
REVENUE ACT OF 1939

JUNE 21 (legislative day, JUNE 15) 1939 —Ordered to be printed

MR. HARRISON, from the Committee on Finance, submitted the following

REPORT

To accompany H. R. 68511

The Committee on Finance, to whom was referred the bill (H. R. 6851) to provide revenue, equalize taxation, and for other purposes, having had the same under consideration, report favorably thereon with certain amendments and, as amended, recommend that the bill do pass.

The House bill made the following changes in existing law:

1. Taxpayers are permitted to carry over their net operating business losses for a period of 2 years. This provision will take effect with respect to taxable years beginning after December 31, 1939. However, a taxpayer which has sustained a net operating business loss in 1939 will be permitted to carry over such operating net loss in reduction of its income for 1940 and, if such net loss is in excess of its income for 1940, to carry over such excess in reduction of its income for 1941.

2. Corporations are given the right to increase their capital-stock tax valuations for the fiscal years ending June 30, 1939, and June 30, 1940, but not to decrease such value for such years. Under the existing law corporations are entitled to a new declaration (either lowering or raising their capital-stock value) for capital-stock tax purposes for the fiscal year ending June 30, 1941.

3. In lieu of the tax now imposed upon corporations with incomes above \$25,000, there is imposed a flat corporate tax of 18 percent. This new rate will take effect with respect to taxable years beginning after December 31, 1939. The present corporation tax containing the undistributed-profits-tax feature will be allowed to expire, as such tax does not apply to taxable years beginning after December 31, 1939.

4. Corporations with incomes of \$25,000 or less are subject to the graduated rates on small corporations provided by existing law.

5. A notch provision is provided to prevent corporations from being heavily taxed by reason of having incomes slightly in excess of \$25,000. If it were not for this notch provision, a corporation with an income of \$25,001 would have its tax increased over \$900 by reason of having \$1 more in taxable income. Since the classification between large and small corporations is based upon normal-tax net income instead of net income, the notch is greatly simplified as compared to the one in existing law.

6. Banks, insurance companies, China Trade Act corporations, and corporations in the possessions of the United States are taxed like other corporations. That is, those with normal-tax net incomes of \$25,000 and less receive the benefit of the graduated rates applicable to small corporations, while those with normal-tax net incomes in excess of \$25,000 are taxed under the notch or at a flat rate of 18 percent, whichever method results in the lesser tax.

7. Foreign corporations engaged in a trade or business within the United States and mutual investment companies are taxed at a flat rate of 18 percent, regardless of the amount of their income.

8. Foreign corporations not engaged in a trade or business within the United States are taxed at the rates provided for in existing law. Under the existing law, this type of corporation is taxed upon fixed or determinable income at a rate of 15 percent, except that in the case of dividends the rate is 10 percent. In the case of a contiguous country, the 10-percent rate on dividends may be reduced by treaty to a rate not less than 5 percent. Thus, the existing law is continued in this bill.

9. Corporations in bankruptcy or receivership, joint-stock land banks, and rental housing corporations are treated under the bill like other corporations. The special treatment accorded to them under the existing law made necessary by the undistributed-profits tax has been abandoned.

10. The \$2,000 limitation applicable to the capital losses of corporations has been repealed except with respect to domestic personal holding companies and foreign personal holding companies. In lieu of this provision, the bill allows capital losses on assets held for more than 18 months to be applied in full against ordinary net income for the taxable year in which the loss was realized. In the case of capital losses on assets held for not more than 18 months, the bill provides that they may be applied only against capital gains on assets held not more than 18 months. If the losses from the sale or exchange of such assets held for not more than 18 months exceed the gains from such short-term transactions the excess loss if not in excess of the net income, may be carried over into the following taxable year and may be applied against short-term capital gains of such year. This is the same treatment accorded individuals under existing law in the case of short-term capital losses. These provisions are applicable only with respect to taxable years beginning after December 31, 1939.

11. The bill also makes certain administrative changes which afford relief both to the Government and the taxpayer. Briefly, these are as follows:

(a) A corporation which establishes to the satisfaction of the Commissioner that it is in an unsound financial condition may redeem its bonds, notes, or other evidence of indebtedness in existence on June 1, 1939, at less than their face value without the recognition of

gain if such redemption occurs after the enactment of the bill and in a taxable year beginning prior to January 1, 1943. This provision will materially aid railroads and other corporations whose bonds can be purchased at the present time at less than their face value, giving them an incentive to liquidate their indebtedness. Proper safeguards prevent the provisions from being utilized by corporations in a sound, financial condition to drive the price of their bonds down in the market.

(b) A provision which permits corporations to continue bona fide business reorganizations without being subject to taxation immediately upon such reorganization by reason of the assumption by one corporation of the debts of the other in the process of reorganization. This provision affords relief both to the Government and to the taxpayer. This change was made in view of the *Hendler case* (303 U. S. 564).

(c) A modification of the limitations on the foreign tax credit to make it less difficult for American corporations to transact business abroad. The limitations on the allowance of a credit for taxes paid to foreign countries were placed in the law to make it certain that the Federal Government would receive its full tax on the income from United States sources. It was not intended for the American tax to apply against the income from foreign sources unless the foreign tax rate was less than the tax rate imposed by the United States. Due to a technical change (inserted in the Revenue Act of 1934 and continued in subsequent acts) making the allowance for intercompany dividends, and interest on Government obligations subject to surtax a credit against net income instead of a deduction from gross income, American corporations operating abroad do not get a full credit for the taxes paid to a foreign country on their foreign income. This makes it difficult for American corporations to compete abroad with foreign corporations. Both the Treasury Department and the State Department requested that immediate steps be taken to correct this situation. By reason of the nature of the tax imposed by section 102, relating to corporations improperly accumulating income to avoid surtax on their shareholders, it is not believed that the credit for taxes paid to foreign countries should be permitted to diminish such tax, and the bill so provides.

(d) A provision amending the Federal lien law to provide that such lien shall not be valid as against any mortgagee, pledgee, or purchaser of a negotiable security for full consideration if the mortgagee, pledgee, or purchaser was without knowledge of the existence of the lien. It was inserted to overcome the effect of the *Rosenfield* decision (District Court, Eastern District of Michigan, December 8, 1938).

(e) A provision validating a Treasury regulation of long standing which required that where a stock dividend was declared the basis of the original shares to be apportioned between those shares and the dividend stock for computing the gain or loss on the sale thereof. In one case, the Supreme Court held that where a taxpayer had received a dividend of common stock on its preferred stock, no part of the cost of the old stock could be allocated to the dividend stock in determining gain or loss (*Koshland v. Helvering*, 298 U. S. 441). In another case where the converse situation was presented, the Court held that no part of the cost of the original stock could be allocated to the dividend stock and therefore the cost basis of the dividend stock was zero (*Helvering v. Gowran*, 320 U. S. 238).

These decisions may affect adversely either the Government or the taxpayer, depending upon the particular stock sold by the taxpayer. The bill corrects this situation by ratifying the Treasury regulations dealing with this point.

(f) Several minor technical changes. One of these makes a special provision in subchapter A, chapter 2 (relating to personal holding companies) so that the gross income of insurance companies other than life or mutual which is specially defined in section 204 and is in part a net income, will be comparable, for the purposes of subchapter A, to the gross income of ordinary corporations. Another change exempts from stamp tax on transfers of worthless stock from an executor or administrator to a legatee, heir, or distributee.

(g) An exemption from the income tax is granted to voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to members of such associations or their dependents, if no part of their net earnings inures (other than through such payments) to the benefit of any private individual or shareholder and the membership is composed solely of Federal officers or employees.

12. The bill extends for 2 years the temporary excise taxes which, under existing law, expire at the end of June or July of this year. It also extends for 2 years the 3-cent postal rate on nonlocal-first-class mail. The bill also extends for 2 years the power of the President to modify postage rates on other than first-class matter.

Your committee approve these changes and recommend the following additional provisions:

EXPLANATION OF SUBSTANTIVE COMMITTEE AMENDMENTS

SECTION 3. TAX ON TOILET PREPARATIONS

Section 3 of the bill, as reported, adds to the section imposing tax on toilet preparations two new provisions. The first provides that sales by a manufacturer to a selling corporation of an article subject to tax as a toilet preparation shall be prima facie presumed to be otherwise than at arm's length if either the manufacturer or the selling corporation owns more than 75 percent of the stock of the other, or if more than 75 percent of the stock of both the manufacturing and selling corporations is owned by the same persons in substantially the same proportions. Sales by a manufacturer to a selling corporation in all other cases shall be prima facie presumed to be at arm's length.

The second amendment made by the section provides a rule for determining the price for which an article subject to the toilet-preparations tax is sold. This amendment provides that whether or not the sale is at arm's length the charge for coverings and containers shall be included only if they are furnished by the actual manufacturer, and the charge incident to placing the article in condition ready for shipment shall be included only if performed by the actual manufacturer. It also provides that whether or not the sale is an arm's-length transaction wholesalers' salesmen's commissions and costs and expenses of selling shall be excluded from the price if the amount is established to the satisfaction of the Commissioner of Internal Revenue. The amendment also provides that a transportation, delivery, insurance, or other charge shall be so excluded if established to the satisfaction

of the Commissioner in cases in which the transaction is not an arm's-length transaction.

SECTION 214. STOCK DIVIDENDS AND STOCK RIGHTS

The amendments made by subsection (c) and (f) to section 214 of the bill provide that under all revenue acts, in determining the period for which a taxpayer has held stock or rights to acquire stock received upon a stock-dividend distribution, there shall, under regulations prescribed by the Commissioner with the approval of the Secretary, be included the period prior to such distribution for which he held the stock upon which such distribution was made, if the basis of the stock or rights so distributed is determined by the rule of allocation.

SECTION 215. DISCHARGE OF INDEBTEDNESS

This section of the House bill which adds a new paragraph (9) to section 22 (b) of the Internal Revenue Code (relating to exclusions from gross income) is retained in the reported bill, except with a modification which is presently explained. The House bill provides that the amount of income of a corporate taxpayer attributable to the discharge within the taxable year of certain of its indebtedness or indebtedness for which it is liable is to be excluded from gross income, if (1) the Commissioner of Internal Revenue is satisfied that such taxpayer was in an unsound financial condition at the time of such discharge and (2) such taxpayer consents to regulations prescribed under the new section 113 (b) (3) of the code, relating to reduction of basis, in effect at the time of the filing of the return.

Many corporations (such as railroads) that will endeavor to bring themselves under the provisions of the new paragraph (9) are corporations that have had, and continue to have, considerable dealings with the Federal Government, where the financial condition of such corporations is an important factor in such dealings. It seems desirable to utilize information obtained by various agencies of the Government and thus relieve the Commissioner of Internal Revenue from the necessity of making an independent finding in each case as to the financial condition of the corporate taxpayer. To carry out this policy, a committee amendment to this section provides that a corporation may obtain the benefits of the new paragraph (9) if it can establish that it was in an unsound financial condition at the time of the discharge of its indebtedness, by the presentation of a certification to the Commissioner by any Federal agency which is authorized to make loans on behalf of the United States to such corporation, or by any Federal agency authorized to exercise regulatory power over such corporation.

SECTION 218. EMPLOYEES' TRUSTS

Under existing law, for taxable years beginning after December 31, 1938, an employees' trust is exempt from income tax only if at any time before the pension liabilities with respect to employees under the trust have been satisfied, it is impossible for any part of the trust fund, including principal and income, to be used for, or diverted to, purposes other than the exclusive benefit of employees. This is a change, introduced by section 165 of the Revenue Act of 1938, over prior law, which permitted an employees' trust to be exempt from

income tax even though it was possible for the employer to revoke or alter the trust at any time.

Your committee believes that it is advisable to allow employers additional time in which to revise their pension-trust plans. Accordingly, this section of the bill amends section 165 of the Internal Revenue Code so as to make the provisions of clause (2) of subsection (a) thereof inapplicable to a taxable year beginning prior to January 1, 1940. This amendment merely has the effect of postponing for 1 year the effective date of the change made by section 165 of the Revenue Act of 1938 and carried over into the Internal Revenue Code.

SECTION 219. INVENTORIES

Section 219 of the bill, as reported, provides an optional method of taking inventories of goods, which is a substitute for the comparable provision of existing law, adopted in 1938. Under existing law the optional method may be used only by tanners and producers and processors of nonferrous metals. Under the bill the option is extended to all taxpayers who use it, apply for it, and use it consistently, regardless of the business in which the taxpayer is engaged. Under section 22 (c), the Commissioner has the power to prescribe the method, and section 219 of the bill reaffirms the power.

The method is to treat the goods remaining on hand at the close of the taxable year, for the purposes of determining the cost of those sold during the year, as being, first, those included in the opening inventory of the taxable year in the order of acquisition of the goods to the extent of the goods so included; and second, those acquired in the taxable year. When this method is used the inventory must be taken at cost. The goods in the opening inventory of the first taxable year in which the method is used for tax purposes (which is the closing inventory of the previous year) must be considered to have been acquired at the same time, and their cost is to be ascertained by averaging their cost. Goods acquired in the taxable year may be treated as having been acquired in the order of their acquisition and so valued, or their cost may be averaged, or any other proper method of valuation may be used with respect to such goods, depending on whatever is the proper treatment under the circumstances.

If a taxpayer elects to use the method, he must specify the goods with respect to which the method is to be used. The taxpayer must show that he, for the period the method is to be used for tax purposes, has used no other method for certain business purposes, such as income statements, applications for bank loans, and reports to shareholders. But if, for these purposes, the taxpayer values such goods at market rather than cost he is still able to use the method for tax purposes.

The Commissioner is given power to prescribe regulations in order that the use of the method with respect to the goods will clearly reflect income, and he may prescribe that the taxpayer use the method, with respect to goods other than those specified in the application, if the Commissioner deems it necessary in order clearly to reflect income.

To remain qualified to use the method, the taxpayer must continue to use it for tax and the business purposes indicated above. The Commissioner may, however, permit him to change. The Commissioner may require him to change to a different method if the taxpayer

changes; but even if the taxpayer does change to a different method for other purposes, the Commissioner may require him to continue to use the method for tax purposes. The change, when the taxpayer changes to a different method (either because he is permitted or required to do so), is subject to regulations of the Commissioner in order that the use of the other method and the change to it may clearly reflect income.

SECTION 220. COMPENSATION FOR SERVICES RENDERED FOR A PERIOD OF 5 YEARS OR MORE

It has been considered a hardship to tax fully the compensation of writers, inventors, and others who work for long periods of time without pay and then receive their full compensation upon the completion of their undertaking. Under existing law, such persons have their income for the whole period aggregated into the final year. This results in two inequities: First, only the deductions, expenses, and credits of the final year are chargeable against the compensation for the full period; second, under our graduated surtax, the taxpayer is subjected to a considerably greater burden because of the aggregation of his compensation.

Section 220 of the bill provides that with respect to compensation for personal services rendered by an individual over a period of 5 or more years and which is paid only on the completion of such services the tax attributable to such compensation shall not be more than the aggregate of taxes which would have been paid had the income been received in equal portions in each of the years in the period. The provision is applicable only to cases where the compensation is required to be included in gross income of the individual for any taxable year beginning after December 31, 1938. However, there is no requirement relative to the year in which such services were commenced so long as the year in which the compensation is paid meets the above standard.

SECTION 221. EXTENSION OF TIME WITH RESPECT TO ORDERS OF SECURITIES AND EXCHANGE COMMISSION

In the 1938 Revenue Act it was provided that certain transactions arising out of the simplification or geographical integration of public utility holding company systems might be accomplished under the revenue act by treating some of the transactions as tax-free exchanges and making various adjustments of the basis of property according to the special treatment provided in supplement R. Under the 1938 act (and the Internal Revenue Code) such transactions had to be in conformity with orders of the Securities and Exchange Commission issued before January 1, 1940, or orders supplementary to such orders. The amendment made by section 221 extends from January 1, 1940, to January 1, 1941, the time during which such an order may be made.

SECTION 222. RENEWAL OF INDEBTEDNESS

Section 27 (a) (4) of the Internal Revenue Code and the Revenue Act of 1938 allow, for undistributed-profits-tax purposes, a credit for amounts used or set aside to pay or retire indebtedness existing at the

close of business on December 31, 1937, and evidenced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued by the corporation and in existence at the close of business on December 31, 1937, or by a bill of exchange accepted by a corporation prior to, and in existence at, the close of business on such date. Section 222 of the bill amends the code and the 1938 act, the effect of which is that indebtedness shall not be deemed to be outside the provisions of section 27 (a) (4) of such acts merely because, at the time payments are made or amounts are set aside, the indebtedness is evidenced by a renewal obligation issued after December 31, 1937. This amendment does not alter the requirement of existing law relative to the time before which the indebtedness must have been incurred and the manner in which it was evidenced at the close of business on December 31, 1937. Under the bill, the renewal obligation need not be one of the type of instruments enumerated in the existing law, and a renewal of a renewal obligation is qualified if the original indebtedness was.

SECTION 223. COMMODITY CREDIT LOANS

The attention of your committee has been drawn to the fact that loans by the Commodity Credit Corporation to producers of agricultural commodities, on the security of such commodities, though in form loans, should be treated for income-tax purposes as though such commodities had been sold in the year of the loan for the amount of the loan. Nevertheless, existing law requires them to be treated as loans, with the result that when the pledged commodities are eventually sold taxpayers are required to take up a large amount of income and, in addition, will not longer have available to them their deductions on account of production expenses. In order to avoid this harsh result, section 223 of the bill adds a new section 49 to the Internal Revenue Code, giving taxpayers an election to treat such loans as income. An election once so made is binding as to all future years unless the Commissioner's approval is obtained to a change of method. Section 223 also adds a new section 113 (b) (1) (G), providing for proper adjustments of basis in the event it ever becomes material to compute gain or loss upon a subsequent sale or other disposition of such commodities.

Subsections (d) and (e) make similar provision relative to the computation of income and the adjustment of basis under the Revenue Acts of 1934, 1936, and 1938, with proper safeguards.

SECTION 224. CHARITABLE CONTRIBUTIONS TO POSSESSIONS AND CHARITIES IN POSSESSIONS

This amendment broadens sections 23 (o) and 23 (q) of the Internal Revenue Code so as to allow deductions to individuals and corporations for contributions made to any possession of the United States or to any corporation, trust, or community chest, fund, or foundation created or organized in, or under the laws of, any possession of the United States subject to the qualifications and limitations now provided by law with respect to other contributions.

SECTION 225. PAN-AMERICAN TRADE CORPORATIONS

Section 225 of the reported bill extends benefits to American corporations engaged solely in the active conduct of a trade or business in Central or South America which are affiliated with another American corporation engaged in the active conduct of a trade or business within the United States. The amendment permits such corporations (including the parent corporation) to file consolidated returns. It has been found impracticable for a parent corporation having many interests in Central or South America to carry on business there in its own name. As a matter of economy and efficiency it is necessary to organize a subsidiary corporation to act in its place. These subsidiary corporations, while organized within the United States, conduct their operations entirely outside of the United States and therefore do not compete with American companies operating within the United States. Your committee is of the opinion that it is a wise policy to encourage the formation of such corporations for the purpose of stimulating American trade abroad. Proper safeguards are inserted to make it clear that the relief granted by this section will not apply unless both the parent corporation and the subsidiary corporations are actively engaged in a trade or business (not mere holding companies) and the subsidiary companies do not receive any gross income from sources within the United States.

SECTION 226. DEDUCTIONS OF INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL

Under existing law insurance companies other than life or mutual must include in gross income, in addition to other items, all items which constitute gross income in the case of ordinary corporations. Such companies are not, however, allowed in full the deductions allowed under section 23 to ordinary corporations. The amendment made by section 226 allows such deductions in full by removing the limitation now contained in section 204 (c) (10).

SECTION 228. COMPUTATION OF DIVIDEND CARRY-OVER FOR PERSONAL HOLDING COMPANY TAX

Under existing law, a personal holding company receives a dividend carry-over only for the dividends declared in excess of its adjusted net income. This results in denying to a personal holding company the full carry-over where its adjusted net income has been reduced through the payment of Federal taxes which are allowed as a deduction for the purpose of computing the tax on personal holding companies. Section 228 of the reported bill corrects this situation by allowing the dividend carry-over for purposes of the surtax on personal holding companies to be determined on the basis of the dividends in excess of the adjusted net income minus the deduction allowed for Federal taxes under the personal holding company provisions.

SECTION 401. TAX LIENS ON SECURITIES

The only changes made in this section by the reported bill are in the new subsection (b) dealing with securities. The House bill provides that even though notice of the tax lien imposed by section

3670 of the Internal Revenue Code has been filed by the collector in the prescribed manner, such lien shall not be valid with respect to securities mortgaged, pledged, or purchased, if at the time such mortgagee, pledgee, or purchaser is without notice or knowledge of the existence of such lien. In such cases the mortgage, pledge, or purchase must be for a full and adequate consideration, but such consideration would be considered as given if a security is accepted in satisfaction of, or as security for, a preexisting obligation. Section 3186 of the Revised Statutes, as amended, was codified in part as section 3670 of the Internal Revenue Code. Prior to the effective date of section 3670 of the code, February 11, 1939, the general tax lien (corresponding to the lien imposed under sec. 3670 after the enactment of the code) was imposed under section 3186 of the Revised Statutes, as amended.

The reported bill expressly extends the provisions of the new subsection (b) to the lien imposed under section 3186 of the Revised Statutes, as amended. The reported bill makes no change in the definition of the term "security." The House bill provides that the new subsection (b) shall apply, regardless of the time when the mortgage, pledge, or purchase was made or the lien arose, except where the lien has been enforced by a civil action which has become final before the date of enactment of the bill. Tax liens are now enforced by distraint or by a civil action. Prior to the enactment of the code, such liens were enforced by distraint or by a suit in equity. To include those methods of enforcement, the reported bill expressly includes a proceeding or suit in the above-mentioned exception. The exception is applicable only if the proceeding, suit, or civil action to enforce the lien has become final before the date of enactment of the bill.

SECTION 403. CREDITS AGAINST ESTATE TAX OF TAX PAID TO POSSESSIONS

Under existing law no credit is allowed against the Federal estate tax for death taxes paid to Puerto Rico or the Philippines. The existing law confines the credit to death taxes paid to the States, Territories, and the District of Columbia. This operates unjustly in the case of American citizens who are residents of the Philippines or who are residents of the United States but own property in the Philippines or Puerto Rico. The Philippine death taxes have a maximum rate of from 27 to 85 percent, according to the relationship of the heirs.

Your committee are of the opinion that the same credit should be allowed for death taxes paid to the possessions of the United States as is allowed for death taxes paid to the States, the Territories, or the District of Columbia, and section 403 of the bill so provides.

SECTION 404. RETURNS OF ATTORNEYS AS TO FOREIGN CORPORATIONS

Under section 3604 (a) of the Internal Revenue Code, attorneys who counsel or advise with respect to the formation or reorganization of foreign corporations are required to file a return with the Commissioner of Internal Revenue within 30 days after the rendering of such advice. The return must set forth such information of the attorney regarding the purpose and affairs of the corporation as the Commissioner may prescribe. However, the section does not require the divulging of privileged communications between attorney and client.

Section 404 relieves attorneys at law who in their practice advise clients from filing any return with respect to the advice they give or the information they receive in the attorney-client relationship. The amendment is effective as of the date of the enactment of the Revenue Code, so that the relief is retroactive.

SECTION 405. EXTENSION OF DATE FOR FILING CLAIMS FOR REFUND OF AMOUNTS COLLECTED UNDER THE AGRICULTURAL ADJUSTMENT ACT

Section 903 of the Revenue Act of 1936 required claims for refund of taxes paid under the Agricultural Adjustment Act to be filed before July 1, 1937. As the 1936 act was approved on June 22, 1936, claimants were allowed only a year and 8 days in which to file their claims.

Section 405 of the bill would extend the period during which such claims may be filed from July 1, 1937, to January 1, 1940.

