALE IN UNITED STATES

It is recommended that articles or products for further manufacturing or processing be excluded from the limitation imposed by section 923 (a) (3) (A) (iii).

EXHIBIT N

SECTION 923 (A) (3) (B) (1), OWNERSHIP PERCENTAGE

The percentage ownership in section 923 (a) (3) (B) (i) should be reduced to 10 percent to correspond with present ownership percentage for allowance of a foreign tax credit under the "tax deemed paid" provision. As a minimum alternative, the provision should not require more than the lesser of (1) 50 percent of the voting stock, or (2) the maximum percentage permitted under foreign law.

EXHIBIT O

SECTION 921. DEFINITION OF WESTERN HEMISPHERE TRADE CORPORATIONS

It is believed that the present Treasury position regarding incidental purchases of Western Hemisphere corporations is inconsistent with the intent of section 109 of the 1939 Internal Revenue Code, and it is recommended that reference to such purchases in section 921 of H. R. 8300 clearly state that purchase of materials for the purposes of the trade or business, regardless of where purchased, should not disqualify a corporation from the definition of a Western Hemisphere corporation.

EXHIBIT P

SECTION 921 AND SECTION 923 (A) (3) (A). DEFINITION OF GROSS INCOME

When defining gross income, there should be excluded therefrom the proceeds of insurance covering any properties outside the United States, its territories or possessions.

EXHIBIT Q

SECTION 1237. DEALERS IN REAL PROPERTY

Section 117 (N) Internal Revenue Code now extends to dealers of securities the possibility of capital asset treatment for securities which they may hold as

investments. The only requirement to get regular capital asset treatment is that such securities be identified as securities held for investment.

Section 1237 of the bill purports, according to the report (p. 84), to offer similar treatment to real-estate dealers. However, there are additional requirements imposed with respect to real-estate dealers, the most important of which is that property designated as investment property must be held for at least 5 years in order to enjoy the benefits of capital asset treatment.

The additional requirement for a 5-year holding period, instead of a 6-month holding period, would appear to be discriminatory and without justification, especially, since under decided court cases, if a real-estate dealer can establish that a particular piece of property was in fact held for investment, he may now enjoy long-term capital gains and loss treatment if he has held the asset for a 6-month period.

While tax provisions relating to real-estate dealers are not of primary concern to the NAM, this provision does, by extending the holding period, run counter to NAM policy on capital gains and indicates the possibility of more restrictive treatment for capital assets in other areas and in other industries.

EXHIBIT R

SECTION 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS

Section 117 (f) Internal Revenue Code now provides that amounts received on retirement of bonds with interest coupons or in registered form shall generally be considered as amounts received in exchange therefor. Accordingly, bonds issued at a discount, which discount may be in lieu of interest, and redeemed at par, results in the discount being treated as capital gains and, in effect, converting ordinary interest income to capital gains.

Section 1232 is designed to treat the original discount at time of issue as interest. This is done by prorating the original discount over the life of the bond and then requiring each holder of the bond to include as ordinary income his pro rata part of the discount as ordinary interest if he sells the bond for more than he pays. If the bond is sold at less, the whole difference is capital loss.

While there is merit in the idea underlying the proposal, it does not seem desirable in its present form. In this connection, it may be noted that: (1) Investors are not always in a position to know the original issue price. (2) The purchase and selling price of an intermediate holder is a reflection of market conditions and has little, if anything, to do with original discount. Thus, in a rising market when a bond issued at par rises to 102, a bond issued at 98 may sell at par. A portion of the gain would be attributable to the original discount. (3) If a bond is purchased at 98 and sold at 98, apparently a proportionate part of the original discount would still be includible as interest. In such case, and indeed in all cases under this section, there is no apaprent provision for adjustment of basis accordingly. (4) There is a de minimus rule so that this section shall not apply if the issue of discount is less than one-tenth of 1 percent per year for the life of the bond.

The CHAIRMAN. Mr. Sprague.

STATEMENT OF KENNETH B. SPRAGUE, AMERICAN & FOREIGN POWER CO., INC., NEW YORK CITY

Mr. SPRAGUE. My name is Kenneth B. Sprague. I am an officer of American & Foreign Power Co., Inc., located at 2 Rector Street, New York City.

I wish to express my company's appreciation for the opportunity of appearing here today to present our position in connection with those sections of H. R. 8300 which relate to the taxation of income from foreign sources. At the outset, may I say that we believe the provisions relating to the taxation of foreign income represent a major step toward encouraging investments in foreign countries, and strongly urge their adoption.

American & Foreign Power Co., Inc., is 1 of the 2 largest investors of private United States capital in Latin America, and the largest single public utility enterprise operating in the Central and South American countries. These operations are conducted through 51 subsidiaries, of which 9 are incorporated within the United States. The subsidiaries serve approximately 2,500,000 electric customers and have total assets aggregating almost $1 billion.

To date, this company has been responsible for the exportation from the United States of electrical equipment and other materials with an estimated value of more than $500 million. The effect of these purchases has been felt throughout our country; and the company's present program of property improvements and expansion will result in at least $1 billion in United States exports to these Latin American countries during the next 10 years. Our experience has been that as more electric power becomes available, expenditures will be made by the countries in which this development occurs for United States materials and equipment which will be required to build and operate factories, mines, and other establishments.

The demand for refrigerators, stoves, water heaters, motors, and household appliances will be greatly stimulated and encouraged by the higher living standards that come with the availability of electric power.

We believe that sound changes in the tax treatment of foreign income to United States private investments in foreign utilities will help provide the incentive for further expansion of these activites with coresponding benefit to the United States economy.

The tax incentives provided in section 923 and related sections, in their present form, should be of considerable aid to the economic development of foreign countries. However, there are one or two modifications in H. R. 8300 which we would like to suggest which would have little effect on tax revenues but would make the provisions of sections 923 and 951 more equitable. To the best of my knowledge, these suggestions have not been brought to your attention by any other witness appearing before this committee.

First, discrimination against companies receiving interest and dividends from United States incorporated subsidiaries. As you know, United States companies invest and carry on a trade or business in a foreign country either (1) through a branch operation, (2) through a foreign-incorporated subsidiary, or (3) through a domestically incorporated subsidiary.

The provisions of section 923 give an allowance of credit in the form of a 14-point reduction in the tax rate when income is derived from a branch or a foreign subsidiary, but when interest and dividend income is received from a domestically incorporated subsidiary engaged in exactly the same business, operating in the same manner, in the same territory as a branch or a foreign subsidiary, and meeting all the earnings and stock-ownership requirements of the section, a parent company does not receive this allowance of credit, simply because the place of incorporation of the subsidiary is in the United States.

The CHAIRMAN. Just a moment, please. What is the staff's position in that matter?

Mr. SMITH. I don't think it has been considered.

Mr. SPRAGUE. I don't think it has been mentioned.

The CHAIRMAN. Go ahead.

Mr. SPRAGUE. Thus, the country of incorporation of the paying company establishes the criterion for the tax relief. Where a domestically incorporated subsidiary operating abroad, in all respects meets the same earnings and business character tests as a foreign subsidiary, and a parent company meets the stock-ownership standards specified in section 923, it seems clearly inequitable and, in fact, almost paradoxical to deny tax relief to a parent company on the sole ground that a subsidiary was incorporated in the United States.

In other words, to obtain tax relief under this section, the place of incorporation of domestically incorporated subsidiaries would have to be changed to a country outside the United States. We feel that such a result is neither within the spirit nor intent of the proposed tax relief.

It has been suggested that the parent corporate stockholder of a domestically incorporated subsidiary operating in Latin America is afforded tax relief under existing and proposed code provisions pertaining to Western Hemisphere trade corporations. This, of course, is not true.

The provisions relating to Western Hemisphere trade corporations have been and will continue to be highly beneficial in the economic development of Latin America, and have, in themselves, demonstrated the value of tax incentives in relation to foreign trade. While the Western Hemisphere trade-corporation provisions apply a tax rate of 38 percent to the net income of such corporations, it should be emphasized that this reduced tax rate does not apply to the United States parent receiving income from the Western Hemisphere trade corporation.

Under both the existing law and under the proposed law, the parent company is taxed at the full 52-percent tax rate on interest from a Western Hemisphere subsidiary. This is the same tax rate imposed under existing law on the interest from a foreign incorporated subsidiary and which is to be changed under the proposed law.

In other words, the deduction for interest paid is allowed at 38 percent to the Western Hemisphere subsidiary, but the same interest, when received by the parent corporation, is taxed at 52 percent—and section 923, as now drawn, affords no relief from this inequity.

As we understand it, the intention of section 923 and related sections is to allow tax relief on interest and dividends which are derived from the earnings of foreign enterprises meeting the tests specified in that section. We take no exception to these tests for relief. However, the bill, as drawn, does not extend this intended tax relief to the parent company of a domestically incorporated subsidiary operating in Latin America, even though all the tests of section 923 are met.

We realize that dividends from a United States subsidiary are not subject to the same tax as those from a foreign subsidiary; hence, this statement is directed primarily to the taxation of interest income which, under existing law, is subject to the same tax rate whether received from a foreign subsidiary or from a domestically incorporated subsidiary.

As previously stated, American Power has 51 subsidiaries which operate wholly within 11 Latin American countries, rendering a public service vital to the citizens and economy of each country.

It seems to us that interest received by American Power on its investment in domestically incorporated subsidiaries operating in such countries should have the same tax relief as now provided in H. R. 8300 for interest and dividends received on investments in foreign corporations.

The proposed change could be readily accomplished by deleting from section 923 the words "foreign corporation" wherever they appear and inserting the words "corporation operating in a foreign country." We are submitting herewith a suggested section 923 which incorporates this modification.

Secondly, deferred income from foreign sources. Part IV of subchapter N of the income-tax provisions relates to deferred income from sources within foreign countries. The report of the Ways and Means Committee on H. R. 8300, at page 76, indicates that the basic purpose of those provisions is to permit a domestic corporation an election to defer tax on the profits of its foreign branches similar to the manner in which taxes are deferred on the profits of foreign subsidiaries.

Under section 951 of part IV, it seems clear that where the requisite qualifications specified in subsection (a) are met, deferral of income may be elected as to—

(*a*) Foreign branch operations of a domestic corporation, or

(*b*) All operations of a domestic corporation whose entire business is conducted within a foreign country.

However, subsection (c) specifies certain corporations which are ineligible for the deferred-income treatment, included among which are Western Hemisphere trade corporations. The exclusion of this class of corporation from deferred-income treatment appears to have no logical basis. Moreover, such exclusion evidently was not intended by the Committee on Ways and Means, since the committee report on H. R. 8300, at page A260, states:

"A corporation which simultaneously qualifies for the benefit of the treatment provided by part IV and for the special deduction allowed by section 922 may choose either of such benefits in the alternative."

It seems fairly obvious that the intention of the House was to permit deferral of tax on all income of the character specified by section 951 derived from foreign sources, whether earned by a branch, a domestically incorporated subsidiary, or a Western Hemisphere trading corporation. This recognition of the need for reinvesting earnings in a foreign country without first being subject to United States income tax is a new and most constructive principle in the taxation of foreign income, since it increases the amount of earnings available for reinvestment. This is especially important to a company such as Foreign Power, which could not possibly meet the rapid growth of demand for electric power in Latin America unless it reinvested a major part of its foreign earnings.

It is suggested, therefore, that section 951 be revised so as to make it clear that Western Hemisphere trade corporations are not to be excluded from the deferred-income treatment. This could be accomplished by deleting in its entirety subparagraph (2) of subsection (c) of section 951.

Thirdly, foreign tax credits. American & Foreign Power Co. and many other taxpayers have urged, and continue to urge, that the "per country limitation" upon the credit for foreign income taxes should be removed. The present bill cancels the "overall limitation" on foreign tax credits. While we have no particular objection to such cancellation, in passing we would like to state, it is our feeling that if income is earned within the United States it should be subjected to United States income tax. One result of the elimination of the "overall limitation" would be to permit a domestic corporation having United States income but a loss in a foreign country to offset the foreign loss against United States income, thereby reducing the United States tax otherwise payable on United States income.

As to the "per country limitation," there are a number of reasons why that limitation operates inequitably in the American & Foreign situation. I shall mention but one. Foreign Power, in order to meet ever-increasing capital requirements, has found it necessary to make substantial borrowings from sources within the United States, which borrowings apply to its operations as a whole. We feel that it is fundamentally unsound to be required, under the "per country limitation," to compartmentalize artificially the taxable income from these foreign countries and, by this procedure, curtail the credit for taxes paid in such countries, when all of such earnings, treated as a whole, must be used to pay fixed charges on indebtedness incurred to carry on the overall operations.

In several countries where the subsidiaries operate, the effective income-tax rate on the net income segregated to the respective countries under the per country limitation is substantially higher than the United States tax rates upon such net income, but the excess foreign income tax may not be taken as a credit against the United States tax imposed upon our total foreign net income. The original and basic purpose of the foreign tax credit provisions is to avoid double taxation of foreign income, but under the "per country limitation," as it now operates, when the total of the foreign and United States taxes paid on foreign income exceed the United States tax rate on the same foreign income, that purpose has been seriously impaired.

We respectfully recommend, therefore, that your committee revise H. R. 8300 so as to eliminate the "per country limitation" and reinstate the "overall limitation" with respect for foreign income-tax credits. This would allow a company operating in several foreign countries to treat foreign income taxes paid on foreign income as one total for credit purposes and, at the same time, leave undisturbed the United States income tax on income derived from within the United States.

Thank you, gentlemen.

The CHAIRMAN. Thank you very much.

(The accompanying statement of Mr. Sprague follows:)

SUGGESTED MODIFICATION OF SECTION 923 OF H. R. 8300

(Matter in brackets to be deleted; new language in italics)

SEC. 923. BUSINESS INCOME FROM FOREIGN SOURCES.

(a) ALLOWANCE OF CREDIT. In the case of a domestic corporation (other than a corporation described in subsection (d)), there shall be allowed a credit as

provided in section 37 with respect to taxable income derived from sources within any foreign country (determined under part I)—

(1) as branch income includible in gross income under part IV;

(2) as compensation for the rendition of technical, engineering, scientific, or like services;

(3) as dividends from a [foreign corporation] *corporation operating in a foreign country* if—

(A) the earnings and profits used in the payment of such dividend (including the earnings and profits of the year in which the dividend is paid), determined under subchapter C (sec. 301 and following) have been accumulated after December 31, 1953, and are earnings and profits of a year the gross income of which year—

(i) has been derived to the extent of at least 95 percent from sources without the United States,

(ii) has been derived to the extent of at least 90 percent from the active conduct of a trade or business through a factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business situated within a foreign country, and

(iii) does not consist of more than 25 percent of gross income derived from the sale of articles or products manufactured in such foreign country and intended for use, consumption, or sale in the United States,

but the credit shall apply only to the dividend or portion thereof paid out of earnings and profits conforming to the provisions of this subparagraph; and

(B) at the date of the declaration of the dividend and during the whole of the respective years in which were accumulated the earnings and profits specified in subparagraph (A)—

(i) such domestic corporation, either alone or in association with not more than three other domestic corporations, owned more than 50 percent of the voting stock of such [foreign corporation] *corporation operating in a foreign country*, or (ii) such domestic corporation owned not less than 10 percent of the voting stock of such [foreign corporation] *corporation operating in a foreign country*, and the trade or business of such domestic corporation was related to the trade or business of such [foreign corporation] *corporation operating in a foreign country* by reason of the rendition of technical, engineering, scientific, or like services or assistance, incident to the operation of the trade or business of such [foreign corporation] *corporation operating in a foreign country*; and

(4) as interest from a [foreign corporation] *corporation operating in a foreign country* if, throughout the year in which the interest is paid, such [foreign corporation] *corporation operating in a foreign country* fulfills the income requirements in paragraph (3) (A), and such domestic corporation fulfills one of the alternative requirements in paragraph (3) (B).

(b) For purposes of subsection (a)—

(1) the term "trade or business" does not include—

(A) the operation of an establishment engaged principally in the purchase or sale (other than at retail) of goods or merchandise, or

(B) the maintenance of an office, or employment of an agent, other than a retail establishment excepted from subparagraph (A), to import or facilitate the importation of goods or merchandise; and

(2) a dividend received by a [foreign corporation] *corporation operating in a foreign country* from another [foreign corporation] *corporation operating in a foreign country* shall be deemed to be income derived from the active conduct of a trade or business for purposes of paragraph (3) (A) (ii) of subsection (a) if—

(A) the earnings and profits used in the payment of such dividend conform to paragraph (3) (A) of subsection (a), and

(B) at the date of the declaration of the dividend and during the whole of the years in which were accumulated such earnings and profits such [foreign corporation] *corporation operating in a foreign country* owned more than 50 percent of the voting stock of such other [foreign corporation] *corporation operating in a foreign country*.

(c) LIMITATION. The aggregate amount within paragraphs (1), (2), (3), and (4) of subsection (a) in the case of any foreign country for any taxable year

shall not exceed the taxable income for the same taxable year from sources within such country.

(d) CERTAIN CORPORATIONS INELIGIBLE FOR CREDIT. The credit provided in section 37 shall not be allowed in the case of a corporation, which for the taxable year—

(1) is allowed a deduction under section 922 (relating to Western Hemisphere trade corporations);

(2) is subject to the tax imposed by subchapter L (sec. 801 and following relating to insurance companies);

(3) is allowed the deduction provided in section 941 (relating to China Trade Act corporations);

(4) is a regulated investment company (as defined in section 851 without the application of subsection (b) (1) thereof);

(5) is a personal holding company (as defined in section 542); or

(6) is a shipowners' mutual protection and indemnity association to which section 526 applies.

The CHAIRMAN. Mr. Brennen.

STATEMENT OF WILLIAM S. BRENNEN, NATIONAL PATENT COUNCIL

Mr. BRENNEN. My name is William Brennen, and I speak for the smaller manufacturers, inventors, and researchers associated with the National Patent Council.

I would like to address my remarks today to the subject of capital gains treatment of income from patents, as provided in section 1235 of H. R. 8300.

In view of the deep significance of——

The CHAIRMAN. Tell us a little bit about the patent council.

Mr. BRENNEN. We are an association of inventors and patent holders and patent attorneys. We have about 1,500 or 2,000 members scattered throughout the country.

The CHAIRMAN. An advisory organization?

Mr. BRENNEN. An educational nonprofit organization.

The CHAIRMAN. Thank you.

Mr. BRENNEN. In view of the deep significance of its subject, we assume that the 5 minutes allotted us at this hearing reflects a determination upon the part of the committee and its staff to give full and serious attention to the written statement requested by your committee and here presented in the requisite number of copies.

The CHAIRMAN. Every one of those statements submitted for the record is carefully analyzed by the staff, and the whole matter will be brought to our attention in executive session.

Mr. BRENNEN. I would like to request that our statement submitted already in full be made a part of the record.

The CHAIRMAN. It will be made a part of the record.

Mr. BRENNEN. America's superior economic and defensive strength has grown out of a broader and more tenacious pattern of law, providing incentives for creative and productive effort, than exists or has existed in any land. Now that our Nation is threatened by devices for destruction built upon our own creations, we can ill afford to neglect even the slightest opportunity to stimulate, with hope of individual reward, all Americans to invent, prepare for production, and produce new and better things for national defense and for the enrichment of our daily lives.

The statement herewith submitted is based upon the deep and intimate experiences of generations of creative and productive citizens—

long consecrated to high diligence in advancing our strength to live well and resist aggression. The compelling social and economic portent of the forces discussed has been attested the hard way by citizens inspired to sacrificial effort only by the hope of earning and accumulating, under protection of our patent system, a competence against a rainy day.

For the past few years we have been taxing away the fruits of diligence. We substitute a deep discouragement, not only of the inventor but also of the man whose savings so often are required to support the inventor and his inventions—until they can be refined and produced in form for greatest service to our people. Our race with foreign enemies for vital technological advantages makes imperative that we withhold no reasonable modification, of taxation of income from patents, that will stimulate the individual to help advance our progress in that race.

Section 1235 of H. R. 8300 provides for a capital gains allowance on patent income for the inventor alone. The driving force of our patent system has come out of the fact that rewards for inventive and productive achievement have not been limited to the inventor alone. These rewards have been shared by others whose help, financial and otherwise, has been indispensable in encouraging the inventor to believe that his efforts, usually sacrificial, would be rewarded.

Frequently, the inventor risks his time and effort, while his associate in the venture risks savings already earned. Only the promise of patent protection and fair tax treatment can give either a hope that will hold fast through disappointments common to all such projects. Tremendous public benefit can be anticipated from the increased incentive resulting from a preferential tax treatment being given to income accruing to the inventor or to any or all associated with him in ownership of the invention. To this end, it is proposed that such income be excluded entirely from gross income subject to taxation. As a minimum alternative, it is proposed that such income be designated as qualified in full for a capital gains allowance. Naturally, the income accruing directly to the inventors, licensees, or assignees from the manufacture, sale, or use of the patented product would remain fully subject to ordinary income tax.

Moreover, no one can predict during what years, if ever, an invention may prove productive of income.

Section 1235, as it now stands, more often would force an inventor, and his risk-taking associates, to accept a very meager return, if any, throughout the "first 5 years," which are normally profitless years, devoted to tedious efforts to give the invention correct design, facilities for production, and market penetration. For maximum public benefit from enhanced inventive incentive, this period should be extended to the full life of the patent.

Resultant impetus to invention and production can readily provide an increase in income from taxes. Resultant increment in strength for national defense could be the deciding factor in determining at last whether we shall have anything left to tax, or have left any power as a sovereign people to levy or abate taxes.

Your serious attention to our recommendations and our supporting brief is most respectfully requested.

The CHAIRMAN. I may say that 5-year provision has come under a lot of criticism and is being carefully studied by the staff.

Mr. BRENNEN. I can well understand that the law as it is right now, is more favorable to the inventors than the proposal which, according to the House, was to increase inventive incentive. And many of the inventors feel quite to the contrary, that it actually decreases it, rather than increases it.

The CHAIRMAN. We will give that careful consideration.

Senator FLANDERS. May I make an inquiry: You made a suggestion here that those who would furnish funds for the development of the invention, as well as the inventor, should share in the capital gains treatment.

Mr. BRENNEN. Yes, sir.

Senator FLANDERS. How would that apply to a situation like that of an inventor whose funds were provided by and whose patents were assigned, say, to the Du Pont Co.?

Mr. BRENNAN. We have mostly small inventors in our association, but I don't see that it would make any difference.

Senator FLANDERS. It must be universal.

Mr. BRENNEN. I think it should.

Senator FLANDERS. As it is restricted in its .erms.

Mr. BRENNEN. The same treatment should be provided. However, I call your attention to the statement that I made, that income arising from the manufacture of an invented product would be normal income and, to a great extent, the so-called big corporations that finance inventors make their money out of producing products.

Senator FLANDERS. I can see a little bookkeeping problem there, and I am quite interested in the matter of increasing that term of 5 years. I am not so clear on extending it to the financial support of the invention.

Mr. BRENNEN. If I could take about 1 minute——

The CHAIRMAN. Senator Flanders is an inventor.

Senator FLANDERS. I have 39 patents in my name.

Mr. BRENNEN. Then, if I may, instead of talking in terms of du Pont, may I talk in terms of a small inventor, working in his barn, who is financed by the widow next door, who puts her last thousand dollars into his invention because of her confidence in him, and she takes in return a share of his invention.

The CHAIRMAN. Off the record.

(Discussion off the record.)

Senator FLANDERS. I might say that one of the most interesting periods of my life was acting as a designer for a French Canadian inventor, whose wife paid my salary by dressmaking. And my duties were, first, to put the invention into a suitable design and, second, to shoo off the creditors at the front door while the inventor ran out the rear door into the lumberyard. So, I have had some experience with those shoestring projects.

Excuse me. That is all extraneous.

Mr. BRENNEN. On the benefit of that experience, I don't think my remarks could add anything.

Senator FLANDERS. And the companies in existence today are just prosperous. And that was in the year 1903, 50 years ago.

The CHAIRMAN. The committee is very much interested in the general subject.

Mr. BRENNEN. If there is anything further in the future we could do, I would be only too happy to submit further information.

The CHAIRMAN. Senator Flanders will give us all the information we need.

Mr. BRENNEN. Thank you.

(The prepared statement of Mr. Brennen follows:)

STATEMENT OF WILLIAM S. BRENNEN

I am William S. Brennen, speaking for smaller manufacturers, inventors, and researchers associated with National Patent Council. I live at 5 Peter Cooper Road, New York City. I speak upon the subject of capital-gains treatment of income from patents as provided in section 1235 of H. R. 8300.

In view of the deep significance of its subject, we assume that the 5 minutes allotted us at this hearing reflects a determination upon the part of the committee and its staff to give full and serious attention to the written statement requested by your committee and here presented in the requisite number of copies.

America's superior economic and defensive strength has grown out of a broader and more tenacious pattern of law, providing incentives for creative and productive effort, than exists or has existed in any land. Now that our Nation is threatened by devices for destruction built upon our own creations, we can ill afford to neglect even the slightest opportunity to stimulate, with hope of individual reward, all Americans, to invent, prepare for production, and produce, new and better things for national defense and for the enrichment of our daily lives.

The statement herewith submitted is based upon the deep and intimate experiences of generations of creative and productive citizens—long consecrated to high diligence in advancing our strength to live well and resist aggression. The compelling social and economic portent of the forces discussed has been attested, the hard way, by citizens inspired to sacrificial effort only by the hope of earning and accumulating, under protection of our patent system, a competence against a rainy day.

We are taxing away the fruits of diligence. We substitute a deep discouragement, not only of the inventor but also of the man whose savings so often are required to support the inventor and his inventions, until they can be refined and produced in form for greatest service to our people. Our race with foreign enemies for vital technological advantages makes imperative that we withhold no reasonable modification of taxation of income from patents, that will stimulate the individual to help advance our progress in that race.

Section 1235 of H. R. 8300 provides for a capital-gains allowance on patent income for the inventor alone. The driving force of our patent system has come out of the fact that rewards for inventive and productive achievement have not been limited to the inventor alone. Those rewards have been shared by others whose help, financial and otherwise, has been indispensable in encouraging the inventor to believe that his efforts, usually sacrificial, would be rewarded.

Frequently, the inventor risks his time and effort, while his associate in the venture risks savings already earned. Only the promise of patent protection and fair tax treatment can give either a hope that will hold fast through disappointments common to all such projects.

Tremendous public benefit could be anticipated from the increased incentive resulting from a preferential tax treatment being given to income accruing to the inventor or to any or all associated with him in ownership of the invention. To this end it is proposed that such income be excluded entirely from gross income subject to taxation. As a minimum alternative, it is proposed that such income be designated as qualified in full for a capital-gains allowance. Naturally, the income accruing directly to the inventors, licensees, or assignees from the manufacture, sale, or use of the patented product would remain fully subject to ordinary income tax.

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Resultant impetus to invention and production can readily provide an increase in income from taxes. Resultant increment in strength for national defense could be the deciding factor in determining at last whether we shall have anything left to tax, or have left any power as a sovereign people to levy or abate taxes.

Your serious attention to our recommendations and our supporting brief is most respectfully requested.

STATEMENT OF JOHN W. ANDERSON, PRESIDENT, NATIONAL PATENT COUNCIL ON H. R. 8300—SECTION 1235 THEREOF APRIL 21, 1954

My name is John W. Anderson. My residence is 578 Broadway, Gary, Ind.

This is the statement referred to by Mr. William S. Brennen, representing National Patent Council, in his brief oral references already heard by your committee. Copy of Mr. Brennen's presentation is attached hereto, for your convenience in reference.

I speak in my own behalf as a citizen; in behalf of the Anderson Co., manufacturers, Gary, Ind.; and in behalf of National Patent Council, Gary, Ind., of which I am president.

The council is a nonprofit, nonpartisan, educational organization of smaller manufacturers, inventors, researchers, and other professional groups active in the fields of science, research, and invention. Smaller manufacturers associated with the council operate in many different industries throughout the Nation.

I am president and active administrative head of the Anderson Co., Gary, Ind., which I founded in 1918. My company is in its 37th year of uninterrupted research, product development, and manufacture. Hundreds of millions of products, embodiments of patented inventions perfected in its laboratories, have served and are serving citizens of America and of all other civilized countries. Its products, original equipment on millions of motor vehicles, boats, and aircraft—and available through thousands of retailers in every State—serve outstandingly in the fields of public safety, economy, and convenience—as well as national defense.

I have served, during the past 30 years, as president of other national associations of manufacturers and am at present affiliated with a number of national manufacturers' associations. I was cofounder, an officer, and a member of the board of directors of the Automotive Council for War Production of Detroit—throughout World War II. During 3 consecutive years of World War II, I served as president of Motor and Equipment Manufacturers Association, a national association with headquarters in New York City. I have represented industry on various advisory committees of Government. I have had wide opportunity to study, in practical experiences at creative and productive levels, the forces that propel our industry.

What men similarly experienced have found to be the basic propulsive forces of our economy I could not perhaps bring to your sympathetic understanding more acceptably than by making a part of this statement the attached copy of my address of April 10, 1950, to the annual congress of the National Society, Daughters of the American Revolution, assembled in Constitutional Hall, Washington, D. C. May I quote from that address, as reflecting its theme, the following:

"In God's primal law—the law of self-preservation—is rooted every beneficient law of man.

"The will to survive demands that it be served with promise of advantage through achievement.

"Security for the Nation can be assured only through productive achievement of the citizen—at labor within a stable pattern of recorded law protecting his production.

"There is no other road to security.

"A citizenry without individual incentive to labor diligently for honest personal profit is doomed."

* * * * * * *

"Among our institutions offering the citizen inducement to extraordinary effort is, for example, that granting the right by patent to exclude others, for a period of 17 years, from the manufacture, sale, or use of his inventions.

"That incentive has kept creative leaders working a hundred hours a week to produce inventions that have made it possible for millions to enjoy, for a 40-hour workweek, the highest standard of living known to man.

"Today those inventions preserve our health and extend our span of life.
"They weave the cloth that clothes us. They make our shoes.
"They wash our clothes. They plant and tend our crops and harvest them.
"They package and preserve our foods.
"From baker's bread to building brick, try to name a single product, fabricated by man, that has not been made better or cheaper because of patented inventions, either embodied in the product or employed in making it."

(Note every product distributed by the income-tax favored cooperative store has been made more useful, more desirable, by the labors of inventors.)

* * * * * * *

"The touchstone of liberty is incentive to produce—thus to serve the needs of all.
"Only as we keep watchful of our liberty—keep strong to fight all those who would destroy incentive to labor long for honest profit—may we deserve our priceless heritage.
"Planners in Government who preach that survival of our Nation and its people can be assured in any other way are ordering—in stupidity or greed—our sure destruction.
"To survive we must return to the faith of our fathers.
"We must return to respect for the divine truth upon which our fathers based our Constitution."

* * * * * * *

The planners of our Nation long since have given incentive-destroying effect, in our Federal tax laws, to their lack of understanding of the traditional American concept of great rewards for great creative achievements. Leveling tactics in taxation, erecting a ceiling in limitation of rewards, as was inevitable, have leveled incentives and ambition—somewhat in proportion. Thousands of creative men, discouraged by punitive policies of taxation, long since have relaxed their efforts to create—with marked reduction in potency of factors for growth of propulsive power in our economy.

Creative men are most sensitive to proofs of lack of appreciation on the part of beneficiaries of their efforts. That characteristic is but a natural result of the tensions that must be maintained by creative men in concentrations essential to success of their projects.

Only the catalytic power of invention—in practical applications of the forces of our newest sciences—can make our Nation truly secure. Invention is a function solely of the individual. Corporations do not—cannot—invent. Incentive to invent must be tailored to the nature of the individual—to his instinct for self-preservation—for personal security. Such incentive should be most lavishly inspired in times of greatest danger to our Nation.

Only by exciting to sacrificial individual effort our citizens capable of creative achievement, may we make overpowering our defenses against those killers of the earth who walk always behind us—with borrowed weapons in their hands—those enemies whose infiltrates among us strive constantly to divert our thinking from those fundamental truths upon which our fathers framed the basic concepts that have made and kept us strong.

Gentlemen of the committee, the inventors of America long have felt what they have considered to be a will on the part of our Congress to discriminate against them, in a discrediting way, by extending capital-gains and depletion allowance advantages to those who merely deal with, and manipulate—while they deplete—age-old resources of our Nation created by natural processes. They understand why it is considered in the public interest to treat woodlands, oil, and mineral deposits as deserving special consideration in the method of applying taxes. Much risk and heavy investment is required in exploration for oil and minerals. Great losses may be encountered. Deposits when finally discovered and put into production are steadily depleted, although they may remain productive for a great deal longer than the average productive life of a patent.

Even a cursory investigation of the business of recovering oil and minerals will make clear that each such operation is greatly facilitated today, as compared with practices of just a few years ago, through contributions by inventors of new tools, equipment, methods, and processes which, until quite recently, were less than a glint in the inventor's eye.

The money invested each year in America, in nonproductive experiments incidental to the development of inventions, greatly exceeds the cost of all the dry holes put down by the oil industry. Such experimental disappointments leave no

spectacular scars visible to the casual traveler. However, they must be paid for out of productivity of the less-frequent inventive projects that mature into salable and useful things.

May we point out one significant difference? The oil deposit, the mineral deposit, that is not discovered today will remain intact for discovery tomorrow. The inventive discovery of the creative mind comes out of nowhere. As a rule it results only from mental diligence inspired by a hope of individual reward. It may lie dormant and unformed in a human mind—to be lost forever when that human is lost—unless that human is excited and encouraged, by hope of gain, to nourish the germ of thought and give it, through labor, its chance to live and grow in usefulness.

History discloses convincingly that when any nation destroys incentive of free citizens to labor long hours to invent, produce, and distribute new and better things, that they may profit, from a share of benefits they bring their neighbors, that nation defies the primal law and works its own destruction.

Witness layer upon layer of lost civilizations whose production expanded, whose cultures deepened and whose strengths for survival were enhanced until exactions and extortions, made or permitted by government, left their citizens no hope that productive diligence would be rewarded.

That all these things are true of course has long been known to you. It is, however, sometimes difficult, when caught in the churning forces of current national problems, to hold fast to fundamental things.

Once we are reminded that our patent system, through hope of reward extended to diligent citizens, becomes the goose that lays the golden inventive eggs of our economy, it becomes quite clear that, if pressure must be applied to that goose, its neck should be avoided.

The neck of the master goose that must continue to produce strength for national security is inventive incentive. Our plea to you today is that such incentive be given the stimulus which must result from removal of the pressure of discriminatory taxation. Let's resolve not to continue to tell the inventor that he somehow is less useful to our public than the man who gambles in the stock of the prosperous corporation his inventions have established. The man who trades in stocks need benefit nobody but himself. The creator of a successful invention—to earn and receive a profit from his efforts—perhaps extended over years of self denial—must benefit the public.

An examination of the House Ways and Means Committee report on H. R. 8300 reveals that the committee members were fully aware of the national advantage to be gained by increasing inventive incentive by reducing taxation on patent income. In their own words, they explain the purpose of the new section to be "to provide a larger incentive to all inventors to contribute to the welfare of the Nation."

Unfortunately, contrary to their avowed purpose, the committee has not only failed to increase incentive but, conversely, has actually decreased the area within which patent income will be treated as capital gains.

Under the existing law, most courts have granted capital-gains treatment to all patent holders, inventors, and financiers alike, during the full life of the patent. It is true that some people, seeking to reduce this incentive, contend that only amateur inventors are entitled to such treatment, but the courts in most recent cases have refused to accept this interpretation.

H. R. 8300 (sec. 1235), as it is proposed, would restrict capital gains to the actual inventor alone and would limit even his benefits to a 5-year period. Obviously such an approach can have only one result—a reduction of the incentive of the inventor to create and of the financier to produce.

While the very thought might outrage the cultured sensibilities of men who from their high places in the world of planning, would wish us always well, according to their understanding of our needs, you will find among conscientious and patriotic men in the world of practicalities a strong conviction that you should make all income from patents free entirely from all Federal or other tax. To do so, they believe, would give to invention in America such tremendous impetus as would create new jobs for millions and would create new corporate and other income yielding to our National Treasury far more in taxes than would have been removed, by such tax remission, to end discouragement of our investors. Even the tax remitted, or most of it, would be devoted at once by the inventor to investment in facilities and opportunities for further extensions of creative effort.

By this one simple stroke we could make certain that we would outdistance all competing nations in our race for survival against whatever hordes of misguided peoples might be led to attack us.

Authors of ideological distortions that obscure—in fact, may be intended to obscure—the basic forces by which our survival must be forged may fight hard to obstruct and prevent enhancement by such a simple expedient of the magic that can be wrought by harnessing our progress to man's most propulsive instinct, fired by the law by which he seeks for himself individual advantage and security.

It is proposed that section 121 of part III; Items specifically excluded from gross income, be renumbered section 122 and that there be added in numerical sequence to part III a section to be designated as section 121, reading as follows:

"SEC. 121. GAIN FROM THE SALE, EXCHANGE, OR LICENSE OF PROPERTY CONSISTING OF A PATENT OR APPLICATION THEREFOR.

"(a) Gross income shall not include any amount received from the sale, exchange, or license of property consisting of a patent or application therefor, or any undivided interest therein, including any part of the rights in such patent or application."

We here propose, as a minimum alternative to the remission of all such taxes on patent income, as above suggested, that all income received from the sale, exchange, or licensing of patents be treated as capital gains. To this end we propose that section 1235 of H. R. 8300 be stricken in full and that there be substituted therefor the following:

"SEC. 1235. SALE, EXCHANGE, OR LICENSE OF PATENTS.

"(a) GENERAL.—Gain from the sale, exchange, or license of property consisting of a patent or application therefor, or any undivided interest therein which includes a part of all rights in such patent or application, shall be deemed gain from the sale or exchange of a capital asset if, and only if—

"(1) Such proceeds of such sale, exchange, or license are received by the seller or licensor during the life of the application and or patent. For purposes of this paragraph, any proceeds due and payable within such period and which have been deferred by reason of failure of the purchaser or licensee (or any successor thereof) to fulfill a contractual obligation relating thereto shall be deemed to have been received within such period."

If additional supporting documentation is desired by the committee or its staff, or by any member of either, we shall be happy to supply it upon request; as promptly as its availability will permit.

Respectfully submitted.

JNO. W. ANDERSON,
President, National Patent Council.

The CHAIRMAN. Mr. Brainerd. Mr. Brainerd, sit down and be comfortable and identify yourself to the reporter, please.

STATEMENT OF ANDREW W. BRAINERD, ATTORNEY, CHICAGO, ILL.

Mr. BRAINERD. Mr. Chairman, distinguished gentlemen, my name is Andrew Brainerd, an attorney from Chicago. I am here to speak briefly to you about sections 923 and 951, being business income from foreign sources.

I am a partner of the Chicago law firm of Baker, McKenzie, Hightower & Brainerd, a firm which has for some years specialized in the field of private international law. In the course of that work, we have had occasion repeatedly, if not constantly, to deal with those of our internal revenue laws which deal with business income and business activities in foreign countries, as well as with the laws of foreign countries which govern that type of income.

Now, I appear here today, gentlemen, at the expense of our firm. No one group of industries has sent us down, nor has any company or group of companies. We represent perhaps 50 companies in different aspects of American industrial life, from the heavy-goods industry to cosmetics, for example, and from machine tools to farm products, which are refined and sent abroad.

Also, I am an unofficial representative of about 6 or 8 foreign trade groups scattered throughout the Middle West, groups such as the Board of Export Managers of Chicago, having some 600 members, and other groups which have gone on record as opposing certain portions of these sections, which I wish to discuss briefly with you today.

I have, incidentally, prepared a formal memorandum, which has been presented both to Mr. Stam and to the Treasury Department, which I would like, at the conclusion of this brief testimony, to have incorporated in the record.

The CHAIRMAN. It will be incorporated.

Mr. BRAINERD. Thank you, sir.

Now, gentlemen, anything I have to say today is predicated on the assumption that it is the wish both of the President and of Congress, including yourselves, that there be some type of tax incentive offered to American foreign trade and investment. In other words, if that is not the fact, then what I have to say is entitled certainly to no consideration. But it is our view, based upon the experience which we as a group collectively have had, and with all of the industries that we represent, that these sections in their present form will give an incentive to perhaps less than 10 percent of the broad range of American industry that is engaged in foreign trade.

I want to explain precisely why: First of all, gentlemen, there are two words in section 923: "retail establishment." We have been repeatedly asked how they got into the law. None of us is able to understand why or how, or where or who put them into the law. Because you and I know, gentlemen, that retail establishments form no part of American foreign trade.

I believe that the Treasury is fully aware that the definition of a retail establishment is just what is set out in a number of Supreme Court cases. The definition has been adopted by the Bureau of the Budget, for example, the Bureau of the Census, and other agencies, that a retail sale is a sale for personal or household consumption. That is the definition repeatedly accepted.

On the other hand, a wholesale sale is one either for resale or for industrial or commercial use.

Now, if you think with me for just a moment, what companies are there who sell in foreign trade in retail establishments?

The CHAIRMAN. We have some subsidiaries of American companies operating in Brazil, for example.

Mr. BRAINERD. Yes, sir; there are a few. I think Sears, Roebuck & Co., F. W. Woolworth, possibly Singer Sewing Machine. But look at what American industry really is. I am talking about heavy equipment, for example, all types of machinery, motors, all types of products that go for sale to industry. All those are excluded, sir, from that category.

Now, I am glad you mentioned Brazil, sir, for this reason: Yesterday there appeared before this body a very distinguished and respected authority in this field, a gentleman by the name of Richard Momsen, an attorney who has lived in Brazil for over 40 years. He is a director of the American Chamber of Commerce for Brazil, here specially to address you on this subject. He testified before this group that less than 20 percent of the companies that are actually in operation in Brazil will benefit by this law. Now——

Senator FLANDERS. Twenty percent will not?

Mr. BRAINERD. Only 20 percent will; yes, sir.

There has been a statement made, I am told, by the Secretary of the Treasury that the Treasury is agreeable to having American income from the sale of goods abroad, of goods manufactured abroad, entitled to this type of tax relief. And for that reason they allowed to be included in these sections the word "factory," which you gentlemen I am sure will recall. In other words, income from a factory abroad is entitled to a credit.

The CHAIRMAN. Just a minute. Mrs. Springer, as I recall, when the Secretary of the Treasury was here, we asked him to give us some supplemental data, justifying the provision which the gentleman is speaking about. Have we had the supplemental data?

Mrs. ELIZABETH B. SPRINGER (clerk). Yes; I think we have received that.

The CHAIRMAN. There have been a lot of complaints. And I think we did not, at the time we heard the Secretary, think the explanation was as clear as it should be. I haven't seen the supplemental explanation, but I do know the staff is giving it very serious consideration.

Mr. BRAINERD. Splendid.

I would like to point out very briefly, if I may, the operation of this word "factory" in actuality. In other words, how it works out in practical operation.

It seems a very easy thing to say that income from a factory abroad will be entitled to this type of credit. But let's look at how this thing really works. Let's take an example from life, a drug concern which has a plant in France, an actual example, sir, and included in this brief, among others. They produce in France 6 or 8 different drug items the standards of performance and quality being very high. In order to remain in business and to remain competitive, they have to sell at least 500 items. Now, they can only make over in France 6, 8, or maybe a dozen items. To stay in France they have to offer for sale 500. Now, if they do business in this way, the way they have been doing business, they aren't going to get any tax relief.

The CHAIRMAN. What has the staff been doing about that?

Mr. SMITH. We are looking at the problem which was mentioned a while ago. While the Secretary was here, there were quite a number of questions asked, and we are going into it very carefully.

The CHAIRMAN. Thank you.

Mr. BRAINERD. Take a branch of a heavy goods industry in France. Understand, sir, that the only incentive offered to American industry in the Eastern Hemisphere is the section I am talking about. Take a branch operating in Paris. They have employees over there, and they have stock, say, on the floor. samples: They get no tax relief under this section.

Take, for example, a company that I know of, the name of which is very familiar to you, the Esso Co. They have extracting facilities operating in Latin America. If they sell abroad those products, those oil products, refined products, which are made abroad, through any one of their operating subsidiaries, that is their merchandising subsidiaries, they get no tax relief whatsoever under these sections.

Now, I merely mention these few examples, gentlemen, for this reason, that these I firmly believe are representative of not just one industry but the whole range of American industry with which we have daily contact.

Senator FLANDERS. Mr. Chairman, might I ask a question here?

The CHAIRMAN. Yes, Senator Flanders.

Senator FLANDERS. I find myself a little confused as to the objectives of this section in the new tax bill. At one time it was more or less clear in my mind that the purpose was to stimulate American investment abroad. Now, you are arguing on the basis of stimulating the expansion of American business abroad, irrespective of whether there is investment involved or any heavy expansion of productive or distributive facilities.

Mr. BRAINERD. That is an excellent point, sir. Let me explain it this way: First of all, take the case of the drug concern. They have a direct dollar investment abroad, in France. They get no relief under this section—none.

Take the case of wholesale activities, that is, the establishment abroad of branches or actual office facilities, including the stocking of an inventory, say, in any country in the Eastern Hemisphere, Africa or Asia, where the trouble really is going on. Those people, regardless of the amount of investment they make, if they have a dozen salesmen out, trying to cultivate sales in the Congo, for example, or in French West Africa, they get no relief at all under these sections. Now, true, those are direct investments abroad.

Let me point this out: According to the latest statistics that are available in the 1953 Statistical Abstract of the United States (although I understand there are later ones), in 1950 there were something like $540 million of American investments in wholesale establishments, that is, in offices and facilities of various kinds in the wholesale distribution facilities of American firms. At the same time, there was $220 million invested, as you have pointed out, Senator Millikin, in retail facilities abroad. The point is that there are 2½ times as many dollars invested in wholesale activities abroad than there are in retail, and yet those people who have, in good faith, gone abroad under the encouragement that Congress and others have given them over the last 6 or 8 years, get nothing whatsoever now by way of a tax incentive.

Now, my hope today only is to point out these things to you gentlemen, in the way of pointing up the fairness which is involved. In other words, if it is fair to people who have gone ahead and spent money, who now are organized over there and who have become directly committed abroad, that any type of relief be taken away from them, then that may be the way it will have to be.

But my point is, gentlemen, that in fairness to all, we feel that these people who are spending money and who have spent money, are going to be entitled fairly to relief.

The CHAIRMAN. What distinction does the Treasury make between a man who invests in a factory abroad and a man who runs a wholesale business with distributive facilities?

Mr. SMITH. The thought, Senator, is that the competitive situation is that a manufacturer in this country, one who has been paying a 38-percent rate, and another a 50-percent rate, and they have buildings right next door in the same town, one shipment is out of the country and the other is into the country.

Mr. BRAINERD. Of course it is an awful job to sell goods abroad today, isn't it?

Mr. SMITH. That was the reason it was restricted.

Mr. BRAINERD. Of course that is what is being taken away from them now, just at the time when they need the help the most. Gentlemen, our office is in daily contact with a number of different industries, and I affirm to you that competition throughout the world today is worse than it has been, certainly, since I have been practicing law, for a good many years, worse now than it has been for years and years. The papers are full of it. Trade journals are full of it. But at a time when these people need some kind of help the most, it is being taken away from them.

The CHAIRMAN. The basic question is what do we want to encourage in terms of foreign investment? Isn't that it?

Mr. BRAINERD. I think that is it; yes.

The CHAIRMAN. Have you had a talk with the gentlemen of the staff.

Mr. BRAINERD. I have furnished them with copies of my brief. I talked to Mr. Greisman, of the Treasury, and Mr. Horn, of Mr. Stam's office, but I didn't have an opportunity to talk to Mr. Stam because he is a very busy man.

I have submitted these briefs. I haven't had any acknowledgment that they have received them, but I believe that they have.

The CHAIRMAN. Have you received the briefs?

Mr. SMITH. Yes; we have.

The CHAIRMAN. Thank you.

Mr. BRAINERD. Thank you very much.

(The statement submitted by Mr. Brainerd follows:)

CHICAGO, ILL., *April 7, 1954.*

Re Sections 923 and 951 of H. R. 8300—A brief review of the probable consequences of the proposed sections, and suggestions in support of a slight alteration of their wording to insure substantial justice and to effectuate the will of Congress.

Mr. COLIN STAM,
New House Office Building, Washington, D. C.

Mr. KENNETH W. GEMMILL,
Main Treasury Building, Washington, D. C.

I. There is an imperative demand for adequate tax legislation in the field of foreign trade and investment

A. The President has urged that "Business income from foreign subsidiaries or from segregated foreign branches * * * be taxed at a rate 14 percentage points lower than the regular corporate rate."

B. The Randall Commission has recommended that income from foreign investment be taxed at a reduced rate, noting that on all sides "there are signs that the world stands at the beginning of an era of expansion of world trade."

C. Throughout the United States, voices are calling attention to our tax legislation which places American business abroad at a competitive disadvantage with that of other countries. (See report of Committee on Ways and Means of House of Representatives, page 74; also, Report of Proceedings of the 40th National Foreign Trade Convention held November 18, 1952, in New York.)

H. R. 8300 purports to meet these pressing requirements outside of the Western Hemisphere through sections 923 and 951. The adequacy of these sections is examined herein.

II. The terms "retail establishment" and "factory," as used in sections 923 and 951, unfortunately exclude the great bulk of American foreign source income from the preferential treatment urged

A. *"Retail establishment"*.—American production flowing abroad is almost exclusively directed either toward resale in the country of destination or to foreign buyers for their commercial or industrial use. Statistics are understandably not available on the ultimate use contemplated for American exports, but even the most casual review of such data on American exports is convincing

that certainly no more than 1 or 2 percent of our entire export goes to the foreign buyer for his personal or household use (as opposed to commercial or industrial use or for resale). This fact is significant because a "retail establishment," as the term is interpreted by the Bureau of the Census, by the Bureau of the Budget, by the Social Security Board, under the Wages and Hours Act, and by "governmental usage" in general (*Roland* v. *Walling*, 326 U. S. 657 at 674), is consistently held to be identified on the basis of whether or not it sells goods for "personal or household consumption," rather than "for resale, or to commercial or industrial customers." Under this definition of the term "retail," what American goods moving abroad are the subject of "wholesale" rather than "retail" sale? Any company within the broad group of construction equipment or industrial goods manufacturers, for example, which has permanent establishments (including a stock of goods) in countries in the Eastern Hemisphere will receive no tax benefit under these sections, regardless of its investment abroad. Consider a machine-tool company with branch offices in France: no matter what it does by way of selling activity there, regardless of its investment in the vital distribution end of its European business, it will receive no tax advantage under these sections. It is true that the "permanent establishment" will be there, sales employees and servicemen may be hired, but there will be no benefit under sections 923 or 951.

A short time ago it was said on all sides that intelligent tax legislation was vitally needed to stimulate American trade and investment abroad. The sections of the present bill clearly cannot have the result of "stimulating" American trade as they in fact discourage the great bulk of it which passes in wholesale selling out of the United States. Perhaps it is within the view of its framers that the act will stimulate investment in "retail establishments," thus encouraging American industry to invest moneys in that direction. If that is its object, then those in American business who have ventured forth already to invest dollars in wholesale distribution abroad have been badly deceived by earlier governmental overtures toward encouraging foreign investment. There are figures on the value of direct United States investment in foreign countries, both by area and by industry.[1] Fortunately, these figures were compiled keeping in mind the difference between "wholesale" and "retail" distribution. These data show that in 1950 there was a direct United States investment of $541,-600,000 in wholesale distribution facilities abroad; at the same time only $220,600,000 in retail trade facilities had been invested. Thus, most of those who have made the "dollar investment abroad" that Congress has talked about since 1946 will not stand to benefit from the proposed legislation.

But will this section stimulate investment abroad? America is great because of its ability to produce and sell quality machinery and equipment in large quantity. Quantity with quality arises where sales mount. To have sales mount, as those with even limited business experience know, you normally have to have a number of outlets—dealers or distributors, as they are called. These sales are the initial step in creating conditions favorable for additional American investment in foreign countries. Yet, paradoxically, it is these very sales to dealers and distributors which sections 923 and 951 rule out from tax benefits. If creation of local selling agencies in the retail field abroad is the goal of these sections, the concept runs contrary to the sum total of the experience and history of American business.

B. "*Factory*."—It is apparently considered by the framers of sections 923 and 951 that reducing the income tax on income derived from a "factory" abroad fulfills the role of "stimulating" investment abroad. Let us look at a concrete situation: It cost X Co.[2] $50,000 last year to set up a Swedish oil pump plant; even then it ended up owning only one-half of it. X Co. makes lathes, milling machines, hydraulic pumps, and a variety of other machines and equipment at different points in the United States. A plant to manufacture one-fifth of X Co.'s whole line of products abroad would cost well over a million dollars, considerably more than it can afford at this time. X Co. also sells goods abroad through its own employees and dealers in different foreign countries. Result: Under the present sections 923 and 951, X Co. is to be commended for investing $50,000 abroad, but no tax credit will be made available to it unless it discontinues selling abroad the goods manufactured by it in the United States. Tax credit will be substantiated only if it restricts itself to the sale of the fuel units manufactured in Sweden, a negligible portion of the X Co. line.

Again, company Y[2] is in the wholesale drug business. In all countries it is

[1] Statistical Abstract of the United States for 1953, p. 885, table 1046.
[2] Actual example.

compelled to meet certain high standards of product performance to be permitted to sell goods. Company Y operates a plant in France, manufacturing perhaps one dozen different drug products. It sells, in Europe and Africa, these products plus some 1,000 other and different products which, for reasons of quality and production control, are best and most economically manufactured in the United States. Result: Company Y enjoys no tax credit for goods thus sold abroad, even though it has a "factory," or, as is the case, factories, situated abroad. Neither trade nor investment has been stimulated.

The requirement of operating a "factory" is an insurmountable obstacle in many of the countries of the world. Before there can be a factory, there must be a demand for the goods which the factory can produce; there must also be an ability on the part of many of the people of that community to purchase the output of the factory. Road-building equipment has sold well in the Belgian Congo in the last few years; it sold in French West Africa in large quantities before that. The framers of these sections would surely not urge American industry to build a factory there. They would not urge a machine-tool company to build a plant in India. Yet they must certainly say that it is desirable and stimulating to United States trade (and eventually investment) to have American industries sell in these areas. The fact is that a concentrated and prolonged selling effort must precede factory activity in most of these areas, areas which are not yet ready for the industrial era which we have experienced. But under sections 923 and 951, no tax benefits are offered to United States companies which are willing to establish and operate the fundamental selling agencies in these outposts. They must first have a "factory" before they can enjoy the encouraging tax rate.

It has authoritatively been further advanced that an assembly plant does not constitute a "factory" within the meaning of these sections. Clearly, agricultural operations are not included within the classification. Perhaps there is a valid, if not apparent, reason for discriminating against these groups.

Unfortunately, the other industrial countries of the world have not adopted the same tax encouragements toward their foreign industry that we have toward ours. The result: international competition now has attained such intensity that it has already forced American production out of many major world markets. It promises to become even more destructive in the immediate future.

III. Considerations surrounding suggested revision

The framers of sections 923 and 951 are quite properly anxious to exclude from tax benefits those companies which risk no capital, have no office, and carry on no bona fide business activity abroad. The wish to exclude these marginal operators, however, has deprived the great bulk of legitimate American business, having establishments abroad, of any tax advantage. Suggested revision of these sections must exclude, therefore, the fringe operators whose existence has been responsible for the unfortunate wording of the present sections. These companies should be compelled to establish a bona fide branch office abroad from which business activities must emanate. Such activities should properly contemplate the hiring of full-time employees within the foreign country to carry on business actively there.

The exclusion from the term "trade or business" of offices or agents to import or facilitate the importation of goods abroad is, as now worded in the bill, entirely appropriate to further insure that fringe exporters do not participate in the tax benefits which should be extended only to those willing to take the added risks of doing business abroad.

IV. Specific recommendations

It is specifically recommended that—

(1) the term "retail establishment" appearing in sections 92 (a) (3) (A) (ii) and 951 (a) be deleted, and the following language inserted: "bona fide retail or wholesale establishment directly engaged in commercial activity";

(2) there be added to subparagraphs 923 (b) (1) (A) and 951 (b) (1) (A), following the word "merchandise," the following restriction: "unless such establishment is a permanent one having bona fide employees directly engaged abroad in its business activities on a full-time basis."

The above and foregoing report and recommendations are respectfully submitted this 7th day of April 1954.

BAKER, MCKENZIE, HIGHTOWER & BRAINERD,
Attorneys at Law.

The CHAIRMAN. Mr. McGregor. Sit down and make yourself comfortable and identify yourself to the reporter.

STATEMENT OF FRANK R. McGREGOR, EXECUTIVE VICE PRESIDENT, COUNCIL FOR INDEPENDENT BUSINESS

Mr. McGREGOR. Mr. Chairman and members of the committee, my name is Frank McGregor. I am executive vice president of the Council for Independent Business, which is an organization which represents small independent business.

I also operate a public-relations business——

Senator FLANDERS. Independent of what?

Mr. McGREGOR. It means it is not part of a large—like it wouldn't be a subsidiary to General Motors.

Senator FLANDERS. Are you independent of NAM, for instance?

Mr. McGREGOR. Our organization is a completely separate, independent organization. Yes, we are.

I also operate a public-relations business, of which I am the head. I am on the board of directors of a couple of other corporations also.

Small and independent business men and women in this country who operate in whole or in part under the protection of our patent system are very much alarmed because of section 1235 of this tax bill. If enacted into law, it would operate to practically deny an inventor any chance to profit from his patent as a capital asset.

I do not intend to read this provision here, because you gentlemen are familiar with it.

You will perhaps remember that the tax bill of 1950, H. R. 8920, contained a provision that "a patent or copyright; an invention or design" could not be held or sold as a capital asset while it was "held by a taxpayer whose personal efforts created such property."

You will also remember, probably, that Mr. C. E. Earle, now deceased, and I appeared before your committee to urge the deletion of that provision and that this committee did cause that provision to be stricken from the bill. The Senate so voted and the House conferees concurred and the bill was so passed.

I submit to you that the section I have referred to is in effect the same philosophy dressed up in different words. Let us not be deceived by the 5 years alloted to the inventor to collect payment for his invention under a capital-gains status. It is common knowledge that inventors do not as a rule have the money to develop, merchandise, and practice their patents. In order to profit from his patent the inventor must either sell it or license its use—usually an exclusive license which the courts have held is equivalent to a sale.

There are very few, if any, inventors who get any recovery within the first 5 years after the issuance of a patent. It is easy to see that the inventor would collect little or nothing during the 5 years the patent was being developed and would then be in the melancholy position during the remaining 12 years of the life of the patent of watching the purchaser of his patent reap the harvest of the inventor's creation. The result, then, would be the same under this provision as it would have been under the provision which your committee struck out 4 years ago.

Let me give you an example that I happen to know about. In 1942 a chemical engineer, after working in his basement for a period of about 18 years, developed a process of combining lithium with lubricating grease. This gave the grease a viscosity heretofore unknown and enabled our planes in World War II to take off from airbases in

the South Pacific in temperatures of 100° or higher and fly into high altitudes where the temperature is as low as 40° below zero, without the lubricating grease becoming thin as water in the hot temperature or solidifying into a mudlike consistency in the cold temperature.

The process is equally valuable for trucks and automobiles and it is in wide use in industry today. This is one of the very few cases where an inventor sold his patent for $1 million, as the patent was sold to a company that specializes in buying and developing patents for something in excess of that amount payable over the remainder of the life of the patent and based on the anticipated earnings from it.

But let us see how the inventor would have fared under section 1235. The first 5 years, there were no profits or royalties to the inventor. The second 5 years the patent earned around a total of $170,000, of which the inventor received a part. The patent now has 5 years to run and, based on the rate at which the lithium grease is increasing in use in industry, it is estimated that the patent will, during that time, earn well over the million dollars to be paid to the inventor. It will be seen that if section 1235 had been in effect when this patent was obtained, the inventor would have received absolutely nothing for his very important contribution to our national defense and welfare; while the purchaser of the patent would have made well over $1 million on which he would have had to pay only a capital-gains tax.

This case is exceptional only in the fact that the patent will earn such a large sum of money. Most inventors do not achieve anywhere near this high figure for their patents. In fact, not 1 inventor in 100,000 ever gets within hailing distance of $1 million.

We Americans believe that the great advantage our economic system has over the Communist philosophy is that we operate under an incentive philosophy whereby a man profits in accordance with his contribution to the wealth of the Nation. This, we believe, is the motivating force which has spurred our people on to make us the greatest industrial Nation on earth.

It is a fundamental belief then in this country that a man who creates wealth for this Nation by inventing something new and useful should be rewarded by society for that contribution. The idea that a bill could be passed depriving the inventor of a large part of the fruits of his labor is so foreign to our conception of what is right and fair, that the American people just cannot believe it could happen here. None of us can understand the philosophy behind the type of thinking that has injected such limitations into this bill.

The Founding Fathers believed so strongly in the importance of rewarding the creator of new things, that they put it in the Constitution. As a matter of fact, during debates on the Constitution, this was one question on which there was no argument. Everybody agreed that we should have a patent system. We had the first patent system in the world. Up to that time it had been granted by monarchs as a monopoly, or the law had to be passed in the colony to get a patent, in the respective colony or State.

Article I, section 8, of the Constitution declares:

> The Congress shall have the power to promote the progress of science and useful arts, by securing for limited times to authors and inventors, the exclusive right to their respective writings and discoveries.

And the Congress of the United States has exercised this power to the great benefit of the people of America by setting up a patent system for this purpose. Now, it appears there are those who want us to turn our backs upon the philosophy of the Founding Fathers and penalize inventors, rather than reward them.

Let there be no doubt as to who is the target—for, it says, and I quote, "a patent * * * (held by)"—the parentheses are mine—"any person whose efforts created such property." This applies, then, to the creator of the invention.

Under this provision, the man who buys an invention from the inventor is privileged to treat it as a capital asset. If, after buying a patent from the inventor, the money man sells it at a fat profit, he can take advantage of the capital-gains tax set forth in this act. In other words, the entrepreneur who buys a patent can treat it as a capital asset, but the man who created the patent by his own thinking and personal efforts is prohibited from so doing, unless he collects his payment in the first 5 years—if, indeed, there is any money to collect during that 5 years.

None of us can understand how a patent, a piece of property which is not held for sale to regular customers in the ordinary course of business, can be in one man's hands a capital asset, yet in another man's hands not a capital asset—and perhaps I should interject here that we are not talking about professional inventors who make a process of inventing things and selling them. We are talking about the man who is an engineer, who is conducting an engineering business, and works nights and invents something. Or, a doctor who invents a new operation and writes it up, and then, if he collects money, he has to pile what he collects on top of his income, and it leaves very little for the work he has done. So he has no incentive to do it.

Our patent system is responsible, to a large degree, for the tremendous and rapid growth of the industrial phase of our economy. Although the individual inventor has rarely been properly rewarded for his advanced thinking, vision, and personal efforts, he deserves the major part of the credit for this great progress. His type of thinking should be encouraged rather than discouraged.

Invention does not thrive on adversity. The old notion that great discoveries are made by starving geniuses in a garret is romantic, but it is just not true. Invention increases as the prosperity of the country increases, and it fades and diminishes in bad times and during war periods.

Attached hereto is a graph entitled "Trend of Inventive Thinking in the United States, 1840–1951."

It shows graphically the effect of depressions and wars on our inventive capacity. It also shows the trend of our inventive ability during the last 90 years.

The graph is based upon the annual number of patent applications for each 10,000 of population in the United States. It also shows patents granted and the relationship between the two. For example, we see that toward the close of the 19th century, when the population was from 60 million to 70 million, patent applications ran as high as 6½ for each 10,000 of population, falling off, of course, during the depressions or "panics"—as they were called then—of the eighties and nineties.

As the 20th century began to unfold, you will observe the number of creative technological ideas considered worth patent application increased until war broke out in Europe, when they declined slightly. When the United States entered the war in 1917, you can see what happened to the inventive mind. With the close of World War I, inventive thinking rose until we hit the recession of 1921.

After this recession was weathered, inventors again were on the march until we hit the big depression in 1929. You will remember that things started to get better in 1934 and 1935, and so did the creative production of inventors.

When Hitler moved into the Rhine, Austria, and Czechoslovakia, and we had an undeclared war in Europe, the effect of this disturbance on the inventive genius of America is shown here, and the negative curve reaches its depth in the midst of World War II. Here it starts to rise again, probably due to the increase in technology of war developments and production. So, we were well on our way again until the cold war and Korea. Now we find ourselves again on the downward path. It is now proposed to pass a bill that will undoubtedly accelerate the speed of this descent.

And, if you would lay a ruler or a pencil over this curve, to compensate the curve, you will see how our inventive genius went up to 1921, and has been going down ever since, and is now the lowest it has been since 1860, about.

The attached graph definitely establishes that technical creation does not flourish in barren soil. Observe, if you will, what happens whenever the economy is disturbed either by wars, rumors of wars, or other factors. The inventor is discouraged and inhibited so that his creative impulses cease to function normally. The inventor flourishes and brings forth fruit when he feels that he is being nurtured in an atmosphere of freedom and a soil rich in opportunity. In other words, the inventor, like we other human beings, does his best thinking when he does not have to worry about getting the money to pay his rent, when he and his family have enough to eat and he can afford to buy decent shoes for his children to wear to school.

The experts who wrote this provision call it plugging up a loophole. Permitting an inventor to get a good reward for his invention is not our idea of a loophole. As for "plugging up," we believe it will effectively plug up the inventor's desire to create new and better things for our people to enjoy. In addition, it will accelerate the further establishment of corporate control of inventions, thus encouraging monopoly and penalizing the small-business man, for the only company that could afford to pay, within a 5-year period, a reasonable portion of what the patent would earn over its 17-year life, would be a corporation with very great assets.

It is estimated by the tax experts that this capital asset provision will yield a maximum of a few hundred thousand dollars a year. For this comparatively picayune sum, we would discourage our inhibiting inventor by putting a ceiling over his opportunities, thus inhibiting his desire to create by depriving him of the major part of the reward which is already pretty small, in most cases. So, the end result will be to deny the economy of this Nation, many inventions potentially worth hundreds of millions of dollars, to say nothing of the loss of potent stimuli to our industrial developments.

I think it is pretty clear that section 1235 of this present bill will have substantially the same effect on the inventor and small and independent business as would have the provision in the 1950 tax bill which your committee caused to be stricken out. If it was wrong then, it is equally wrong now, we believe, especially, at this period of readjustment when many small companies are being forced out of business and we are in one of those downward turns when inventors need to be encouraged rather than harassed and discouraged.

In the name of the individual inventor who forms the base upon which our gigantic industrial system has been built, and in the name of small and independent businessmen throughout the Nation, and to preserve and foster the inventive genius that has made this Nation the greatest on earth, we respectfully and urgently request you to delete the words "if and only if" of paragraph (a) as well as its subparagraphs (1) and (2) in their entirety, lines 35 through 47 on page 259, section 1235, of H. R. 8300.

Thank you very much.

The CHAIRMAN. Thank you. We will give that very careful consideration.

(The prepared statement of Mr. McGregor follows:)

TESTIMONY OF FRANK R. MCGREGOR, EXECUTIVE VICE PRESIDENT, COUNCIL FOR INDEPENDENT BUSINESS, WASHINGTON 5, D. C.

Mr. Chairman and members of the committee, my name is Frank R. McGregor. I am executive vice president of the Council for Independent Business. I also operate a public relations business of which I am the head and I am on the board of directors of a couple other corporations.

Small and independent businessmen and women in this country who operate in whole or in part under the protection of our patent system are very much alarmed because of section 1235 of this tax bill (H. R. 8300). If enacted into law, it would operate to practically deny an inventor any chance to profit from his patent as a capital asset.

May I read the new restrictions fastened on the inventor as set forth in this bill.

"SECTION 1235. SALE OR EXCHANGE OF PATENTS BY THE INVENTOR.

"(a) GENERAL. Gain from the sale or exchange of property consisting of a patent or application therefor, or an undivided interest therein which includes a part of all rights in such patent or application, by any person whose efforts created such property shall be deemed gain from the sale or exchange of a capital asset if and only if—

"(1) the seller retains no interest whatsoever in the patent, application, or undivided interest therein so transferred, except to the extent that the purchase price may be related to the productivity, use, or disposition of the property transferred within a period of 5 years from the date of such sale or exchange; and

"(2) the entire proceeds of such sale or exchange are received by the seller within a period of 5 years from the date of such sale or exchange. For purposes of this paragraph, any proceeds due and payable within such period which are received thereafter solely by reason of failure of the purchaser (or any successor in interest of such purchaser) to fulfill a contractual obligation shall be deemed to have been received within such period."

You will remember that the tax bill of 1950 (H. R. 8920) contained a provision that "a patent or copyright; an invention or design" could not be held or sold as a capital asset while it was "held by a taxpayer whose personal efforts created such property." You will also remember probably that Mr. O. E. Earle (now deceased), and I appeared before your committee to urge the deletion of that provision and that this committee did cause that provision to be stricken from the bill. The Senate so voted and the House conferees concurred and the bill was so passed.

I submit to you that the section I refer to is in effect the same philosophy dressed up in different words. Let us not be deceived by the 5 years allotted to the inventor to collect payment for his invention under a capital gains status. It is common knowledge that inventors do not as a rule have the money to develop, merchandise and practice their patents. In order to profit from his patent the inventor must either sell it or license its use—usually an exclusive license which the courts have held is equivalent to a sale.

There are very few if any inventors who get any recovery within the first 5 years after the issuance of a patent. It is easy to see that the inventor would collect little or nothing during the 5 years the patent was being developed and would then be in the melancholy position during the remaining 12 years of the life of the patent of watching the purchaser of his patent reap the harvest of the inventor's creation. The result then, would be the same under this provision as it would have been under the provision which your committee struck out 4 years ago.

Let me give you an example that I happen to know about. In 1942 a chemical engineer, after many years of work and experimentation, developed a process of combining lithium with lubricating grease. This gave the grease a viscosity heretofore unknown and enabled our planes in World War II to take off from airbases in the South Pacific in temperatures of 100 degrees or higher and fly into high altitudes where the temperature is as low as 40 degrees below zero, without the lubricating grease becoming thin as water in the hot temperature or solidifying into a mudlike consistency in the cold temperature. The process is equally valuable for trucks and automobiles and it is in wide use in industry today. This is one of the very few cases where an inventor sold his patent for $1 million, as the patent was sold to a company that specializes in buying and developing patents for something in excess of that amount payable over the remainder of the life of the patent and based on the anticipated earnings from it.

But let us see how the inventor would have fared under section 1235. The first 5 years there were no profits or royalties to the inventor. The second 5 years the patent earned a total of around $170,000 of which the inventor received a part. The patent now has 5 years to run and, based on the rate at which the lithium grease is increasing in use in industry, it is estimated that the patent will, during that time, earn well over the million dollars to be paid to the inventor. It will be seen that if section 1235 had been in effect when this patent was obtained, the inventor would have received absolutely nothing for his very important contribution to our national defense and welfare; while the purchaser of the patent would have made well over $1 million on which he would have had to pay only a capital gains tax.

This case is exceptional only in the fact that the patent will earn such a large sum of money. Most inventors do not achieve anywhere near this high figure for their patents. In fact not 1 inventor in 100,000 ever gets within hailing distance of $1 million.

We Americans believe that the great advantage our economic system has over the Communist philosophy is that we operate under an incentive philosophy whereby a man profits in accordance with his contribution to the wealth of the Nation. This, we believe, is the motivating force which has spurred our people on to make us the greatest industrial nation on earth.

It is a fundamental belief then in this country that a man who creates wealth for this Nation by inventing something new and useful should be rewarded by society for that contribution. The idea that a bill could be passed depriving the inventor of a large part of the fruits of his labor is so foreign to our conception of what is right and fair, that the American people just cannot believe it could happen here. None of us can understand the philosophy behind the type of thinking that has injected such limitations into this bill.

The Founding Fathers believed so strongly in the importance of rewarding the creator of new things, that they put it in the Constitution. Article 1, section 8 of the Constitution declares—

The Congress shall have the power to promote the progress of science and useful arts, by securing for limited times to authors and inventors, the exclusive right to their respective writings and discoveries. And the Congress of the United States has exercised this power to the great benefit of the people of America by setting up a patent system for this purpose. Now it appears there are those who want us to turn our backs upon the philosophy of the Founding Fathers and penalize inventors, rather than reward them.

Let there be no doubt as to who is the target—for, it says, and I quote "a patent * * * (held by)[1] any person whose efforts created such property." This applies then to the creator of the invention.

Under this provision, the man who buys an invention from the inventor is privileged to treat it as a capital asset. If, after buying a patent from the inventor, the money man sells it at a fat profit, he can take advantage of the capital gains tax as set forth in this act. In other words, the entrepreneur who buys a patent can treat it as a capital asset, but the man who created the patent by his own thinking and personal efforts is prohibited from so doing, unless he collects his payment in the first 5 years—if indeed there is any money to collect during that 5 years.

None of us can understand how a patent, a piece of property which is not held for sale to regular customers in the ordinary course of business, can be in one man's hands a capital asset, yet in another man's hands, not a capital asset—except under such restrictive conditions that it would effectively deny him the fruits of his labor.

Our patent system is responsible, to a large degree, for the tremendous and rapid growth of the industrial phase of our economy. Although the individual inventor has rarely been properly rewarded for his advanced thinking, vision, and personal efforts, he deserves the major part of the credit for this great progress. His type of thinking should be encouraged rather than discouraged.

Invention does not thrive on adversity. The old notion that great discoveries are made by starving geniuses in a garret is romantic, but it is just not true. Invention increases as the prosperity of the country increases and it fades and diminishes in bad times and during war periods.

Attached hereto is a graph entitled "Trend of Inventive Thinking in the United States, 1840–1951."

It shows graphically the effect of depressions and wars on our inventive capacity. It also shows the trend of our inventive ability during the last 90 years.

The graph is based upon the annual number of patent applications for each 10,000 of population in the United States. It also shows patents granted and the relationship between the two. For example we see that toward the close of the 19th century, when the population was from 60 to 70 million, patent applications ran as high as six and a half for each 10,000 of population, falling off of course during the depressions or "panics" (as they were called then) of the eighties and nineties.

As the 20th century began to unfold, you will observe the number of creative technological ideas considered worth patent application increased until war broke out in Europe when they declined slightly. When the United States entered the war in 1917, you can see what happened to the inventive mind. With the close of World War I, inventive thinking rose until we hit the recession of 1921.

After this recession was weathered, inventors again were on the march until we hit the big depression in 1929. You will remember that things started to get better in 1934 and 1935 and so did the creative production of inventors.

When Hitler moved into the Rhine, Austria, and Czechoslovakia, and we had an undeclared war in Europe, the effect of this disturbance on the inventive genius of America is shown here, and the negative curve reaches its depth in the midst of World War II. Here it starts to rise again, probably due to the increase in technology of war developments and production. So we were well on our way again until the cold war and Korea. Now we find ourselves again on the downward path. It is now proposed to pass a bill that will undoubtedly accelerate the speed of this descent.

The attached graph definitely establishes that technical creation does not flourish in barren soil. Observe, if you will, what happens whenever the economy is disturbed either by wars, rumors of wars, or other factors. The inventor is discouraged and inhibited so that his creative impulses cease to function normally. The inventor flourishes and brings forth fruit when he feels that he is being nurtured in an atmosphere of freedom and a soil rich in opportunity. In other words the inventor, like we other human beings, does his best thinking when he does not have to worry about getting the money to pay his rent, when he and his family have enough to eat and he can afford to buy decent shoes for his children to wear to school.

[1] The parentheses are mine.

The experts who wrote this provision call it "plugging up a loophole." Permitting an inventor to get a good reward for his invention is not our idea of a loophole. As for "plugging up" we believe it will effectively plug up the inventor's desire to create new and better things for our people to enjoy. In addition, it will accelerate the further establishment of corporate control of inventions, thus encouraging monopoly and penalizing the small-business man, for the only company that could afford to pay, within a 5-year period, a reasonable portion of what the patent would earn over its 17-year life, would be a corporation with very great assets.

It is estimated by the tax experts that this capital asset provision will yield a maximum of a few hundred thousand dollars a year. For this comparatively picayune sum, we would discourage our individual inventor by putting a ceiling over his opportunities, thus inhibiting his desire to create by depriving him of the major part of the reward which is already pretty small in most cases. So the end result will be to deny the economy of this Nation, many inventions potentially worth hundreds of millions of dollars, to say nothing of the loss of potent stimuli to our industrial developments.

I think it is pretty clear that section 1235 of this present bill will have substantially the same effect on the inventor and small and independent business as would have the provision in the 1950 tax bill which your committee caused to be stricken out. If it was wrong then, it is equally wrong now we believe, especially, at this period of readjustment when many small companies are being forced out of business and we are in one of those downward turns when inventors need to be encouraged rather than harassed and discouraged.

In the name of the individual inventor who forms the base upon which our gigantic industrial system has been built, and in the name of small and independent businessmen througout the Nation, and to preserve and foster the inventive genius that has made this Nation the greatest on earth, we respectfully and urgently request you to delete the words "if and only if" of paragraph (a) as well as its subparagraphs (1) and (2) in their entirety—lines 35 through 47 on pages 259, section 1235 of H. R. 8300.

The CHAIRMAN. Congressman Davis, we are glad to have you here. Make yourself comfortable.

STATEMENT OF HON. CLIFFORD DAVIS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TENNESSEE

Representative DAVIS. Mr. Chairman, I shall not ask to impose upon the committee, but I will be very grateful, if you will permit me to file for the purposes of the record a very short statement on a bill that I introduced in the other body, relating to tax-exempt organizations.

The CHAIRMAN. It will be put in the record. And we are very glad to have you here.

Representative DAVIS. Thank you very, very much, Mr. Chairman.

(The statement of Representative Davis follows:)

STATEMENT WITH REGARD TO H. R. 8300 BY REPRESENTATIVE CLIFFORD DAVIS

My statement is directed particularly to subchapter F, Exempt Organizations; part III; section 521, Exemption of Farmers' Cooperatives From Tax, and section 522, Tax on Farmers' Cooperatives.

A year ago, I reintroduced in the 83d Congress a bill which I had offered and urged in previous sessions. It is numbered H. R. 5508 and it is entitled "A bill to provide tax equity through the taxation of cooperative corporations and to provide tax credits for recipients of dividends from genuine cooperatives." I shall file with the clerk of the committee copies so that every member may see it.

This is a proposal which would accomplish a number of very highly desirable results. In the first place, it would do away with the utterly unfair competitive situation that now exists between fully taxpaying companies and companies of identically the same kind that enjoy the Federal Government's subsidy of tax exemption, either in whole or in part. In the second place, it would eliminate the disastrous effects of the provision of the 1951 Revenue Act under which co-

operatives are required to report patronage dividends paid to farmer members, so the Internal Revenue Service may hound the farmers and make them pay individual income tax on dividends which they have not received in cash money and may never receive. Third, it would put cooperative corporations and their members and stockholders on a single-tax basis, instead of the double tax that other corporations and their stockholders are now required to pay. And fourth, this proposal would bring into the Treasury of the United States at least $400 million of new revenue.

The members of the Senate Finance Committee are fully aware of the tremendous growth in volume of cooperative business; of its expansion into practically all lines of enterprise, many of them far removed from the farmer's needs for marketing or purchasing; and of the complaint of businessmen and other taxpayers because of the tax privileges which are granted to cooperative competitors.

Now, while the revenue code is being rewritten, is the time to correct this situation. H. R. 5598 is, in the opinion of many persons, the fairest and best way to do it. Sections 521 and 522 of H. R. 8300 are, to all intents and purposes, identical with subsections 12 and 13 of section 101 of the present Internal Revenue Code. My bill, H. R. 5598, proposes that these sections be eliminated from the code, thereby doing away with the present legal exemption of cooperative corporations from payment of Federal income tax on their earnings. Further, I would insert at the proper place in the code a definition of the cooperative corporation as a taxable entity, and, to the end that there could be no misinterpretation of the intent of the new law, I would explicitly terminate the present deduction of patronage dividends from the net income of the cooperative corporation.

In other words, a cooperative corporation would then be treated, for tax purposes, in exactly the same manner as any other corporation.

I have gone further, however, in suggesting a provision that is, I am convinced, highly desirable as a measure of just and additional relief for our farmers.

Treasury regulations have always insisted that the farmer-members of cooperatives should report their patronage dividend receipts and pay income tax on them. Until 1951, however, there was no effort to enforce this regulation and consequently it was, I believe, generally ignored. In 1951 Congress wrote into law a binding requirement that co-ops report the patronage dividends paid to members so the Internal Revenue Service can check up on our farmers' individual income-tax returns and force them to pay income tax whether they have received their dividends in cash, in stock, in scrip, in merchandise, by book allocation, or by any other so-called constructive method. All this means that in probably 9 cases out of 10 the farmer will have to dig down into his pants pocket for money earned by the sweat of his brow to pay the tax on patronage dividends that he may never get in cash so long as he lives.

That, I insist, is an evil conception of taxation. It should be corrected so that the farmer may be freed from this unwarranted burden and the cooperative corporation be made to pay the tax and give a credit to the farmer or city member. Then, instead of an addition to his tax, he might well have a subtraction.

That is just what H. R. 5598 proposes to do. That primarily is why it should be included in the Senate's version of H. R. 8300. The farmer is being hurt. He should be given relief—but the tax should be paid nevertheless. The cooperative corporation should pay it—no one else.

The revenue to come from enactment of legislation such as I propose would be a very considerable sum. My own figure of $400 million or more would go some way toward making up the losses resulting from other features of the bill as it stands.

My proposal will bring justice to competitive businesses, relief to farmers, and new revenue to the Treasury. I urge its immediate consideration and its inclusion in H. R. 8300.

The CHAIRMAN. All right, Mr. Balluff.

STATEMENT OF E. J. BALLUFF, CHAIRMAN, SPECIAL COMMITTEE ON TAXATION, AMERICAN PATENT LAW ASSOCIATION

Mr. BALLUFF. Mr. Chairman, my name is Edwin J. Balluff. I am a patent lawyer. I have my offices in the city of Detroit, Mich. I am appearing here as chairman of the special committee on taxation of

the American Patent Law Association, to express its views on section 1235 of H. R. 8300, with reference to the sale or exchange of patents by an inventor. We are pleased to have this opportunity to express our views.

I would like to file the report of the special committee on taxation of the American Patent Law Association, together with an accompanying memorandum, which is a collection of cases having to do with the question of capital gains tax treatment of patents by the courts.

The CHAIRMAN. It will be put into the record.

(The report, with accompanying memorandum, follows:)

REPORT BY E. J. BALLUFF, CHAIRMAN OF THE SPECIAL COMMITTEE ON TAXATION OF THE AMERICAN PATENT LAW ASSOCIATION ON SECTION 1235 OF H. R. 8300—INTERNAL REVENUE CODE OF 1954

This section proposes for the first time special consideration in the tax laws of revenue derived from patent rights. In reporting the new tax bill, H. R. 8300, the Committee on Ways and Means of the House of Representatives with reference to this section stated that it would obviate the distinction under present law between amateur and professional inventors with respect to capital gain treatment of income from the sale of patent rights. The committee also reported that this section would "provide a larger incentive to all inventors to contribute to the welfare of the Nation," and was "applicable equally to all inventors, whether amateur or professional, regardless how often they sell their patents."

The special committee on taxation of the American Patent Law Association endorses such policy of offering greater incentive to all inventors to contribute to the welfare of the Nation, and the elimination of the distinction between so-called amateur and professional inventors, but has serious doubts that the section as worded would actually further this policy and therefore has voted to disapprove the section in its present form.

Section 1235 as worded would enable inventors (but not assignees) to treat the gain from a sale or exchange of a patent or application therefor or an interest therein as a capital gain if, and only if, the seller retains no interest in the patent rights sold, and if the entire proceeds are received within a period of 5 years from the date of such sale or exchange.

While section 1235 makes no distinction between so-called amateur and professional inventors, it materially limits the established rule of the *Myers* case (6 T. C. 258 (1946)) which has been generally followed by the courts but has not been acquiesced in by the Bureau of Internal Revenue. In the Myers case the Tax Court of the United States held that an exclusive license under which the licensee agreed to pay stated percentages in royalties was a sale of the invention even though the license was subject to a condition subsequent which permitted either the licensee or the licensor to cancel, and the inventor was permitted to treat the gain received as a sale of a capital asset within the meaning of section 117 (a).

In March 1950, the Commissioner of Internal Revenue withdrew his previous acquiescence in the Myers case and announced that for income-tax purposes the Bureau would tax royalties as ordinary income where in consideration of the assignment of a patent or of an exclusive right thereunder the assignee or licensee agreed to pay an amount measured by production, sale or use, or amounts payable periodically over a period generally coterminous with the transferee's use of the patent. However, prior to the Commissioner's statement of nonacquiescence in the Myers case, the method of payment was accorded little weight in determining whether the revenue from the transaction was entitled to capital gains treatment.

Thus, at the present time the tax treatment of situations like that in the Myers case is generally viewed in one light by the courts and in an opposite light by the Bureau, since the Bureau has had little success in getting its nonacquiescence doctrine generally adopted by the courts.

The report of the Committee on Ways and Means with reference to section 1235 leaves the impression that under current law a party could not obtain capital gains tax treatment under an exclusive license arrangement where the licensee agreed to pay royalties measured by production, sales, or use, and

that section 1235 now for the first time makes this possible if the entire proceeds are received within a period of 5 years from the date of such sale or exchange, whereas under exclusive license arrangements of the type involved in the Myers case, which are quite common, royalties equal to a percentage of the selling price of the articles manufactured and sold are generally given capital gains tax treatment by the courts if not excluded by section 117 of the present act.

The report of the Committee on Ways and Means with reference to section 1235 also creates the impression that under existing law only inventors, and then only amateur inventors, can obtain capital gains tax treatment, whereas the fact is that any party—that is, an inventor, an assignee, or a corporation—who can qualify under section 117 is entitled to capital gains tax treatment under the doctrine of the Myers case. For example, an assignee or a corporation who sells or exclusively licenses a patent is entitled to capital gains tax treatment if the property sold is not excluded by the subdivisions of section 117.

It is unfortunate that the report of the Committee on Ways and Means employed the term "amateur" to indicate the type of inventor now entitled under the law to capital gains tax treatment because the cases show that it is now possible for a professional inventor to qualify for capital gains tax treatment under certain conditions.

Section 1235 as worded may be availed of by an inventor only if he retains no interest whatever in the patent right transferred except to the extent that the purchase price may be related to the productivity, use or disposition of the property transferred within a period of 5 years from the date of the sale or exchange and if the entire proceeds are received or payable within such period of 5 years. Such prohibition against retention of interest would automatically exclude the usual exclusive license arrangements which are now held by the courts to be tantamount to a sale. In the usual exclusive license arrangement the licensor retains title but grants to the licensee the exclusive rights subject to the obligation to pay royalties, usually conditioned upon the extent of use of the invention. Exclusive license agreements frequently include conditions subsequent which permit termination of the license by the licensor or the licensee. Notwithstanding this, the doctrine of the Myers case recognizes an exclusive license of this type as being tantamount to a sale and as entitling the licensor to capital gains tax treatment if the taxpayer is not precluded by reason of the subdivisions of section 117.

The requirement in section 1235 that the entire proceeds of the sale or exchange must be received or payable within a period of 5 years from the date of the sale or exchange would also for practical purposes generally preclude the posibility of making a deal which would be entitled to capital gains tax treatment. Patents are issued for a period of 17 years after pending in the Patent Office for a period which usually lasts several years. The value of a patent can be seriously affected by obsolescence, invalidity, the successful designing around the patent so as to avoid infringement thereof, and a number of other factors. Generally speaking, it would be practically impossible in many cases for an inventor and a prospective purchaser or exclusive licensee to agree on the amount which must be paid to the inventor within a period of 5 years to permit the use by the licensee or the assignee of the invention over the full life of the patent. This would be particularly true for an important invention! The existence of two or more patents which would have to be included in such a deal, as frequently happens, would further complicate the problem.

It is also quite usual in connection with the sale or exclusive licensing of patents that the assignor or licensor be required to include improvements which may be made within some determinable period in the future. Since these improvements are not yet in being, it would be practically impossible to arrive at any evaluation thereof at the time that the sale or exclusive license is made. As there is no way of evaluating the actual worth of improvements in any kind of deal which must be paid out in 5 years, the inventor would be forced to forego capital gains tax treatment of the proceeds if he desired to be paid for such improvements, and improvements are frequently of real value, particularly in the case of experienced inventors whose ability makes them peculiarly well qualified to try to anticipate today the problems of tomorrow.

It also frequently happens in the case of a sale or exclusive license that two or more patents which issued years apart may be included in the deal, one of them being perhaps somewhat basic and the other perhaps a specific improvement which is thought to be particularly well suited for commercial exploitation. The relative value of these patents may be difficult if not impossible to determine,

but because of the 5-year limitation in section 1235 an inventor, if he were desirous of getting for the sale or exclusive license of his patents an amount equal to their worth, would, generally speaking, be forced to make a deal which would not qualify under section 1235. The value of a patent is determined to an appreciable extent by its relation to the business protected by it and/or by the extent to which the invention is used in such business. While a patent's life is 17 years, the useful life of a patent may be less than 17 years, and may come at any time during the 17-year period. The actual worth of a patent may well not be proved during the first 5 years after the making of a deal.

It also sometimes happens that an inventor in order to make a deal looking toward the commercial exploitation of his patent must acquire a patent right from another inventor, which is included as a part of the deal. Section 1235 would be inapplicable to a patent right in the hands of a person other than the inventor and yet it would be difficult if not impossible to allocate the value as between the purchased patent right and that of the inventor in such a deal.

Practical problems in arriving at a fixed valuation for the sale of patent rights probably were one of the principal reasons for the development of the exclusive license type of arrangement which permitted the licensee to enjoy fully the benefits of the patent and to pay for the same in accordance with the extent of use thereof over the life of the patent.

The foregoing demonstrates that the wording of section 1235 is quite inapplicable to exclusive license arrangements, and if section 1235 is adopted as now worded it will as a practical proposition exclude most patent sales or exclusive license arrangements from capital gains tax treatment.

Section 1235 as worded would even exclude from its benefits a corporation wholly or largely owned by an inventor for the purpose of exploiting his own inventions.

As section 1235 is applicable only to an inventor and provides the only method under the new code whereby the inventor of a patent can obtain capital gains tax treatment on its sale, it appears in view of the foregoing that those inventors whose exclusive licenses can now qualify under the Myers decision will be in a much worse position than at present.

Since section 1235 deals specifically with patents but is applicable only to inventors, the following possibilities are suggested:

1. By excluding assignees is it contemplated they shall be denied capital gains tax treatment in all cases? Some have so construed section 1235.

2. As section 1235 excludes only inventors from qualifying under section 1221, is it intended that an assignee might qualify for capital gains tax treatment under section 1221 under the doctrine of the Myers case for example and on more favorable terms than those available to an inventor under section 1235? This could permit an assignee owner of an undivided interest in a patent to obtain capital gains tax treatment while the inventor would be denied such favorable treatment.

If section 1235 does not affect capital gains tax treatment of assignees as strongly urged by many, then it appears that section 1235, which is designed to provide a larger incentive to all inventors to contribute to the welfare of the Nation, actually gives them less favorable tax treatment than they now enjoy and less favorable than that which would be enjoyed by assignees under section 1221. To say the least, this seems quite unrealistic.

Patents are the legal vehicles by means of which inventions are converted into property rights. The Constitution, by giving Congress the power to promote the progress of science and the useful arts by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries, recognized the importance of encouraging activity which is productive of inventions for the benefit of the public at large.

Very recently, the Supreme Court in referring to such constitutional provision stated:

"The economic philosophy behind the clause empowering Congress to grant patents and copyrights is the conviction that encouragement of individual effort by personal gain is the best way to advance public welfare through the talents of authors and inventors in 'science and useful arts.' Sacrificial days devoted to such creative activities deserve rewards commensurate with the services rendered."

The policy expressed by the Committee on Ways and Means as a premise for the enactment of section 1235 to "provide a larger incentive to all inventors to contribute to the welfare of the Nation" is an affirmation of the philosophy behind the constitutional basis for patents.

Inventors are benefactors of the public because after the expiration of a patent, the invention covered thereby is available for the free use of the public. However, since patents protect inventions for a limited time, they make possible the establishment of industries and businesses which are vitally important to the economic welfare of the country as a whole.

For the reasons pointed out, section 1235 as now worded is wholly inadequate to encourage inventive activity and the expenditure of funds to support the same. In fact, in many respects it seems to be a step backward and perhaps places inventors in a worse position than their financial backers. Because of the substantial expense necessarily involved in carrying on the type of work which is productive of inventions, it is vitally important that inventors and their financial backers be accorded such favorable tax considerations as will further stimulate inventive activity and the expenditure of funds in support thereof. The risks and uncertainties of the return involved in activities of this kind require that real and substantial recognition be accorded by the tax laws to inventors and their financial backers.

It is our belief that any tax incentive to be effective as a stimulus to inventive activity and the expenditure of funds required to support the same necessitates the removal of the 5-year limitation and the prohibition against retention of any interest. With these modifications, the section should also be revised to make it applicable to all gain from the sale, exchange or licensing of patent rights. Furthermore, assignees who usually furnish the required funds, as well as inventors, should be entitled to the same favorable tax considerations.

As an indication of the extent to which special tax treatment should be given to encourage inventive activity, the special committee on taxation of the American Patent Law Association has heretofore approved H. R. 7645, which proposed to amend section 117 of the present Internal Revenue Code to provide that revenue from the sale or license of patents should be treated as capital gains. It has also approved H. R. 7646 which proposed to amend the present Internal Revenue Code to provide a depletion allowance against income obtained from patents. These approvals of the special committee on taxation with reference to H. R. 7645 and 7646 have been approved by the board of managers of the American Patent Law Association.

MEMORANDUM SUBMITTED BY E. J. BALLUFF, CHAIRMAN, SPECIAL COMMITTEE ON TAXATION, AMERICAN PATENT LAW ASSOCIATION

The following tax decisions follow the doctrine of *Edward C. Myers* v. *Commissioner* (6 T. C. 258) respecting capital gains tax treatment of royalties under exclusive license agreements:

William M. Kelley v. *Commissioner* (6 T. C. M. 646, June 12, 1947).
Kimble Glass Co. v. *Commissioner* (9 T. C. 183, Aug. 14, 1947).
Raymond W. Hessert v. *Commissioner* (6 T. C. M. 1190, Oct. 31, 1947).
Elrod Slug Casting Machine Co. v. *Commissioner* (7 T. C. M. 157, Mar. 26, 1948).
Carl G. Dreymann v. *Commissioner* (11 T. C. 153, Aug. 9, 1948).
Hofferbert v. *Briggs* (50–51 U. S. T. C. 178, F. (2d) 743 C. A. 4, Dec. 21, 1949).
Thompson v. *Johnson* (50–51 U. S. T. C., DCSD NY, July 26, 1950).
Halsey W. Taylor v. *Commissioner* (16 T. C. 376, February 19, 1951).
Lamar v. *Granger* (99 F. Supp. 17, D. C. Pa., July 3, 1951).
Wilma M. Imm v. *Commissioner* (11 T. C. M. 258, Mar. 24, 1952).
Herbert Allen v. *Commissioner* (11 T. C. M. 1093, Nov. 12, 1952).
Carruthers v. *U. S.*, (53–51 U. S. T. C. p. 9316, D. C. Oregon, March 3, 1953).
Arthur C. Cope (12 T. C M. 525, May 15, 1953).
General Spring Corp. (12 T. C. M. 847, July 27, 1953).
Corporate licensor given capital gains tax benefits.

The following decisions follow the doctrine of the Myers case, but are more liberal than Myers from the viewpoint of the taxpayer:

Kavanagh v. *Evans* (188 F. (2d) 234 C. A. 6, decided Apr. 9, 1951).

The agreement stated that the license was nonexclusive as to certain of the subject matter, and the licensor retained the right to manufacture, use, or sell the licensed device when designed for a specific use.

Allen v. *Werner* (190 F. (2d) 840 C. A. 5, decided July 13, 1951).

The license granted the exclusive right to make and sell, but failed to grant the right to use. The licensee was prevented from assigning its interest except in connection with sale of the entire business. Parole evidence was admitted

to show that failure to include the right to use was inadvertent and not controlling.

Pike v. *U. S.* (101 F. Supp. 100, D. C. Conn., decided Aug. 15, 1951).

The agreement expressly stated that the parties contemplated only a license and not a sale, but this language was not held controlling.

Kronner v. *U. S.* (110 F. Supp. 730, U. S. Court of Claims, decided Mar. 3, 1953).

This was an exclusive license in which the licensor was obligated to defend infringement suits against the licensed subject matter and was required to hold the licensee and its customers harmless.

The following decisions do not follow the Myers case:

Bloch v. *U. S.* (200 F. (2d) 63 C. A. 2, decided Nov. 21, 1952).

Suit to recover taxes withheld on royalties under sections 143 and 211. The nonresident alien taxpayer granted an exclusive license to a United States corporation.

The agreement called for a fixed price of $75,000, $40,000 down and royalties to make up the balance, plus royalties thereafter at reduced percentages. The $40,000 initial payment was taxed as ordinary income since the Revenue Act of 1934 then in effect made no distinction between license royalties and the proceeds of a sale. The Revenue Act of 1936 exempted from tax the proceeds of a sale of personal property by a nonresident alien. If the taxpayer's position had been sustained, he would have paid no tax on any of the royalty payments. The court held that the transaction was a mere license and not a sale. The basis of the decision is that no sale took place because of "the retention of an interest in the profitable exploitation of the patented articles by a receipt of a percentage of the sales price or a stated amount for each article sold." The court expressly disagrees with the Myers and Kimble Glass Co. cases.

Eterpen Financiera Sociedad v. *United States* (108 F. Supp. 100, U. S. Court of Claims, decided Nov. 4, 1952)

Suit by a foreign corporation taxpayer to recover taxes withheld on royalties under section 143. The taxpayer granted an exclusive license to two United States corporations, jointly, with the usual exclusive license provisions including royalties based on a percentage of sales. The parties executed an option simultaneously with the agreement, under which either or both of the United States corporations could purchase the entire right, title, and interest in the patents for a stipulated amount. As in the Bloch case, if the agreement was held to be a sale, no taxes of any kind would be paid. The agreement was held to be a license and not a sale on the ground that if the license was actually an assignment or sale, the option would be meaningless, and therefore the intent of the parties was to grant a license only. The court also relied upon the fact that the licensees were not only expressly given the right to sue in their own names and upon the use of the words "license" and "royalties" in the agreement. A dissenting opinion was filed. The court distinguished the fact situation from that presented in the Myers case. The same court followed the Myers case in the subsequent case of *Kronner* v. *U. S.* (110 F. Supp. 730).

Mr. BALLUFF. I would like to say a few words at this time.

Section 1235 proposes for the first time in the tax code special tax consideration of patent rights by the inventor, if and only if the seller retains no interest whatsoever in the property transferred, except to the extent that the purchase price may be related to the productive use or disposition of the property transferred within a period of 5 years from the date of sale or exchange; and, secondly, if the entire proceeds from the sale are received or payable within a period of 5 years from the date of the sale or exchange.

With reference to this section, the House Ways and Means Committee, in its report to the House, stated that it would provide a larger incentive to all inventors to contribute to the welfare of the Nation and, also, that this section would obviate the distinction under present tax law between amateur and professional inventors with respect to capital gains treatment from the sale of the patent right.

The Special Committee on Taxation of the American Patent Law Association endorses the policy of offering greater incentive to all inventors to contribute to the welfare of the Nation. But it has serious doubts that the section, as worded, would contribute to this policy. And, therefore our committee has voted to disapprove this section in its present form.

Because of the difficulty of fixing the fair value of most patent rights for the purposes of sale, it is a common practice for an inventor, and a prospective buyer who desires to exploit the invention, to enter into an exclusive license arrangement. Exclusive license arrangements generally have been held by the courts to be tantamount to a sale, for tax purposes. Under the usual exclusive license arrangement, the inventor retains legal title to the patent rights, but grants the licensee the enjoyment and use of the invention for a consideration, usually depending upon the productivity or use of the invention during the life of the patent, which is 17 years.

It is also quite common in an exclusive license arrangement to provide conditions subsequent that permit the licensee to cancel, or the licensor.

As section 1235 is now worded, it would exclude such exclusive license arrangement from its benefits because of the 5-year rule, and because of the prohibition against retention of interest on the part of the seller.

While the courts now generally accord capital gains-tax treatment to exclusive license arrangements, the report of the House Ways and Means Committee leaves the impression that such is not the case. And accompanying the report of the special committee, I have attached a list of recent cases dealing with this subject, which shows that all of the courts, except one, have accorded capital-gains treatment to exclusive license arrangements.

I want to point out, however, that the Bureau of Internal Revenue, in 1950, adopted an opposite policy and has been following that policy since that time.

The report of the House Ways and Means Committee, in referring to the elimination of distinction for tax purposes between so-called amateur and professional inventors, also leaves the impression that under existing law professional inventors cannot obtain capital gains-tax treatment, whereas such is not the case, as may be determined by consideration of the cases cited in the memorandum attached to our report.

Section 1235, as worded, is inapplicable to exclusive license arrangements and would, as a practical proposition, eliminate most sales or exclusive licensing arrangements from its benefits. Certainly, for those inventors who can now qualify for capital gains-tax treatment under the Myers case, which is a leading case on the subject, section 1235 represents less favorable tax treatment than they now enjoy.

Since section 1235 deals specifically with patents, but is applicable only to inventors, it leaves the following two possibilities:

1. By implication it excludes assignees from capital gains-tax treatment, which many can now qualify for under section 117 (a) of the present Internal Revenue Code.

2. Section 1235 leaves assignees free to qualify under the new section 1221, which corresponds with section 117 (a), and it would thus leave assignees in a position to get capital gains treatment on

more favorable terms than are available to an inventor under section 1235.

If the latter possibility is true, and there are many members of our profession who feel that this is the case, it follows that section 1235, which is supposed to provide a larger incentive to all inventors to contribute to the welfare of the Nation, actually provides less favorable tax treatment than many now enjoy, and less favorable tax treatment than would be enjoyed by assignees under section 1221 of the new code.

Investors are benefactors of the public, because after the expiration of a patent, the invention is available for free use of the public, and the protection afforded by patented inventions for a limited time makes possible the establishment of businesses and industries which are vitally important to the economic welfare of the country.

For the reasons pointed out, section 1235 is inadequate to encourage incentive activity and the expenditure of funds to support the same.

It is our belief that to be effective section 1235 should have eliminated therefrom the 5-year limitation and also the rule against the retention of any interest in the patent rights sold.

It is also our recommendation that, so modified, section 1235 should be applicable to all gain from the sale, exchange, or licensing of patent rights, and that assignees should also be accorded the same favorable consideration.

I thank you.

The CHAIRMAN. Thank you very much. I hope the staff will consider this very carefully. There have been a lot of complaints on it.

Mr. Jackman, we are glad to see you.

STATEMENT OF WILLIAM JACKMAN, PRESIDENT, INVESTORS LEAGUE, INC.

Mr. JACKMAN. I am William Jackman, president of the Investors League, with headquarters at 175 Fifth Avenue, New York. The league that I represent is the oldest and most successful organization of investors, with thousands of members residing throughout every State in the Union. It is an organization of investors, both large and small, who make up the backbone of our national economy.

The CHAIRMAN. Do you want to put your written statement into the record?

Mr. JACKMAN. Yes, sir.

The CHAIRMAN. We will include it.

Mr. JACKMAN. I will only deal with the conclusion of my statement, Senator.

First, I would like to thank the committee for allowing me to present the views of the individual investor on H. R. 8300, the tax bill presently under consideration. Since I have but a limited time allotted to me, I will confine my remarks to those sections of the bill which are of immediate concern to investors, namely, the sections dealing with dividend income (secs. 34 and 116).

Gentlemen, in my estimation H. R. 8300 represents a milestone in Federal tax legislation. Among the many provisions designed to overhaul and simplify the Internal Revenue Code, one alone will prove to be of immense importance to our present economic situation.

I am speaking, of course, of the long overdue recognition of the inequity and evils inherent in taxing dividends twice—first, at the corporate level, and again when the income is distributed to stockholders. Double taxation of dividends is the last remaining vestige of the discredited and short-lived undistributed corporate profits tax experiment of 1936.

The House Ways and Means Committee recognized the vital need for this change when, in the report on H. R. 8300, the majority of the committee stated that the dividend provisions were necessary because double taxation had "contributed to the impairment of investment incentives" and "restricted the ability of companies to raise adequate capital."

Economic progress demands heavy expenditures for new plants, new equipment, and modernization. The funds to finance economic progress must come directly or indirectly from individuals willing to risk their savings. If the building process is to continue rapidly enough to meet the needs, then the Government must maintain an economic climate conducive to the free flow of equity capital.

We are at the economic crossroads. The whole functioning of our great economic machine is of serious concern to every right-thinking American.

President Eisenhower, in his recent radio talk on taxes, ably expressed the importance of dividend tax relief in the overall picture when he stated:

> This will be important to all of us, whether our savings are large or small. It will encourage Americans to invest in their country's future. The more we encourage savings and investment, the more prosperous will be the 160 million American citizens.

Already the inability of corporations to obtain equity funds has resulted in an unhealthy reliance on mortgaged futures—debt financing. Witness the postwar period when corporate debt doubled. I am concerned with this capital structure, topheavy with debt, and I believe that H. R. 8300 provides the incentives necessary to build an equity base for this debt. And the cost, gentlemen, is negligible.

As corporate enterprise shifts from debt issues to equity issues, I am certain that the revenue loss from this proposal will be more than offset.

I therefore respectfully urge that the committee approve these provisions.

Most of the criticism leveled against dividend tax relief can be centered around the theme of a "rich man's bill." Gentlemen, nothing could be further from the truth. The expression is nothing but political demagoguery.

According to Treasury statistics, nearly 80 percent of the taxpayers reporting dividends are members of families earning under $10,000 a year, while almost half of all dividend recipients earn less than $5,000 a year. If you want further proof, I need only refer you to the recent study made by the United States Steel Corp. of its nearly 300,000 stockholders. More than half of these stockholders receive less than $5,000 a year, with one-third having incomes of less than $3,000. Are these the rich men constantly referred to?

It has been said that the little man receives no benefits from these proposals. Yet, under the $100 dividend exemption, more than 90 percent of the persons relieved completely from the burden of double

taxation will be receiving less than $10,000 per year. In addition, the percentage deduction in tax liabilities is greater in the lower-income bracket and relief becomes progressively less as the income or dividend level rises.

When facts are exhausted, the opponents of dividend tax relief scream that such provisions discriminate against wage earners in favor of the "coupon clippers." Gentlemen, the 10 million American share owners and the other millions of savers who are indirectly investors, are wage earners first and income earners second. Dividends for most share owners constitute only a small portion of their total income. For example, dividends accounted for approximately 11 percent of the income of the average share owner earning $5,000 and less than 20 percent for those earning $30,000.

It is interesting to note that Senator Walter F. George said in 1949:

> The law should be changed to allow a credit to the individual stockholder for taxes already paid by the corporation. As a starter, we should provide a credit of a certain percentage—say 10 percent or perhaps 16.6 percent, the amount of the first-bracket individual income tax. Ultimately we should exempt dividends from taxation completely.

Rather than being discriminatory against wage earners, I would say that these provisions will be a step in the direction of restoring a tax balance between the various forms of income received by wage earners.

In view of the importance of dividend relief, I am at a loss to understand the reasons behind the move to strike this provisions out of the law and substitute higher exemptions unless the reasons be, as I have stated, strictly political. Raising exemptions means only a slight increase in the workers' take-home pay, on the average of 50 cents per week per exemption. It will not create more jobs, increase productive facilities, or lubricate our great economic system. The raising of personal exemptions by even $100 will throw us back into substantial deficit financing. That is the reason, gentlemen, why the President of the United States and the Secretary of the Treasury are fighting so hard against this move.

Gentlemen, we believe there is no more propitious time than the present for removing complex confusion, inequities, discrimination, and gross unfairness from the Internal Revenue Code. We therefore earnestly request that the provisions of H. R. 8300 relating to dividend income be retained in their present form, since they alleviate by far the grossest injustice in the present law. As I stated before the House Ways and Means Committee, "the best incentive device is a tax code that stimulates thrift." Double taxation of dividends is destructive of the very incentive that Congress is desirous of creating and upon which our future depends. A dividend tax credit would cost the Government only a small fraction of what it would gain through stimulation of day to day efforts to earn more and save more. Savers and investors are essential to our way of life. We cannot have big industry without them.

Thank you very much.

The CHAIRMAN. You are very welcome, indeed. Glad to see you.

(The prepared statement of Mr. Jackman follows:)

STATEMENT OF THE INVESTORS LEAGUE, INC., ON H. R. 8300

I am William Jackman, president of the Investors League, Inc., with headquarters at 175 Fifth Avenue, New York, N. Y. The league I represent is the oldest and most successful organization of investors, with thousands of mem-

bers spread throughout every State in the Union. It is an organization of investors, both large and small, who make up the backbone of our national economy.

First, I would like to thank the committee for allowing me to present the views of the individual investor on H. R. 8300, the tax bill presently under consideration. Since I have but a limited time allotted to me, I will confine my remarks to those sections of the bill which are of immediate concern to investors, namely, the sections dealing with dividend income (secs. 34 and 116).

In my opinion, the House Ways and Means Committee warrants the thanks of every American taxpayer for the job it has done in overhauling and simplifying the Internal Revenue Code. H. R. 8300 represents a milestone in Federal tax legislation.

Among the many changes proposed in H. R. 8300, one alone will prove to be of immense importance to our present economic situation. I am speaking, of course, of the long overdue recognition of the inequity and evils inherent in taxing dividends twice, first at the corporate level, and again when the income is distributed to stockholders. Double taxation of dividends is the last remaining vestige of the discredited and short-lived undistributed corporate profits tax experiment of 1936.

The House Ways an Means Committee recognized the vital need for this change when, in the report on H. R. 8300, the majority of the committee stated that the dividend provisions were necessary because double taxation had "contributed to the impairment of investment incentives" and "restricted the ability of companies to raise adequate capital."

The importance of equity capital to the soundness of our economy is well known, as is the fact that economic progress demands heavy expenditures for new plants, new equipment, and modernization. Equity capital plays a vital part in this investment picture. The funds to finance this economic necessity must come directly or indirectly from individuals willing to risk their savings in productive enterprise. If this building process is to continue rapidly enough to meet our needs, then the Government must maintain an economic climate conducive to the free flow of investment funds. The fact that it takes well over $10,000 in capital investments to provide a new job in our industrial system must not be overlooked. The dividend proposals are designed to encourage equity investment. Thus, the enactment of the provisions relating to the taxation of dividend income can be of immeasurable help, particularly under present-day conditions. We are at the economic crossroads. The whole functioning of our great economic machine is of serious concern to every right-thinking American.

President Eisenhower, in his recent radio talk on taxes, ably expressed the importance of dividend tax relief in the overall picture, when he stated "This will be important to all of us, whether our savings are large or small. It will encourage Americans to invest in their country's future. The more we encourage savings and investment, the more prosperous will be the 160 million American citizens."

Again, in the words of the House committee, "The changes affecting depreciation and the double taxation of dividends are the two most important changes made to reduce tax barriers to production and employment and are, in fact, necessary to maintain as well as increase the revenue base."

If the present inequities are allowed to remain in our tax laws, I feel certain that unsound and inadequate corporation financing would be accentuated. Already, the inability of corporations to obtain equity funds has resulted in an unhealthy reliance on mortgaged futures—debt financing. Witness the postwar period when corporate debt doubled—rising from 100 to 190 billion dollars from 1946 to the end of 1953. I am not so much concerned with the level of the debt as I am with the danger of a capital structure top-heavy with debt. I believe that H. R. 8300 provides the incentives necessary to build the base. And the cost, gentlemen, is negligible.

I understand that official Treasury estimates place the loss of revenue from the dividend proposals at $240 million in 1954, about $600 million in 1956, and somewhat over $800 million in subsequent years. This loss, I believe, will be only temporary. To quote the House committee again, "Several of the changes which appear to involve permanent income losses will stimulate production and national income and thereby expand the tax base, both immediately and in the long run. An effect of the dividend exclusion and credit, for example, will be to shift corporate financing away from debt issues toward equity issues. Eventually

this will more than offset the loss presently anticipated from the new dividend provisions."

I therefore respectfully urge that the committee approve these provisions.

Most of the criticism leveled against dividend tax relief can be centered around the theme of a rich man's bill. Gentlemen, nothing could be further from the truth. The expression is nothing but sheer political demogogery.

According to Treasury statistics, nearly 80 percent of the taxpayers reporting dividends are members of families earning under $10,000 a year, while almost half of all dividend recipients earn less than $5,000. If you want further proof, I need only refer you to the recent study made by the United States Steel Corp. of its nearly 300,000 stockholders. More than half of these get less than $5,000 a year, with one-third having incomes of less than $3,000. Only 10 percent of its share owners have over $25,000. In 1953, the American Telephone & Telegraph Co. reported that the average holdings of its nearly 1.3 million share owners amounted to 27 shares. Are these the rich men constantly referred to?

It has been said that the little man receives no benefits from these proposals. Yet, under a $100 exemption, more than 90 percent of the persons relieved completely from the burden of double taxation will be receiving less than $10,000 per year as shown in the following table (1948 Statistics of Income data).

TABLE I.—*Number of income tax returns exempt from dividend taxation by a $100 exclusion*

[Based on 1948 returns, last 3 digits omitted]

Adjusted gross income classes	All returns with dividend income	Number of returns exempt under $100 exclusion	Percent of total returns exempt (cumulative)	
Under $5,000	1,836	721	65	65
$5,000 to $10,000	855	296	27	92
$10,000 to $25,000	450	73	7	99
Over $25,000	181	11	1	100
Total	3,322	1,100	100	......

Source: U. S. Treasury Department Statistics of Income, pt. I, 1948.

It is also argued that the rich man will receive proportionately higher tax relief than will the small taxpayer. Actually the reverse is true. As you can see by the following table, the relief lessens as income increases. The percentage reduction is greatest in the lowest income bracket and declines progressively as the income level rises. The same relationship holds true for dividend income. As dividends increase relative to income, tax relief decreases.

TABLE II.—*Tax relief afforded under dividend proposals full effect, 1956—10 percent credit $200 exclusion, married—joint return 10-percent deduction*

ALL INCOME FROM DIVIDENDS

Total income	Present tax	New tax	Tax savings (percent)
$2,000	$120	$42	65
$4,000	480	222	54
$6,000	844	402	52
$10,000	1,636	834	48
$15,000	2,810	1,544	45
$25,000	5,744	3,593	38
$50,000	16,528	12,085	27

25 PERCENT OF INCOME FROM DIVIDENDS

Total income	Present tax	New tax	Tax savings (percent)
$4,000	$480	$344	28
$8,000	1,240	966	20
$16,000	3,080	2,620	15
$40,000	11,800	10,700	9

Source: N. Carothers, Commercial and Financial Chronicle, Mar. 25, 1954.

In fact, if the provisions are enacted into law, the dividend tax burden will be shifted to an even greater degree to the upper income groups. At present, persons earning over $10,000 receive about 75 percent of the dividend income. If the relief provisions become law these same individuals will receive about 70 percent of the estimated 1956 $814 million tax relief.

When facts are exhausted, the opponents of dividend tax relief scream that such provisions discriminate against wage earners in favor of "coupon clippers." Gentlemen, the investors of America are wage earners first and income earners second. Dividends for most shareowners constitute only a small portion of their total income. For example, in 1950, dividends accounted for approximately 11 percent of the income of the average shareowner earning $5,000 and less than 20 percent for those earning $30,000. Rather than being discriminatory against wage earners, I would say that these provisions will be a step in the direction of restoring a tax balance between the various forms of income received by wage earners. For, unlike wages and other forms of income, dividends are taxed twice.

The effect of these proposals on Treasury revenue is negligible. For example, the revenue loss in fiscal 1955 would amount to considerably less than 1 percent of the estimated $62.7 billion of receipts in that year.

I think that this problem of equity in our tax laws is as important to a consideration of these proposals as any other reason offered. I think Representative Boggs has the same viewpoint. I would like to quote the statement he made as part of the minority report on H. R. 8300. In dissenting from the view of the other members of his party on the committee, with respect to the dividend proposals, Representative Boggs said, "I fully subscribe to the minority views, except those on the provisions relating to the exclusion and tax credit for dividends. While a valid argument might be advanced that this is not the time, because of the urgent necessity for an increase in exemptions, to urge the dividend relief, I cannot subscribe to the attack on the principle involved.

"This is the only area in the whole Federal tax structure where double taxation exists in fact, and until recent years this was recognized in our tax structure. In addition to this, failure to take some action would continue this discrimination."

It is also interesting to note that Senator Walter F. George said in 1949:

"The law should be changed to allow a credit to the individual stockholder for taxes already paid by the corporation. As a starter, we should provide a credit of a certain percentage—say 10 percent or perhaps 16.6 percent, the amount of the first-bracket individual income tax. Ultimately we should exempt dividends from taxation completely."

In view of the importance of the dividend relief proposals I am at a loss to understand the reasons behind the move to strike this provision out of the law and substitute higher exemptions unless the reasons be, as I have previously stated, strictly political. Raising exemptions means only a slight increase in the workers' take-home pay. On the average, this increase will amount to about 50 cents per exemption per week. It will not create more jobs, increase productive facilities, or lubricate our great economic system. Why not be truthful, and tell the man without a job that he is better off because his next door neighbor can afford an extra pack or two of cigarettes.

There are a few gentlemen of the legislature who are bowing to political expediency and practicing, in some instances, political persecution by trying to profit politically at the expense of the poor fellow without a job. It is jobs that are required, not such political sleight of hand, as is exemplified by increasing the exemption by $100. What does a $100 added exemption mean to the jobless man?

Gentlemen, I repeat, this is sheer political demagogery.

The raising of personal exemptions by $100 would throw us back into substantial deficit financing. That is the reason, gentlemen, why the President of the United States and Secretary Humphrey are fighting so hard against this move. In addition the President and the Secretary of the Treasury oppose, on principle, the removal of from 4 to 7 million persons from the taxrolls and hence from any personal responsibility for the cost of Government.

We believe there is no more propitious time than the present for removing complex confusion, inequities, discrimination, and gross unfairness from the Internal Revenue Code. We therefore earnestly request that the provisions in H. R. 8300 relating to dividend income be retained in their present form, since they alleviate by far the grossest injustice in the present law. As I stated before the House Ways and Means Committee, "the best incentive device is a

tax code that stimulates thrift. Double taxation of dividends is destructive of the very incentive that Congress is desirous of creating and upon which our future depends. A dividend tax credit would cost the Government only a small fraction of what it would gain through stimulation of day-to-day efforts to earn more and save more. Savers and investors are essential to our way of life. We cannot have big industry without them."

I thank you.

CONCLUSION

Gentlemen, in my estimation H. R. 8300 represents a milestone in Federal tax legislation.

Among the many provisions designed to overhaul and simplify the Internal Revenue Code, one alone will prove to be of immense importance to our present economic situation. I am speaking, of course, of the long overdue recognition of the inequity and evils inherent in taxing dividends twice; first at the corporate level, and again when the income is distributed to stockholders. Double taxation of dividends is the last remaining vestige of the discredited and short-lived undistributed corporate profits tax experiment of 1936.

The House Ways and Means Committee recognized the vital need for this change when, in the report on H. R. 8300, the majority of the committee stated that the dividend provisions were necessary because double taxation had "contributed to the impairment of investment incentives" and "restricted the ability of companies to raise adequate capital."

Economic progress demands heavy expenditures for new plants, new equipment, and modernization. The funds to finance economic progress must come directly or indirectly from individuals willing to risk their savings. If the building process is to continue rapidly enough to meet the needs then the Government must maintain an economic climate conducive to the free flow of equity capital. We are at the economic crossroads. The whole functioning of our great economic machine is of serious concern to every right-thinking American.

President Eisenhower, in his recent radio talk on taxes, ably expressed the importance of dividend tax relief in the overall picture, when he stated, "This will be important to all of us, whether our savings are large or small. It will encourage Americans to invest in their country's future. The more we encourage savings and investment, the more prosperous will be the 160 million American citizens."

Already the inability of corporations to obtain equity funds has resulted in an unhealthy reliance on mortgaged futures—debt financing. Witness the postwar period when corporate debt doubled. I am concerned with this capital structure, topheavy with debt, and I believe that H. R. 8300 provides the incentives necessary to build an equity base for this debt. And the cost, gentlemen, is negligible.

As corporate enterprise shifts from debt issues to equity issues I am certain that the revenue loss from this proposal will be more than offset.

I therefore respectfully urge that the committee approve these provisions.

Most of the criticism leveled against dividend tax relief can be centered around the theme of a "rich man's bill." Gentlemen, nothing could be further from the truth. The expression is nothing but political demagogery.

According to Treasury statistics, nearly 80 percent of the taxpayers reporting dividends are members of families earning under $10,000 a year, while almost half of all dividend recipients earn less than $5,000. If you want further proof I need only refer you to the recent study made by the United States Steel Corporation of its nearly 300,000 stockholders. More than half of these stockholders receive less than $5,000 a year, with one-third having incomes of less than $3,000. Are these the rich men constantly referred to?

It has been said that the little man receives no benefits from these proposals. Yet under the $100 dividend exemption more than 90 percent of the persons relieved completely from the burden of double taxation will be receiving less than $10,000 per year. In addition, the percentage deduction in tax liabilities is greater in the lower income bracket and relief becomes progressively less as the income or dividend level rises.

When facts are exhausted, the opponents of dividend tax relief scream that such provisions discriminate against wage earners in favor of "coupon clippers." Gentlemen, the 10 million American shareowners and the other millions of savers who are indirectly investors are wage earners first and income earners second. Dividends for most shareowners constitute only a small portion of their total

income. For example, dividends accounted for approximately 11 percent of the income of the average shareowner earning $5,000 and less than 20 percent for those earning $30,000.

It is interesting to note that Senator Walter F. George said in 1949:

"The law should be changed to allow a credit to the individual stockholder for taxes already paid by the corporation. As a starter, we should provide a credit of a certain percentage—say 10 percent or perhaps 16.6 percent, the amount of the first-bracket individual income tax. Ultimately we should exempt dividends from taxation completely."

Rather than being discriminatory against wage earners, I would say that these provisions will be a step in the direction of restoring a tax balance between the various forms of income received by wage earners.

In view of the importance of dividend relief I am at a loss to understand the reasons behind the move to strike this provision out of the law and substitute higher exemptions unless the reasons be, as I have stated, strictly political. Raising exemptions means only a slight increase in the workers' "take-home pay"—on the average of 50 cents per week per exemption. It will not create more jobs, increase productive facilities, or lubricate our great economic system. The raising of personal exemptions by even $100 will throw us back into substantial deficit financing. That is the reason, gentlemen, why the President of the United States and the Secretary of the Treasury are fighting so hard against this move.

Gentlemen, we believe there is no more propitious time than the present for removing complex confusion, inequities, discrimination, and gross unfairness from the Internal Revenue Code. We therefore earnestly request that the provisions in H. R. 8300 relating to dividend income be retained in their present form, since they alleviate by far the grossest injustice in the present law. As I stated before the House Ways and Means Committee, "the best incentive device is a tax code that stimulates thrift. Double taxation of dividends is destructive of the very incentive that Congress is desirous of creating and upon which our future depends. A dividend tax credit would cost the Government only a small fraction of what it would gain through stimulation of day-to-day efforts to earn more and save more. Savers and investors are essential to our way of life. We cannot have big industry without them."

The CHAIRMAN. Is Mr. Landman here? Are there any other witnesses who are scheduled to appear this morning?

We will meet at 10 o'clock tomorrow.

(By direction of the chairman, the following is made a part of the record:)

STATEMENT PRESENTED ON BEHALF OF UNITED CEREBRAL PALSY ASSOCIATIONS IN CONNECTION WITH H. R. 8300 ON THE SUBJECT OF—X. SPECIAL ITEMIZED DEDUCTIONS FOR INDIVIDUALS—C. CHILD-CARE EXPENSES (SEC. 214)

GENERAL STATEMENT

Mr. Chairman and members of the committee, my name is Karl K. Van Meter. I reside in New York City and I have been the executive director of United Cerebral Palsy Associations for about 3 years.

Gentlemen, I am truly grateful for the privilege of presenting this statement to you on behalf of the thousands of mentally retarded and physically disabled children and teen-agers in the United States.

United Cerebral Palsy Associations, Inc., is a nonprofit membership corporation, organized in 1948—the only nationwide organization devoted exclusively to a united attack on cerebral palsy. Its humanitarian work is supported by voluntary public contributions. Its officers and board of directors serve without compensation of any kind. National headquarters are at 369 Lexington Avenue, New York City.

United Cerebral Palsy comprises over 200 affiliated State and local organizations throughout the United States.

United Cerebral Palsy and its affiliates are dedicated to an all-out effort to help the cerebral palsied to take their rightful places alongside their more fortunate brothers and sisters—part of the never-ceasing struggle to preserve our freedom and the concepts we hold dear. America's youth must be strong.

Cerebral palsy is the general term for a group of disorders caused by injury to the motor centers of the brain which result in the loss or impairment of

voluntary muscle control. The condition may be severe or very mild; many muscles may be affected, or only a few. The lack of control may be in the arms, legs, tongue, speech mechanism, eyes, or it may affect the hearing. The extent of the disability varies widely and may affect the entire range of muscular activity.

Cerebral palsy occurs most frequently at birth but it may happen at any time before birth, or in childhood or adult life as the result of an accident, illness, or infection. Anyone may be affected by the condition, regardless of age, race, economic standing, or environment.

Estimates indicate that there are some 550,000 persons in the United States who are suffering from cerebral palsy, 200,000 of whom are under 21 years of age.

While I am aware of the fact that the parents of the cerebral palsied would benefit if the suggestions made in this statement were adopted, yet I like to make it clear at the outlet that this plea is presented not only on behalf of the parents of the cerebral palsied but for all of the parents of the mentally retarded and physically disabled who are unable to attend a regular school.

On August 6, 1953, Mr. William E. Mallett, president of United Cerebral Palsy of Mississippi, Inc., a member of the board of directors of United Cerebral Palsy Associations, Inc., the national organization, and the father of a cerebral palsied child, testified at the general revenue revision hearings held by the Committee on Ways and Means of the House of Representatives. At that time Mr. Mallett spoke for all of the mentally retarded and physically disabled children and made a plea for a specific tax exemption of $600 for a taxpayer supporting a dependent who is permanently disabled. He called the attention of the committee to the fact that there is now in the Internal Revenue Code a specific exemption of $600 for a blind person and he expressed the opinion that he was unable to recognize the difference between a blind person and one who is permanently disabled.

This testimony is particularly pertinent to that part of the report of the Committee on Ways and Means of the House of Representatives which accompanied H. R. 8300 under the title of "X. Special Itemized Deductions for Individuals or Corporations * * *. C. Child-Care Expenses, section 214," found on page 30.

The committee's bill provides for a new deduction for child-care expenses paid by a working widow, widower, or divorced person, or a working mother whose husband is incapacitated. It states the child must be below the age of 10 (or 16 if the child is physically or mentally unable to attend a regular school).

It would seem to be elementary that a mentally and physically defective child who is unable to attend a regular school would require much more attention and care during his or her adolescent period (which for the purpose of discussion we shall assume reaches to the age of 21), than that of a child of 10.

Why, therefore, should this effort on the part of the Ways and Means Committee to afford relief for these unfortunate parents stop at the age of 16?

It has been suggested to me that it may suffice if I, as executive director of United Cerebral Palsy Associations, and by reason of my familiarity with the problem, were to make a definite statement that the age limit for the relief of the parents of the mentally retarded and physically disabled should be increased from 16 to 21 years. I discussed the problem, if there is one, with Dr. Glidden L. Brooks, medical director of United Cerebral Palsy Associations, and we agreed that it would be helpful if we were to obtain the opinion of someone who is a recognized authority on the subject.

Dr. Brooks was fortunate in obtaining an opinion from Dr. George G. Deaver, professor of clinical rehabilitation and physical medicine, director of children's service of the Institute of Rehabilitation, New York University Medical Center. Dr. Deaver's opinion is attached to this statement and made a part thereof.

Risking the criticism that may be directed at me because of repetition, I feel that I should restate the following part of Dr. Deaver's letter:

"The definition should most certainly encompass such children during the adolescent period since the majority are totally dependent for their daily care upon the parent until at least the age of 21 years. Not only is this so but because they are handicapped such individuals constitute a much greater burden of care from the standpoint of time, effort, and expense than any normal child under the age of 10."

We all realize that the ideal treatment of this problem would be for this relief to extend beyond the age of 21 because that certainly is not the age when these unfortunate parents must stop paying for this care and attention, but we

would be thankful if your honorable committee would give us the relief asked for in this statement.

NEW YORK UNIVERSITY-BELLEVUE MEDICAL CENTER,
INSTITUTE OF PHYSICAL MEDICINE AND REHABILITATION,
New York, N. Y., April 19, 1954.

DR. GLIDDEN L. BROOKS,
Medical Director, United Cerebral Palsy Associations, Inc.,
369 Madison Avenue, New York, N. Y.

DEAR DR. BROOKS: Thank you for bringing to my attention the provision relative to the term "child" as defined in the report of the Committee on Ways and Means of the House of Representatives which accompanied H. R. 8300, a bill to revise the internal-revenue laws of the United States, in which it refers to a presumably normal person who has not attained the age of 10 years, or one who has not attained the age of 16 years and who because mentally or physically defective is not able to attend a regular school.

I am in agreement that setting the age level for the mentally or physically handicapped child at 16 is not a realistic approach to this very serious problem. The definition should most certainly encompass such children during the adolescent period since the majority are totally dependent for their daily care upon the parent until at least the age of 21 years. Not only is this so but, because they are handicapped, such individuals constitute a much greater burden of care from the standpoint of time, effort, and expense than any normal child under the age of 10.

I share your conviction if such measure of tax relief is to be provided single parents of this unfortunate group of children it should be as liberal as is commensurate with good governmental policy.

Sincerely yours,

GEORGE G. DEAVER, M. D.,
Professor of Clinical Rehabilitation and Physical Medicine,
Director of the Children's Service.

CHADBOURNE, HUNT, JAECKEL & BROWN,
New York 5, April 21, 1954.

MRS. ELIZABETH SPRINGER,
Clerk, Senate Finance Committee,
Senate Office Building, Washington, D. C.

DEAR MRS. SPRINGER: I enclose for submission to the Committee on Finance three copies of a memorandum recommending some minor but significant changes to section 402 of the proposed Internal Revenue Code of 1954 reported by the Ways and Means Committee of the House of Representatives as H. R. 8300.

A similar memorandum was submitted to the Committee on Taxation of the Association of the Bar of the City of New York, and, on page 66 (first 2 full paragraphs) of its first report to the Senate Committee on Finance, that committee recommends the adoption of the changes I have suggested. I am, however, forwarding the enclosed directly to you since, due to lack of time and space, the association of the bar report does not set forth the detailed reasons for the changes.

I am also sending copies of this memorandum to the American Bar Association in the thought that that association might wish to go on record in favor of the changes I have suggested.

Very truly yours,

G. BARRON MALLORY.

MEMORANDUM RE SUGGESTED CHANGES TO SECTION 402 OF THE PROPOSED INTERNAL REVENUE CODE OF 1954

The proposed Internal Revenue Code of 1954 (H. R. 8300), as reported by the Ways and Means Committee of the House of Representatives, includes a provision (sec. 402) purporting to cover the taxability of beneficiaries of employees' trusts. Section 402 (a) provides in part as follows:

"(1) GENERAL RULE.—Except as provided in paragraph (2), the amount actually distributed *or made available* to any distributee by any employees' trust described in section 501 (e) which is exempt from tax under section 501 (a) shall be taxable to him, in the year in which so distributed *or made available*. * * *" [Emphasis supplied.]

The report of the House Committee on Ways and Means (H. Rept. 1337), at page 42, states in part as follows with respect to section 402 of the proposed code:

"Covered individuals would be taxed on benefits *as they receive them*, to the extent such benefits exceed their own contributions. * * *" [Emphasis supplied.]

There is an evident conflict between section 402 and the Ways and Means Committee report. Under the proposed code, beneficiaries of employees' trusts are regarded as taxable on benefits "made available" to them, whereas the Ways and Means Committee says in its report that they are taxable only on benefits "as they receive them." It is suggested, for the reasons mentioned below, that the Senate Committee on Finance urge that section 402 (a) be amended so as to bring its provisions in conformity with the interpretation set forth in the report of the House Ways and Means Committee. This can be accomplished through the omission from the legislation as finally enacted of the words "or made available" appearing twice in section 402 (a) (1).

Under section 165 (b) of the present Internal Revenue Code, beneficiaries of employees' trusts are taxable when their benefits are "distributed or made available." In three actual cases, with which the undersigned is intimately familiar, the Internal Revenue Service has taken inconsistent positions with respect to profit-sharing plans having identical provisions allowing the withdrawal by members during the course of their employment of payable units.

In one case the Internal Revenue Service, some time ago, issued a private ruling to the effect that units that became payable to employees who continued their employment were not "made available" unless and until the units actually were withdrawn, provided the employees would suffer a penalty upon withdrawal thereof. The employee's loss of the following was considered a sufficient penalty: (*a*) the share of tax-free trust earnings otherwise creditable for the year of withdrawal and in the future to withdrawn units, and (*b*) the share of forfeitures (upon severance of employment by members whose credits are not fully vested) otherwise creditable in the year of withdrawal and in the future to withdrawn units. Other penalties (not taken into account by the Service but nevertheless real ones) suffered by a withdrawing employee are the loss of the privilege to report the value of withdrawn units at long-term capital gains tax rates (sec. 165 (b) I. R. C.) instead of at ordinary income-tax rates and the investment advantage of participating in a large fund which generally benefits through expert investment advice.

In the other two cases, which were more recent, the argument was made that the employee whose withdrawal right accrues should not be taxed on the constructive receipt theory since these penalties represented a substantial bar to withdrawal. However, in one of these cases, the Internal Revenue Service has now taken the position that these penalties are not sufficient to avoid the application of the constructive receipt doctrine. In support of its position, the Internal Revenue Service cited G. C. M. 27580, dated December 5, 1952, in re: *Electro Refractories & Abrasive Corportion* (unreported).

Mr. Isidore Goodman, technical adviser to the pension trust branch, covered the question in an unofficial speech before the American Pension Conference on February 4, 1954. With respect to this speech, the following is reported in the Prentice-Hall pension and profit-sharing service (Rept. No. 7, vol. XV, dated February 19, 1954):

"Here's Mr. Goodman's answer: 'Under section 165 (b), we consider the payable units as income currently taxable to the employee unless he makes an election, before they actually become payable, to have their receipt deferred.' He needn't make this election once and for all, Mr. Goodman continued, but may do so annually, before the date each year when employees can draw from their profit-sharing accounts. The annual election may take the form of a notice to the employer from a participant that the participant doesn't wish to draw anything from his account on the regular yearly withdrawal date. This type of election insures that the employee won't be taxed on the value of the additional payable units credited to his account that year."

It is understood that since the delivery of the speech referred to, Mr. Goodman has taken the position that the election must be filed by the employee within a "reasonable" time prior to the accrual of the withdrawal right.

It is respectfully suggested that the uncertainties should be resolved at this time through clarifying legislation. Employers and employees, in cases where their pension or profit-sharing plans contain provisions permitting withdrawals during employment, have no crystallized rule to follow. Mr. Goodman's views are helpful but do not eliminate the uncertainty because (*a*) they are unofficial and, until a revenue ruling is issued on the subject, the agents in the field are

not bound thereby, (*b*) it is impossible to determine with preciseness the period prior to which the election should be filed to avoid constructive receipt, and (*c*) they do not cover the case where the withdrawal right accrues upon the occurrence of an emergency or where the employee is subjected to extraordinary medical expenses and the like (in which case the right to withdrawal accrues automatically and before the member can file an election). Also, in some plans no mechanics are provided for the filing of an election not to withdraw. Finally, the present uncertain situation is unsatisfactory because it is probable that many employers and employees will not recognize that they have the problem until it is brought out by an agent in the field, when it would be too late to take remedial steps.

The undersigned, therefore, respectfully urges that your committee give favorable consideration to the changes in section 402 (a) which I have suggested herein. It is probable that the loss of revenue resulting from such a change would be negligible. The present situation constitutes little more than a time-consuming annoyance to those concerned and can easily be rectified in the manner above suggested.

Respectfully submitted.

G. BARRON MALLORY,
Member of the Bars of New York and Connecticut.

NEW YORK 5, N. Y., *April 20, 1954.*

MEMORANDUM SUBMITTED TO SENATE COMMITTEE ON FINANCE RE SUGGESTED CHANGES TO SECTION 402 (A) (4) OF THE PROPOSED INTERNAL REVENUE CODE OF 1954 (H. R. 8300)

Section 402 (a) (4) of the proposed Internal Revenue Code of 1954 (H. R. 8300), as adopted by the House of Representatives, provides as follows:

"(4) CERTAIN LIFE INSURANCE CONTRACTS.—If a trust described in section 501 (e) which is exempt from tax under section 501 (a) purchases life insurance contracts (including retirement income contracts) with life insurance protection payable on the death of the employee participants, or pays any part of the cost of such insurance contracts, no part of the premiums paid on such insurance contracts shall be taxable to the employee participants, but the proceeds, when distributed, shall be taxable under paragraph (1) of this subsection. This paragraph shall not apply to group term insurance contracts."

The effect of the foregoing is to change, except as mentioned in the next sentence, present law covering the taxability of life-insurance protection provided to employees who are members under their employers' pension and profit-sharing plans. Under this proposed legislation, the provision to an employee of life-insurance protection under such a plan, except life protection underwritten through group term insurance contracts, would not result in a tax to the insured members.

Previously the Internal Revenue Service had taken the position, under existing law, that the provision of life-insurance protection to a member under pension and profit-sharing plans represents a taxable current distribution; at the present time the amount of such distribution is regarded as the 1-year term premium cost of the insurance involved, calculated at the age of the insured member. Under this rule, such amount is reportable as taxable income by the individual insureds (Mim. 6477, 1950-1 C. B. 16).

Apparently this rule applies to all kinds of insurance, i. e., ordinary life, retirement income policies with life-insurance protection, group permanent insurance and, more recently, this rule has been held to apply to group term insurance (Rev. Rul. 54-52, I. R. B. 1954-8, 11, Feb. 22, 1954).

It is submitted that the elimination from the taxable income of members under pension and profit-sharing plans of the value of this life-insurance protection is beneficial. While it is true that the member who is thus insured does receive a valuable benefit in the form of life-insurance protection, still if he survives throughout the year he has retained no tangible asset on which he has paid a tax. It is further submitted that if it is desirable to provide relief to employees insured under ordinary life, retirement income policies, and group permanent insurance policies, it is equally desirable to provide the relief to those insured under group term insurance.

There is no apparent reason for making a distinction between the latter type of insurance and the others. In fact, it would seem that if relief were to be

granted to any kind of insurance, it would be more logical to grant it in the field of group term insurance than in the others mentioned. The reason for this conclusion is that an insured under a group term policy retains no permanent benefit in the event he survives, whereas an insured under one of the other kinds of insurance mentioned retains a lasting asset; each of these policies have cash values which increase each year as premiums are paid thereon.

The Internal Revenue Service has seen fit to treat the value of group term insurance acquired by an employer outside a qualified trust as tax free to individual insureds (sec. 39.23 (a)-8 of regulations 118). (This rule does not apply to the other forms of insurance mentioned above.) If the value of group term insurance acquired outside of pension and profit-sharing trusts is tax free to the insureds, there would appear to be no logical reason for the legislative levy of a tax on such insurance provided through qualified plans.

Furthermore, there would appear to be no logical reason for the enactment of legislation exempting from tax the protection provided under the permanent forms of life insurance, while, at the same time, taxing protection under group term policies which, by their very nature, are temporary.

For the foregoing reasons, it is respectfully submitted that the last sentence of the above-quoted provision should be eliminated, with the result that life-insurance protection provided by any form of policy acquired under a qualified pension or profit-sharing trust shall be exempt from tax.

Respectfully submitted.

G. Barron Mallory,
Member of the Bars of New York and Connecticut, 70 Pine Street, New York, N. Y.

April 26, 1954.

Statement on Behalf of the Toilet Goods Association, New York 20, N. Y., in Re H. R. 8300 a Bill to Revise the Internal Revenue Laws of the United States—Section 5331 (a) (1), Denature of Alcohol

The Honorable Eugene Millikin,
Chairman, Committee on Finance,
Senate Office Building, Washington, D. C.

My Dear Senator: We respectfully request that the following be made a part of the record in the hearings before your committee in re H. R. 8300.

The Toilet Goods Association, Inc., 9 Rockefeller Plaza, New York 20, N. Y., is an association of manufacturers producing more than 90 percent of the toilet preparations sold in America. Many members of our association manufacture preparations such as skin lotions, hair tonics, mouth washes, and similar products in which denatured alcohol is an important ingredient.

This association has noted with concern language contained in section 5331 (a) (1) of H. R. 8300, relating to denatured alcohol, which we think should be amended and clarified.

Section 5331 (a) (1) of H. R. 8300 is substantially a copy of section 1 of the act of June 7, 1906, the original act providing for tax-free denatured alcohol. Some of the expressions used therein are long out of date and they may well give rise to confusion in the administration of the law and to expense and trouble to the users of denatured alcohol.

Section 5331 (a) (1) provides insofar as pertinent herein:

"Domestic alcohol * * * may be withdrawn from bond * * * provided such alcohol shall have been mixed * * * with methyl alcohol or other denaturing material * * * which destroys its character as a beverage and *renders it unfit for liquid medicinal purposes.*" [Italics supplied.]

This language obviously seems to prohibit the use of tax-free denatured alcohol for any liquid medicinal purposes.

In fact, such was the original construction of this language by the Bureau of Internal Revenue and the Treasury Department. Later, however, and because of later legislation the Bureau of Internal Revenue permitted tax-free denatured alcohol to be used in the manufacture of liquid medicinal preparations—provided the medicinal preparation was to be used externally. In times past the above-mentioned toilet preparations have been classified tax-wise as medicinal.

For some years the distinction which the Bureau of Internal Revenue has drawn has been whether the medicinal preparations was intended and sold for external use or for internal use. In the latter case, permits to manufacture with tax-free denatured alcohol have been denied. In the case of external use, permits have been allowed.

Section 5331 (a) (1) of H. R. 8300 makes no such distinction; it apparently denies use for any liquid medicinal purpose.

This language should be amended to plainly express the Bureau's long-established practice and such an amendment would seem to be comparatively simple.

It is possible that the Bureau of Internal Revenue will not change its present practice and that it will construe the new act as it has the present law. But this seems to leave the rights of the users dependent upon administrative grace and not upon law. Administrative constructions often change with administrators and we respectfully submit that property rights should not rest upon so unstable a base.

We respectfully suggest that since the legislation is now being revised "to delete obsolete material" and to restate the law "in a more understandable manner" this language should be corrected.

Respectfully yours,

THE TOILET GOODS ASSOCIATION,
By FULLER HOLLOWAY, *Counsel*.

WASHINGTON 5, D. C.

STATEMENT ON BEHALF OF WESTERN NEW YORK WATER CO., BUFFALO, N. Y., IN RE: H. R. 8300, A BILL TO REVISE THE INTERNAL REVENUE LAWS OF THE UNITED STATES—SECTION 1033. INVOLUNTARY CONVERSIONS

INVOLUNTARY CONVERSIONS

Section 1033 (a) of H. R. 8300 is identical to section 112 (f) of the Internal Revenue Code excepting changes in references to other sections made to conform to changes in numbering and lettering of such other sections. Section 1033 (c), concerning the basis of property acquired through involuntary conversions, is likewise conformed to replace section 113 (a) (9) of the Internal Revenue Code.

Section 112 (f) of the Internal Revenue Code deals with situations in which a taxpayer is forced to part with property by reason of causes wholly beyond his control, such as fire, theft, or condemnation. Where property is involuntarily converted into property similar or related in service or use to the property converted, any gain realized at the time of the conversion is not recognized. Where property is involuntarily converted into cash or different property and within a specified time the taxpayer replaces the converted property by purchasing property similar or related in service or use to the property converted, or purchases stock in acquisition of control of a corporation owning such other property, gain is recognized, at the election of the taxpayer, only to the extent that the amount received on conversion exceeds the cost of the replacement property.

The basic objective of the involuntary conversion rule is to prevent the immediate incidence of taxation on gains which may have been realized as a result of events or circumstances completely beyond taxpayer's control—provided he reinvests the proceeds so that the gain can be recognized later where a voluntary realization occurs. This rule does not permit escape from taxation on such gains, but merely gives the taxpayer the same freedom of choice of the time when gain will be recognized as is the case in nonforced sales of property. This is accomplished through section 113 (a) (9) which provides that the basis of the replacement property shall be the cost of such property decreased by the amount of the gain not recognized on the involuntary conversion. Thus, assuming that the replacement property is subsequently sold, the hitherto nonrecognized gain is then accounted for through the use of the reduced basis.

Existing law provides that the replacement property must be similar or related in service to the property converted, which provision under usual circumstances is equitable and permits a taxpayer whose property has been involuntarily converted to resume his position prior to the conversion.

Conditions obtain, however, which make the objective of the existing law unattainable in practice by public utilities. Public utilities appear to be unique among business organizations in that there is little or no freedom of choice in replacing property condemned and taken over by public authority. For example, where a privately owned water system is condemned by public authority for purposes of public ownership, the private water company ordinarily has little or no opportunity to reinvest the proceeds of the condemnation in property

"similar or related in service or use to the property converted" within the meaning of the existing provisions of section 112 (f) (3). The construction of new facilities is precluded because the company's franchise is normally included in the property condemned. It probably cannot acquire another franchise in the same or different locality as existing franchises and facilities have preempted the available field. Because of the nature of regulated public utilities, it is usually impossible to purchase the operating property of another public utility. Furthermore, operating franchises are often not transferable or assignable even if a utility of comparable size might be found. Nor is it ordinarily practicable to purchase stock in acquisition of control (ownership of 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) of another public-utility corporation. Shares of the stock of public-utility corporations are usually held in small proportions by many shareholders. Also, the problem of finding a utility in which "control" can be acquired at a cost approximating the condemnation award may make the replacement impractical if not impossible.

The case of Western New York Water Co. (for convenience hereinafter referred to as Western New York) presents a typical situation. The facts in that case are as follows:

For over 50 years prior to 1953, Western New York had owned and operated a water system for suburban Buffalo, N. Y. On July 26, 1951, a proceeding in the county court of Erie County, N. Y., was instituted against Western New York for the condemnation of all its properties.

On or about October 8, 1953, the case was settled pursuant to an agreement whereby Western New York was to receive an aggregate of approximately $14,760,000, and said amount was paid to Western New York on December 23, 1953. Approximately $6,595,000 of the proceeds had to be used immediately to pay outstanding indebtedness consisting principally of bonds, debentures and bank loans, which automatically became due by reason of the involuntary conversion. The balance has been temporarily invested in 90 day Treasury bills.

The amount received exceeded the adjusted basis of the condemned property by several million dollars.

Because of the trend toward public ownership of water systems, particularly in the State of New York, the difficulties in the way of postponing the tax on Western New York's gain under the present provisions of section 112 (f) appear to be insurmountable. Certainly in view of this trend, the acquisition of another water system in the State of New York is not even remotely possible. The construction of new facilities is precluded because the company's franchise was included in the property condemned and in view of such trend toward public ownership, the possibility of finding a municipality from which a new franchise could be obtained is certainly not promising. Nor does Western New York know of any privately owned system of comparable size available for purchase. Even if one could be found, it would probably be in the shadow of condemnation and, in that event, the reinvestment in such properties would only be temporary and postpone the problem.

Attached hereto is a revision of section 1033 which is designed to carry out the basic objective of the involuntary conversion rule by providing a practicable means for replacement of investment in public utilities which have been condemned by public authority. Subject to the limitations hereinafter referred to, the revision permits a public utility to postpone the tax on the gain by paying its indebtedness and reinvesting the balance of the proceeds of the condemnation in stock of any public utility, as defined, whether or not control of such utility is acquired.

Public utilities normally are financed in part by securities representing indebtedness. Ordinarily such securities representing indebtedness automatically mature and must be paid at the time the condemnation proceeds are realized. Under the revision, payment in retirement or cancellation of securities representing indebtedness is also considered an expenditure for property similar or related in service or use to the property converted. Such provision is necessary since a like amount of indebtedness probably cannot be replaced in the financial structure of the public utility whose stock is acquired with the condemnation proceeds. Nor is it believed advisable to require the taxpayer to incur new indebtedness for the purpose of reinvestment in the stock of another public utility.

The revision provides, however, that the gain to be recognized at the time of the involuntary conversion shall not be less than the amount by which the total gain realized on the involuntary conversion exceeds the total of expenditures for

replacement stock, without regard to the said payments in retirement or cancellation of securities representing indebtedness. This provision is necessary in order to preclude the possibility that some of the gain realized on the conversion might escape taxation altogether and not be merely postponed where, because of the amount of the indebtedness, the balance remaining for investment is less than the total amount of the gain. In such a case, the full amount of the gain obviously cannot be postponed through a reduction of the cost of the replacement property under subsection (c) (sec. 113 (a) (9) I. R. C.).

WESTERN NEW YORK WATER CO.,
By CHARLES D. HAMEL, *Counsel.*

WASHINGTON 5, D. C.

INTERNAL REVENUE CODE OF 1954, H. R. 8300, RECOMMENDED AMENDMENTS TO SECTION 1033

(Amendments italicized)

SEC. 1033. INVOLUNTARY CONVERSIONS.

(a) GENERAL RULE.—If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

(1) CONVERSION INTO SIMILAR PROPERTY.—Into property similar or related in service or use to the property so converted, no gain shall be recognized.

(2) CONVERSION INTO MONEY WHERE DISPOSITION OCCURRED PRIOR TO 1951.—In money, and the disposition of the converted property occurred before January 1, 1951, no gain shall be recognized if such money is forthwith in good faith, under regulations prescribed by the Secretary or his delegate, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund. If any part of the money is not so expended, the gain shall be recognized to the extent of the money which is not so expended (regardless of whether such money is received in one or more taxable years and regardless of whether or not the money which is not so expended constitutes gain). For purposes of this paragraph and paragraph (3), the term "disposition of the converted property" means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(3) CONVERSION INTO MONEY WHERE DISPOSITSON OCCURRED AFTER 1950.—Into money or into property not similar or related in service or use to the converted property, and the disposition of the converted property (as defined in paragraph (2) occurred after December 31, 1950, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) Nonrecognition of Gain.—If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe. For purposes of this paragraph—

(i) no property or stock acquired before the disposition of the converted property shall be considered to have been acquired for the purpose of replacing such converted property unless held by the taxpayer on the date of such disposition; and

(ii) the taxpayer shall be considered to have purchase property or stock only if, but for the provisions of subsection (c) of this section, the unadjusted basis of such property or stock would be its cost within the meaning of section 1012; and

(iii) *if the taxpayer is a public utility and property owned by it is compulsorily or involuntarily converted as a result of requisition*

or condemnation or threat or imminence thereof, a purchase of public utility property or of stock or securities of a public utility or holding company (whether or not representing control of such public utility or holding company) shall be considered a purchase of such other property or such stock; and a payment in complete or partial retirement or cancellation of securities representing indebtedness of such taxpayer shall also be deemed a purchase of such other property or such stock for the purpose of computing the gain to be recognized under this paragraph, but not for the purpose of computing the basis under subsection (c); provided, however, that the gain to be recognized shall not be less than the amount by which the total gain realized on the involuntary conversion exceeds the total of such purchases of such other property or such stock without regard to the said payments in retirement or cancellation of securities representing indebtedness.

(B) Period Within Which Property Must Be Replaced.—The period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending—

(i) one year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or

(ii) subject to such terms and conditions as may be specified by the Secretary or his delegate, at the close of such later date as the Secretary or his delegate may designate on application by the taxpayer. Such application shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe.

(C) Time for Assessment of Deficiency Attributable to Gain Upon Conversion.—If a taxpayer has made the election provided in subparagraph (A), then—

(i) the statutory period for the assessment of any deficiency, for any taxable year in which any part of the gain on such conversion is realized, attributable to such gain shall not expire prior to the expiration of 3 years from the date the Secretary or his delegate is notified by the taxpayer (in such manner as the Secretary or his delegate may by regulations prescribe) of the replacement of the converted property or of an intention not to replace, and

(ii) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of section 6212 (c) or the provisions of any other law or rule of law which would otherwise prevent such assessment.

(D) Time for Assessment of Other Deficiencies Attributable to Election.—If the election provided in subparagraph (A) is made by the taxpayer and such other property or such stock was purchased before the beginning of the last taxable year in which any part of the gain upon such conversion is realized, any deficiency, to the extent resulting from such election, for any taxable year ending before such last taxable year may be assessed (notwithstanding the provisions of sec. 6212 (c) or 6501 or the provisions of any other law or rule of law which would otherwise prevent such assessment) at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed.

(E) *Definitions.*—

(i) As used in this subsection, the term "public utility" means a corporation engaged in the furnishing or sale of electric energy, gas, water, telephone or telegraph service, or sewerage disposal services, or transportation on intrastate, suburban, municipal, or interurban electric railroad, or on an intrastate, municipal, or suburban trackless trolley system, or on a municipal or suburban bus system if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of the District of Columbia or of any State or political subdivision thereof; and

(ii) *as used in this subsection, the term "holding company" means a corporation whose principal purpose is investment in stock or securities of a public utility.*

(b) RESIDENCE OF TAXPAYER.—Subsection (a) shall not apply, in the case of property used by the taxpayer as his principal residence, if the destruction, theft, seizure, requisition, or condemnation of residence, or the sale or exchange of such residence under threat or imminence thereof, occurred after December 31, 1950, and before January 1, 1954.

(c) BASIS OF PROPERTY ACQUIRED THROUGH INVOLUNTARY CONVERSION.—If the property was acquired, after February 28, 1913, as the result of a compulsory or involuntary conversion described in subsection (a) (1) or (2), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made. This subsection shall not apply in respect of property acquired as a result of a compulsory or involuntary conversion of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition, or condemnation of such residence, or the sale or exchange of such residence under threat or imminence thereof, occurred after December 31, 1950, and before January 1, 1954. In the case of property purchased by the taxpayer in a transaction described in subsection (a) (3) which resulted in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the cost of such property decreased in the amount of the gain not so recognized; and if the property purchased consists of more than one piece of property, the basis determined under this sentence shall be allocated to the purchased properties in proportion to their respective costs.

(d) *Subject to the provisions of subsection (b), the provisions of this section shall be applicable in respect of all taxable years ending after December 31, 1953, and all taxable years ending prior to January 1, 1954, in which a disposition of the converted property occurred if any part of the replacement pursuant to the provisions of this section is made after December 31, 1953.*

(e) CROSS REFERENCES.—

(1) For determination of the period for which the taxpayer has held property involuntarily converted, see section 1223.

(2) For treatment of gains from involuntary conversions as capital gains in certain cases, see section 1231 (a).

ILLINOIS STATE CHAMBER OF COMMERCE,
Chicago, April 21, 1954.

To the Senate Finance Committee:

STATEMENT OF THE ILLINOIS STATE CHAMBER OF COMMERCE IN REGARD TO H. R. 8300

The Illinois State Chamber of Commerce presents this statement on behalf of the approximately 12,000 Illinois businessmen comprising its membership. These businessmen are located in 346 cities throughout Illinois. Since 1948 when we presented a comprehensive report to Mr. Colin F. Stam, chief of staff of the Joint Committee on Internal Revenue Taxation we have been especially concerned with seeing the code improved in various technical and administrative particulars. We have brought our previous work and experience with this subject to bear upon the proposals that are embodied in H. R. 8300.

Our basic position in regard to this bill is that it very materially improves the present Internal Revenue Code and that it should therefore be adopted. Before adoption, however, it should be amended in the particulars enumerated herein for correcting various inequities and for overcoming certain impractical features.

In proposing amendments we have been guided by certain definite criteria. Our primary concern is with those sections deemed to be of widespread interest; no comment is made in regard to various specialized problems. The approach has also been to develop recommendations for correcting features found to be of an impractical or inequitable nature. In accordance with these criteria we are making no comments about the many desirable provisions in the bill. Neither

are we addressing ourselves to questions of rates or types of taxation. Such matters, in our opinion, should not be allowed to confuse the question of making changes of a purely technical or administrative nature. And finally we are not urging inclusion of substantive changes for items not already dealt with in the bill.

The various sections of H. R. 8300 for which amendments are proposed are as follows:

Section	*Topic*
167 (c) and (e)	Depreciation.
172	Net operating loss deductions.
275	Deductibility of interest on income debentures.
309, 336, 359, 391, and 771	Corporate reorganization problems, subchapter C.
461	Accounting periods and methods of accounting.
472 and 1321	LIFO inventory.
501 and 505	Pension, profit sharing, and other employee benefit plans.
642-675, 2031, 2032, and 2515	Federal income taxes of trusts, estate taxes, and gift taxes.
706	Partnership problems.
951	Income from foreign branches.
6016	Advance payment of corporation income taxes.
6153	Dates for filing estimates and returns and payments of income taxes.

1. DEPRECIATION

(*a*) *Section 167* (*c*)

Recommendation.—Amend section 167 (c) to permit use of the declining balance and other methods provided in section 167 (b) for all tangible property acquisitions after December 31, 1953, except acquisitions of pre-1954 additions from closely related taxpayers.

Explanation.—The requirement that section 167 (b) methods of depreciation shall be limited to property new in use after December 31, 1953, is motivated by the desire of Congress to promote the construction and sale of capital additions. Success in this objective is essential to provide production facilities of the magnitude and efficiency required to meet the needs of our Nation.

However, it appears that insufficient consideration has been given to this matter from the standpoint of the purchasers of new depreciable property. A purchaser who is willing to expand his plant capacity should have the benefits of the declining-balance method, and other methods, whether or not he acquires new assets as such expansion will also tend to increase employment. In this connection it is understood that rebuilt property would qualify as new property, but that property which is merely reconditioned would not be so classified. The elimination of the new requirement would also eliminate the many controversies which are sure to occur on the question of whether property has been rebuilt or was merely reconditioned.

All taxpayers should be permitted to use more liberal depreciation methods regardless of when the property was acquired. It is recognized, however, that the extension of the subsection (b) provisions to all property regardless of when acquired would create certain technical problems in changing over and would also result in such a substantial loss of tax revenue to the Government that Congress might not want to approve a change of this nature.

The suggestion above to exclude acquisitions of pre-1954 items acquired from related taxpayers should take care of the Ways and Means Committee's fear that "the application of the new methods to used property might artificially encourage transfers and exchanges of partially depreciated assets motivated only by tax considerations."

(*b*) *Section 167* (*e*)

Recommendation.—Eliminate the provision permitting the Internal Revenue Service to require a change in a rate of depreciation where it determines that the useful life of any property differs from that used by the taxpayer by more than 10 percent. Provide instead that the taxpayer shall have full discretion in adopting rates and methods of depreciation applicable to the conditions existing in his business. Also provide that in the event of any proposed change in the rate or method of depreciation the burden of proof shall be on the Internal Revenue Service.

Explanation.—The recommended substitute provision is in accordance with the new administrative policy which was announced last year by the Commissioner of Internal Revenue. So far as can be determined the new policy has been effective in eliminating most depreciation controversies.

The Ways and Means Committee in its report states that the provision in the proposed subsection (e) is not intended to affect the present Internal Revenue Service administrative policy in anyway nor is it intended to be a statutory substitute for that policy and indicates that the bill provides for protection should the Internal Revenue Service withdraw its present policy. The committee states further that "it is hoped that by providing a minimum statutory leeway for the taxpayer in making his estimates of useful life, most of the needless friction in this area will be eliminated."

This hope may not be realized. It is understood that there is a belief on the part of engineering personnel in the national and field offices of the Internal Revenue Service that if subsection (e) remains in H. R. 8300, the engineering section of the Service will be back in business, but that if this subsection is eliminated in its present form, the administrative policy in effect since last year not to disturb depreciation deductions will continue to be followed.

This would be a logical development. Also, it appears safe to assume that in some instances there might be a tendency by Revenue Service examiners to propose large depreciation rate changes than would otherwise be made in order to exceed the 10 percent provision in subsection (e).

2. NET OPERATING LOSS DEDUCTIONS

Recommendation.—Eliminate the adjustments required by section 172 (d) (2), (5) and (6) in regard to converting a net operating loss to a net operating loss deduction, and to recomputing the taxable income of years through which a loss is carried.

Explanation.—Section 172 of H. R. 8300, in its present form, represents an improvement on section 122 of the Internal Revenue Code in two ways: (1) It extends by 1 year the period to which losses may be carried back, and (2) it reduces the number and extent of adjustments which the 1939 Code section 122 requires in converting a loss to a net operating loss deduction.

An example of an adjustment which is required under current law is that for tax-exempt interest. Such interest both in the year of loss and in the year to which the loss is carried must presently be recognized to reduce the amount of the net operating loss deduction. Proposed section 172 would eliminate the adjustment for tax-exempt interest entirely and would eliminate other adjustments required by current law in the year to which a loss is carried.

While proposed section 172 represents an improvement over current law, it does not go far enough. In order to equalize the Federal income-tax burden among taxpayers with steady profits and taxpayers with fluctuating profits, an objective discussed in the House committee report, all adjustments to taxable income except those which concern items of income or expense not related to a trade or business should be eliminated. Only by this method will taxpayers with fluctuating incomes receive the benefit of provisions dealing with such subjects as percentage depletion, capital gains, and the dividends received credit to the same extent as taxpayers with steady profits.

3. DEDUCTIBILITY OF INTEREST ON INCOME DEBENTURES

Recommendation.—Delete section 275 and incorporate in section 163 (which deals specifically with interest deductions) intended limitations on the deduction of interest payments made to holders of corporate securities.

In no event should the deduction for interest on corporate securities outstanding prior to the effective date of H. R. 8300 be affected by the new bill.

Explanation.—Section 275 disallows the deduction of amounts paid with respect to nonparticipating stock as defined in section 312 (d). Section 312 deals with the definitions relating to corporate distributions, and is interrelated with several very complex sections in subchapter C. In attempting to correlate the disallowance in section 275 with the definitions in section 312, the code as it stands unnecessarily complicates the determination of what is and what is not deductible interest.

Section 163 allows a deduction to both individuals and corporations for interest paid or accrued on indebtedness. If it is intended to restrict or limit in any way the deduction allowed for interest on corporate indebtedness, it would

seem that such restriction or limitation should be incorporated in section 163 along with the other limitations presently contained therein. There is no reason for excluding the proposed limitation from section 163; in fact, it should be included properly to comply with one of the basic objectives of the bill—to have all related provisions appearing together.

As presently written, section 275 confuses rather than clarifies the taxpayer's position with respect to payments made on corporate obligations, and very substantial amounts of interest which have been deducted in the past without question are to say the least jeopardized by the combined effect of section 275 and 312 (b), (c), and (d).

If there are corporate securities which are made to appear to be indebtedness solely to obtain an interest deduction under section 163, but are in fact some variant of an equity security, this situation should be taken care of precisely and simply by defining the word "indebtedness" as used in section 163.

4. CORPORATE REORGANIZATION PROBLEMS—SUBCHAPTER C

(a) Sections 391 and 771

Recommendation.—Eliminate the March 1, 1954, effective date for subchapter C and make this subchapter apply only to taxable years beginning after December 31, 1954. Alternatively, and at a minimum, provide that subchapter C will not apply to transactions which take place prior to 90 days after the enactment of the bill.

Explanation.—H. R. 8300 makes a complete structural revision of the law relating to corporate distributions, liquidations, and adjustments. Many such adjustments have, no doubt, already been agreed upon, or are in process, all in reliance upon laws now in effect. Obviously, taxpayers so involved should not be penalized by retroactive application of the proposed statutes which make many substantial and exceedingly technical changes in the existing law.

The inclusion of the retroactive provisions in the bill make it inevitable that proposed corporate adjustments, refinancing, etc., be held in abeyance pending enactment of the bill. This, it is believed, will unnecessarily restrain business transactions and may impose substantial hardships where corporate adjustments have already been agreed upon.

(b) Section 359 (a)

Recommendation.—The classification of corporations in section 359 (a) into publicly held corporations and nonpublicly held corporations is wholly arbitrary, serves no useful purpose, and should be eliminated.

Explanation.—It appears from the House committee report that the committee was concerned about the use of reorganization procedures by closely held corporations for the purpose of getting tax benefits for shareholders, rather that to promote the business purposes of the corporations. To guard against such practices (which it is noted the committee does not state categorically exist), it is proposed to adopt several arbitrary rules.

First, it is proposed to classify corporations into two groups: (1) Publicly held corporations, and (2) nonpublicly held corporations. The nonpublicly held group includes those corporations in which 10 or fewer shareholders own 50 percent or more of the stock. A more than 50-percent owned subsidiary would fall in this group, although it obviously is quite different from a family closely held corporation. All other corporations are publicly held corporations.

Second, it is proposed to establish an arbitrary size limitation on reorganizations where one, or both, of the parties thereto falls in the nonpublicly held classification. By this device, corporations falling within the range of specified sizes will automatically be regarded as qualifying for tax deferment, whereas those without the size limitation will be regarded as serving a stockholder purpose and tax deferment denied.

It is submitted that the proposed policy is not only unsound, but that the procedures proposed to make it effective will seriously restrict corporate reorganizations which have bona fide business purposes, rather than stockholder purposes.

(c) Section 359 (b) and (c)

Recommendation.—Eliminate the arbitrary and discriminatory requirement that the shareholders of an acquired corporation must obtain an interest of 20 percent in the participating stock of the acquired corporation, in the case of corporate adjustments where 1 or both of the 2 parties thereto falls in the nonpublicly held classification.

Explanation.—Under section 359 (b) (2) and (c) (1), if 1 or both of the 2 corporations involved in a corporate readjustment is not publicly held, the shareholders of the acquired corporation must own at least 20 percent of the stock of the acquiring corporation immediately after the transaction. The practical effect of this is to prevent tax-free reorganizations in a case where one of the corporations is less than one-fourth the size of the other. Closely held corporations would generally fall in the nonpublicly held classification, with the result that this rule would greatly limit reorganizations in this area notwithstanding the fact that adequate corporate business reasons for the corporate readjustment exist.

In effect, the bill establishes a conclusive presumption that a corporate reorganization beyond the size limitations is for shareholder, and not for corporate, purposes. Under the bill, a reorganization having unquestioned corporate business purposes (but exceeding the size limitations) would nevertheless constitute a taxable transaction. It is submitted that whether a shareholder or corporate-business purpose will be served by a reorganization should be determined in the light of the particular facts in each case, and not under such arbitrary and inflexible rules.

(d) Section 309

Recommendation.—This section, designed to prevent a so-called preferred stock ballout, should receive further study and, in any event, should be revised to impose the tax on the shareholder, rather than the corporation, if there has, in fact, been a ballout.

Explanation.—Admittedly, the so-called bailout device has been employed for tax avoidance purposes by placing a shareholder in possession of corporation earnings and profits at capital gain tax rates. Generally, this is accomplished by the issuance of redeemable preferred stock in a nontaxable transaction. The sale of such stock to an outsider results in gain, taxable at capital gain rates. Thereafter, the preferred stock is redeemed by the corporation.

Under the bill, various specific situations are set out under which a redemption of stock will result in capital gain treatment (sec. 302), but any redemption which does not meet one of these tests will constitute a dividend distribution. The implementing section 309 provides a penalty tax of 85 percent of money, fair value of securities, or property, distributed in redemption of preferred stock within 10 years from the date of its issuance. The tax, it is noted, does not apply if the distribution is treated as a dividend.

Here again the statute imposes arbitrary and rigid rules. The tax may apply whether a bailout has, in fact, taken place. The preferred stock being redeemed within the 10-year period may have been issued and outstanding long prior to January 1, 1954. Notwithstanding this, redemption within 10 years after January 1, 1954, might result in the imposition of the 85-percent penalty tax.

It may well be questioned whether the penalty tax is not imposed on the wrong taxpayer. The shareholder who is benefited by the so-called bailout may never be subjected to tax. Moreover, substantial minority interests might well be punished by the imposition of the penalty tax against the corporation, although they were not a party to any bailout.

(e) Section 336

Recommendation.—Relax the unnecessary restriction of section 336 so that capital gain treatment of pro rata distributions in partial liquidation will be accorded where they are made because there has been a reduction in the capital needs of the corporation by reason of the abandonment or reduction of business activities.

Explanation.—Under section 336, a partial liquidation is limited to a distribution which affects a complete termination of a part of the business which has been separately operated. Books and records for the terminated business must have been maintained separately. It is apparently anticipated that, by the application of the rigid requirements of the statute, it will readily be determinable whether the distribution made effects a liquidation, or an ordinary dividend distribution. It is submitted that the application of the rigid, narrow, and inflexible rules will undoubtedly result in much hardship. The benefits of capital gain treatment should rather be accorded in each case where the distribution is pro rata and made because there has been a reduction or curtailment of the business and a resulting reduction in the capital needs of the company.

5. ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

Section 461. Taxable year of deduction of property taxes

Recommendation.—Amend section 461 relating to the taxable year property taxes (1) so that it is applicable to all property taxes instead of only to real property taxes, and to specify that the year of deduction is that of the taxpayer instead of that of the taxing body.

Explanation.—In many States substantial amounts of taxes are assessed against personal property as well as against real property. Moreover, the same rate of taxation is often applied to both classes of property. Provisions of the Internal Revenue Code should be uniform in regard to all property.

As far as the question of the taxable year is concerned, section 461 (c) (1) should be rephrased to leave no doubt that the "definite period of time" in which property taxes are accrued is the accounting period of the taxpayer.

6. LIFO INVENTORY

(a) Basis of valuation

Recommendation.—Revise section 472 in order (1) to permit LIFO companies to value inventories at the lower of cost or market, and (2) to clarify statutory requirements as to the use of "no other procedure" in financial statements. Section 472 of H. R. 8300 was formerly section 22 (d) (1)-(5) of the 1939 code.

Explanation—(1) *Lower of cost or market.*—The LIFO method of inventory valuation is widely recognized as most accurately reflecting the true profit results of a business. Many businesses, however, have been deterred from adopting the LIFO method in recent years because by so doing the prevailing high-price level would become a floor for all future profit determinations. Failure to recognize a decline in the market value of goods included in an inventory departs from the long-established accounting principle that foreseeable future losses should be provided for. Furthermore, this procedure can have a substantial effect upon the determination of the accumulated earnings and profits of taxpayers engaged in a similar type of business and having comparable operations and facilities with the only difference being that they elected to commence using the LIFO principle at varying dates. Adoption of the recommendation is necessary to attempt to place all taxpayers in a comparable position, whether the LIFO inventory method was elected during the early development period of the administration of section 22 (d) of the 1939 Internal Revenue Code or at a much later date.

(2) *Statutory restrictions on financial statements.*—The section of the Internal Revenue Code providing for the use of LIFO is the only portion of the current income-tax law which refers to the manner in which the taxpayer computes income for financial-statement purposes. While the statutory requirement is literally limited to the use of no other method in inventorying the goods covered by the LIFO election for tax purposes "to ascertain the income, profit, or loss," for the purpose of reports or statements to shareholders or other owners, or for credit purposes, and does not prescribe the manner of financial statement preparation, a great deal of confusion has arisen in practice. The regulations do not attempt to extend the scope of the statutory requirement, and contain the statement "the taxpayer's use of market value in lieu of cost or his issuance of reports or credit statements covering a period of operations less than the whole of the taxable year not being considered at variance with this requirement." Although it can be reasoned that the showing of the "replacement cost," "replacement value," or "current value" of the LIFO inventory in connection with financial statements is merely using market in lieu of cost as permitted by the regulations, there is a need for clarification either in the statute or the regulations of permissible practices.

(b) Involuntary liquidation

Recommendation.—Revise section 1321 in order (1) to broaden the definition of "involuntary liquidation" and make this provision a permanent part of the statute, and (2) to eliminate a technical time limit which has resulted in inequities for certain taxpayers. Section 1321 of H. R. 8300 was formerly section 22 (d) (6) of the 1939 code.

Explanation—(1) *Broaden and extend the liquidation and replacement provisions.*—Circumstances sometimes make it impossible for a company to keep its inventory up to the normal level at the year end. If, when replacement can be made, prices are higher than the LIFO cost of the goods liquidated, the replacement cost becomes cost for inventory purposes thereafter. The effect is that the company must pay tax on any excess of replacement cost for the goods liqui-

dated over the LIFO cost, even though it must reinvest the entire excess to bring its inventory up to a normal level. Congress has recognized the injustice when the inability to replace the inventory quantities by the end of the taxable year is due to a very restricted set of specified causes, and the limited period to which this restricted provision is applicable is proposed to be extended in H. R. 8300 for 1 year. According to the report of the Ways and Means Committee this extension is necessary because of the continued war in Asia forcing involuntary liquidations of inventories.

In order to accomplish the basic purpose of LIFO the replacement provisions of the statute should be permanent, and the causes of the liquidations, which are deemed to be involuntary, should be substantially broadened. Inventory quantities at the end of a particular year may be reduced below the quantities as of the beginning of the year, because, for example, of labor difficulties in the taxpayer's plant or the plant of one or more suppliers of its materials, of a fire which occurred just prior to the end of the year, or of an innumerable variety of accidents, rather than the exercise of business judgment by the management of a company. These accidents could result from delays in shipping, a flood, or even inclement weather, and it is therefore not possible to prepare a completely satisfactory definition of an involuntary liquidation which could be subject to replacement and restored to the LIFO inventory at the original carrying value. If the statute permitted taxpayers to file an election to have any decreases in the LIFO inventory quantities subject to replacement within a reasonable period, there would be removed the cause of disturbing economic conditions existing in some markets when the principal members of an industry are all attempting to make abnormal purchases at the same time or delay making shipments to build up inventory quantities temporarily diminished. This type of modification of the LIFO inventory procedures as presently included in the Internal Revenue Code is essential to accomplish the principal purpose of LIFO and to minimize the instances in which management decisions as to current operations are influenced by tax considerations.

(2) *Time limit of filing refund claims.*—A statutory amendment is necessary in order to prevent hardships suffered by taxpayers who have made the irrevocable election to have the involuntary liquidation and replacement provisions apply, but are barred from securing a retroactive adjustment of tax by the absolute statutory time limit. The law provides that such an adjustment may be made only if a refund claim is filed within an absolute 3-year period from the date of filing of the income-tax return for the year of replacement. It is proposed that section 22 (d) (6) (E) of the 1939 code be amended retroactively so as to be applicable with respect to all taxable years beginning after December 31, 1940, to provide that such claim for refund may be filed within the present 3-year period or within any extension thereof arising as a result of an agreement between the Commissioner of Internal Revenue and the taxpayer extending the period for assessment of additional tax. The committee reports applicable to section 22 (d) (6) of the 1939 code do not show that Congress deliberately made the 3-year period absolute, and it may have been assumed that this period would be automatically extended upon the execution of an agreement having the effect of extending the ordinary 3-year period of limitations upon assessment of additional tax.

Under present conditions a taxpayer may lose entirely the deduction for the excess of replacement cost over original LIFO cost of inventories involuntarily liquidated due to rulings or findings of the Internal Revenue Service made subsequent to the absolute 3-year period within which a claim for refund must be filed. For example, a taxpayer who believes that his LIFO inventories constitute a single group or unit may have realized an involuntary liquidation in 1942 but no liquidation in 1943 but elected for both years to adopt the provisions of section 22 (d) (6). Subsequently, in 1950, the taxpayer replaces a portion of the inventories liquidated and files a claim for refund of tax paid for the year 1942 based on the excess costs incurred in replacement. Within an extended period of limitations under section 276 (b), extended at the request of the Internal Revenue Service, the taxpayer's income tax return for the year of replacement is examined by an agent and it is held that the taxpayer's LIFO inventories constitute more than one group or class and that liquidations also occurred in some of the groups in 1943. As the taxpayer did not file a claim for refund for 1943 within the absolute 3-year period, no refund of 1943 tax will be allowed. As the law is now applied, the examining agent eliminates the excess cost of replacement from inventory in the year of replacement, but the absolute 3-year period precludes any tax adjustment whatsoever for those expended dollars.

7. PENSION, PROFIT SHARING AND OTHER EMPLOYEE BENEFIT PLANS

Recommendation.—For the most part an excellent job has been done as respects these plans, although some refinements and changes in detail in several sections would be desirable. However, both section 501 (e) and section 505 are most objectionable. It is recommended that section 501 (e) be virtually rewritten and that section 505 be deleted entirely from the bill.

Explanation.—As respects section 501 (e), the Ways and Means Committee report (p. 44) states:

"The coverage requirements adopted by your committee are more specific and more liberal than the present regulations but are carefully limited to prevent discrimination * * *"

This is most certainly not the case under the proposed section. Few small or medium-size employers could adopt a plan covering only salaried employees. This is essential in many cases since many employers have collective bargaining agreements covering employees within collective bargaining units and they therefore establish plans limited to employees outside the bargaining unit. Even in other cases many employers pay hourly employees on the basis of "take home" rather than deferred pay and desire to limit deferred plans to salaried employees. In general, section 501 (e) proposes to eliminate discrimination in favor of shareholders or so-called "key employees" by certain mathematical tests. The proposed tests are arbitrary and wholly unrealistic and hence would operate inequitably in the case of the small or medium-size employer.

Under section 501 (e), a classification is considered discriminatory if more than 30 percent of the contributions are used to provide benefits for shareholders or more than 10 percent of the participants in the plan are key employees. However, a classification is not considered discriminatory in any case if an employer has no more than 20 regular employees and 50 percent or more are participants, or if an employer has more than 20 regular employees and 10 of such regular employees, or 25 percent, whichever is greater, are participants in the plan. A regular employee is defined as an employee other than one who has been employed not more than a minimum period specified by the plan, not exceeding 5 years, and part-time employees as defined in the old act. Under the tests prescribed, an employer who employs less than 4,000 regular employees must cover at least 25 percent of such employees in a plan in order to qualify it. Assume a company has 300 employees, of whom 200 are considered regular, and that 50 regular employees are participants in a profit-sharing plan for salaried employees. All of the top 10 percent of regular employees would be considered "key employees" (20 people in this illustration) and would ordinarily be among the 50 participants. Under section 501 (e), if more than five of these so-called key employees were included, the plan would not qualify. Actually, probably not more than five would be key employees in the true sense.

An employer should be able to adopt a plan if the eligibility requirements are based on any one or a combination of the requirements set forth in clauses (i) through (v) of section 501 (e) (3) (A), which are as follows:

(i) Employees compensated on an hourly basis.

(ii) Employees compensated on a salary basis.

(iii) Employees who have been employed for a minimum period not exceeding 5 years.

(iv) Employees who are compensated on an annual rate in excess of a specified amount, not exceeding $4,000.

(v) Employees who have reached a specified age, not more than age 35.

Any mathematical tests should be applied only if eligibility is limited to employees in a designated plant, division, department, office, or other operating unit of the employer or a classification other than one or a combination of the requirements set forth in paragraphs (i) through (v) above. Even in those cases, however, the percentage of participants in the plan who are key employees should be raised from 10 to at least 25 percent and key employees should be redefined. It is believed that the case will be rare where as many employees as 10 percent of the highest paid are "key employees." In many cases, even 5 percent would not be so considered.

One test that has been suggested and which would minimize but not cure objections to this section would be to define a key employee as one whose total compensation on the basis of which benefits under the plan are computed exceeds the average total compensation of the highest paid 10 percent of the regular employees of the employer up to a limit of the 100 highest paid employees. There should also be an additional classification. The kinds and types of busi-

nesses in this country are so varied and have so many different practical problems that no formula could be applied in every case. It is, therefore, desirable to permit qualification of such cases by application to the Commissioner if the employer can demonstrate to the Commissioner's satisfaction that the plan serves a good business purpose and is not primarily designed as a subterfuge for dividends or the avoidance of surtaxes for a few highly paid employees.

The section defines compensation to be "the basic or regular rate of compensation or total compensation if amounts other than basic or regular compensation are determined under a definite formula." There is absolutely no equity or justification for this provision. The form of compensation should make no difference. Many companies prefer to keep fixed compensation low and to pay cash bonuses to supplement the fixed or basic pay. Such bonuses are frequently used as an incentive to increase effort and efficiency and are therefore not based on formula. "Compensation otherwise paid or accrued," as used in section 403 to fix maximum employer deductions should be used in section 501 as well.

The provisions of section 501 (e) (4) also are confusing in that the provisions relating to "contributions or benefits" are incorporated in the same paragraph, whereas in operation plan formulas are usually based on one or the other. It is suggested that this paragraph be broken down so as to provide substantially as follows:

(1) As respects money purchase pension plans, contributions could be allocated pro rata according to compensation; or

(2) As respects other pension plans, the benefits can be provided by a formula, whether as a percentage for each year of service, or a fixed percentage, of total compensation, average compensation over a period of years, or otherwise, applied on a uniform basis to all regular employees covered by the plan.

(3) In the case of a profit sharing plan, at least 75 percent could be allocated pro rata according to compensation and the remaining 25 percent on a discretionary basis as is now provided by the section, provided the higher paid employees do not get more than twice the percentage of compensation allocated to the lower paid employees. It should be permissible, however, to allocate forfeitures under a profit sharing plan either pro rata according to compensation paid or pro rata according to the credit balances in accounts.

In any case, compensation of less than $4,000 per year can be disregarded, if the employer so chooses.

The requirement that the classifications meet the tests at least 1 day each quarter should be deleted. The administration of plans would become very burdensome in many cases if this provision is retained. Certainly, a plan that met the requirements when it was established should qualify for the year of establishment. It should also qualify in each succeeding year if at the end of the year it met the tests. If the failure to meet the tests is beyond the control of the employer, the plan should not be disqualified.

It would be advisable also to permit a minimum contribution under a profit sharing plan regardless of profits or accumulated surplus.

Section 505

Section 505 is an entirely new section and concept in that it specifies the classes and percentages of investments for qualifying trusts and is objectionable for the following, among other, reasons:

(1) How a trust fund should be invested should be the subject of local trust law, not a revenue law. This problem should be left to the States and should not be usurped by the Federal Government.

(2) Section 505 is a throwback to the restrictive "Legal list" which has been superseded in the laws of State after State (including Illinois) by the "Prudent man rule."

(3) No similar investment limitations are imposed on charitable or other exempt trusts or organizations.

(4) The burden of policing investments should not be thrown on the Internal Revenue Service. Its job is to collect taxes.

(5) As now written, tax exemption is denied a trust "unless at the close of each quarter of the tax year" all assets of the trust are invested as specified. The requirement for meeting this test four times a year will result in wasteful expense in administration. A valuation would have to be made at least 8 times a year, 4 times just before the respective quarter ends to see whether action would be necessary to prevent violation and 4 times at the respective quarter ends to prove that violation had not occurred. Even that number of times might not be sufficient. In any case, the tests for qualification of a specific investment should be applicable at and only at the time the investment is acquired.

(6) The present section would not permit investment in the common trust funds operated under Federal Reserve regulations and other arrangements for the pooling of investments of employees trust under the management of State and national banks and trust companies.

(7) The limitation of investments in any one parcel of real estate to not more than 5 percent of the total value of the trust, and the limitation of investments in general securities of any one issuer to an amount of not more than 5 percent of the total value of the trust and 10 percent of the combined voting power of all classes of stock of such issuer, is much too restrictive.

8. FEDERAL INCOME TAXES OF TRUSTS, ESTATE TAXES AND GIFT TAXES

(a) Federal income tax

Section 642 (b)

Recommendation.—Under this section a trust which is required to distribute all of its income currently is allowed an annual exemption of $300 and all other trusts are allowed an annual exemption of $100. It is recommended that the annual exemption of $300 be granted to all kinds of trusts.

Explanation.—It does not seem equitable arbitrarily to favor one type of trust over another type of trust in this respect.

Sections 665 through 668

Recommendation.—These sections should be eliminated because (1) they are too complicated to be capable of practical administration; (2) they have not been integrated with other sections of the code; and (3) they produce inequitable results in many cases. In the event it is decided not to eliminate these sections (1) distributions for medical care or pursuant to any other reasonably definite standard spelled out in the trust instrument should not be regarded as an "accumulation distribution" for the purposes of section 665; (2) the "throwback period" provided for in section 666 should not exceed 2 years; (3) provisions should be inserted which permit the distributee to change any elections he or she may have made as respects method of tax computation or taking of deductions which are based on "adjusted gross income," and (4) the trustee should be permitted to obtain a refund of taxes imposed under this chapter if the result is to reduce the combined taxes payable by the trustee and distributee for any taxable year.

Explanation.—These sections provide an entirely new set of arbitrary and complicated rules for assessing additional income tax against a distributee of accumulated trust income even though such trust income has been taxed to the trustee for the year in which the trustee received it. The method adopted is to treat distributions from a trust which exceed the "distributable net income" of the trust for the current year as if such distributions had been made from the "distributable net income" of the trust for each of the 5 preceeding taxable years which was not in fact distributed in inverse order and to recompute the distributees' income tax for those past years on that basis. The distributee is given a credit against any additional tax payable by him on such income for such years but the trustee is not entitled to a refund for any tax paid on such income for such years. It is believed that few discretionary trusts are created for the purpose of income-tax avoidance. In any event it seems inequitable in cases in which the "throwback rule" would be applicable not to permit the distributee and trustee to minimize the tax payable by each of them respectively by changing elections as respects method of tax computation and taking of deductions and to recover any refunds which thereby would result.

Section 675 (4)

Recommendation.—This section sets forth rules for determining when the income of an irrevocable trust should be taxed to the grantor of the trust as the substantial owner thereof. For the purposes of this section the grantor should not be treated as the owner of any portion of a trust in respect of which he has given a "power of administration" to a person having an adverse interest in its exercise or nonexercise. It should be made clear that cases where the grantor has voting control of a corporation apart from the holdings of a trust he has created are not regarded as "corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control" for the purposes of this section. In addition, if the power is exercisable by a person

as trustee, it should be presumed for the purposes of this section that the power is exercisable in a fiduciary capacity.

Explanation.—The above recommendations either are supported by the rules currently set out in regulations 111, section 29.22 (a)-21 (e) (4), decided cases or both.

(b) Federal estate tax

Section 2031 (b)

Recommendation.—This section states that in valuing closely held stock for which there is no market consideration shall be given to the value of stock of corporations engaged in the same or a similar line of business which are listed on an exchange. The value of stock of such corporations which are sold on the over-the-counter market also should be given consideration for this purpose.

Explanation.—Such over-the-counter trading frequently is helpful in deriving the value of a closely held stock for which there is no market.

Section 2032

Recommendation.—This section would permit use of the 1 year after death optional valuation date which currently is permitted only if the representatives of an estate can show that the assets of the estate have declined by more than one-third during the year following the date of death. It is recommended that the proposed restrictions relating to use of the optional valuation date not be enacted.

Explanation.—The proposed legislation would only permit use of the 1 year after death optional valuation date in the event of a major catastrophe. Any requirement that the estate representatives show the estate assets have decreased in value a specified percentage is unworkable since in the case of many types of assets it makes values as of two different dates a matter of contention. The statement in the committee report to the effect that the present permissible optional valuation date tends to retard the distribution of assets included in the gross estate is based on misinformation.

(c) Federal gift tax

Section 2515

Recommendation.—Under this section the creation of a tenancy by the entirety in real property and additions to the value thereof by either spouse would not be deemed to constitute taxable gifts to the other spouse unless the donor spouse elected to have the transaction so treated. In addition, no taxable gift would result upon the termination of such a tenancy if on termination the property or proceeds were distributed to the respective spouses in proportion to their contributions. Similar treatment should be given in the case of the creation and termination of joint tenancies with right of survivorship by one or both spouses.

Explanation.—Tenancies by the entirety have been abolished in many jurisdictions and the inequity proposed to be abolished also is applicable in the case of joint tenancies with right of survivorship.

9. PARTNERSHIP PROBLEMS

(a) Calendar year basis

Recommendation.—Eliminate the restrictions in section 706 (b) against the adoption of calendar or fiscal years by partnerships and partners because these restrictions unfairly discriminate against certain partnerships as compared to other partnerships.

Explanation.—Section 706 (b) prohibits a change by a partnership from a calendar year to a fiscal year, the use of any taxable year other than a calendar year by a partnership organized after June 30, 1954, or any change of taxable year by a partner, except that such changes may be made if approved by the Secretary or his delegate. It does not prohibit a partnership from changing from 1 fiscal year to another fiscal year or from a fiscal year to a calendar year. The prohibition against taxable year changes by partners would prevent a change of fiscal year by a partner to conform to the fiscal year of his partnership.

This discriminates against certain partnerships as compared to others. For example, a partnership on a November 30 fiscal year could change to another fiscal year such as one ending January 31 and thus effect a postponement of 11 months of income to the partners in place of the 1-month postponement under its

existing fiscal year, assuming the partners to be on a calendar year basis. Also, a partnership on a fiscal year with partners filing on the same basis could change to a calendar year without restriction under subsection (e) and thus effect a postponement of income to the partners.

Last year the Commissioner of Internal Revenue liberalized the regulations for changes in fiscal years. The regulations now provide for automatic election of a change in fiscal year, but there are certain restrictions designed by the Commissioner for the purpose of preventing an undue loss of revenue to the Government through a postponement of realization of income caused by a change of year. It would seem unnecessary to have any provision in the new bill on this matter unless the present regulations were to be incorporated into the law.

In addition to the foregoing there is a possible defect in section 706, probably with respect to the first sentence in subsection (b) (1). The Ways and Means Committee report at page A225 discussing section 706 (a), states:

"A partnership taxable year shall be determined as though the partnership were a taxpayer. For example, the partnership must annualize its income for a short year caused by a change of its accounting period."

Although the committee's comment apparently refers to subsection (a), the first sentence quoted above is taken from subsection (b) (1). If the committee's conclusion that a partnership must annualize its income for a short year is correct, a question arises as to what sort of a computation is to be made. There are no instructions on this point in the partnership section of the new code, as partnerships do not pay income taxes. Section 443 of the new code contains instructions for taxpayers filing returns for periods of less than 12 months. Briefly, that section requires that income for a short period be placed on an annual basis by multiplying the income by 12 and dividing by the number of months in the short period. The tax is then computed on the annualized income and such tax is then reduced by dividing by 12 and multiplying the result by the number of months in the short period. The net effect of the computations is to tax short period income at the same high-bracket rates as would be in effect if such short period income were part of a full 12 months of income.

The impracticability of annualizing with respect to a partner's share of income in a short period return of a partnership is obvious when it is realized that a partner or his spouse usually has substantial income for the full calendar year over and above his partnership income. The partner, entitled to file a return for a full 12-month year could not comply with instructions in section 443 because he is filing for a full year—a partnership could not comply with such instructions because it is not a taxpayer for tax computation purposes.

Assuming that the Ways and Means Committee comment about annualizing short year partnership income is a proper interpretation of the first sentence in section 706 (b) (1), that sentence should be eliminated.

(*b*) *Treatment of partnership salaries*

Recommendation.—Delete section 707 (c) which provides that guaranteed salaries (payments to a partner for services without regard to income of the partnership) shall be considered as compensation income to partners under section 61 (a) (1) and a compensation deduction to the partnership under section 162 (a) (1).

Explanation.—Section 707 (c) might result in distortion of income to partners and might result in controversies as to the reasonableness of such payments. For example, a partner with a tax reporting year different from his partnership under present law reports guaranteed salaries for the period of the partnership's fiscal year as a part of his taxable income for his year in which the partnership year ends. Presumably under section 707 (c) guaranteed salaries would be reported by the partner as received. If so, the partner's return for his first taxable year under the new law would include guaranteed salaries for a full year under the old method of reporting plus salaries for 1 or more months under the new method of reporting such salaries. A similar result could occur in 1954 if a partnership filing returns on a different fiscal year from its partners, should change its fiscal year in 1954.

On the matter of reasonableness of salaries, it is likely that controversies may arise under the proposed section 707 (c) putting partners' salaries on the same basis as other compensation because of the long history of litigation on this point. On the other hand there has been practically no controversy on partner's salaries in the past because such salaries have not been a separate item—each partner's salary was merely a part of his total partnership income.

(c) *Interest of a retiring partner*

Recommendation.—Amend section 736 by eliminating subsection (a) entitled "Payments Other Than for Interest in Partnership" and by clarifying subsection (b) (2) (B) relating to goodwill payments in liquidation of a partner's interest.

Explanation.—Subsection (a) provides that in connection with the liquidation of the interest of a retiring partner or a deceased partner the amount of income or other items of a partnership allocable, and guaranteed payments made, to a retiring partner or a successor in interest of a deceased partner, shall be considered as ordinary income to the recipient during the first 5 years after retirement or death, but that any such allocations or payments after 5 years shall be tax free to the recipient, but shall be taxed to the remaining partners.

Subsection (b) provides that subsection (a) shall not apply to the extent that payments to a retiring partner or to a successor in interest of a deceased partner are determined under regulations of the Secretary or his delegate to be made for an interest in the partnership. To the extent that they are so regarded, under regulations, the payments are to be considered as a distribution by the partnership and are not added to the taxable income of the remaining partners.

Numerous manufacturing, mercantile, and professional partnerships may have substantial goodwill or other intangible assets. In those cases payments to a retiring or deceased partner for his interest in the partnership will generally take into account not only the value of the interest due to tangible assets but also the value arising from goodwill or other intangible assets. The value of the entire interest of a partner may be determined in various ways, sometimes by negotiation, sometimes by the use of an agreed formula. The formula may be complex or simple. One formula may merely provide that the goodwill or intangible value be deemed to be the retiring partner's proportionate share of several years of earnings. Another formula might value the entire interest, tangible and intangible, on the basis of several years of earnings. Another one might provide one formula for valuing the tangible asset part of the business and another one for the intangible part, determined for example by capitalizing the excess earnings over an agreed rate of earnings for tangibles.

Regardless of the method of determining the amount to be paid for a retiring partner's interest, and regardless of how the valuation formula is stated in the partnership agreement, no question should arise regarding the method of taxation to the retiring or deceased partner of any gain from the disposition of his interest in the partnership if the amount paid to a partner is in fact in liquidation of his interest. Such gain should be regarded as a capital gain under the regular rule provided in section 731. Nor should there be any arbitrary allocation to the remaining partners of gain which is realized by a retiring or deceased partner. It is understood that the provisions discussed above were placed in the new bill at the instance of the Treasury Department in order to eliminate certain tax avoidance practices indulged in by some closely held partnerships. If such practices have resulted in substantial revenue losses to the Government it would appear that the situation could be taken care of by restricting the provisions in question to the situation which the Treasury Department wanted to correct rather than by inserting a "shotgun" provision in the bill which would adversely affect many partnership distributions where there is no possible tax avoidance element.

Subsection (b) (2) (B) states that payments for an interest in a partnership shall not include "amounts paid for goodwill in excess of the fair market value of such goodwill to persons not members of the partnership." This provision might cause considerable controversy as the value of partnership goodwill to an outsider would usually be difficult to ascertain.

10. INCOME FROM FOREIGN BRANCHES

Recommendation.—Amend sections 37, 923, and 951 to also provide a tax 14 points lower than the regular corporate rate for income derived from the operation of a wholesale establishment of a foreign branch or subsidiary of a domestic corporation.

Explanation.—The avowed purpose of the 14-point program is to place American firms doing business abroad on a more competitive basis with foreign firms whose tax burdens are less onerous. This is to say that the program is a form of incentive taxation designed to encourage our firms to expand their foreign trade and investment abroad, thereby stimulating and strengthening our domestic economy—a sound and laudable policy indeed.

The 14-point program, however, contains the incongruous feature of excluding from the benefits of the proposed legislation the very type of foreign trade which can do the most for the American economy, namely, the wholesaling abroad of goods manufactured in the United States. Is there anything wrong about encouraging American manufacturers to increase their production at home and to dispose of their surplus goods abroad? Should we discriminate against the manufacturer who increases his investment in the United States, uses domestic raw materials and domestic labor to process goods, and then sells such goods abroad, and in favor of the manufacturer who builds a factory in a foreign country and uses foreign materials and foreign labor to process goods for sale abroad? Obviously not, but that is exactly what the 14-point program does.

Nor can the argument be made that a domestic manufacturer which wholesales its goods through a foreign establishment has no "significant investment" abroad. Certainly the investment in a wholesale operation will at least equal that of a retail operation. In this connection, it should be borne in mind that not only is the investment in the warehouse or other building housing the foreign wholesaling operations usually substantial, but also that inventories of wholesalers normally exceed those of retailers. The special risks of a foreign investor are present to a substantial degree in both cases, and both merit the benefits of the 14-point program.

Another consequence of the provisions in their present form is that a taxpayer with a foreign subsidiary engaged in 3 or 4 operations, 1 or more of which might be an "excluded" activity would probably be forced to break this foreign subsidiary into 4 or more separate subsidiaries in order to qualify a certain portion of the dividends received under section 923. The proposed section seems to be an undue policing of the form of activity and undesirable from the viewpoint of an American taxpayer with a foreign subsidiary.

11. ADVANCE PAYMENT OF CORPORATION INCOME TAXES

Recommendation.—Delete sections 6016, 6074, 6154, and 6655, which embody a new principle of advance payments for corporation income taxes.

Explanation.—H. R. 8300 proposes a system of declarations of estimated tax for the larger corporations which reduces the time a corporation is given for the payment of its tax. According to the report of the Ways and Means Committee, by exempting from the declaration requirement and the new tax payment schedule corporations whose yearly tax cannot reasonably be expected to exceed $50,000, only approximately 35,000 out of the total 425,000 corporations will be affected. This statement itself appears to be a basis for criticism of the proposal, since it places a burden upon a corporation merely because of its size.

In the committee report it is commented that the lumping of the flow of corporate tax payments to the Treasury aggrevates the effect of Treasury operations on the money markets and increases the problems of managing the public debt. It is stated that many corporations in effect make advance payments of their income taxes by the purchase of short-term Government securities which involves additional interest payments by the Government although serving to make funds available.

It appears that the proposal will result merely in placing an additional burden upon a comparatively few large corporations and that part of the expense of financing the Government debt is being imposed directly upon this group of taxpayers. From the standpoint of business, it appears that the problem of making funds available to the Government ratably throughout the year could better be met by an educational program to encourage corporations to buy short-term Government securities designed primarily to apply against tax payments. Even though only a low rate of interest is paid on these securities, it is believed that substantial amounts would be invested therein for the purpose of funding the corporation's tax obligation. The allowance of such interest to the large corporations is equitable and would put them in a position comparable to that of the 390,000 corporations whose annual tax liability is less than $50,000.

It is also believed that the proposal is subject to criticism because of the additional administrative expense of determining whether or not a corporation should be subject to an additional charge because of underpayment. Taxpayers would be required to carefully ascertain whether or not 1 of the 4 stated requirement tests has been met. In many cases it can be foreseen that there would be a substantial amount of correspondence between the taxpayer and Treasury Department representatives to determine whether the additional charge should be

imposed. Furthermore, the nature of the statutory tests and the rate of 6 percent per annum are such as to make it likely that many corporations will actually pay more than the required minimum.

This provision of H. R. 8300 appears inequitable because of its discriminating against less than 10 percent of the total number of corporations merely because of size, and because of creating a situation which may induce payments to the Government in advance of the actual due date as a consequence of the complexity of the statute and its administration.

12. DATES FOR FILING OF ESTIMATES AND RETURNS AND FOR PAYMENTS OF INCOME TAXES

Recommendation.—Amend section 6153 to establish January 31 instead of January 15 as the date for the payment of the final installment of the amount of the individual income tax of the previous year, to coincide with the due date for returns of withholding tax.

Explanation.—Section 6153 requires payment of the last installment of the individual income tax on or before January 15 of the following year. In reviewing their taxes on that date many taxpayers prefer to file a final return for the year. But to do this they need withholding statements not due from their employers until January 31, section 6051 (a).

LAW SCHOOL OF HARVARD UNIVERSITY,
Cambridge, Mass., April 21, 1954.

Hon. EUGENE D. MILLIKIN,
United States Senator from Colorado,
Senate Office Building, Washington, D. C.

DEAR SENATOR MILLIKIN: Since you are now studying the proposed Internal Revenue Code of 1954, H. R. 8300, we believe you will be interested in the analysis we have made of sections 923 and 951. For the last year, as part of research in taxation at Harvard Law School in the international program in taxation, we have been studying the attitudes of executives in United States companies in order to determine what changes in the United States tax law could be made to provide a stimulus to foreign investment. We have interviewed executives and studied investment policies of about 40 companies, including such concerns as Ford, International Harvester, Sterling Products, Gulf, and Anderson Clayton. This research project was undertaken after a preliminary survey of United States taxation of foreign income for the United Nations by Prof. Stanley S. Surrey, of Harvard Law School, and Dan Throop Smith, now Assistant to the Secretary of the Treasury.

As a result of our investigation, we have concluded that lower United States taxes are unlikely to provide any significant stimulus to foreign investment. Neither are lower United States taxes needed by companies presently engaged in operations abroad to protect their competitive position. Moreover, lower United States taxes on foreign income, as proposed in H. R. 8300, would result in a cost to the Government substantially in excess of the $147 million estimated by the Ways and Means Committee. In our opinion, more favorable tax treatment for foreign income is unjustified unless such treatment is likely to further the interests of the Government and people of the United States. If the treatment proposed in H. R. 8300 would stimulate United States investment abroad, we believe that it would be in the interests of the United States. But the lower tax proposed in H. R. 8300 would not stimulate investment; it would only represent a bonus to concerns already engaged in investment activity in foreign countries. As our analysis indicates, sections 923 and 951, far from simplifying United States tax treatment of foreign income, make it more complicated and contain certain defects that would result in inequitable treatment of present foreign investors.

We are enclosing a report[1] containing our conclusions on foreign investment policies of companies and suggesting a change in the method of taxing foreign income, which we believe would provide a stimulus to foreign investment and remove any inequities in the present law, together with a brief three-page summary of this report.

Sincerely,

E. R. BARLOW,
Assistant Professor of Business Administration.
IRA T. WENDER,
Assistant Director, International Program in Taxation.

[1] United States Tax Incentives to Direct Private Foreign Investment.

"UNITED STATES TAX INCENTIVES TO DIRECT PRIVATE FOREIGN INVESTMENT"

A SUMMARY

A plan to provide tax incentives to foreign investment and to simplify United States taxation of foreign income is presented in a report just published by the Harvard Law School's international program in taxation. This 60-page report, "United States Tax Incentives To Direct Private Foreign Investment," is based on a year's research by its authors, E. R. Barlow and Ira T. Wender, of the program staff, into the policies and attitudes of American corporations toward foreign investment and the effect of taxation on decisions whether or not to invest abroad.

The plan presented reflects the knowledge gained as to foreign investment decisions and would adapt the United States tax structure to prevailing business views of foreign operations. It is an alternative approach to the taxation of foreign income that differs substantially in method though not in cost from H. R. 8300, the proposed Internal Revenue Code of 1954, which the report examines in detail.

The following summarizes the major points in the report:

Research.—The research for the report consisted chiefly in detailed interviews with the policy executives of about 40 companies, generally either the president or the board chairman, with the top officers concerned with foreign operations, and with the tax executives. Companies with and without foreign investments were consulted. In addition, the authors analyzed, with the Bureau of Foreign Commerce of the Department of Commerce, the results of interviews conducted by it with over 350 business firms on the obstacles and impediments to foreign investment.

Basis of recommendations.—From the analysis of these interviews a number of important conclusions emerged on the attitudes of businessmen toward foreign operations and also on the effects of taxation on foreign investment decisions:

(1) In the past United States taxation has had surprisingly little effect on foreign investment decisions of companies.

(2) A reduction in the rate of United States tax on foreign income is not likely to have much effect on the amount of foreign investment by United States companies unless accompanied by other tax changes.

(3) Most United States companies prefer to finance foreign investments through reinvesting profits earned abroad.

(4) Most United States companies view their foreign operations as a unit distinct from domestic operations and include in foreign operations their export and investment activities.

(5) Manufacturing investments in a foreign country tend to follow from developing a market in that country through exporting.

Thus to stimulate foreign investment a tax proposal should have enough psychological appeal to interest firms that have not in the past considered foreign investment, should utilize the willingness of firms to reinvest foreign earnings, and should recognize that the nature of foreign operations is unitary, including both export and investment. At the same time the cost of a tax-incentive proposal should in large measure be proportional to the resulting increase in investment.

Recommendations.—The principal recommendation to achieve these objectives is to establish a special class for tax purposes of American corporations, called foreign business corporations. Foreign business corporations are designed to be the vehicle for all foreign operations and would be permitted to engage in export and to operate abroad directly or through foreign subsidiaries. United States taxes would be imposed on the income of a foreign business corporation in the same manner as any other domestic corporation. However, the payment of the tax due on the income would be deferred until that income was distributed directly or indirectly to its shareholders or used in the United States other than for foreign operations. A foreign business corporation could invest its funds in bank accounts here and in United States Government bonds. The tax rate on the distributed income of a foreign business corporation is suggested as 85 percent of the regular corporate tax rate. A corporate shareholder of a foreign business corporation would pay no intercorporate dividends tax on receipt of a distribution.

In this manner the foreign operations of American companies would be put upon a remittance basis. United States tax would be deferred until the income was distributed. Funds earned from export or investment could be accumulated for further foreign investment without imposition of United States tax. Under this proposal, all foreign activities would be taxed in the same way whether

organized as foreign subsidiaries or branches. The law would also be simplified by doing away with the special provisions for Western Hemisphere trade corporations and corporations operating in United States possessions.

The report suggests a number of technical changes to implement this policy. Income from exports would be considered as foreign if the goods were destined for use or consumption abroad. Special provisions are proposed for foreign extractive activities and banks operating abroad. The per-country limitation on the foreign tax credit would be removed in recognizing the unitary nature of foreign operations.

Tax revenue aspects.—The report also analyzes the amount of revenue now collected by the United States from export and foreign investment which amounts to between $900 million and $1 billion. Of these sums, $200 million is collected on income from direct private foreign investment and $700 million to $800 million on export earnings.

With so much revenue involved, the report points out that any tax-incentive proposal based on a substantial cut in the rate of tax on foreign income will be exceedingly expensive unless export earnings can be excluded from the tax reduction. Therefore, the report considers the various methods of exclusion that have been suggested. It concludes that a satisfactory distinction cannot be drawn because a definition that will exclude all export will also exclude many forms of investment income from the benefits and, conversely, a definition that includes all investment income necessarily includes substantial export earnings.

H. R. 8300.—The report then analyzes in detail the provisions of H. R. 8300, the proposed Internal Revenue Code of 1954, dealing with foreign activities of United States firms. It concludes that the provisions fail to distinguish adequately between investment and export income, will be very difficult to administer, and are discriminatory in treating differently firms engaged in substantially similar activities. Further, the provisions of H. R. 8300 do not reflect sufficiently the scope and variety of foreign activities of United States firms and the attitudes of these firms toward foreign investment. The proposal, it is believed, would not prove an incentive to new foreign investment.

Cost.—The revenue cost of the foreign business corporation plan is estimated in the report to be of the same order as that of H. R. 8300, if no increase in the rate of foreign investment results. If the rate of investment increases, the plan would be more costly, but the cost would be in direct proportion to the investment which was stimulated.

The rest of the report presents a detailed analysis of the technical matters in operation of the foreign business corporation proposal.

The international program in taxation plans to publish, at a later date, a full report on the results of its own and the Department of Commerce interviews on the manner in which foreign investment decisions are made by United States firms and the factors they weighed in these decisions.

* * * * * * *

The Harvard Law School's international program in taxation was established to cooperate with the Fiscal Division of the United Nations Department of Economic Affairs in creating a training center for foreign tax officials and in the conduct of research into international aspects of taxation. The program is directed by Prof. Stanley S. Surrey, of the law school. This report was prepared by assistant Prof. E. R. Barlow, of the Harvard Business School, and Ira T. Wender, of the New York bar, assistant director of the program.

The Fiscal Division of the United Nations did not take part in the preparation of the report.

Copies of the report may be obtained for $1.50 each from the international program in taxation, Harvard Law School, Cambridge 38, Mass.

INTERNATIONAL PROGRAM IN TAXATION

UNITED STATES TAX INCENTIVES TO DIRECT PRIVATE FOREIGN INVESTMENT

(By E. R. Barlow and Ira T. Wender, Harvard Law School)

FOREWORD

This paper is a preliminary report of research conducted by the Harvard Law School international program in taxation. It is one aspect of a larger research project on the role of taxation in private international investment in which the

international program in taxation cooperates with the Fiscal Division of the United Nations Department of Economic Affairs. The Fiscal Division, however, did not participate in the preparation of the present study.

The purpose of the research project as a whole is to discover to what extent existing tax rules in capital-exporting and capital-importing countries create deterrents, obstacles, or inconveniences in the foreign investment field and the possibilities of ameliorating those effects. It also seeks to determine whether positive tax incentives can play an effective part in promoting foreign investment and to appraise alternative incentive proposals. Several research methods are being used in the development of this project. One method is the analysis of tax laws of a number of capital-exporting and capital-importing countries. These analyses are generally prepared by tax experts in the foreign countries. Another method is that of detailed interviews with business and tax executives in capital-exporting countries on the manner in which enterprises make foreign investment decisions and the effects of taxation on these decisions.

Prof. Dan Throop Smith, of the Harvard Business School, and I, with Mr. Wender, prepared a study for the Fiscal Division published in January 1953 as United Nations document ST/ECA/18, United States Income Taxation of Private United States Investment in Latin America, from which the present research has developed. This study indicated that, before recommendations could be made with respect to the tax treatment of foreign income, more information was required about a number of aspects of the problem. Thus, while the central theme of the study was to ascertain the impact of taxation on the amount, direction, and conduct of foreign trade and investment, it was recognized that a great many matters other than taxation must be considered so that the influence of taxation could be placed in perspective. Knowledge was, therefore, needed concerning the factors that were important to investors in reaching decisions regarding foreign investment.

In addition, more information was required regarding the organization and operation of foreign business activities to ascertain what patterns had developed in response to particular tax rules and to compare those patterns with the business requirements in the absence of tax influences. For example, it was recognized that much of foreign business activity was conducted through foreign subsidiaries and holding companies with a consequent insulation of foreign income from United States taxation. While this "foreign umbrella" had effective tax consequences, the resulting pattern in many instances appeared to be at odds with more desirable business methods of conducting the foreign activities. Thus, a "domestic umbrella" which provided similar insulation from United States tax but permitted the conduct of the foreign activities to be centralized under domestic corporate forms appeared to offer promising possibilities. This and other operating problems, therefore, had to be explored with experienced business and tax personnel to ascertain to what extent tax rules could be rationalized in the light of practical requirements. The further research being conducted under the project was accordingly planned in response to these needs.

The present paper on United States tax incentives to direct private foreign investment is a preliminary report on one phase of the project. The current importance of this subject has lead us to publish this paper at this time in order to make available the relevant information and analysis developed to date as part of the overall research in this field. The paper represents a significant part of the work carried out on this project by E. R. Barlow, assistant professor of business administration and business consultant to the program, and Ira T. Wender, assistant director of the program.

Future reports will deal with other aspects of the role of taxation in private international investment. In addition, the portion of this study which deals briefly with the manner in which foreign investment decisions of United States corporations are made will be expanded to consider in detail the interviews conducted with United States corporate executives. The results of the program's collaboration with the Bureau of Foreign Commerce of the United States Department of Commerce in the classification and evaluation of answers to questionnaires of that Department eliciting information from United States corporations on foreign-investment activities and decisions will also be discussed.

The program is indebted to the many corporate executives and counsel who were consulted during the considerable field work required for this project and who so generously gave of their time and information. Substantial assistance has also been obtained from the Bureau of Foreign Commerce of the United States Department of Commerce.

The Harvard Law School international program in taxation is financed with the aid of a grant from the Ford Foundation.

STANLEY S. SURREY,
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INTRODUCTION

The main purpose of this phase of the research project on the role of taxation in private international investment was to determine what action the United States Government could take with respect to taxation of foreign income to provide an incentive for increased direct private investment abroad.

When we first began our investigation of possible changes in United States taxation of foreign income which might stimulate foreign investment, we discovered that two main questions would have to be answered: (1) Which companies might invest in foreign countries, and (2) how do these companies reach decisions concerning investment.

While many proposals have been made for changes in United States taxation of foreign income to stimulate investment abroad, not enough attention has been given to the particular companies or kinds of companies which could supply the capital and know-how for investment in foreign countries. In other words, little attempt has been made to think in terms of the market for foreign investment. As a matter of fact, little information has been compiled concerning the companies that are currently engaged in foreign investment.

One of the first steps in our research, therefore, has been to determine which companies have been investors in the foreign field. The importance of large companies in the investment picture is indicated by the following quotation from the Department of Commerce census of foreign investment:

"As in the case of domestic organizations, large companies are a major factor in the investment picture. It is clear from the earlier discussion that their activities as a rule center in industries where widespread operations and large capital investments are required. Thus, the 10 reporters with the largest stake abroad accounted for 40 percent of the total investment at the end of 1950 and about half the total investment at that date was held by 25 reporters. Of these 25 reporters, 10 were manufacturing companies, 5 petroleum companies, 3 were in public utilities, 2 each in mining, agriculture, and trade, and 1 in insurance." [1]

In addition, the Office of Business Economics advised us that 442 firms accounted for over 90 percent of direct foreign investment outstanding in 1950.

From our experience and knowledge of companies with foreign operations, and from material published by the Federal Trade Commission, the Securities and Exchange Commission, the New York Stock Exchange, the United States Department of Commerce, and the Department of Trade and Commerce of the Government of Canada, we have been able to compile comprehensive lists of large United States companies with and without foreign investments. The recent census of foreign investments of the United States has been particularly valuable in providing data on United States direct investments abroad.

From these various sources, we have determined that—

(1) Most foreign investment has been by comparatively few large firms.

(2) Most large firms have had some experience with foreign investment.

(3) Yet, a significant number of these firms have never invested outside the United States and Canada.

While 80 percent of United States companies with assets of over $50 million have had some experience with foreign investment, one-quarter of these firms have only Canadian investments, which most companies regard as part of domestic rather than foreign operations. Thus, 40 percent of all firms with assets of over $50 million have no investments outside the United States and Canada.

The bulk of capital investment abroad in the future must be provided by large firms. Investors must increase their investments, and large firms that are not now foreign investors must begin to invest in foreign countries. Certainly smaller companies should not be disregarded, although small firms are not likely to provide a substantial amount of foreign investment. These firms have not provided much capital in the past, though it is impossible to measure their effectiveness in helping firms in other countries to build their own industries through providing experience and know-how. But small firms have neither the money nor the management available for investment in significant amounts in

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[1] U. S. Department of Commerce, Office of Business Economics, Foreign Investments of the United States, Census of 1950, U. S. Government Printing Office, Washington, 1953.

foreign countries. The time of their executives must be devoted to supervising domestic operations. For large capital investment in the future, we must rely primarily on the large firms, although clearly any incentives provided should be equally available to both large and small companies.

Since the larger companies must provide the bulk of funds for foreign investment, we sought to learn what factors were important to their executives in reaching investment decisions. In order to determine what kinds of changes in the tax laws might be effective in stimulating investment, we first had to consider the broader problem of why companies did or did not invest in foreign countries.

The Bureau of Foreign Commerce of the Department of Commerce has been of immeasurable assistance to us in studying the attitudes of businessmen toward foreign investment. We have acted as consultants to the Department in compiling and analyzing the results of interviews with over 350 business firms on the obstacles and impediments to foreign investment. Included in the sample were companies with extensive experience with foreign investments, companies with no foreign investments, banks, and investment houses. Considerable information about the reasons companies do and do not invest in foreign countries has been provided by this study.

Our main field work has consisted of interviews with a carefully selected group of companies from different parts of the United States. This group has included investors and noninvestors in various fields of business. Although we have seen some small companies, the great majority have been large concerns.

Our interviews were conducted at various levels within each company. We talked with the top-policy executives of the companies, generally either the president or the chairman of the board, with the top officers concerned with foreign operations and with the tax executives. We discussed with these executives their company's general policy toward foreign investment and the manner of reaching investment decisions. We were interested in ascertaining whether the same factors were considered in connection with foreign and domestic investments. Our purpose was to discover not only what effect taxes, both United States and foreign, had upon investment decisions, but what changes in decisions would have resulted from a different tax situation. After discussing generally, the policy of the company toward foreign investment we proceeded to cross check these views by a study of one or more specific investment propositions in each company. Thus, wherever possible we traced through particular investment proposals from the time they were suggested to the time that they were either carried out or discarded by the board of directors. In most cases the the company made available to us the complete files on these investment proposals, including reports, memoranda, and letters. We questioned the executives about the relative importance of the various factors considered in reaching a decision. The time spent with a company varied from several hours to several days.

In the following chapters we present the conclusions that have emerged from our field investigation about the factors affecting investment decisions of executives, a summary of our major recommendations, and a comparison of our proposal with other approaches to the taxation of foreign income. Considerable attention is then given to the major problem in this field, which is to provide an incentive to foreign investment without incurring a substantial loss of United States tax revenue from export earnings. We estimate the amount of United States tax revenue involved and the possibility of distinguishing between export and investment. Finally, we present in detail our recommendations for changes in the methods of taxing foreign income.

I. Conclusions and Recommendations

BASIS FOR RECOMMENDATIONS

Our chief purpose in making recommendations for changes in the tax laws with relation to foreign income have been to provide additional incentive for foreign investment and to simplify the present law and eliminate many of its complexities. We have been principally concerned with providing a stimulus to United States companies either to expand their present foreign activities or to begin a policy of investment in foreign countries. Our recommendations stem from the information obtained through our case studies of company investment decisions. We, therefore, present in the following pages a brief summary of our conclusions on the manner in which these decisions are made.

The role of tax incentives

Our study of the attitudes and policies of United States companies toward foreign investment has convinced us that the role of United States taxation in investment decisions has been minor in the past and that changes in United States taxes cannot alone be expected to have a significant effect upon the attitudes of the executives responsible for investment decisions. Any large increase in United States foreign investment will depend upon related action in several other fields.

We believe that greater United States foreign investment is dependent upon a change in the attitude of top executives toward business activities in foreign countries. Undoubtedly many opportunities for profitable foreign investment exist. Companies fail to take advantage of these opporunities because their top executives either are not interested in foreign investment, or because they believe that the future growth of the economies of foreign countries will not permit profitable opportunities for private business. Only if the attitude of these executives changes will their companies become major foreign investors. When the attitude of the top executives results from lack of interest and failure to investigate foreign propositions, anything that stimulates their interest and leads them to study specific opportunities will result in greater investment.

Business attitudes toward foreign investment

While most proposals to encourage foreign investment have assumed that a substantial tax rate reduction is an effective incentive, we conclude as a result of our investigation that a rate reduction alone is likely to have little effect on foreign investment. As a matter of fact, we could find no single instance in which the complete elimination of United States tax would have changed a decision against investing abroad by top management. Nor could examples be found of investment opportunities which would have received more serious attention from the persons in charge of developing them if the earnings from the investment were exempt from United States taxes.

The presumption behind the theory that lower United States taxes on foreign income would stimulate investment is that companies would be encouraged to invest by the extra return. Most of the noninvestors interviewed had not even considered particular foreign investments in specific terms. Since they did not know and had not even attempted to ascertain whether they could make a larger or smaller profit than they could make domestically, they had not considered the impact of taxes. As long as the noninvestors have no idea of the rate of return that they can obtain on a foreign investment, any improvement in this unknown rate of return cannot affect their decision to invest overseas.

Viewpoints of investors and noninvestors.—We discovered in our interviews that there is a basic psychological difference in viewpoint toward foreign investment even between firms in the same line of business. Foreign investors tend to be optimistic; they believe present foreign markets are large and untapped. Further, they expect these markets to expand rapidly in the foreseeable future. On the other hand, companies which have no foreign investments tend to be pessimistic with regard to the present size and future growth of foreign markets.

Companies which do invest abroad usually take a long run rather than a short run approach. They do not think primarily in terms of high initial profits, or of getting their money back within any specified number of years. For example, one executive said, "I am not interesting in getting my money back within 3 years; I've got my money now. I'm interested in establishing a sound business that will grow and return profits over the next 20 years."

Foreign investors are concerned with the relation of a particular investment to the future of their business operations. Thus they always consider foreign investment in the light of their belief about the future course of business within a particular country. They invest because they believe that a sound and growing market can be developed within a particular country. They believe that the economic conditions within the country will be favorable for the particular investment for many years. Their attitude toward their future business opportunities within the country is optimistic.

On the other hand, companies that decide against investment abroad usually are pessimistic about opportunities for their business in the particular country under consideration. They believe that the market is not large enough now or likely to be large enough in the future to support a profitable business for them.

The investors are usually optimistic about the future of business within a particular country. They doubt their ability to serve the market through export from the United States because of the continuing tendency of foreign governments

to restrict imports. The noninvestors are likely to be pessimistic about the future growth of business within a particular country, but feel confident of their ability to serve the market through export. If exports to a particular country have already been curtailed, they believe that the situation will improve in the future so that exports can be resumed.

Consequently, a tax incentive to foreign investment will not be effective in the case of noninvestors unless it causes a basic change of their viewpoint. Merely increasing the rate of return will not change fundamental thinking about investment opportunities.

Reinvestment of earnings.—One of the outstanding characteristics of companies engaged in foreign investment is that they tend to begin with a small investment in a particular coutry and expand out of retained earnings. Further, executives view foreign earnings as, in a sense, "gambling dollars." In other words, they are prepared to take risks with retained earnings that they would not take with fresh capital. Their viewpoint is likely to be: "The earnings from our foreign operations represent extra funds. If we should lose them, it will be unpleasant, but, after all, it won't affect our overall operations. Let's take a chance with them, therefore, and, to the extent that we can finance an investment with local earnings, let's go ahead and do so." It is pointless to argue that this is not a reasonable view—that one dollar is just as good as another as far as the company is concerned. The fact is that many companies look at foreign earnings in this way. Therefore, it is sound policy to take advantage of this fact in changing the taxation of foreign income.

Conclusion

From our investigation of the manner in which foreign-investment decisions are made, a number of conclusions emerged which must be considered in any proposal to provide tax incentives to foreign investment. The role of United States taxation has in the past been minor and is not likely to become the major factor in investment decisions. On the other hand, we feel that it is possible to give some stimulus to direct foreign investment through changes in taxation of foreign income, but that lowering the rate of tax on foreign income will not be an effective stimulus. In order to increase substantially the rate of direct private foreign investment, it will be necessary to change the viewpoint of executives in large companies which are not major foreign investors. This viewpoint might be changed by a method that has dramatic appeal and that utilizes the willingness of companies to reinvest their foreign earnings. The cost in revenue to the United States Government of a tax change should not be too substantial, however, because the role of taxation is minor.

We believe that our principal recommendation for the establishment of a foreign business corporation will tend to accomplish these objectives. Whatever the positive effects of our proposal on foreign investment, it would be a substantial improvement over the present method of taxing foreign income in that it would eliminate many complexities and inequities.

RECOMMENDATIONS

The following is a summary of our recommendations which are discussed in detail at a later point:

(1) Foreign business corporation

We propose the establishment of a special class of domestic corporation to be known as a foreign business corporation, which could hold the stock of foreign corporations or other foreign business corporations, operate abroad directly, export, and carry on all types of foreign business activities.

Existing foreign operations could be transferred to a foreign business corporation without imposition of United States tax.

The assets of the foreign business corporation would have to be entirely abroad except for bank accounts in the United States, United States Government bonds, stock and obligations of other foreign business corporations, and assets necessary for the conduct of the foreign activities.

No United States tax would be imposed on the earnings of a foreign business corporation until distributed, but it would be required to file a return each year showing its income, its foreign tax credits, and its potential United States tax with respect to such profits. When a distribution occurred, tax would be imposed. The amount of United States tax due would be calculated by determining the years from the earnings of which the distribution was made, on a "last in

first out" basis. The amount of tax payable on the distribution would be in accordance with the tax returns previously filed.

A distribution would be defined as a dividend, a loan to the shareholders by the foreign business corporation or its subsidiaries, liquidation of the foreign business corporation, or any act which made the foreign business corporation's or its subsidiary's earnings available in any way to the shareholders.

The rate of tax suggested is 85 percent of the regular United States corporate tax rate. Such a rate would give companies about the same rate of tax as now paid on the income of foreign subsidiaries or the earnings of Western Hemisphere trade corporations after distribution to the parent.

Source of income from purchase and sale of personal property would be determined by the place where title passed, except that on exports from the United States the source would be determined by the destination of the goods.

Companies which under the laws of the United States are not permitted to operate through subsidiary corporations would be permitted to treat their international division as a foreign business corporation. A foreign business corporation would be permitted to elect to file a consolidated return with a foreign subsidiary when under foreign law the company is required to operate through a foreign subsidiary.

The sections of the Internal Revenue Code relating to Western Hemisphere trade corporations and corporations deriving a substantial portion of their income from possessions of the United States would no longer be necessary, since these corporations could qualify as foreign business corporations.

(2) *The foreign-tax credit*

The method of calculating the foreign-tax credit on dividends received from a foreign subsidiary should be changed and the method now used for calculating the tax credit of a branch be substituted. As a result, the taxes paid by branches and foreign subsidiaries would be equalized.

The per country limitation on the foreign-tax credit should be removed and the overall limitation retained.

Certain minor defects in the foreign-tax credit relating to the year in which a credit is permitted and to the application of the Statute of Limitations to foreign-tax credit should be corrected.

DISCUSSION OF RECOMMENDATIONS

We shall here confine our principal discussion to the main proposal, the establishment of a foreign business corporation, since the other recommendations are either directly related to the main proposal, or are primarily of a technical nature.

The recommendation of a foreign business corporation would introduce a new concept to United States tax law. Basically it proposes that for tax purposes the Government regard foreign business in the same manner that businessmen typically consider it—as a unitary activity quite distinct from business in the United States. Thus, all foreign activities, including export, would be permitted by the foreign business corporation.

The chief incentive element is the permission to defer United States taxation on foreign income and to utilize foreign earnings either for expansion within the country in which earnings were realized or anywhere else in the world. A company might have large earnings in Brazil, but desire to expend in Australia. The Brazilian earnings could be accumulated in the foreign business corporation and utilized for investment in Australia without payment of United States tax. Further, companies could use their export profits for expansion of investment abroad. At present a tax of 52 percent must be paid on the export earnings, so that exporting through a foreign business corporation would double the funds that would be available for expansion from this source. Psychologically there would be a tendency to accumulate funds in the foreign business corporation and use them for expansion in the foreign countries. With funds on hand that could be used tax free only for foreign investment, there would be greater interest in considering foreign investment opportunities. This proposal would stimulate interest in specific propositions, and thus tend to result in more foreign investment.

Many of the technical changes similarly flow from the recognition of foreign business as a unitary activity distinct from operations within the United States. Thus, export earnings are regarded as foreign income no matter where title to the goods passes. Our recommendation for the removal of the per country

limitation to the foreign-tax credit also stems in part from a recognition that companies view their foreign business not on a country-by-country basis, but as a unit.

Comparison with other approaches to tax incentives

The proposal for a foreign business corporation differs from most recommendations that have been made for tax stimuli for foreign investment in that it does not rely on a substantial rate reduction. While the rate suggested is slightly below the domestic rate, this rate was selected in order not to affect existing foreign operations which already obtain a rate benefit as Western Hemisphere trade corporations or as foreign subsidiaries. Instead of a rate reduction, the chief incentive is the privilege of deferring United States tax.

The two main criticisms of proposals dependent upon a substantial lowering of the rate of tax on foreign income are that (1) they are not likely to prove effective as stimuli to foreign investment, and (2) any substantial lowering of the rate involves a considerable loss of revenue to the United States Government.

The first objection based on the ineffectiveness of a substantial reduction in the United States tax is, of course, a matter of judgment and taken alone, would not bar reduction or elimination of tax on foreign income. In other words, if the cost of a reduction in tax on foreign income were not significant, there would be little objection to this action. Moreover, it is possible that some stimulus to foreign investment might, thereby, be provided. The fact is, however, that substantial reduction of United States tax on foreign income would cause a large loss of Government revenue which we feel would render the proposal undesirable.

The reason for the costliness of a rate reduction is that income from export as well as from investment would qualify unless a practical method could be devised to distinguish between income from export and income from investment. We do not believe it is possible to exclude by definition all export income from tax benefits without also excluding much investment income, and conversely, we believe that a definition broad enough to encompass all types of investment income will include considerable export income. As a result, we feel efforts to reduce the cost of a substantial rate reduction will fail. Therefore, our proposal does not attempt to make a distinction between export and investment.

The inclusion of export income in our proposal permits the Government to take advantage of the attitudes and practices of businessmen to provide an effective incentive to foreign investment. Thus, while most proposals have attempted to extend a benefit to a company only after it has made a foreign investment, this proposal encourages an exporter to undertake foreign investment.

Most foreign investment, at least in the manufacturing field, is made by companies that have previously exported to the particular country in which they invest. Sometimes a company decides to invest in a country after it has developed the market for its products through export because it is possible to lower the cost or broaden the market by manufacture in that country. Other times a company invests because the regulations and restrictions imposed by foreign governments make continued export no longer possible. In such cases companies invest in order to retain their market in a country. Since investment thus tends to follow export, foreign investment will be stimulated by a proposal which permits companies to utilize their export profits for foreign investment without United States tax. In other words, the plan will make exporters examine the markets in foreign countries more closely to determine whether they can enlarge their markets through local assembly or processing. If a foreign government is restricting United States exports, ability to use tax-free export profits for investment will contribute to the willingness of a company to invest in the particular foreign country. Thus, the extension of tax deferral to export income should help companies to make the transition from export to foreign investment.

We have made no attempt to distinguish between export and investment income in our proposal for two reasons: (1) We believe that foreign investment will be stimulated if tax-free export earnings can be used for financing, and (2) we do not believe a workable plan can be developed for distinguishing between export and investment income. For this latter reason any tax incentive plan based on a substantial rate reduction would apply to export and investment income and, therefore, would be costly in Government revenue. Since this conclusion is of prime importance, it is necessary to analyze in detail the amount of revenue involved in the taxation of export and investment income, and the possibilities of distinguishing between the income from export and foreign investment.

II. The Distinction Between Export and Investment

The distinction between export and investment income is a major problem only if the revenue loss incurred through extending the advantages of a lower tax rate to export is substantial. If the loss is substantial, the question arises of whether it is possible to exclude export income through a change in the present definition of foreign income, which now includes both export and investment income. In this section we first consider the amount of revenue involved in present United States taxes on both foreign investment and export income, then various methods that have been proposed for excluding export income from the benefits of any reduction in taxes.

Tax Revenue from Export and Foreign Investment

We estimate that the total United States tax revenue collected in 1952 on income from direct foreign investment and export amounted to between $900 million and $1,000 million. Of this, $200 million is derived from foreign investment and $700 million to $800 million from export.

Revenue from direct foreign investment

The most recent figures available on income from United States direct foreign investments and foreign taxes paid are contained in Foreign Investments of the United States,[3] a publication of the United States Department of Commerce. From the data published in this document, a rough calculation of United States taxes on foreign income can be made. Using the four main area breakdowns for which figures were compiled, we calculated that the total tax paid on branch earnings and dividends received from foreign subsidiaries was $95.4 million for 1950. A breakdown by area is shown in table 1.

Table 1.—*United States taxes on branch earnings and dividends of foreign subsidiaries and affiliates in 1950*

[Millions]

Area	Branch earnings	Dividends
Canada	0	0
West Europe	$3.6	0
Latin America	0	$10.4
Other	65.6	9.8
Total United States tax	69.2	20.2

For calculation, see appendix A.

In addition, United States tax revenue on royalties, fees, and interest can be estimated at approximately $47.7 million. Thus, the 1950 total revenue on foreign income from direct investment is estimated at $133.1 million.

There are several factors which would tend to increase the total of $133.1 million, but at least one major factor working in the other direction. Thus, of the tax on branch profits, $65.6 million came from "other areas." Included in this category were the extensive petroleum investments in Saudi Arabia and other parts of Asia and Africa, which accounted for the largest part of the estimated tax. No depletion deduction, however, was provided for in the above calculations. Had it been, the figure of $65.6 million would have been substantially reduced, and perhaps even eliminated.

Several factors work to increase the estimate of tax. Two types of averaging of foreign tax rates were involved in the estimate:

(1) In all of the areas but Canada, an overall tax rate was calculated by comparing the sum of the taxes paid in the individual countries with the sum of the earnings before taxes in each country. Since taxes in some countries were in excess of the amount creditable against United States taxes, while in other countries local taxes were less than the United States tax due, some United States tax would actually be paid on earnings from these latter countries. On an area basis, using an average tax rate, no United States tax liability would be shown.

[3] U. S. Department of Commerce, Office of Business Economics, Foreign Investments of the United States, Census of 1950, U. S. Government Printing Office, Washington, D. C., 1953.

(2) In each country the effect of progressive tax rates has been eliminated by the averaging process. In any given country some firms may be paying taxes at less than the United States rate, and will thus be subject to United States taxes; others may be paying at higher than the United States rate, and will, therefore, have no United States tax.

An additional factor that would tend to increase the United States tax revenue is the intercorporate dividend tax on distributions of earnings of Western Hemisphere trade corporations. The revenue so obtained was not included in the calculations. While it is not possible to calculate the amount of this revenue, the maximum amount that could have been received can be determined. Branch earnings in Latin America were $513.8 million. Foreign income taxes, which exceeded United States estimated tax calculated at the then Western Hemisphere rate of 28 percent, were $150.3 million. Assuming that all of the balance of $363.5 million was distributed, the intercorporate dividend tax would amount to $22.9 million. Clearly, the actual tax would be considerably less than this maximum.

The tax on royalties, fees and interest would be either higher or lower than our estimate of $47.7 million, depending on the actual foreign taxes imposed on these remittances. We have used an average rate of foreign tax of 20 percent. The maximum United States tax would have been $72.9 million, which is 42 percent of the $173.5 million received as royalties, fees and interest. This maximum would be on the assumption that no foreign taxes were paid on such remittances, and thus no credit was available.

When all of the pressures working on both directions are taken into account, $150 million is a workable estimate of the United States tax revenue on income from direct investment in foreign countries in 1950.

Since 1950, the United States corporate income taxes have risen to an average rate approaching 52 percent. Taxes in many foreign countries have also gone up, but it is impossible to determine whether the spread between United States taxes and foreign taxes is higher or lower than in 1950. The latest figures for income receipts from foreign investments show an increase of 11 percent in 1952 as compared with 1950.[8] If United States tax receipts increased by the same relative amount, the total revenue from foreign income would be $166.5 million. In view of all the uncertainties, both in the calculation of taxes for 1950 and the changes that might have resulted by 1952, a figure of $200 million for United States tax revenue from foreign income in 1952 from direct investment would seem to be a reasonable estimate.

To the $200 million of tax revenue received from direct investment income must be added revenue received on income from portfolio investments to calculate the entire Government revenue on foreign investment. According to the Office of Business Economics of the Department of Commerce, approximately $196 million was received in 1952 as income from this source. The major portion was derived from Canada, with the balance divided between Europe and Latin America. Assuming an average of 15 percent withholding tax imposed at the source, the gross figure would be $231 million. Since foreign securities are mostly held by wealthy individuals and investment houses, we assume that the average rate of United States income tax on this income would be 50 percent. Accordingly, the United States tax after the foreign tax credit would be about $80 million. The total revenue from all types of foreign investment is, thus, estimated at $280 million. This estimate compares with a recent informal estimate by a high Treasury official of total United States tax revenue from foreign source income in 1952 of $285 million We are here only concerned with the $200 million revenue from direct foreign investment.

Revenue from export

The total of regular commercial exports in 1952 (excluding military items) amounted to $13.2 billion. If the average rate of profit after taxes in 1952 for all United States corporations of about 5 percent on net sales is applied to $13.2 billion, the profit after taxes on United States exports was $660 million. Since in 1952 taxes for United States corporations amounted to about 55 percent of income before taxes, export income before taxes assuming the same rates of tax and profit was around $1,460 million. Thus, the Government collected revenue from this source of approximately $800 million.

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[8] U. S. Department of Commerce, Office of Business Economics, Survey of Current Business, Income on United States Foreign Investments, by S. Pizer and F. Cutler, December 1953, p. 9.

A more precise estimate of the revenue involved can be obtained by considering export by product class. About $9,486 million of the total of $13.2 billion of exports in 1952 was represented by exports of items that are classified under the 13 industry categories shown in table 2. From data released by the National City Bank of New York, the profit per dollar of sales after taxes for various types of United States companies may be found. Applying these percentages to export sales by product groups, we find that on exports of $9,486 million the net profit after taxes amounted to $429.3 million. The average rate of profits was 4.5 percent. Applying this rate to the balance of United States exports ($13.2 billion less $9.5 billion), we find that total export earnings after taxes were $595.8 million. Assuming that the average rate of corporate income tax of 55 percent applied to these earnings, the profit before taxes would have been $1,324 million in 1952, and the revenue to the Government would have been $728 million.

The figure of $728 million obtained by the analysis of the principal products exported differed from the rough estimate of $800 million, because the detailed analysis indicated that the rate of profit on the principal products exported was somewhat lower than the average rate of profit of United States companies in 1952. It could be argued that the rate of export profit should be even lower than the domestic rate of profit for these companies. Thus companies would have to allocate some portion of export earnings to domestic business in the event that they attempted to qualify such earnings as foreign income. Presumably products would be transferred from the domestic company to a subsidiary that would be responsible for export. At the time of transfer, some profit would have to be allocated to the domestic company.

TABLE 2.—*Exports and estimated profits, 1952*

Commodity group	Exports [1] (millions)	Percentage (on sales after taxes [2])	Estimated profits after taxes (millions)
Wheat and flour	$942		
Other grains and preparations	540		
Fruits and vegetables	246		
Subtotal	1,728	3.0	$51.8
Vegetables, oils, and oilseeds	164	3.1	5.1
Tobacco manufacturers	304	3.4	10.3
Cotton manufacturing	874	1.6	14.0
Textile manufacturers	663	3.0	19.9
Coal and related products	510	2.0	10.2
Petroleum and products	577	10.5	60.6
Iron, steel, and mill products	722	5.0	36.1
Machinery, electrical and industrial	2,155	5.0	107.8
Automobiles, parts and accessories	988	5.0	49.4
Chemicals and related products	801	8.0	64.1
Subtotal	9,486	4.5	429.3
Balance of exports ($13.2 less $9.5)	3,700	4.5	166.5
Total	13,186		595.8

[1] U. S. Department of Commerce (Foreign Commerce Weekly, vol. 49, No. 11, Mar. 16, 1953, Washington, D. C., p. 17).

[2] National City Bank of New York, Monthly Letter on Economic Conditions, Government Finance, New York, April 1953, p. 42.

It is difficult to tell, however, what the result would be when allocation of profits were made between domestic and foreign earnings. Typically, the net price that companies receive for exported products is about the same as for those sold in the United States, but the expenses of advertising, selling, and administration are lower. Thus, the profit on exports is usually higher than on domestic business. It is quite possible that even after a portion of the export profit were allocated to the domestic company, the rate of export profit would be higher than on domestic business. Therefore, we should perhaps have used higher rates in calculating the export earnings and the tax revenue on those earnings.

The estimate of tax revenue received in 1952 should undoubtedly be adjusted to take into account the volume of exports now handled by Western Hemisphere trade corporations, because these companies are taxed at a lower rate. Since

the volume of exports which such companies account for is unknown, we have not attempted to adjust our estimates accordingly.

Therefore, we estimate that the United States Government in 1952 collected $700 to $800 million in revenue from taxes on export earnings. Adding the $200 million of taxes on income from direct foreign investment, we estimate that from $900 million to $1,000 million of revenue was collected in 1952 by the United States Government from these two sources.

Conclusion

Thus, the amount of revenue presently obtained by the Government from export earnings is roughly four times the revenue obtained from foreign investment, and the cost of reducing taxes on foreign income can be substantial. If export income could be excluded from foreign income, the cost of any incentive tax rate would be limited to $200 million. Various proposals have been advanced for excluding export income in order to reduce the cost of an incentive plan. Some advocates of an incentive tax rate have urged that this end could be accomplished by a strict enforcement of the provisions of the Internal Revenue Code respecting intercompany pricing. Others have suggested various redefinitions of foreign income. In the next sections we consider these alternative possibilities.

EXCLUSION OF EXPORT INCOME UNDER THE PRESENT LAW

The method usually suggested for excluding the bulk of export income from classification as foreign income under the present definition of that term is through a strict enforcement of the intercompany pricing provisions of the Internal Revenue Code. Before analyzing the effect of these pricing provisions, let us examine the present definition of foreign income.

The present definition of foreign income

There is little difficulty in classifying most items of income as foreign or domestic under United States law. Generally, dividends and interest are foreign if paid by foreign corporations. The source of compensation for personal services is the place where the services are performed. Income from real estate is from the place in which the real estate is located. Royalties are treated as derived from the country in which the patents are located and used. It is only in the area of sales of personal property that serious problems arise. Under the Internal Revenue Code, the standards for determining the source of profits from the sale of personal property are:

(1) Income from the sale of personal property which was originally purchased by the seller is derived entirely from the country in which the property was sold.

(2) Income from the sale of personal property which was produced within and sold without the United States or which was produced without and sold within the United States is derived partly from sources within and partly from sources without the United States.

Passage of title rule.—Since both of these propositions depend upon the place of sale, further rules are necessary to determine the place of sale. The country in which property was sold has been interpreted by several court decisions as the place where title to the goods passed from the seller to the buyer. This rule has been adopted by the Internal Revenue Service with the proviso that if the transaction was arranged for the purpose of tax avoidance, the place of title passage would not alone determine the source of income. Instead, all factors in the transaction including the negotiation and execution of the contract, the place of payment, and the location of the property, would be considered. The place of the sale would be the country in which the substance of the transaction occurred. The scope of this tax avoidance qualification to the title passage rule has never been tested. Possibly, the Internal Revenue Service would view any transaction markedly at variance with customary commercial practice as tax avoidance which would necessitate the determination of the source of income by the substance of the transaction rather than by the title passage rule.

Commercial practice.—The commercial function of passage of title is to determine the risk of loss of goods. If the buyer has title, the loss of goods in transit will be his; whereas if title has not passed until the goods reach the buyer's country the risk of loss is the seller's. In the law of sales, passage of title is said to be a matter of intention, although certain presumptions as to passage of title arise because of commercial practice. Thus, on a sale by a

United States company, which is engaged only in selling f. o. b. New York to a Brazilian buyer, title passes on delivery in New York. If the same sale were arranged f. o. b. Sao Paulo, title would pass in Brazil. Historically, this distinction may have been of great practical importance. Today, the chief significance of passage of title is probably only to determine which party has the legal right to enforce the insurance claim in the event of loss. In a very limited number of situations, the party with title may suffer a real loss. However, such cases are so small a percentage of total exports sales, that there is seldom real bargaining between buyer and seller concerning the assumption of this risk. Thus, there is no reason why a United States exporter would not be willing to bear this risk by retaining title until the goods reach a foreign destination.

On shipment f. o. b. United States, the seller usually either receives payment before the goods leave the United States through a letter of credit, or ships the merchandise under a sight draft with the documents being endorsed in favor of a bank that will act as a collecting agent. The buyer cannot obtain the documents which permit him to get physical possession of the goods until the draft is paid. While the buyer may have title to the merchandise from the time it leaves the United States, a bank retains a security title to the merchandise. The buyer cannot obtain the merchandise until payment is made. If the buyer refuses to accept the merchandise, the seller can dispose of the goods elsewhere. Thus, until the payment is made the seller still retains an interest in the goods even though title has passed upon shipment from the United States. Although the buyer is supposed to make insurance claims, it is not uncommon in the event of substantial or total loss of merchandise for the buyer to refuse to pay the draft and for the seller to recover from the insurance company.

If the seller retains title to the merchandise until the goods arrive in the foreign port, his risks change little. The seller would have to settle any claims with the insurance company. But aside from this fact, a transaction would proceed in much the same way as where title passed before leaving the United States. Problems that would make retention of title impossible might arise in connection with shipments under a letter of credit. Since the buyer would have paid for the merchandise before it left the United States, he might object to the seller retaining title until the merchandise reached a foreign country. Furthermore, under a letter of credit shipment, a court might hold that title actually passed in the United States since payment was made before shipment. Some companies have attempted to protect themselves from this latter possibility by arranging to have customers open letters of credit in favor of their Canadian subsidiaries. Shipment is made from the United States with title being passed in the country of destination. The parent does not receive payment from its Canadian subsidiary until after the goods reach their destination.

Use of export subsidiary.—Under the two rules for determining the source of income from the sale of personal property, foreign income can only arise if title passes in a foreign country. If the property was originally purchased by the seller, the entire income is derived from the place in which title passes. On the other hand, if the property was originally produced in the United States and is sold by the producer with title passing in a foreign country, the income from the sale is derived partly from sources within and partly from sources without the United States. The regulations provide that to determine the amount of the income that is foreign in this latter case, either the independent factory price or a formula provided in the regulations will be used. If it is important for a company to qualify its export income as foreign, it will use an export subsidiary, since a larger portion of its income will usually qualify as foreign on a price basis than under the formula.

Conclusion.—If the effect of retaining title in the seller were to reduce substantially United States taxes, there is no doubt that most United States exports would be sold through an export subsidiary with title passing in a foreign country. Under present law, a 9.2-percent differential in United States tax is offered by the Western Hemisphere trade corporation provisions. A substantial number of companies have been willing to rearrange their export sales and pass title abroad in order to obtain this benefit.

If the Internal Revenue Service were to look beyond the place where title passed into the substance of the transaction, as is suggested in the ruling for cases of tax avoidance, the result would be no more satisfactory. Provided enough of the operative factors would occur abroad, exports could still qualify as foreign income. There could be no certainty for the taxpayer since the facts of each sales transaction would have to be examined to determine the source of the income.

The present definition of foreign income, therefore, offers no firm basis to distinguish between investment income and income from export. Export income would qualify equally with investment income if rate benefits were offered to foreign income.

Intercompany pricing provisions

It has been claimed by those favoring a lower rate of taxation for foreign income that there would not be any serious loss of tax revenue on export income if the Government relied on strict enforcement of the intercompany pricing provisions of the Internal Revenue Code in order to allocate income between domestic and foreign sources. Under code section 45, the Commissioner of Internal Revenue is authorized to reallocate income between related businesses if such action is necessary to prevent tax avoidance or to reflect clearly the income of the related businesses. The standard which the courts have adopted in applying this provision is that the price between the related companies be an arm's-length price, that is, a price which would be charged if the businesses were not related. Thus, in the case where a company utilizes an export subsidiary to purchase goods from the parent and sells with title passing in a foreign country, it is claimed that strict enforcement of these intercompany pricing provisions would result in a price so high as to reduce the export income to an insignificant amount. The assumption behind this argument that the price would be high is that there is either no such thing as an export profit, or else that the export profit is very small in relation to the total dollar amount of merchandise exported. Let us consider, therefore, the existence and size of export profits.

Existence of export profit.—If there is any question about exporting being a regular business function that can expect to be operated at a profit, it should be answered by the fact that several thousand companies operate as exporters and make profits.

A manufacturing company has the choice of handling its own exports or selling to exporters who will export for them. If a company decides to export itself, it has the choice of using an export department or establishing a separate export corporation. If it decides upon an export corporation, the problem of intercompany pricing arises.

Unless the export corporation performs no function, it is difficult to see how any reasonable method of pricing would eliminate the profits from the export corporation. Some companies for business purposes have established international corporations to handle all export business. The pricing policy that has been set up was not intended to swell the profits of the international corporation for tax purposes, yet these corporations do operate at a profit.

Size of export profit.—Not only is there an export profit with reasonable intercompany pricing practices, but as the following discussion will indicate, this export profit may actually be larger in relation to sales than are domestic profits. For example, assume the XYZ corporation has sales of $10 million of which exports are $1 million. In the United States, the company sells $6,600,000 direct to manufacturers and $2,400,000 to wholesalers, who sell to smaller manufacturers which the company cannot economically reach through its own sales force. The selling price to the manufacturers is $1, and the selling price to the wholesalers is $0.80; the wholesaler in turn resells to manufacturers at $1. At the present time the XYZ corporation has a small export department which has appointed distributors or representatives in various countries of the world to act as the company's sales force in foreign countries. The representatives obtain orders from foreign manufacturers at the same price at which goods are sold in the United States, plus the freight, insurance, duty, etc. Thus, the price is $1 f. o. b. factory. The representatives receive a commission of 10 percent for obtaining the orders.

Assume now that the XYZ corporation decides to set up a subsidiary corporation to take over the export business. At what price would the parent sell to the subsidiary? One method of looking at the situation would be to use the price at which the parent sells to independent customers, i. e., the United States wholesalers. If this price were used, the export corporation would buy from the parent at $0.80, and sell to the foreign manufacturer at $1. From its margin of $0.20, it would pay a 10 percent commission to the foreign representative. Thus, on $1 million of sales the export company would pay $800,000 to the parent and $100,000 to the foreign representative. It would show a margin of $100,000 against which its expenses would be deducted. Assuming that the expenses were less than $100,000, the export corporation would show a profit.

Undoubtedly $0.80 is too high a price to charge the subsidiary, because included in that price were many costs that were not incurred in export. For example, among the costs that the parent would be covering by the $0.80 price would be the costs of advertising in the United States and selling to wholesalers. Since no effort would be involved in selling to the export company, and since the foreign customers would not benefit from the domestic advertising, these costs should not be included in the price to the subsidiary. Thus, the price to the subsidiary should be lower than $0.80 and the export profit would, therefore, be proportionately increased.

Allocation of costs.—If we were to assume in the previous example that the parent did not sell to wholesalers, but sold entirely through its own sales force in the United States, it would be necessary to allocate costs in order to find out what price should be used.

Let us assume on the previous example that the net profit to the XYZ corporation prior to establishing the export corporation was $1 million on sales of $10 million, shown on the operating statement as follows:

Net sales		$10,000,000
Manufacturing cost		5,000,000
Gross margin		5,000,000
Selling and advertising	$3,000,000	
Administrative expense	1,000,000	
		4,000,000
Net profit		1,000,000

The costs of the export department for salaries, advertising, etc., were $50,000. In trying to establish a price for selling to a new export corporation, it would be clear that of the $3 million expended for advertising and selling, only $150,000 actually was applicable to the export operations. ($50,000 of salaries, advertising, etc., plus $100,000 commission of distributors.) The general administrative burden might be harder to allocate, so we will assume that it is divided in proportion to present sales. One hundred thousand dollars would then be allocated to export. Without attempting to determine what profit the domestic company should make on the export business, let us allocate the costs to the various sides of the business:

	Domestic	Export
Net sales	$9,000,000	$1,000,000
Manufacturing cost	4,500,000	500,000
Gross margin	4,500,000	500,000
Selling and advertising	2,850,000	150,000
Administrative	900,000	100,000
	3,750,000	250,000
Net profit	750,000	250,000

If the parent company were to sell to a new export corporation, presumably it should make some profit. Suppose the same rate of profit were permitted it as on the balance of its sales with export not considered. The profit would then be at the rate of 8.3 percent. Thus on the volume sold to the export corporation, the manufacturing cost to the company would be $500,000. Since the profit of 8.3 percent is to be calculated on the selling price, this price would be determined by dividing $500,000 by 91.7 percent. The price would, therefore, be $545,000. The operating statements of the two corporations would now look as follows:

PARENT		EXPORT COMPANY	
Net sales	$9,545,000	Net sales	$1,000,000
Manufacturing cost	5,000,000	Cost of goods sold	545,000
Gross margin	4,545,000	Gross margin	455,000
Selling and advertising	2,850,000	Selling and advertising	150,000
Administrative	900,000	Administrative	100,000
Total	3,750,000	Total	250,000
Net profit	795,000	Net profit	205,000

The above calculation shows that about 20 percent of the entire profit of the combined companies comes from the export operations, as compared with 10 percent of the sales.

Profit without export.—Another way of looking at the export profit would be to determine the profit of the corporation without the export business. Since the $100,000 of administrative expenses would remain, the only reduction in expense would be in the direct export costs, selling and advertising, of $150,000. The operating statement would be as follows:

Net sales	$9,000,000
Manufacturing cost	4,500,000
Gross margin	4,500,000
Selling and advertising	2,850,000
Administrative	1,000,000
Total	3,850,000
Net profit	650,000

It is quite possible that the manufacturing cost of $4,500,000 might be increased somewhat due to the fact that the fixed manufacturing cost would have to be spread over a smaller number of units. If the fixed cost amounted to one-quarter of total manufacturing cost, the manufacturing cost would be made up of one element of $1,250,000 which was fixed, and the balance variable. Thus, the variable cost would be 90 percent of $3,750,000 or $3,375,000 to which would be added $1,250,000. The total manufacturing cost would thus be $4,625,000. The profit would be reduced from $650,000 to $525,000. Thus, one might say that the difference between the profit with the export business of $1 million and the profit without it of $525,000 or $475,000, was attributable to the export operations.

Conclusion.—Certainly there can be no question about the existence of export profits. We are not endeavoring to suggest how the export price should be determined; we recognize that the situation would vary from case to case. Our purpose is only to indicate how complicated the problem is and to suggest that any fair system of pricing would result in some export profits. They might not be greater in proportion to export sales than domestic profits were to domestic sales, as the above examples suggest. A fair method of establishing intercorporate pricing would, therefore, not eliminate the profits of export companies. Thus, reliance on the intercompany pricing provisions of the Internal Revenue Code would not eliminate export profits and, hence, there would still be foreign income.

We conclude from the above analysis that use of the present definition of "foreign income" would permit export income to qualify for any special benefits accruing to foreign income; further, reliance on strict enforcement of the intercompany pricing section of the Internal Revenue Code would not result in any substantial reduction in the amount of export earnings.

ALTERNATIVES TO THE PRESENT DEFINITION OF FOREIGN INCOME

Since the present law does not provide a satisfactory basis for distinguishing between investment income and income from export, is it possible to exclude export income by special definition of the foreign income which qualifies for a rate benefit? The approach most commonly proposed has been to add a requirement of a foreign permanent establishment, which has been defined in a variety

of ways. The use of a formula approach has also been suggested. In H. R. 8300, the proposed Internal Revenue Code of 1954, section 923, a specific attempt has been made to exclude export from a reduced rate of tax through definition of eligible foreign income. We shall now analyze these various approaches.

Permanent establishment approach

The theory behind advocacy of a foreign permanent establishment test is that any tax benefits extended should depend upon there being actual activities carried on in a foreign country beyond merely selling to buyers in that country.

Present definition of permanent establishment: The term "permanent establishment" is defined in the United States income-tax treaties with foreign countries. An example is the definition in the United States-United Kingdom treaty, article 2 (1) (L):

"The term 'permanent establishment' when used with respect to an enterprise of one of the contracting parties means a branch, management, factory or other fixed place of business, but does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of such enterprise or has a stock of merchandise from which he regularly fills orders on its behalf. An enterprise of one of the contracting parties shall not be deemed to have a permanent establishment in the territory of the other contracting Party merely because it carries on business dealings in the territory of such other contracting Party through a *bona fide* commission agent, broker or custodian acting in the ordinary course of his business as such. The fact that an enterprise of one of the contracting Parties maintains in the territory of the other contracting Party a fixed place of business exclusively for the purchase of goods or merchandise shall not of itself constitute such fixed place of business a permanent establishment of such enterprise. The fact that a corporation of one contracting Party has a subsidiary corporation which is a corporation of the other contracting Party or which is engaged in trade or business in the territory of such other contracting Party (whether through a permanent establishment or otherwise) shall not itself constitute that subsidiary corporation a permanent establishment of its parent corporation."

The definition clearly does not exclude a strictly export operation. If an agent has power to contract for the exporter or if goods are shipped to him on consignment so that he has a stock of goods from which to fill orders, the exporter has a foreign permanent establishment. Thus, the present definition of a permanent establishment does not exclude export.

Redefinition of permanent establishment.—A change in the definition of a permanent establishment to require greater local activities such as a foreign subsidiary or branch, would not present any firmer ground for distinction. In a number of countries of which Panama is the best known example, there is a free trade zone and low income taxes are imposed on trading activities. A company could set up a Panamanian export corporation or a Panamanian branch of a domestic export corporation, as a considerable number of United States companies have already done. It would then sell to this corporation which in turn would handle export sales to all areas of the world from Panama. The export profits of the United States company would be shifted to the Panama subsidiary. The earnings of the Panama subsidiary, when remitted to the United States, would then be considered as eligible foreign income. It would be relatively easy for large numbers of companies to change their operations in this way. Since a large company with a considerable volume of export sales could better afford to organize through a Panama corporation or branch, such a permanent establishment rule would discriminate against small companies and would not exclude export.

Permanent establishment at place of sale.—Another possibility, in addition to requiring a foreign subsidiary or branch, would be also to require a permanent establishment at the place in which the goods were consumed. Such a provision would prevent Panamanian corporations or branches from obtaining tax rate benefits because they would not be able to sell a large proportion of their output for final consumption in Panama. At the same time, however, other companies which manufacture in one foreign country and sell in others might also fail to qualify. For example, a subsidiary of a United States company manufacturing in England might be required by the British Government to export as much as 50 percent of its output. This company would not qualify under this definition unless it had a branch or subsidiary in every country in which it sold.

This limitation would create a serious policy problem. It is difficult for companies to sell throughout Europe from a plant located in a single country. The

United States Government, however, has urged closer economic alliance of the countries of Europe along the lines already existing in the Benelux agreement. Certainly, therefore, nothing should be done in our tax legislation to increase the difficulties of a company selling throughout several European countries the products of a plant located in one of them.

Manufacture at a permanent establishment.—It would be possible to define permanent establishment in such a way that purely selling activities would be excluded from qualification. Thus, a corporation or branch would have to manufacture abroad to qualify its earnings as foreign income.

The object of excluding export and local selling would be to encourage local manufacture, but any approach of this nature would require careful definition so as to refer to the particular products of a company rather than to its activities as a whole. Otherwise, a company manufacturing both radios and refrigerators, could manufacture radios in a foreign subsidiary, but also import refrigerators from the United States and sell them in foreign countries. A competitor that manufactured refrigerators in the United States, but not radios, would be unable to qualify the income of a foreign subsidiary that was selling refrigerators imported from the United States. It would be improper, therefore, to permit all income from a subsidiary to qualify because of some manufacture. Since typically foreign subsidiaries of United States companies manufacture only a part of the parent's line of products, and import the balance of the line from the United States, a limitation of qualifying income to that derived from sale of articles manufactured abroad would require a difficult allocation of the sales and profits of each foreign subsidiary to exclude from qualifying income the profits on the imported portion of the line.

There is also the problem under this approach of defining manufacture. For example, the line between assembly and manufacture is difficult to draw. The assembly of a radio shipped in 4 or 5 parts would be simple and inexpensive. It might be argued that such assembly was little different from exporting. Yet, excluding assembly from qualification as manufacturing would eliminate some automobile assembly plants employing thousands in foreign countries.

Value added at a permanent establishment.—A possibility with respect to the definition of 'manufacture" would be to require that a certain proportion of the value of goods must be added by manufacturing within the foreign country. This would mean attempting to define the amount of manufacture which should be performed in each permanent establishment. It would be exceedingly difficult to make this provision workable. It would require a careful definition of what was meant by the value added by manufacture, and a clear picture as to what constituted a desirable percentage. A desirable percentage would vary by the type of manufacturing performed. It would be impractical to undertake to establish desirable percentages for each type of manufacturing activity. Further, the administration of such a provision would impose an impossible burden on the Internal Revenue Service.

Conclusion.—As the above analysis indicates, none of the alternatives considered offers a satisfactory basis for use of a permanent establishment approach to distinguish between income from export and foreign investment. Moreover, most of the alternatives we have considered would not necessarily be appropriate for the activities of companies in such fields as petroleum, agriculture, mining, public utilites, and finance. If any one of the alternatives were to be used, therefore, still other definitions of foreign income would be necessary to qualify the earnings of companies in these other fields. Thus, several concepts of foreign income would be required. Since companies with foreign activities whose income did not qualify under one of these alternatives might nevertheless incur foreign taxes, an additional concept of foreign income would be necessary to permit them a foreign tax credit.

Formula approach

Another approach to this problem might be the use of a formula for the allocation of domestic and foreign income. Actually, there is such a provision in the Treasury regulations. When a United States manufacturer directly sells to foreign buyers with title passing outside the United States, the income from such sales is treated as derived partly from sources within and partly from sources without the United States. The part allocated to the United States can be calculated on several bases. If an independent factory price exists for the goods, this price is to be used. Where there is no independent factory price, a formula is provided. Total net income from the domestic production and foreign sales is divided in half. One-half is allocated to the United States in

proportion to the value of the seller's property in the United States to the value of his property in the United States and in the foreign country. The remaining half of the income is allocated in proportion to the seller's gross sales within the United States to his gross sales within the United States and the foreign country. While this formula is only applied to determine the foreign income of a company which manufactures in the United States and sells abroad directly rather than through a selling subsidiary, theoretically it would be possible to apply the formula to a manufacturer selling abroad through a subsidiary.

A formula approach is, however, likely to raise more problems than it solves. Foreign countries do not base the tax they impose on a formula determination of the amount of the profits of a unified business allocable to them. Foreign taxes are imposed on profits earned in the foreign country. Thus, for example, in the case of a foreign subsidiary these profits are generally calculated by deducting from the gross receipts in the country the expenses including the cost of purchase of the goods from the United States company. Obviously, the amount of a company's income which would be allocated on a price system to manufacture and to sale would vary from the amount allocated on the basis of property. As this example illustrates, adoption of a formula approach would require use of two concepts of foreign income: one on a price basis for purpose of the foreign credit and the other on the formula basis for determination of the income qualifying for a reduced rate of tax. If a formula approach were used for the purpose of calculating the foreign-tax credit, such inequities as a company paying more foreign tax than the amount of its foreign income under the formula could result.

Even if the formula were only used to determine the income eligible for the lower United States tax rate, the results would be unsatisfactory. Export would not necessarily be excluded. The amount of income which would be allocated to a foreign country might bear no relation to the income earned in the country. Further, the accounting problems raised by this approach would be formidable.

General adoption of a formula method by tax treaties to determine the income for foreign-tax purposes would be no more satisfactory. At present most of the States in the United States use formula methods to determine the amount of a company's income which should be subject to State income tax. For most companies differences in interpretations of formulas have led to the imposition of State taxes on sometimes as much as twice their actual income. Since State taxes are generally minimal and are deductible in determining income subject to the much heavier Federal income tax, this problem has never assumed the proportions it would in the international field.

A SPECIFIC ALTERNATIVE: SECTION 923 OF THE PROPOSED INTERNAL REVENUE CODE OF 1954

A specific attempt is made to distinguish between export and investment income for the purpose of granting a 14-point tax-rate differential to the latter in section 923 of H. R. 8300, the proposed Internal Revenue Code of 1954. Since throughout the above discussion we have indicated that we believe attempts to distinguished between export and investment income are not practical, let us analyze the pertinent sections of H. R. 8300.

Description of provisions

Section 923 of the bill introduces a new concept of business income from foreign sources which is to be taxed at a rate of 38 percent. Dividends, interest, or branch profits can qualify. Section 923 (a) (3) (A) provides that dividends of a foreign corporation will be taxed at 38 percent if the foreign corporation's gross income—

(i) has been derived to the extent of at least 95 percent from sources without the United States;

(ii) has been derived to the extent of at least 90 percent from the active conduct of a trade or business through a factory, mine, oil or was well, public-utility facility, retail establishment, or other like place of business situated within a foreign country.

In section 923 (b) (1) it is specified that the term "trade or business" does not include—

(A) the operation of an establishment engaged principally in the purchase or sale (other than at retail) of goods or merchandise; or

(B) the maintenance of an office or employment of an agent, other than a retail establishment excepted from subparagraph (A), to import or facilitate the importation of goods or merchandise.

Interest will qualify if the payor meets the above requirements, and profits of a branch which satisfies these conditions will also qualify.

Interpretation of provisions

The Ways and Means Committee of the House of Representatives has commented in detail on these provisions in its report. According to the report, the test provided by the law is that 90 percent of the gross income must be from the active conduct of a trade or business. To determine whether a particular foreign activity is the active conduct of a trade or business, "the entirely activity * * * should be examined." If a foreign establishment is maintained principally for importation of goods, income from that establishment does not obtain the special rate. Income from a foreign establishment which principally buys and sells at wholesale similarly does not qualify. On the other hand, a foreign company which manufactures a product from local materials and sells the product would qualify. A company operating a retail store selling locally produced or imported items also would meet the test.

Between the extremes, the test is based on the *principal* business activity of the foreign company. The report states "If the trade or business activities consist *principally in the production or manufacturing and sale of goods or merchandise*, and *incidentally in the purchase and sale of goods or merchandise*,[4] such trade or business would not be excluded." Further, since the exclusion refers to purchase or sale of goods, the report specifies that "if goods are purchased and are then *processed, manipulated, or changed in form*[4] before sold, this exclusion does not apply."

With this interpretation of the proposal, the words "factory, mine, oil or gas well, public utility facility, retail establishment, or other like place of business" do not modify the phrase "90 percent from the active conduct of a trade or business." Rather they describe the type of activities which, if performed by a foreign establishment, may entitle the income of the foreign establishment to a reduced rate of tax. In accordance with this analysis, the report states that "other like place of business" is to be interpreted broadly to include operation of a bank or of an air transportation business.

Analysis of provisions

As the above discussion indicates, these provisions represent an attempt to distinguish between export and investment income by another variation of a foreign permanent establishment. Basically the test for qualification is that the foreign activity not consist principally of importing or selling at other than retail. Consequently, export is to be excluded by excluding activities in foreign countries that are principally of a marketing nature. Thus, the income from foreign subsidiaries or branches of United States companies selling in a foreign country goods imported either from the United States or any other country would not qualify for the 38 percent rate.

Analysis of the application of the tests to specific situations indicates that it will not necessarily exclude export income and that many inequities will be created.

Qualification of export.—Export income would be able to qualify for the 38 percent rate in a number of ways. According to the report, profits from sales within a foreign country of merchandise exported to that country will qualify if those sales do not constitute the principal activity of the foreign establishment. The following are a few examples of the manner in which export income can qualify.

Retail establishments.—Income from a retail establishment is specifically enumerated as qualifying. No definition of the term "retail establishment" is given in section 923 or in the committee report. Retailing normally means selling to the ultimate consumer, and a retail establishment is a place of business for sale to ultimate consumers. According to the Bureau of the Census, the term "retail establishment" has a broad meaning. It includes not only department stores but also gasoline stations, lumberyards, office-equipment establishments, and other types of selling concerns.

In view of the broad meaning of the term "retail establishment," it may be possible for many companies to qualify their selling activities in foreign countries

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[4] Italics added.

for the 38-percent rate by leasing space in a retail store or by consignment sale.

The bill clearly permits a retail establishment to import all of the merchandise which it sells. Further, as long as the operation of a retail establishment is the principal activity, a company could also sell imported mechandise at wholesale. This combination of importing for sale at both the wholesale and retail levels is commonly found in foreign countries. Thus, through the use of a retail establishment, considerable export income could be made to qualify.

Incidental imports.—Companies manufacturing or processing goods in a foreign country typically fill out the product line through the addition of goods imported from the United States or other countries. As long as the import and sale of such goods represents only an incidental portion of the foreign activity, the profits from the sale of these goods would qualify for the 38-percent rate. There is no indication of the amount of selling activity which would make it more than incidental.

Branches of foreign subsidiaries.—If a foreign subsidiary manufactures goods in one country which it sells through branches in another country, the profits from the sales will apparently be taxed at the 38-percent rate. While the intention of the bill may be to require manufacturing in the country in which sales are made, the language of the section does not. Further, if branches of a foreign manufacturing subsidiary sell goods produced in the United States, the income from these export sales would also qualify so long as these sales did not represent the principal activity of the foreign manufacturing subsidiary. As a result it would appear that profits from selling exported merchandise in a foreign country are only excluded if earned directly rather than indirectly by a United States company.

Active conduct of a trade or business.—According to the committee report, "If goods are purchased and are then processed, manipulated, or changed in form before sold, this exclusion [of business principally engaged in purchase and sale of goods] does not apply." Apparently companies will be able to qualify their export income for the 38-percent rate by performing some processing or manipulation of goods within a foreign country before sale. For example, chemicals can be rebottled abroad or radios put into cabinets without a substantial investment in a foreign facility. Ultimately the extent to which export profits will qualify in this manner will depend upon the administration of the provisions.

Inequities in tax treatment.—As a consequence of adoption of a test that the principal activity of a company be other than the purchase and sale of merchandise, many inequities in tax treatment will result. Companies with nominal foreign investments may receive the 38-percent rate, while other companies with substantial foreign investments will fail to qualify. Companies selling the same exported products may be subject to different rates of tax. Companies engaged in similar activities in foreign countries will be taxed differently, depending upon their manner of organization. Finally, the problems in administration of the provisions may create further inequities.

Size of investment.—A retail establishment is singled out from other forms of marketing for the 38 percent rate; yet wholesalers frequently have larger investments in a foreign country than retailers. Presumably the theory upon which a retail establishment is included is that the export of mass-distribution techniques will have a favorable effect on foreign economic development. Sears, Roebuck & Co.'s operation in Latin America is representative of the type of activity to be encouraged; yet other retail establishments may operate in an entirely different manner. For example, a Fifth Avenue specialty shop might open a store in Paris. The Paris store would qualify for the 38 percent rate, whereas a large wholesaler of petroleum products, with an investment in storage facilities and rolling stock many times the investment of the store, would not receive the special rate.

Similarly companies with minor investment in processing facilities in a foreign country could qualify, whereas other companies with considerable investment in a subsidiary or branch engaged principally in import and sale of merchandise would fail to qualify.

Incidental imports.—Companies selling similar products in a foreign country may pay different rates of United States tax as a result of the ability of a company to qualify the income from the imported portion of its line. For example, in a foreign country the same company may sell imported refrigerators and assemble and sell automobiles. The refrigerator sales may represent only an incidental part of the business so that dividends of the company would

be taxed at 38 percent. A United States company, the only business of which is refrigerators, may also sell refrigerators through a local company in that country in exactly the same way as the other company; yet, under section 923, it would pay a tax of 52 percent on dividends from the selling company.

Form of organization.—There are a number of ways in which differing tax rates can result from the form of organization of a foreign business. The United States tax rate on exactly the same economic activities in the same country can vary substantially. For example, in the case of a business engaged in a single country in the production and wholesaling of goods, four different methods of organization through subsidiaries are possible. The United States tax rate would vary with the method used.

(1) If a single subsidiary both manufactures and sells, the dividend income from the entire activity is probably to be taxed at 38 percent by the United States.

(2) If one subsidiary of the United States parent manufactures and another sells, the dividend income from the manufacturing subsidiary is to be taxed at 38 percent and from the selling subsidiary at 52 percent.

(3) If the manufacturing subsidiary owns the stock of the selling subsidiary dividend income derived from the earnings of the manufacturing subsidiary will be taxed at 38 percent unless more than 10 percent of the manufacturing's subsidiaries gross income is derived from dividends of the selling subsidiary. Should dividends of the selling subsidiary constitute more than 10 percent of the gross income, the entire dividend of the manufacturing company would be taxed at 52 percent.

(4) If the selling subsidiary owns the stock of the manufacturing subsidiary, dividend income from the selling subsidiary will be taxed at 52 percent unless 90 percent of the selling company's gross income is derived from dividends of the manufacturing subsidiary.

Thus, given the same economic activity in a foreign country, the rate of United States tax can be 38 percent on income from both manufacturing and selling, 38 percent on the income from manufacturing and 52 percent on the balance, or 52 percent on the income from both manufacturing and selling.

A company might reorganize its activities so as to qualify both manufacturing and selling profits for the 38 percent rate. However, rearranging the corporate structure may be impossible under foreign law or costly under the United States or foreign tax law. Alternatively, it might be possible through pricing arrangements to shift all profits to the manufacturing company if section 45 were not applied. Even if the Service were willing to permit this shifting, foreign tax law might not. As a consequence, United States companies operating in the same countries producing the same goods may pay different rates of United States tax on their profits.

Form of organization can also determine the tax rate on export sales. As indicated in the discussion of export income which might qualify, the 38 percent rate could apply to income from sales of United States or other exported merchandise by the branch of a foreign manufacturing subsidiary. On the other hand, if sales in a foreign country of merchandise produced in the United States or in another foreign country are through a subsidiary of the United States parent, the income of the subsidiary is to be taxed at 52 percent.

Administrative problems.—If qualification will depend upon processing or manipulation of imported goods prior to their sale, serious inequities are likely to result from the immense administrative burden that will be imposed. There are today in the neighborhood of 10,000 foreign establishments of United States firms. The Internal Revenue Service to administer these provisions will require arbitrary standards to eliminate certain activities. However, since the variations in patterns of doing business are almost infinite, individual rulings on a substantial number of these establishments will be necessary to determine whether they qualify for the 38 percent rate. The unavoidable reliance on administrative discretion is likely to prove unsatisfactory both to business and to the Service. The Service will have a particularly difficult task because of the heavy demand for rulings and its inability to check the facts upon which rulings will be based unless revenue agents are stationed abroad. The administrative burden cannot be avoided, since without supervision, businesses which are principally engaged in export will obtain the reduced rate.

Strict interpretation of provisions

While the interpretation placed on the provisions by the committee report is broad, the language of section 923 would permit a much narrower construction

of the business activities to which the 38-percent rate would apply. The words used in the bill are "factory, mine, oil or gas well, public utility facility, retail establishment." All are words with a restrictive meaning. They refer to a piece of physical property of a business, not the type of activity generally conducted by a business.[5] Under such an interpretation, the 38-percent rate would apply solely to the income obtained from the operation of such physical properties in a foreign country. Further, 90 percent of a company's gross income would have to be so derived for its dividends to be taxed at the reduced rate.

This interpretation would exclude most export except export through a retail establishment in a foreign country, but at the same time income from many forms of foreign investment would also be excluded. Most companies, in order to qualify any of their income in a foreign country, would have to split the producing and selling functions of the business into separate corporations. Many of the inequities previously discussed would be eliminated, but new ones would be introduced; a definition of "factory" would be required, splitting the business could involve problems of both United States and foreign tax law, and difficult accounting and administrative problems for both business and Government would be posed. Many of these problems were previously discussed in connection with distinguishing between export and investment income by requiring manufacture at a foreign permanent establishment.

Conclusion

We conclude from the foregoing analysis that neither a broad or a narrow interpretation of section 923 provides a satisfactory basis for granting rate benefits. Under the committee interpretation much export is not excluded, and some foreign investment income is excluded. In view of the many ways in which export income can qualify for the 38-percent rate, the revenue loss is likely to be considerably in excess of the $147 million estimated by the committee. A narrower interpretation would result in exclusion of much export income, but at the same time considerable investment income. Both interpretations would result in many inequities and would present major administrative problems for the United States Government. In our opinion the problems encountered in applying these provisions of H. R. 8300 would be raised by any plan to differentiate between various types of foreign business income.

SUMMARY

At the beginning of this discussion of the major problem encountered in any plan to reduce the rate of tax on foreign income; namely, the distinction between export and investment income, we indicated that the problem was only important if the revenue involved were substantial. We estimated that the revenue presently obtained by the Government from taxation of foreign income amounted to between $900 and $1,000 million, with $200 million from taxes on income from direct investment and the balance from taxes on export profits. Thus, unless some method could be evolved for distinguishing between export and investment income, any substantial lowering of the rate of United States tax on foreign income could cost considerable tax revenue.

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[5] The term "factory" pertains to manufacturing, manipulation, or processing of goods, but does not include the marketing of the goods. If the term "manufacturing business" were used instead of "factory," it would be clear that the marketing activities were included. A "manufacturing business" is the term used to describe the chief characteristic of the operations. For example, General Motors is considered to be a manufacturer, and the company's activity would be classified as manufacturing. Yet, the company does more than just manufacturing; it finances, sells, and performs research. If the term "factory" were to be used in connection with General Motors, it would refer to the business performed in one of the many General Motors factories—either the manufacturing or assembling of autos, refrigerators, or other products; but "factory" would not include the merchandising, advertising, and selling operations.

Support for the narrow concept of income from operation of a factory can be found in the regulations. Regulation 118, section 39, 119 (e)-1 uses the concept of a factory price to allocate between domestic and foreign income in the case of production of goods within the United States and sale of the goods outside the United States. The word "factory" is used in a restrictive sense to describe part of a business, rather than the whole business. Thus, "the net income attributable to sources within the United States shall be computed by an accounting which treats the products sold by the factory or productive department of the business to the distributing or selling department at the independent factory price so established."

Similarly, support for a restrictive definition of "mine, oil or gas well" can be found in the Internal Revenue Code and Regulations. Depletion is allowed only on income from the physical property of a mine, oil or gas well. In this context, the segregation of income from such property from the balance of a company's income is regular practice.

We have discussed a number of possibilities for reducing the revenue loss. Thus, we considered the use of intercompany pricing provisions with the present definition of foreign income, exclusion of export income by various definitions of foreign income that would qualify for rate benefits, a formula approach to the problem, and the proposal in H. R. 8300.. None provided a method for reducing the revenue loss that seemed satisfactory.

We have concluded, therefore, that even assuming a rate reduction on foreign income would provide an effective stimulus to investment, the cost of such a proposal would be too great as a result of inability to exclude export income from the benefits. Further, our discussions with businessmen suggested that a rate benefit would not be an effective stimulus to foreign investment.

Our proposal for a foreign business corporation depends on a deferral of United States taxes for an incentive. Since the rate suggested for the foreign business corporation is only slightly below the domestic corporate rate, it is not necessary to distinguish between export and investment income, and a major problem is thereby avoided. While the inclusion of export will result in some loss of revenue to the Government, the loss will not be substantial.

Thus far we have discussed only the general outlines of the foreign business corporation proposal. In the next section this proposal and related tax changes in the treatment of foreign income are analyzed in detail.

III. Analysis of Recommendations

Our recommendations fall into two categories: First, the foreign business corporation, and, second, the foreign tax credit.

FOREIGN BUSINESS CORPORATIONS

We recommend that the Internal Revenue Code be amended to provide for a special class of domestic corporations to be known as foreign business corporations. The purpose of the recommendation is (1) to enable companies to utilize the earnings from their foreign operations to expand their activities in foreign countries without payment of United States income tax, and (2) to permit companies to obtain a unitary United States tax treatment of their foreign income to match the management concept which regards foreign operations as quite distinct from domestic operations.

These corporations would be permitted to carry on all types of foreign activities, including operating abroad directly, holding the stock of operating foreign subsidiaries and exporting. These corporations would pay United States taxes on their earnings only when earnings were distributed. No intercorporate dividends tax would be imposed on corporate shareholders receiving a distribution from a foreign business corporation. A corporation which wished to organize its foreign activities under a foreign business corporation would be permitted to transfer its existing foreign holdings in a tax-free reorganization to a foreign business corporation. Since Western Hemisphere trade corporations and corporations which qualify for the benefits of section 251 of the code would fall within the definition of a foreign business corporation, those sections of the code would no longer be necessary.

Functions of the foreign business corporation

A foreign business corporation would be permitted to operate directly in foreign countries or through subsidiary foreign corporations; it could engage in export operations; it could own foreign patents, copyrights, and trade-marks, and receive royalty income for their licensing; it could provide or purchase technical and management service for foreign companies and receive compensation for such services; it could loan money to foreign concerns and receive interest on these loans; it could accumulate funds either in the United States or elsewhere, but certain restrictions would be placed on the manner in which these funds could be used in the United States. The corporation would be permitted to purchase and store goods in the United States for resale in foreign countries, for the use of associated companies in foreign countries or for its own use in foreign countries.

The corporation would not be permitted to conduct business operations in the United States apart from those necessary for its overseas activities. Thus, it would not be permitted to manufacture in the United States, but it could buy and warehouse the merchandise manufactured by the parent, an affiliated company or any other company for sale in foreign markets.

The foreign business corporation would not be permitted to own any United States assets except those incident to its foreign activities, the securities or obligations of other foreign business corporations, deposits in banks, or United States Government bonds.

Any advance directly or indirectly to its stockholders, or to an affiliated or subsidiary corporation for use in the United States, would be considered a distribution of earnings.

All of a foreign business corporation's gross income, other than interest on its accumulated funds or gains from the sale of United States Government bonds, would have to be foreign. The source of income on sale of personal property would be determined by the place where title passed, except that on exports from the United States a destination rule would be used to determine source.

Adoption of a foreign business corporation proposal would permit a company to form a domestic subsidiary in which all foreign operations would be integrated. All of the income received from foreign operations of a company could channel through this foreign business corporation. If the company wished to distribute the income to the parent, it would pay United States taxes. If it wished to accumulate the earnings from foreign operations for further expansion in foreign countries, the earnings would not be immediately subject to United States tax. Since companies typically consider all their foreign activities as integrated business operations quite distinct from activities in the United States, the establishment of a foreign business corporation would permit them to utilize a single mangement and corporate organization for supervision of foreign activities.

Evidence favors creation of foreign business corporations

There are sound business reasons which suggest that this proposal would be attractive to companies interested in expanding their operations in foreign countries. A number of United States companies have organized foreign holding companies for all or part of their foreign operations. The laws of such countries as Panama, Canada, Bermuda, and Uruguay permit the formation of companies similar in concept to the foreign business corporation. Such companies are subject to very low tax because their income is earned outside the country in which they are organized. These holding companies can utilize earnings from one country for expansion in another without United States tax. Our proposal is, therefore, to permit this utilization of earnings directly by use of a domestic corporation.

The ability to use a foreign holding company today is, in practice, severely limited. Unless a company already utilizes a foreign holding company, use of such a company is restricted to new foreign investors. The tax consequences of the liquidation or transfer of existing foreign subsidiaries prevents companies from consolidating their foreign holdings into a foreign holding company. The transfer of ownership in a foreign company would usually be taxable under present United States law, even though a company transferred its ownership in a foreign subsidiary to another foreign subsidiary. As a result, the foreign organization of many companies has become frozen in unwieldy structures made up of various corporations and branches organized at different times in the past. In many instances, these companies were established in a particular form for a reason that no longer exists. Yet, the cost of changing the form of organization has kept the structure awkward. A change in the law providing for the establishment of a foreign business corporation and the transfer of existing operations to such a company free of United States tax would permit many companies to clean up the structure of their foreign organizations, and thereby obtain the same advantages that newer investors can realize through foreign holding companies.

Even to new investors, there are drawbacks to the use of a foreign holding company. Since at least two governments are involved in any foreign investment, the United States and the country in which operations take place, many companies have been reluctant to utilize a foreign holding company which brings a third government into the picture. They feel that enough complications are involved in keeping track of the laws and regulations of the countries in which they operate without adding further problems. They, therefore, decide against the use of foreign holding companies. These companies might welcome the opportunity to form a foreign business corporation.

With a foreign business corporation, companies could use either branches or foreign subsidiaries according to dictates of business reasons rather than tax advantage. In the extractive industries companies prefer to operate as branches of a United States company because only through a domestic organization can they obtain the benefit of United States depletion allowances. Under this pro-

posal, companies could utilize branches of a foreign business corporation to obtain the benefits of depletion and, in addition, the privilege of deferring tax until their earnings were distributed.

Finally, passage of a law permitting the use of foreign business corporations would permit the Government to adopt a firmer policy toward companies' misuse of foreign holding companies. Some of these companies loan money to the parent in such a way that the parent obtains the use of accumulated earnings of the foreign subsidiaries without payment of United States tax. Since companies would be permitted to perform all necessary functions through foreign business corporations, the misuse of foreign holding compantes could be discouraged. It would also be advantageous to the Internal Revenue Service to have holding companies for foreign operations subject to United States laws and regulations.

The rate of tax on a foreign business corporation

A number of factors must be taken into consideration in fixing the rate of tax for the income of a foreign business corporation. Among these are (1) the present rate of tax on foreign income, (2) the effect of raising or lowering the rate, and (3) the cost of lowering the rate.

Relation to present rates.—Today there are in effect a number of different rates of combined United States and foreign income tax at which foreign earnings of United States investors are taxed.

In the case of a branch of an ordinary United States corporation, foreign profits bear the same rate of tax as domestic earnings. The amount of foreign income tax paid on earnings of a branch which can be credited against the United States tax is limited to the amount of the United States tax on the branch profits. If the foreign rate is less than 52 percent, the combined rate of foreign and United States tax is still 52 percent of the branch's profit.

A second rate of tax exists for domestic corporations which can qualify as Western Hemisphere trade corporations. Such corporations pay a United States income tax of 38 percent, 14 percentage points less than is paid on ordinary domestic income. In addition, on the distribution of the income of a Western Hemisphere trade corporation to its parent, an intercorporate dividends tax of 7.8 percent of the dividend is imposed. The net result is that on profits from a foreign activity carried on through the medium of a corporation which qualifies as a Western Hemisphere trade corporation, a corporate investor pays a combined United States and foreign tax of 42.8 percent[6] so long as the average rate of foreign tax is less than the 38 percent Western Hemisphere trade corporation rate.

Finally, there is a rate of between 52 percent and 45.2 percent on the distributed earnings of a foreign subsidiary, which rate varies as the foreign rate of tax varies between 0 and 52 percent. This variable rate occurs because of the manner of calculating the foreign tax credit allowed a domestic corporation for foreign income taxes paid by a foreign subsidiary. (This is discussed in detail in appendix B.)

This situation of differing rates of tax depending on the interaction of the foreign rate and the form of organization of the foreign investment is familiar to tax planners. Based on these differences, the foreign operation of some United States corporations have been organized to take advantage of the lower rates. Any change in the method of taxing foreign income presumably would have to take into account the basic fact that United States companies have relied on the continuation of this system.

Effect of higher rate.—Perhaps of greater concern in any decision on an increase in the rate of tax on foreign income is that in the minds of most United States businessmen the only real tax incentive the United States Government has offered foreign investment is the Western Hemisphere Trade Corporation Act. Elimination of the rate incentive of the Western Hemisphere Trade Corporation Act provisions would have little effect on the actual return of most foreign enterprises, but the psychological effect would, we believe, be serious. If in a change which purported to provide tax encouragement to foreign investment some rate advantage were not retained, it would meet with considerable opposition.

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[6] The total tax equals the Western Hemisphere trade corporation rate (38 percent) plus the intercorporate dividend tax (7.8 percent) times the amount available for distribution after the WHTC tax (62 percent of the earnings).

From our interviewing it was clear that many businessmen, even those directly concerned with their firms' foreign operations, did not understand the details of the manner in which foreign income is now taxed. They did, on the other hand, believe that an advantage was extended to them by the lower rate in the Western Hemisphere trade corporation provisions. While there was no indication that any single investment decision was either made or rejected because of the tax factor, it was evident that in the minds of businessmen there was something encouraging to them in the existence of this lower rate.

In view of the psychological considerations, we believe that the rate of tax on the earnings of foreign business corporations should not be raised above the current rates on the distributed earnings of Western Hemisphere trade corporations and foreign subsidiaries.

Effect of lowering the rate.—Proposals have at various times been made to eliminate or reduce substantially the rate of tax on foreign income. For example, in H. R. 8300, a rate of 38 percent is suggested for certain types of foreign income. Since no distinction between export and investment income is made for a foreign business corporation, any tax rate below the present domestic rate of 52 percent will involve a loss of revenue to the Government. On the basis of total estimated earnings of United States companies from export of $1,460 million before taxes, for each percentage point reduction in tax on the income of a foreign business corporation, the cost in United States tax revenue may be as high as $14.6 million.

A large rate differential also increases the problems of pricing between the parent and the foreign business corporation on merchandise exported from the United States.

In addition to the loss of revenue from export incurred with each point drop in the rate at which income of the foreign business corporation is taxed, a slight lowering of the rate could eliminate all the present revenue the Government obtains from branches and from the distributed earnings of foreign subsidiaries. At the present time there are few countries which tax foreign investors at a rate lower than 38 percent. Therefore, a rate as low as 38 percent would largely eliminate United States taxes for most companies with operations in foreign countries. The Treasury has estimated the loss with a 38-percent rate for only certain types of foreign income at $147 million.

Inasmuch as our field investigation has indicated that rate reductions are likely to prove ineffective as a stimulus to foreign investment, and in view of the cost considerations, there seems little justification for lowering the rate of tax on the income of a foreign business corporation below the present rates imposed on the distributed income of Western Hemisphere trade corporations and foreign subsidiaries.

Suggested rate of tax for foreign business corporations

We recommend that the distributed income of foreign business corporations be taxed at about the same rate now imposed on the distributed earnings of Western Hemisphere trade corporations and foreign subsidiaries. Further, it would seem advisable to peg this rate to the United States corporate tax rate so that with each change in that rate it would not be necessary to enact special provisions for the rate reduction accorded foreign business corporations. Since under the present United States rate structure, the actual rate of tax on distributed foreign income may be as low as 43 to 45 percent, it is recommended that the tax be set at 85 percent of the tax which would be due on the equivalent amount of domestic income. This proposal would result in a rate of tax today of 44.2 percent.

Reducing the rate below 44.2 percent would provide little or no additional stimulus to investment. The chief beneficiaries would be exporters. On the basis of $14.6 million cost of revenue per point of rate reduction on export income, the difference between a 44.2 percent and a 38 percent rate could amount to over $85 million. This loss of revenue to the Government would be without any compensating advantage.

The chief advantages of a foreign business corporation for conducting foreign operations will lie in the privilege of deferring taxes on foreign income to utilize the funds for further foreign investment, and in the opportunity created to integrate all foreign operations in one corporation. Many companies might find that the advantages of a foreign business corporation would justify payment of the domestic rate of corporate tax on its income. The 52 percent rate would eliminate many of the problems connected with export. Yet, because some foreign income now receives a rate benefit, it seems essential that this differential be maintained in taxing the income of foreign business corporations.

Cost of proposal for foreign business corporations

In our opinion the cost of this proposal would be reasonable. The rate at which earnings would be taxed when distributed is about the same as companies now pay on earnings of foreign subsidiaries and Western Hemisphere trade corporations.

Revenue loss on present foreign investment.—There would be a slight loss of revenue from the shifting of companies presently owning foreign subsidiaries to foreign business corporations which we estimate at about $25 million. Another $25 million to $50 million revenue loss would be incurred through the elimination of the per country limitation. Thus, the revenue collected from earnings of foreign branches and subsidiaries would in 1952 have amounted to between $125 million and $150 million under this proposal, instead of $200 million.

If foreign earnings were withheld for further foreign investment, a temporary revenue loss would result. The funds so witheld would be in direct proportion to the amount of foreign investment that took place. Thus, the proposal is directional in that it encourages companies to use earnings free of United States tax for foreign investment. The loss of revenue in any one year that would result from the failure of foreign business corporations to distribute earnings to the parent cannot be determined. For 1952 for example, it would have been limited to the total of the tax revenue which would have been received if this proposal had been in effect or $125 million to $150 million. Since all earnings undoubtedly would not have been withheld, the cost would have been something less than that figure.

Revenue loss on export.—A number of companies now engaged in purely export operations would form foreign business corporations to transact their exports. To the extent that companies received only the differential rate but did not exercise the deferral privilege the loss would be limited to 15 percent of the present tax receipts on export earnings. Since we have estimated this revenue at from $700 million to $800 million, 15 percent of the top estimate would amount to $120 million. The loss that could be directly attributable to the establishment of foreign business corporations would be about $60 million, because about one-half United States exports can already qualify for as low a rate by exporting through a Western Hemisphere trade corporation.

If companies did not distribute their earnings from export operations, the loss would be temporarily greater, but there would be little or no incentive to retain earnings in the foreign business corporation unless the company intended to use the earnings for foreign investment. Any loss to the Government suffered as a result of companies failing to distribute their earnings would be reflected in an increase of investment abroad. Thus, the provisions would tend actively to stimulate the use of foreign earnings and the taxes deferred on them for foreign investment. Proposals to lower or eliminate the tax on foreign income would have no such direct relationship.

Details of the foreign business corporation proposal

The proposal for establishment of a foreign business corporation raises several questions of policy and technique which require elaboration.

Requirements for qualification.—Generally, for a domestic corporation to qualify as a foreign business corporation would require:

(1) that it derive 95 percent of its gross income from foreign sources or from permissible assets in the United States, and

(2) that it own only property situated outside the United States except for certain permissible assets in the United States.

Permissible assets in the United States would be bank accounts, United States Government bonds, the securities and obligations of other foreign business corporations, and property incident to the conduct of its foreign business. Securities and obligations of foreign corporations should be defined as property situated outside the United States.

In drafting the provisions for a foreign business corporation it would be necessary to add minor safeguards to prevent the misuse of the company for investment or speculation in United States Government bonds.

Method of taxation.—United States taxes due on the income of a foreign business corporation would be computed in the same manner as the taxes for any domestic corporation, but the payment of the taxes due would be deferred until the earnings of the foreign business corporation were distributed. No tax would be paid by a corporate recipient of a distribution. An individual would treat the dividend of a foreign business corporation in the same way as the dividend of any other domestic corporation.

Distribution would be broadly defined to include loans to shareholders, or to an affiliated or subsidiary company for use in the United States, and to a liquidation of the foreign business corporation. The reason for this definition of a distribution is to limit the use of funds on which United States taxes have been deferred to investment in foreign activities and permissible assets in the United States. A liquidation is treated as a taxable event in order to prevent a company from accumulating earnings for several years and bringing those earnings tax free into the United States by a liquidation.

There should be no constitutional problem with taxing such distributions, because the privilege of deferring tax was granted only so long as earnings were used in a special manner. Since the use of funds in the United States by a foreign business corporation is restricted to permissible assets in the United States there will be little advantage for a firm to accumulate indefinitely foreign earnings.

Annual filing.—A foreign business corporation would be required to file United States income-tax returns annually. Thus, for each year calculation would be made of the amount of the corporation's income, the United States tax due on that income, and the amount of its foreign tax credits. The filing of the return would have the same effect for administrative purposes as the filing of the return and payment of tax for an ordinary corporation. Three years after filing the statute of limitations would bar the Government from asserting a deficiency except for adjustments arising from changes in foreign credits. For each year the taxpayer would then know the amount of its accumulated earnings and the United States tax due on those earnings. A last-in-first-out rule would be used to determine the years from the earnings of which the distribution was derived. Whenever a distribution was made from a portion of the earnings of a particular year, the same portion of the United States tax due for that year would be paid. The income of each year would, therefore, bear the same rate of tax it would have borne if the tax had not been deferred. This system would simplify the administration of a foreign business corporation for United States companies. Instead of requiring the perpetual accumulation of records to prove the amount of an earlier years' foreign tax credits, the United States income-tax return would be proof of the amount of the foreign business corporation's United States tax liability.

Alternative approach.—An alternative approach to taxing the foreign business corporation which would accomplish a deferral of United States tax would be to treat the foreign business corporation in the same manner as corporations operating in a possession of the United States qualifying under code section 251. The corporation would then be exempt from United States tax, but its dividends would be taxed in the same manner as dividends of a foreign corporation.

If the recipient were taxed instead of the foreign business corporation, it would also be necessary to treat a loan to the parent or a liquidation as a taxable distribution to the recipient in order to prevent companies from using untaxed foreign earnings in the United States. Preventing the misuse of accumulated earnings of a foreign business corporation will be a problem under either method of taxation, but we believe that the problem can be more effectively dealt with by taxing the foreign business corporation.

The major disadvantage of taxing the recipient rather than the foreign business corporation is that it would encourage companies to postpone distribution by the foreign business corporation in anticipation of a reduction in the rate of United States tax. For example, if a company had accumulated earnings in a foreign business corporation and expected the United States tax rate to go down in a subsequent year, the company might wait for the lower rate before distributing the earnings of the foreign business corporation. Under such circumstances, the United States Government would lose tax revenue. On the other hand, if the foreign business corporation is taxed rather than the recipient and the amount of tax is determined annually, a company would gain no advantage by postponing distribution in anticipation of lower United States taxes.

Undoubtedly there are disadvantages also in the recommended method of taxing the income of the foreign business corporation. On balance, however, this method would seem superior in solving the problems raised by a tax deferral proposal.

Calculation of tax.—The application of this proposal can be illustrated by the following example: Assume the X foreign business corporation in 1954 had received $100,000 of income from country A on which there was a foreign tax credit of $10,000, $20,000 of dividends from country B on which there was a tax credit of $5,000, and $30,000 of dividends from country C on which there was a

tax credit of $10,000. In 1955 its receipts and foreign tax credits were the same. Assume further that the United States tax rate was 52 percent in 1954 and 40 percent in 1955. At the end of 1955, $200,000 was distributed. In 1954, the tax return of X would show:

Income		$150,000
Ordinary United States tax		78,000
85 percent of United States tax		66,300
Tax credits:		
Country A	$10,000	
Country B	5,000	
Country C	10,000	
		25,000
United States tax liability		41,300

Accumulated profits for 1954 would, therefore, be $108,700, and the deferred United States tax liability would be $41,300.

In 1955, the return of X would show:

Income		$150,000
Ordinary United States tax		60,000
85 percent of United States tax		51,000
Tax credits:		
Country A	$10,000	
Country B	5,000	
Country C	10,000	
		25,000
United States tax liability		26,000

Thus, the accumulated profits would be $124,000 and the referred United States tax liability $26,000.

The tax due on a $200,000 distribution would be calculated in the following manner: The 1955 accumulated profits of $124,000 would be deemed distributed and $26,000 of deferred tax liability would be due the United States. The remaining $76,000 would be from the accumulated profits of 1954. This would represent a distribution of 70 percent of the profits of 1954 and, therefore, 70 percent of that year's deferred United States tax of $41,300, or $28,910, would become due. Thus, on a $200,000 distribution $54,910 would be paid in taxes.

Safeguards.—A problem arises concerning the tax treatment of a company which after several years of foreign business corporation status with accumulated deferred-tax liability, fails to qualify for the current year. A company might fail to qualify as a result of a deliberate decision to use its accumulated profits in the United States for investment in nonpermissible Unifed States assets. On the other hand, a company might fail to qualify unintentionally. For example, in a particular year the foreign business corporation might inadvertently sell in the United States merchandise purchased for export. The income from United States sources might exceed the allowable percentage. If the entire deferred-tax liability were to become due, the penalty would be too severe. On the other hand, some method of barring the use in the United States of funds on which tax is deferred is necessary to prevent misuse of the foreign business corporation device.

We, therefore, recommend that in a year in which a company fails to qualify, it lose the special-tax rate and the privilege of deferring United States tax for that year. In addition the deferred tax on accumulated profits would become payable to the extent these funds are invested in nonpermissible United States assets. In this way, if a company accumulated a surplus of $200,000 from 5 years of qualification as a foreign business corporation, its tax treatment in the sixth year in which it failed to qualify would be the same as any other United States corporation with foreign income. However, if any of its $200,000 surplus were invested in United States property, the deferred tax on the amount so invested would become payable.

Transfer to a foreign business corporation.—Companies with existing foreign investments will be able to benefit from legislation establishing foreign business corporations only if they are permitted to change their form of organization into a foreign business corporation without United States taxes on the liquidation or

transfer of their existing holdings. Since a large percentage of the companies which could take advantage of this new type of organization already operate in many foreign countries, they should be permitted to transfer their existing foreign activities to a foreign business corporation without tax liability. Thus, companies owning foreign subsidiaries directly may wish to transfer ownership in them to the foreign business corporation. Companies with branches abroad may wish to operate these as branches of the foreign business corporation. Companies receiving income as royalties or technical fees may wish to reorganize in such a way that these fees will be earned by the foreign business corporation. Companies owning one foreign subsidiary through another foreign subsidiary may wish to transfer ownership from the latter foreign subsidiary to the foreign business corporation. All these transfers and reorganizations should be permitted without United States tax liability.

If these tax-free transfers are not permitted, companies which have been foreign investors will be discriminated against in favor of the companies which just start foreign operations. Undoubtedly the major portion of future foreign investment will have to be made by companies which now have some foreign operations. Any organizational device which was unavailable to present investors would, therefore, lose much of its effectiveness.

In order to permit tax-free transfers to a foreign business corporation it will be necessary to amend section 112 (1) of the Internal Revenue Code to specify that this section will not apply to the transfer of stock in a foreign corporation by a domestic corporation to a foreign business corporation, or to a transfer of property of a foreign business corporation to a foreign subsidiary, or to liquidation of a foreign holding company into a foreign business corporation.

Income test.—In addition to the limitation of United States property of a foreign business corporation to permissible assets, a corporation to qualify should be required to derive 95 percent of its gross income from foreign sources or from permissible assets in the United States. The purpose of this requirement is to prevent misuse of a foreign business corporation.

In applying this test, only items of income enumerated in the Internal Revenue Code as derived from sources within the United States would be considered as domestic income. Thus, insurance proceeds on goods lost in transit and interest on United States tax refunds would be considered foreign income. Profits from the sale of stock in a foreign subsidiary should be considered foreign wherever title passed.

Since United States Government bonds are a permissible asset, it would be necessary to exclude a company which was in the business of trading in Government bonds from qualifying as a foreign business corporation.

Definition of foreign income.—One of the major areas of uncertainty in the taxation of foreign income is the determination of the source of income from sales of personal property. We recommend that the income of a foreign business corporation from exports be characterized as foreign if the destination of the goods sold is a foreign country. Since the foreign business corporation is permitted to export, there is no reason to require title to be passed abroad in cases in which normal business practice would result in title passage in the United States. Except for exports of a foreign business corporation, we recommend that the title passage rule be made a part of the Internal Revenue Code to determine the source of income.

Consolidated returns and treatment of branches as corporations.—The Randall Commission has recommended that permission be granted to foreign subsidiaries to elect to be taxed as branches and to foreign branches to be taxed as subsidiaries. The objective of permitting a foreign subsidiary to be taxed as a branch is presumably to take care of the problem of extractive industries. While companies in the extractive field within the United States are permitted liberal depletion allowances, these allowances cannot be deducted from dividends received from a foreign corporation carrying on the extractive activity. Instead of this approach to the problem, taxation of a subsidiary as a branch, we recommend that a company be permitted to file a consolidated return with a foreign subsidiary if the law of the foreign country in which the company operates requires the activity to be conducted by a local corporation. Thus, depletion allowance would be available to extractive companies utilizing a foreign subsidiary. Consideration should be given to the possibility of reducing the stock ownership requirements for consolidation with such foreign subsidiaries.

The second aspect of the Randall Commission's proposal is to permit branches to elect to be taxed as corporations. The justification for this is that the privilege of deferring United States tax should be extended to branch operations. If the foreign business corporation proposal is adopted, this effect will be achieved for

most companies. However, nationally chartered banks are not permitted by United States law to operate abroad through subsidiaries. We recommend, therefore, if operation abroad as a branch is required under the laws of the United States, that permission be granted to such companies * * *, subject to arrangements worked out with the Commissioner of Internal Revenue, to treat their branches as foreign subsidiaries for tax purposes or to treat their foreign division as a foreign business corporation.

Integration with other Internal Revenue Code provisions

While a foreign business corporation is chiefly intended for the use of publicly held large corporations, it could also be used by individuals and closely held corporations. Accordingly, it is necessary to prevent the use of a foreign business corporation for tax avoidance.

In part, protection would be offered by not providing for deferral of the penalty tax imposed by section 102 for improper accumulation of surplus. A closely held company would, thus, be able to accumulate its earnings only so long as there were business purposes for the accumulation.

In the case of a closely held corporation, a problem would also be presented by the personal holding company provisions. Under the foreign business corporation proposal a tax incentive is offered to establishment of holding companies for foreign operations. This policy directly clashes with the personal holding company penalty tax on corporations deriving 80 percent of their income from dividends, interest, and royalties. Exemption of foreign business corporations from this special tax would open up the possibility of avoiding limitations on personal holding companies through investment in foreign securities. At the same time closely held companies should not be foreclosed from using foreign business corporations as a medium for foreign investment. Therefore, we recommend that in computing personal holding company net income in the case of a foreign business corporation, a special deduction be allowed for amounts invested during the year or set aside in good faith for investment in an at least 10 percent owned foreign subsidiary which would not, if it were a domestic corporation, meet the gross income requirements of a personal holding company.

Because of the inclusion of liquidation of a foreign business corporation as a distribution, the problem of tax manipulation by conversion of ordinary income into capital gain is no greater than in the case of an ordinary domestic corporation. Sales of the stock of its foreign business corporation by a large corporation would rarely occur since this would mean the transfer of the company's name and market abroad. Small corporations and individuals would be more likely to sell their interest in a foreign business corporation, but there would be no particular tax advantage accruing from a sale.

In the case of a corporate owner of a foreign business corporation, the profit from the sale would be taxed as capital gain. The price a buyer would pay for the stock would take into account the deferred United States tax which would become payable if the purchaser wished to distribute the accumulated profits of the foreign business corporation. As a consequence, the actual tax difference to a corporate owner in selling the stock of the foreign business corporation compared to liquidating the company and then selling its assets would be slight. There would be no tax on the owner upon the liquidation but a capital gains tax would be imposed on the profits from selling the foreign business corporation's assets.

Individual owners would similarly have little to gain from selling the stock of a foreign business corporation instead of liquidating. The price which could be obtained for the stock would reflect the deferred United States tax liability. On a liquidation individual shareholders would have capital gain if the value of the property received exceeded their basis in the stock. A sale of the stock would also result in capital gain.

THE FOREIGN TAX CREDIT

Two major changes in the foreign tax credit are recommended:

(1) The removal of the "per country" limitation on the foreign tax credit; and

(2) The calculation of the subsidiary foreign tax credit should be changed to conform to the method now used in calculating the tax credit on earnings of a foreign branch.

Both of these changes stem from the foreign business corporation approach to the taxation of foreign income. This approach involves recognition in the tax law of the unitary nature of foreign activities. Since all foreign income of a

foreign business corporation would be treated as a unit, segregation of income on a country-by-country basis for the foreign tax credit would be inconsistent. Similarly, the form through which the foreign activity is conducted should not affect the rate of United States tax. Thus, the method of calculating the tax credit on dividends from a foreign subsidiary should be changed to the method now used in the case of a branch.

Removal of the per country limitation

There are now both a per country and an overall limitation on the foreign tax credit. The purpose of the two limitations is presumably to prevent the foreign tax credit from reducing United States income tax on purely United States income. The per country limitation treats income received from each foreign country as a separate unit. It, therefore, limits the amount of the foreign tax credit to the amount of United States tax on the income from each country. On the other hand, the overall limitation treats all foreign income and losses as a single unit. The total of tax credits from all of the foreign countries from which income was received cannot exceed the United States tax on net foreign income; that is, all foreign income less all foreign losses.

If foreign income is received from only one country, the limitations operate in the same way. If, however, income is received from more than one country, or income is received from one country and loss incurred in another, the limitations have different consequences.

If a company has income from 2 foreign countries and in 1 of these the income-tax rate exceeds the United States income-tax rate, the per country limitation will limit the amount of the taxpayer's foreign tax credit. The United States tax on the income from each country must be separately calculated under the per country limitation and the amount of the credit for tax paid any foreign country is limited to the United States tax on the income from that country. On the other hand, if only the overall limitation were imposed, the excess of foreign tax over the United States tax in the high-rate country would reduce the additional United States tax due on income from the low-rate country. Thus, the overall limitation permits the averaging of foreign tax rates. Yet, it does not permit foreign tax credit to reduce United States tax on United States income, because the total tax credit cannot exceed the United States tax on the whole of the foreign income.

If a company has income from one country and a loss in another in which it operates as a branch, but not as a foreign subsidiary, the overall limitation prevents the foreign loss from being deducted from domestic income, because foreign income is considered as a unit with foreign losses set off against foreign profits. If the per country limitation were the only limitation imposed, a foreign tax credit on the income from the profitable operation would be permitted up to the amount of United States tax on that income, and the foreign loss could be deducted from domestic income.

H. R. 8300 provides for the removal of the overall limitation and retention of the per country limitation on the foreign tax credit. In explanation of this action, the committee says, "As a practical matter, however, the overall limitation is unfortunate because it discourages a company operating profitably in one foreign country from going into another country where it may expect to operate at a loss for a few years. Consequently your committee has removed the overall limitation."

While this explanation seems plausible, our field investigations have convinced us that to the extent either of the limitations act to discourage investors, it is the per country limitation which has a negative effect. United States companies typically do not invest abroad unless they foresee an immediately profitable venture. Certainly they rarely expect a loss for more than the first year of operation. Further, foreign operations are frequently established in the form of foreign corporations. As a consequence, a loss in the first year is the foreign subsidiary's loss and could not be offset against domestic income even if the overall limitation were removed.

Most business groups have also argued against the retention of the per-country limitation. They contend that the overall limitation is simpler to apply and corresponds more accurately to the way in which foreign operations are viewed by by most companies. Moreover, they are more troubled by the fact that if a company actually receives income from some countries in which the foreign tax rate is higher than the United States rate, the per-country limitation results in the company's paying a higher aggregate tax burden than would be paid if a similar amount of income were earned in the United States.

Under the present law some companies are able to avoid the effects of the per-country limitation. If a corporation has a foreign holding company, the

Internal Revenue Service has ruled that all the income of the foreign holding company is deemed to be from sources within the country in which it is incorporated and that all foreign taxes are deemed to have been paid to the country of incorporation of the holding company. As a result, taxes paid in various countries can be averaged and, thus, the effect of the per-country limitation can be avoided.

It should be pointed out that if the foreign business corporation form were utilized, the loss effects of the overall limitations could still be avoided when it was a serious problem. A company with several profitable foreign ventures held through a foreign business corporation could operate a new venture directly as a branch of the company. Losses in the new venture would be a deduction for the company in computing its income subject to United States tax. It would, therefore, not be discouraged from undertaking the new venture. At the same time, the company would have the benefit of being able to average the high foreign tax rates in some areas with the low rates in others.

Therefore, we recommend that the percountry limitation on the calculation of the foreign tax credit be removed. Further, an inequity in the present application of the overall limitation should be corrected. If a company has a foreign capital loss, present law may require the amount of the loss to be deducted in computing the amount of the company's foreign income for purposes of the overall limitation. The company may have no foreign capital gains from which the loss can be deducted. Since the capital loss in this situation could not be deducted from ordinary foreign income for purposes of computing United States tax on that income, the company could be in a position where it had not only suffered a foreign loss, but also, as a result of the loss, increased the United States tax due on its foreign income. We, therefore, propose that in computing the overall limitation on the foreign tax credit, foreign capital losses should be deducted only to the extent of foreign capital gains.

Change in calculation of the subsidiary foreign tax credit

We recommend that the method of calculating the tax credit of a branch be used in calculating the foreign subsidiary tax credit.

At present, a corporation receiving a dividend from a foreign subsidiary reports the amount of the dividend as income and claims a credit computed by multiplying the average foreign rate of tax times the amount of the dividend. The result is to combine both a deduction of the whole foreign tax and a credit of a portion of it. The effect is frequently to reduce the United States tax on the dividends of a foreign subsidiary to a rate below the prevailing United States corporate rate.

In the case of a branch, the corporation reports the entire foreign profit before deduction of the foreign tax, and the United States tax is computed on the entire foreign profit. The actual amount of foreign tax paid is then deducted from the United States tax computed to determine the actual United States tax due on the branch earnings.

The method used to calculate the credit of a branch could be applied to a subsidiary. The operation of the two systems of calculating the credit can be illustrated by an example. Assuming that United States corporation X has a foreign operation in country A, which earned $100, paid $40 of foreign tax, and distributed the remaining $60 to X. The effect of the country A operation being a branch, a subsidiary under the present method of calculating the credit, and under the proposed method of calculating the credit is as follows:

	Branch	Subsidiary	
		Present foreign tax credit	Proposed foreign tax credit
Foreign earnings	$100	$100.00	$100
Foreign income tax	40	40.00	40
Branch profit or dividend	60	60.00	60
Income subject to United States tax	100	60.00	100
Tentative United States tax	52	31.20	52
Foreign tax credit	40	24.00	40
United States tax	12	7.20	12
Net after all taxes	48	52.80	48

If in the above example the foreign operation in country A were conducted by a foreign business corporation, the calculation of the credit would be as follows:

	Branch	Subsidiary	
		Present foreign tax credit	Proposed foreign tax credit
Foreign earnings	$100.00	$100.00	$100.00
Foreign income tax	40.00	40.00	40.00
Branch profit or dividend	60.00	60.00	60.00
Income subject to United States tax	100.00	60.00	100.00
Tentative United States tax	52.00	31.20	52.00
85 percent of United States tax, foreign business corporation	44.20	26.52	44.20
Foreign tax credit	40.00	24.00	40.00
United States tax	4.20	2.52	4.20
Net after United States and foreign tax	55.80	57.48	55.80

In these examples we have assumed that all of the foreign subsidiary's income was distributed. If only a portion of the subsidiary's income were distributed as a dividend, a corporate shareholder desiring to claim the foreign tax credit would include in its income subject to United States tax the amount of the dividend plus a portion of the tax paid by the foreign corporation. This portion included would be the same percentage of the total foreign tax paid by the foreign corporation that the amount distributed to it as a dividend was of the profits from which the dividend was paid. The United States tax would be calculated on the actual dividend plus this portion of the foreign tax, and a credit would be allowed equal to this portion of the foreign tax in determining the amount of United States tax payable on the dividend.

The application of this method of calculating the foreign tax credit can be best shown by an example. Assume that United States corporation X receives a dividend of $30 from foreign corporation F, and that F had earnings of $100 on which a tax of 40 percent was paid. The profits of F after tax were, therefore $60. A distribution of $30 was 50 percent of the profits after tax. Thus, X on claiming a foreign tax credit would report $50 of income, the $30 dividend plus $20 of tax. At the current United States rate of 52 percent, the tax due on the dividend would be $26, from which the foreign tax of $20 would be deducted. The United States tax liability of X would then be $6.

The proposed method of calculating the subsidiary foreign tax credit would be no more difficult than the present method. The benefits derived from its adoption would be considerable. The foreign tax credit would operate in accordance with the theory upon which it is based. Taxpayers would really pay only the difference between the United States rate and the foreign rate. Tax planning would be simplified since all forms of organization of a foreign venture would result in the imposition of the same rate of tax. Accordingly, the choice of the form would be dictated by business considerations alone.

Other defects in the foreign tax credit

Two closely related defects in the foreign tax credit should be corrected. The first is that a foreign tax cannot be claimed as a credit in the year in which the tax was imposed if the taxpayer contests his liability for the tax. Instead, the credit may be claimed in the year in which the taxpayer's liability is settled. Consequently, the value of the credit will depend entirely on whether or not the taxpayer has enough income from that country in the year in which his liability is settled to absorb the tax. In view of these uncertainties, companies operating abroad often feel that the price of contesting an arbitrary foreign tax assessment is too high to warrant any gain they may derive from saving local tax. We recommend that this rule be changed. Companies should be permitted to claim the credit in the year for which a foreign government asserts a tax. If the tax liability is contested successfully, United States tax can be adjusted for the earlier year.

The second aspect of the foreign tax credit which has caused difficulty is the application of the statute of limitations. Under the code, the United States is not barred from collection of additional tax through a reduction in an earlier year's foreign tax. On the other hand, a taxpayer can only claim a refund because of a subsequent increase in foreign taxes within 3 years after the United States tax was paid. Often, the statute of limitation for assessment of additioned tax in foreign countries is 10 or more years. In addition, audit of returns by foreign countries will sometimes take 4 or 5 years. Final foreign tax liability will, therefore, be settled after the time has passed for claiming a refund of United States tax. In view of the fact that the statute of limitations does not bar the United States from claiming additional taxes after 3 years, we recommend that taxpayers should likewise not be barred by the 3-year statute of limitations from claiming a refund because of an increase in foreign taxes.

APPENDIX A. CALCULATION OF REVENUE TO UNITED STATES GOVERNMENT FROM TAXES ON FOREIGN INCOME

The Department of Commerce has calculated foreign and United States income taxes on income from direct investments in 1950 in table 19 of Foreign Investments of the United States.[7] We have followed the Commerce calculations for obtaining the taxes on foreign branches of United States companies, but we have recalculated the tax for subsidiaries and affiliates, using the data in appendix table 18, together with data from table 19. We have used the same area breakdown used in the census. A closer calculation could be made by working with individual countries, but data was only published by the Department of Commerce for certain countries.

Because of the averaging between countries and individual firms within a country, calculations can only be very rough. (Amounts in millions.)

Canada

SUBSIDIARIES AND AFFILIATES	
Earnings before taxes	$863.8
Taxes	$338.1
Average rate percent	39.2
Dividends	$286.8
Credit ($296.8 × 39.2 percent)	$112.4
Dividend withholding tax	$23.0
Total credit	$135.4
United States tentative tax (at 42 percent)	$120.5
United States tax due	0

BRANCHES	
Profits of branches	$16.9
United States tentative tax	$7.1
Credit	$8.5
United States tax due	0

Latin American Republics

SUBSIDIARIES AND AFFILIATES	
Earnings before taxes	$301.6
Taxes	$100.8
Average rate percent	25.8
Dividends	$144.0
Credit (144 × 25.8)	$37.2
Dividend withholding tax	$6.9
Total credit	$44.1
United States tentative tax (at 42 percent)	$60.5
United States tax due	$16.4

BRANCHES	
Profits of branches	$513.8
United States tentative tax	$143.9
Credit	$150.3
United States tax due	0

[7] U. S. Department of Commerce, Office of Business Economics, Foreign Investments of the United States Census of 1950, U. S. Government Printing Office, Washington, 1953.

Western Europe

SUBSIDIARIES AND AFFILIATES		BRANCHES	
Earnings before taxes	$555.6	Profits of branches	$20.7
Taxes	$269.0	United States tentative tax	$12.5
Average rate ... percent	48.4	Credit	$8.9
Dividends	$90.3	United States tax due	$3.6
Credit ($90.3×48.4 percent)	$43.6		
Dividend withholding tax	$4.0		
Total credit	$47.6		
United States tentative tax (at 42 percent)	$37.9		
United States tax due	0		

Other countries

SUBSIDIARIES AND AFFILIATES		BRANCHES	
Earnings before taxes	$340.9	Profits of branches	$326.4
Taxes	$92.1	United States tentative tax	$137.1
Average rate ... percent	27	Credit	$71.5
Dividends	$137.8	United States tax due	$65.5
Credit ($137.8×27 percent)	$37.2		
Dividend withholding tax	$10.9		
Total credit	$48.1		
United States tentative tax (at 42 percent)	$57.9		
United States tax due	$9.8		

Summary

SUBSIDIARIES AND AFFILIATES		BRANCHES	
Canada	0	Canada	0
Latin America	$16.4	Latin America	0
Western Europe	0	Western Europe	$3.6
Other countries	9.8	Other countries	65.6
Total	26.2	Total	69.2

Total tax (subsidiaries and affiliates plus foreign branches), $95.4 million.

Tax on royalties, fees, and interest

Royalties and fees	$125.7
Interest	47.8
Total	173.5

Assuming that the average withholding tax on such remittances was 20 percent and that $173.5 represents the net after withholding tax, the original amount of royalties, fees, and interest would be $173.5 divided by 80 percent or $216.9. Therefore:

Royalties, fees, and interest	$216.9
Tentative United States tax (42 percent)	91.1
Credit	43.4
United States tax liability	47.7

Assuming that there was no withholding tax on remittance of royalties, fees, and interest, the United States tax would be calculated on $173.5. Thus:

Royalties, fees, and interest	$173.5
United States tax at (42 percent)	72.9

The maximum United States tax on such remittances is $72.9; a minimum estimate is $47.7.

APPENDIX B. METHOD OF CALCULATING UNITED STATES TAX ON DIVIDENDS FROM FOREIGN SUBSIDIARY CORPORATIONS [*]

"Section 131 (f) of the Internal Revenue Code permits a United States parent to credit against its United States income tax on dividends from a foreign subsidiary a portion of the foreign income taxes paid by the subsidiary on the earnings from which the dividend distribution was made. The years out of the earnings of which the dividends are derived must be determined. For each year the amount of the credit is that portion of the foreign income taxes which bears the same ratio to the total foreign income taxes of that year as the dividend received by the parent out of the earnings of that year bears to the profits before foreign income taxes of that year. The foreign tax credit is the sum of the credits for each of the years from the earnings of which the dividend is derived. Mathematically it may be expressed as follows:

$$\frac{\text{Credit}}{\text{Foreign income taxes paid}}=\frac{\text{Dividend received}}{\text{Profits before foreign income tax}}$$

$$\text{Credit}=\frac{\text{Foreign income taxes paid}\times\text{Dividends received}}{\text{Profits before foreign income tax}}$$

Since foreign taxes paid divided by profits before foreign income tax equals the average foreign income tax rate, the credit is the average annual foreign income tax rate times the dividend. This is derived as follows:

$$\text{Credit}=\frac{\text{Foreign income taxes paid}}{\text{Profits before foreign income tax}}\times\text{Dividends received}$$

$$\frac{\text{Foreign income taxes paid}}{\text{Profits before foreign income tax}}=\text{Average foreign tax rate}$$

Therefore, by substitution:

Credit equals average foreign tax rate times dividends received.

The credit for a subsidiary's taxes is also subject to the per country and overall limitation.

"The mechanics of the credit for a subsidiary's taxes usually result in a lower tax on foreign earnings than the prevailing United States rate. The reason for this is that, in effect, both a deduction from taxable income and a tax credit is accorded the foreign tax paid by the subsidiary. United States income taxes are imposed on the dividends, that is, earnings after deducting foreign income tax. In addition, that portion of the foreign tax attributable to the dividend is credited. The amount by which the parent's return on foreign earnings of the subsidiary exceeds the return on domestic earnings depends on the rate of foreign tax. The relationship of the foreign rate to the increased return to the parent may be expressed by the following formula:

Earnings of foreign corporation before taxes $=1$
Foreign rate of tax $=y$
Foreign tax $=y\times1$
Dividend to corporate shareholder $=1-y$
Tentative U. S. tax $=.52(1-y)$
Credit $=$ (Foreign Rate) (Dividend) $=y(1-y)$
U. S. tax $=$ Tentative tax less credit
$=.52(1-y)-y(1-y)$
$=.52-1.52\times y2$
Income after foreign and U. S. taxes to parent $=$ Dividend $-$ U. S. tax
$=(1-y)-(.52-1.52y+y2)$
$=(.48+.52y-y2)$
Income after taxes from domestic earnings of $=1-.52$
$=.48$
Excess of income after taxes from foreign earnings of subsidiary over domestic earnings................ $=(.48+.52y-y2)-.48$
$=y(.52-y)$"

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[*] Source: United States Income Taxation of Private United States Investment in Latin America; United Nations, Department of Economic Affairs, New York, January 1953, pp. 19–21.

The effect of this formula is illustrated in the following table:

Operation of United States tax on dividends from foreign subsidiaries. (United States corporate rate 52 percent)

Rate of foreign income tax:	*Effective rate of combined United States and foreign tax:*
0 percent	52.00 percent.
7 percent	48.85 percent.
14 percent	46.68 percent.
20 percent	45.60 percent.
26 percent	45.24 percent.
32 percent	45.60 percent.
38 percent	46.68 percent.
45 percent	48.85 percent.
52 percent	52.00 percent.

(Whereupon, at 12:25 p. m., the committee recessed, to reconvene at 10 a. m., Thursday, April 22, 1954.)

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