Calendar No. 1683

77TH CONGRESS 2d Session | SENATE | REPORT No. 1631

THE REVENUE BILL OF 1942

REPORT

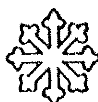
OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

TO ACCOMPANY

H. R. 7378

A BILL TO PROVIDE REVENUE, AND FOR OTHER PURPOSES



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77TH CONGRESS 2d Session } SENATE { REPORT No. 1631

THE REVENUE BILL OF 1942

OCTOBER 2, 1942.—Ordered to be printed

Mr. GEORGE, from the Committee on Finance, submitted the following

REPORT

[To accompany H. R. 7378]

The Committee on Finance, to whom was referred the bill (H. R. 7378) to provide revenue, 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.

SUMMARY OF PRINCIPAL CHANGES

I. INDIVIDUAL INCOME TAX

1. TAXABLE YEARS

In general the changes made by the bill with respect to the individual income tax are effective with respect to taxable years beginning after December 31, 1941. However, exceptions are made with respect to certain technical amendments and in the case of fiscal-year taxpayers.

2. PERSONAL EXEMPTIONS AND CREDITS FOR DEPENDENTS

Personal exemptions.—Your committee recommends the adoption of the provisions of the House bill which further broadens the individual income-tax base by reducing the personal exemptions for a married person from $1,500 to $1,200 and for a single person from $750 to $500. The proposed exemptions on a weekly basis are $9.62 for a single person and $23.08 for a married person.

Dependents.—The House bill made no change in existing law with respect to the $400 credit for each dependent under 18 years of age, or one incapable of self-support.

Your committee recommends reducing this credit to $300. Prior to the last World War no credit for dependents was allowed, and

during the period 1917–20 a $200 credit was allowed for each dependent. Since 1920 the credit has remained at $400 although the personal exemptions have been drastically reduced. It is estimated that this change will add 600,000 new taxpayers. The following table gives a comparison of personal exemptions and credit for dependents under prior revenue acts:

TABLE I.—*Personal exemption and credit for dependents allowed under the Revenue Acts of 1913–41, the House bill, and Senate Finance Committee bill*

Revenue Act	Income year	Personal exemption and credit for dependents		
		Single or married and not living with husband or wife and not head of family	Married and living with husband or wife, or head of family	Credit for each dependent
1913	Mar. 1, 1913, to Dec. 31, 1915	[1] $3,000	[1] $4,000	
1916	1916	3,000	4,000	
1917	1917	1,000	2,000	$200
1918	1918 to 1920	1,000	2,000	200
1921	1921 to 1923	1,000	[2] 2,500	400
1924	1924	1,000	2,500	400
1926	1925 to 1927	1,500	3,500	400
1928	1928 to 1931	1,500	3,500	400
1932	1932 and 1933	1,000	2,500	400
1934	1934 and 1935	1,000	2,500	400
1936	1936 and 1937	1,000	2,500	400
1938	1938 and 1939	1,000	2,500	400
1940	1940	800	2,000	400
1941	1941	750	1,500	400
1942:				
House bill	1942	500	1,200	400
Senate Finance Committee bill.	1942	500	1,200	300

[1] No provision for head of family in Revenue Act of 1913. Exemption prorated for period Mar. 1 through Dec. 31, 1913.
[2] For net income in excess of $5,000, personal exemption is $2,000.

3. SOLDIERS AND SAILORS RELIEF

The committee bill amends the provision in the House bill granting special allowance for the relief of soldiers and sailors in active service by limiting such allowance to the personnel below the grade of commissioned officer.

Under the House bill a specific exclusion from gross income of $250 is allowed in the case of a single person, and $300 in the case of a married person, irrespective of rank, if engaged in active service with the armed forces. In lowering the personal exemptions for taxpayers generally, your committee does not believe that the personnel of our armed forces below the grade of commissioned officer should be required to bear this increased burden. During the last World War the revenue law contained a special exclusion from gross income for those in the military and naval service.

4. RATES

Normal tax.—Your committee recommends the adoption of the provision of the House bill increasing the existing 4 percent normal rate to 6 percent. The following table compares the proposed normal tax rate with those levied under prior revenue acts:

TABLE II.—*Normal tax rates under the Revenue Acts of 1913–41 and under proposed revenue bill of 1942*

Revenue act	Income year	Normal tax rate	
		Net income subject to tax	Percent
1913	Mar. 1, 1913, to Dec. 31, 1915	All	1
1916	1916	All	2
1917	1917	First $2,000	2
		Balance over $2,000	4
1918	1918	First $4,000	6
		Balance over $4,000	12
	1919, 1920	First $4,000	4
		Balance over $4,000	8
1921	1921–23 [1]	First $4,000	4
		Balance over $4,000	8
1924	1924	First $4,000	2
		Second $4,000	4
		Balance over $8,000	6
1926	1925–27	First $4,000	1½
		Second $4,000	3
		Balance over $8,000	5
1928	1928	First $4,000	1½
		Second $4,000	3
		Balance over $8,000	5
	1929 [2]	First $4,000	½
		Second $4,000	2
		Balance over $8,000	4
	1930, 1931	First $4,000	1½
		Second $4,000	3
		Balance over $8,000	5
1932	1932, 1933	First $4,000	4
		Balance over $4,000	8
1934	1934, 1935	All	4
1936	1936, 1937	All	4
1938–41	1938–	All	[3] 4
1942 House and Finance Committee bill.	1942–	All	6

[1] Tax for 1923 reduced 25 percent by credit or refund under sec. 1200 (a) of the Revenue Act of 1921.
[2] See joint resolution of Congress No. 133, approved by the President Dec. 16, 1929, reducing rates of income tax for 1929.
[3] Not including 10-percent defense tax provided for by the Revenue Act of 1940.

Surtax rates.—In addition to the recommended increase in the normal tax rate, the committee recommends the adoption of the increased surtax rates as approved by the House. The following table shows a comparison of the proposed increased surtax rates with those under existing law:

TABLE III.—*Comparison of proposed surtax rates and cumulative surtax under present law, House bill, and Senate Finance Committee bill*

Surtax net income classes	Surtax rates			Cumulative surtax on higher amount shown in bracket		
	Present law	House bill	Senate Finance Committee bill	Present law	House bill	Senate Finance Committee bill
	Percent	*Percent*	*Percent*			
$0 to $2,000	6	13	Same as under House bill	$120	$260	Same as under House bill
$2,000 to $4,000	9	16		300	580	
$4,000 to $6,000	13	20		560	980	
$6,000 to $8,000	17	24		900	1,460	
$8,000 to $10,000	21	28		1,320	2,020	
$10,000 to $12,000	25	32		1,820	2,660	
$12,000 to $14,000	29	36		2,400	3,380	
$14,000 to $16,000	32	40		3,040	4,180	
$16,000 to $18,000	35	43		3,740	5,040	
$18,000 to $20,000	38	46		4,500	5,960	
$20,000 to $22,000	41	49		5,320	6,940	
$22,000 to $26,000	44	52		7,080	9,020	
$26,000 to $32,000	47	55		9,900	12,320	

TABLE III.—*Comparison of proposed surtax rates and cumulative surtax under present law, House bill, and Senate Finance Committee bill*—Continued

Surtax net income classes	Surtax rates			Cumulative surtax on higher amount shown in bracket		
	Present law	House bill	Senate Finance Committee bill	Present law	House bill	Senate Finance Committee bill
	Percent	*Percent*	*Percent*			
$32,000 to $38,000	50	58	Same as under House bill	$12,900	$15,800	Same as under House bill
$38,000 to $44,000	53	61		16,080	19,460	
$44,000 to $50,000	55	63		19,380	23,240	
$50,000 to $60,000	57	66		25,080	29,840	
$60,000 to $70,000	59	69		30,980	36,740	
$70,000 to $80,000	61	72		37,080	43,940	
$80,000 to $90,000	63	75		43,380	51,440	
$90,000 to $100,000	64	77		49,780	59,140	
$100,000 to $150,000	65	79		82,280	98,640	
$150,000 to $200,000	66	81		115,280	139,140	
$200,000 to $250,000	67	82		148,780	180,140	
$250,000 to $300,000	69	82		183,280	221,140	
$300,000 to $400,000	71	82		254,280	303,140	
$400,000 to $500,000	72	82		326,380	385,140	
$500,000 to $750,000	73	82		508,780	590,140	
$750,000 to $1,000,000	74	82		693,780	795,140	
$1,000,000 to $2,000,000	75	82		1,443,780	1,615,140	
$2,000,000 to $5,000,000	76	82		3,723,780	4,075,140	
Over $5,000,000	77	82				

5. SIMPLIFIED RETURN

Your committee recommends the continued use of the simplified return for those having a gross income of $3,000 or less which was first authorized by the Revenue Act of 1941 and has proved successful and economical of administration both to the taxpayer and to the Government. Under the present law, the use of the simplified return is confined to persons having income only from salaries, wages, compensation for personal services, dividends, interest, rent, annuities or royalties. In order to coordinate the operation of this return with the victory tax return, it is necessary to eliminate rent and royalties from the types of income for which the simplified form may be used.

Under existing law taxpayers having a married status on the last day of the taxable year are entitled to a married person's exemption for the entire year. The House bill modified this provision so that those having a married status on July 1, of the taxable year receive a married person's exemption. Your committee concurs in this change.

6. TAX ON NONRESIDENT ALIEN INDIVIDUALS

Under the present law the rate of tax on nonresident alien individuals, not engaged in trade or business in the United States is 27½ percent. The House bill increased this rate to 37 percent. From data presented to your committee, it is apparent that the 37 percent rate is on the average in excess of the tax which would be paid by such persons under the rates applicable to citizens and resident aliens under the bill. This is true for the reason that a great majority of the nonresident aliens deriving income from United States sources would be in the lower brackets for ordinary income-tax purposes.

Consequently, your committee has reduced the rate from 37 percent to 30 percent.

The rate for withholding of tax at the source applicable to fixed or determinable amounts paid to nonresident alien individuals is adjusted accordingly.

7. Personal Exemption of a Nonresident Alien Residing in a Contiguous Country

The committee bill amends section 214 of the Internal Revenue Code in regard to exemptions allowed nonresident aliens engaged in trade or business in the United States and therefore required to file tax returns under our income-tax laws. Heretofore such aliens, married or unmarried, have been allowed the exemption allowed to unmarried residents of the United States. Canada, which has had a similar practice, recently enacted certain provisions in its income-tax laws having the effect of allowing residents of a country contiguous to Canada who derive earned income from Canada the same exemptions or tax advantages as are allowed generally to residents of Canada. These provisions are generally to be effective only if the contiguous country allows residents of Canada similar advantages under similar circumstances. In view of this, it is believed advisable for the United States to provide, upon a reciprocal basis, exemptions in the case of nonresident aliens residing in a contiguous country but engaged in trade or business in the United States, corresponding generally to those allowed in the case of residents of the United States. Thus, for example, a Canadian employed in the United States but residing in Canada will be allowed the personal exemption incident to the married status if such Canadian occupies such status. In view of the severe rates of income taxation imposed or contemplated in both the United States and Canada, it would appear desirable to liberalize the personal exemption to this restricted extent. It is anticipated that, in view of the tax convention now existing between Canada and the United States, no appreciable difficulty will be encountered in securing information with respect to the marital status of residents of Canada who are employed in the United States.

8. Pensions for Disability Resulting From Military Service

Under the bill, pensions for personal injuries or sickness resulting from active service in the armed forces of any country are exempt. Under the existing law, pensions received for active service in the armed forces of countries other than the United States are subject to the Federal income tax.

9. Returns Under Oath no Longer Necessary

The income-tax law has always specifically provided that returns must be made under oath. This requirement causes considerable annoyance and inconvenience to taxpayers in that their returns must be sworn to before a notary public or other similar officer.

Your committee bill removes this necessity by substituting for the requirement of an oath the requirement of a written declaration that the return was made under the penalties of perjury.

10. Deduction of Medical Expenses

The committee bill allows, within prescribed limits, the deduction of expenses for the medical care of the taxpayer, his wife, and his dependents. The term "medical care" is broadly defined and includes amounts paid for accident and health insurance.

Only such expenses are deductible as exceed 5 percent of the net income computed without the deduction. The maximum deduction allowable is $2,500 in the case of a head of a family or a husband and wife filing a joint return; in all other cases, the maximum is $1,250.

This allowance is recommended in consideration of the heavy tax burden that must be borne by individuals during the existing emergency and of the desirability of maintaining the present high level of public health and morale.

II. VICTORY TAX

The bill imposes a Victory tax of 5 percent upon the Victory tax net income in excess of $624 for each taxable year beginning after December 31, 1942. In the case of a husband and wife filing a joint return, if the Victory tax net income of one of the spouses is not less than $624 and that of the other is less than such sum, the aggregate specific exemption of both spouses is $624 plus the Victory tax net income of the spouse having a Victory tax net income of less than $624.

The Victory tax net income consists of the gross income (excluding capital gains) less expenses and other allowable deductions connected with a trade or business, or incurred in the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. In the case a taxpayer elects to compute his tax on the simplified form, Victory tax net income is defined as the gross income for the year.

Current Credits Against the Victory Tax

The committee bill permits the taxpayer to take credit for certain expenditures against the Victory tax for each taxable year. The credit for these expenditures during any taxable year cannot exceed the post-war credit for such year, and to the extent such expenditure credit is taken, the post-war credit is reduced. These expenditures are as follows:

(1) The amount paid, not in excess of the post-war credit, by the taxpayer during the taxable year as premiums on life insurance in force on September 1, 1942, upon his own life, the life of his spouse, or his dependents. This will cover amounts paid as premiums on life insurance which is a renewal or conversion of life insurance in force on September 1, 1942, to the extent that such premiums do not exceed the premiums payable on such life insurance in force on September 1, 1942.

(2) Amounts paid on indebtedness during the taxable year. This credit is limited to an amount by which the smallest amount of indebtedness of the taxpayer outstanding at any time during the period beginning September 1, 1942, and ending with the close of the preceding taxable year, exceeds the amount of the indebtedness of the taxpayer outstanding at the close of the current taxable year. Thus if the taxpayer had a debt of $30 outstanding on September 1, 1942, and his debt outstanding as of December 31, 1943, was $20, he would

be allowed a tax credit of $10 if such amount was not in excess of his post-war credit.

(3) The taxpayer is also allowed a credit against the Victory tax but not in excess of the post-war credit for the amount of the obligations of the United States owned by the taxpayer on the last day of the taxable year, exceeding the greater of, (1) the amount of the obligations owned by the taxpayer on December 31, 1942, or (2) the highest amount of such obligations owned by the taxpayer on the last day of any preceding taxable year beginning after December 31, 1942. For example, assume a taxpayer on December 31, 1942, owned obligations of the United States of $100. On December 31, 1943, he owned obligations of $200. He would be entitled, up to the amount of his post-war credit, to a credit of $100. If in 1944, he sold United States obligations in the amount of $200, and purchased additional obligations of $100, he would not be entitled to any such credit for 1944.

As used in this paragraph, the term "owned by the taxpayer" includes the amount of the obligations owned solely by the taxpayer and one-half of the amount of the obligations owned jointly by the taxpayer and another, but excludes obligations acquired by the taxpayer by gift or inheritance, or otherwise than by purchase; the term "obligations of the United States" means such obligations of the United States as the Secretary may by regulations prescribe, and as are purchased in such manner and under such terms and conditions as he may specify; and the term "amount of obligations of the United States" means the amount paid for them.

As already stated, the expenditures up to the amount of the post-war credit will be allowed as a credit against the tax. This will afford some relief to taxpayers with fixed obligations, such as life-insurance premiums and debts, expenditures which do not conflict with the war effort or affect the inflation problem. Those taxpayers who do not avail themselves of this current tax credit will, of course, obtain the full benefit of the post-war refund after the war. Those who take advantage of such credit will have their post-war credits reduced to that extent. The current debt, War bond, and insurance credit does not reduce the amount withheld at the source. To secure this credit, the taxpayer must apply it against his Victory tax on his return.

Post-War Credit

A post-war credit is allowed equal to the following percentages of the Victory tax:

(1) In the case of a single person, 25 percent of the Victory tax or $500, whichever is the lesser.

(2) In the case of the head of a family, 40 percent of the Victory tax or $1,000, whichever is the lesser.

(3) In the case of a married person living with husband or wife, where separate returns are filed by each spouse, 40 percent of the Victory tax or $500, whichever is the lesser.

(4) In the case of a married person living with husband or wife, where a separate return is filed by one spouse and no return is filed by the other spouse, 40 percent of the Victory tax or $1,000, whichever is the lesser.

(5) In the case of a husband and wife filing a joint return, 40 percent of the aggregate Victory tax or $1,000, whichever is the lesser.

(6) For each dependent, 2 percent of the victory tax or $100, whichever is the lesser.

If the taxpayer's marital or dependent status changed during the taxable year, the amount of the post-war credit shall be apportioned according to the number of months before and after such change. In the case of a taxpayer using the simplified form, his status will be determined as of July 1 of each year.

As soon as practicable after the cessation of hostilities in the present war, the amount of the post-war credit which has not been absorbed currently will be credited against any income tax then due from the taxpayer, and any balance refunded to the taxpayer. A period of limitation provides that no post-war credit shall be allowed after 7 years from the date of cessation of hostilities unless claim therefor is filed before the expiration of such date.

Since the Victory tax does not allow any deduction for State income taxes, your committee deemed it advisable to provide that the total income tax and Victory tax should not exceed 90 percent of the taxpayer's net income. For example, the normal and surtax in the case of a married person with no dependents, with a gross income of $2,000,000 and a net income of $1,800,000, will amount to $1,558,000. This is 86.56 percent of the net income. The 5 percent Victory tax if computed without any limitation in such a case will amount to $99,968.80. The total normal, surtax, and Victory tax in such a case will amount to $1,657,968.80. This is 92.11 percent of the net income. Therefore, the limitation will apply and the Victory tax will be reduced to $62,000, making the total tax $1,620,000 or 90 percent of the net income.

The taxpayer will compute his Victory tax on his regular income-tax return except where not required to file a regular income-tax return. In the latter case, a return will be required for the Victory tax, in all cases where the gross income for the taxable year is in excess of $624.

A taxpayer whose gross income is not more than $3,000, and consists only of salaries, wages, annuities, interest and dividends, is permitted to compute his regular income tax on a short form known as Form 1040–A. The Victory tax will be computed on this short form. The following sample of Form 1040–A will illustrate how the Victory tax is computed in a typical case.

FORM 1040 A
Treasury Department
Internal Revenue Service

OPTIONAL
UNITED STATES
INDIVIDUAL INCOME TAX
RETURN

1943

This Return MAY Be Filed Instead of Form 1040 by Citizens or Resident Aliens if Gross Income is Not More Than $3,000 and is ONLY From Sources Stated Hereon

PRINT NAME AND HOME OR RESIDENTIAL ADDRESS PLAINLY BELOW

MR. JOHN DOE
(Name) (Use given names of both husband and wife, if this is a joint return)

2943 14th Street
(Street and number, or rural route)

Boston, Mass.
(Post office) (County) (State)

Occupation..............................

Do not write in these spaces

Serial No.

Amount Paid, $

(Cashier's Stamp)

Cash—Check—M. O.

DEPENDENTS ON LAST DAY OF YEAR

List persons *deriving their chief support from you* (other than husband or wife) under 18 years of age or mentally or physically incapable of self-support

Name of dependent	Relationship	If 18 years of age or over, give reason for listing
None		

GROSS INCOME LESS ALLOWANCE FOR DEPENDENTS		
1. Salary, wages, and compensation for personal services		
2. Dividends, interest, rent, annuities, and royalties	$3,000	00
3. Total	3,000	00
4. Less: $330 for each dependent		
(If you are the head of a family (see definition on other side) *only because of dependent(s) listed above*, $330 for each listed dependent *except one*.)		
5. Income Subject to Income Tax	3,000	00
INCOME TAX		
6. Income tax to be paid (from Column A, B, or C of table on other side)	431	00
VICTORY TAX		
7. Total income (Item 3)	3,000	00
8. Less: Specific exemption	624	00
9. Income subject to Victory tax (Item 7 minus Item 8)	2,376	00
10. Victory tax, 5% of Item 9	118	80
11. Less: Post-war refund claimed in advance on this return (From Schedule A) $29 70 Victory tax withheld at source (List in Schedule B, name of employer and amount of tax withheld	29	70
12. Balance of Victory tax (Item 10 minus item 11)	89	10
TAX SUMMARY		
13. Income tax (Item 6)	431	00
14. Balance of Victory tax (Item 12)	89	10
15. Total tax payable (Item 13 plus Item 14, or minus Item 14, if item 11 exceeds item 10)	520	10

An income-tax return is required to be filed by single persons having a gross income (item 3 above) of $500 or more, and married persons having a gross income of $1,200 or more. A husband and wife may make a joint return on this form if their combined gross income is not more than $3,000. A separate return may be made on this form if the gross income of the one filing the return is not more than $3,000. If this return is used, it must be filed with the Collector of Internal Revenue for your district on or before March 15, 1944. The tax may be paid in equal quarterly installments commencing March 15, 1944. Pay tax, if any, to the Collector and if payment is made by check or money order, make payable to "Collector of Internal Revenue."

SCHEDULE A. POST-WAR REFUNDS

1. Victory Tax, Item 10 .... $118.80
2. Post-war refund, based on Item 1 at 25% arrived at as follows:
   25%, if single, or married and not living with husband or wife, and no dependents. } Based on status as of July 1, 1943
   40%, if head of a family, or married and living with husband or wife, and no dependents.
   2%, for each dependent. 29.70
3. Credit claimed in advance on this return consisting of:
   (a) Premium on life insurance in force September 1, 1942, allowable under section 453 (a) (1) .... -------
   (b) Payment of debt contracted prior to September 1, 1942, allowable under section 453 (a) (2) $400.00
   (c) Purchase of War Bonds, allowable under section 453 (a) (3) 300.00
   .... 700.00
4. Balance, if any, refundable after the war .... None

SCHEDULE B. VICTORY TAX WITHHELD AT SOURCE

Name of employer	Salaries, wages, fees, commissions, bonuses	Tax with held
Totals	$	$

If a taxpayer is not eligible to use the simplified form (Form 1040 A) his Victory tax will be computed on Form 1040. The following sample form shows how the Victory tax will be computed. It is understood, however, that this is merely a sample form and is subject to revision by the Commissioner.

Form 1040 Treasury Department Internal Revenue Service	United States INDIVIDUAL INCOME TAX RETURN	Page 1 1943
(Auditor's Stamp)	Optional Form 1040A may be filed instead of this form if gross income is not more than $3,000 and consists *wholly* of salaries, wages, other compensation for personal services, dividends, interest, rent, annuities, or royalties. For Calendar Year 1943 or fiscal year beginning ...., 1943, and ending ...., 1944 To be filed with the Collector of Internal Revenue for your district not later than the 15th day of the third month following the close of your taxable year PRINT NAME AND ADDRESS PLAINLY (See Instruction C) Mr. John Doe (Name) (Use given names of both husband and wife, if this is a joint return) 54 Wall Street (Street and number, or rural route) New York (Post office) .... (County) N. Y. (State)	(Do not use these spaces) File Code Serial No. District (Cashier's Stamp) Cash—Check—M.O. First Payment $ ....

Item and Instruction No.	INCOME	*Amount*	*Deductible Expenses* (Attach itemized statement)				
1.	Salaries and other compensation for personal services	$	$	$20,000	00		
2.	Dividends						
3.	Interest on (*a*) bank deposits, notes, etc., $200; (*b*) corporation bonds, $300			500	00		
4.	Interest on Government obligations, etc.: (*a*) From line (*h*), Schedule A, $2,000; (*b*) from line (*i*), Schedule A, $			2,000	00		
5.	Rents and royalties. (From Schedule B)						
6.	Annuities						
	Items 7, 8, and 9, below (and pages 3 and 4) need not be considered unless you have income (or losses) in addition to items above.						
7.	(*a*) Net short-term gain from sale or exchange of capital assets. (From Schedule F)			2,000	00		
	(*b*) Net long-term gain (or loss) from sale or exchange of capital assets. (From Schedule F)						
	(*c*) Net gain (or loss) from sale or exchange of property other than capital assets. (From Schedule G)						
8.	Net profit (or loss) from business or profession. (From Schedule H) (State total receipts, from line 1, Schedule H, $ ....)						
9.	Income (or loss) from partnerships; fiduciary income; and other income. (From Schedule I)						
10.	Total income in items 1 to 9					$24,500	00
	DEDUCTIONS						
11.	Contributions paid. (Explain in Schedule C)			$595	00		
12.	Interest. (Explain in Schedule C)						
13.	Taxes. (Explain in Schedule C)			788	00		
14.	Losses from fire, storm, shipwreck, or other casualty, or theft. (Explain in Schedule C)						
15.	Bad debts. (Explain in Schedule C)						
16.	Other deductions authorized by law. (Explain in Schedule C)						
17.	Total deductions in items 11 to 16					1,383	00
18.	Net income (item 10 minus item 17)					23,117	00

COMPUTATION OF TAX

19. Net income (item 18 above)			$23,117	00
20. Less: Personal exemption. (From Schedule D-1)	$1,200	00		
21. Credit for dependents. (From Schedule D-2)	600	00	1,800	00
22. Balance (surtax net income)			21,317	00
23. Less. Item 4 (*a*) above	$2,000	00		
24. Earned income credit. (From Schedule E-1 or E-2)	1,400	00	3,400	00
25. Balance subject to normal tax			17,917	00

26. Normal tax (6% of item 25)			$1,075	02
27. Surtax on item 22. (See Instruction 27)			6,605	33
28. Total (item 26 plus item 27)			7,680	35
29. Total tax (item 28 or line 16, Schedule F)			7,680	35
30. Less: Income tax paid at source	$			
31. Income tax paid to a foreign country or U. S. possession. (Attach Form 1116)				
32. Balance of income tax (item 29 minus items 30 and 31)			7,680	35

VICTORY TAX

33. Total income (Item 10)		$24,500	00
34. Less: Items 4 (a) and 7 (a) (b)		4,000	00
35. Item 33 minus Item 34		20,500	00
36. Less: Specific credit		624	00
37. Income subject to Victory tax (Item 35 minus Item 36)		19,876	00
38. Victory tax, 5% of Item 37		993	80
39. Less: Post-war refund claimed in advance on this return (From Schedule A)	$437.27		
Victory tax withheld at source (List in Schedule B name of employer and amount of tax withheld)	968.80	1,406	07
40. Balance of Victory tax (Item 38 minus Item 39)		(412	27)

TAX SUMMARY

41. Income tax (Item 32)	7,680	35
42. Balance of Victory tax (Item 40)	(412	27)
43. Total tax payable (Item 41 plus item 42, or minus item 42, if item 39 exceeds item 38)	7,268	08

SCHEDULE A. POST-WAR REFUNDS

1. Victory Tax, Item 38 .... $993.80
2. Post-War refund, based on Item 1 at 44% arrived at as follows:
   25%, if single, or married and not living with husband or wife, and no dependents
   40%, if head of a family, or married and living with husband or wife, and no dependents
   2%, for each dependent 437.27

3. Credit claimed in advance on this return consisting of:
   (a) Premium on life insurance in force September 1, 1942, allowable under section 453 (a) (1) $628.00
   (b) Payment on debt contracted prior to September 1, 1942, allowable under section 453 (a) (2) ....
   (c) Purchase of War Bonds, allowable under section 453 (a) (3) .... 1,200.00 ——— 1,828.00

4. Balance, if any, refundable after the war .... None

SCHEDULE B. VICTORY TAX WITHHELD AT SOURCE

Name of Employer	Amount of salaries, wages, fees, commissions, bonuses	Tax Withheld
Steel Door Co.	$20,000.00	$968.80
Totals	$20,000.00	$968.80

Victory Tax Burden and Effective Rates of Tax

The following table will show the Victory tax burden in the case of a single person with no dependents, a married person with no dependents, and a married person with two dependents. The tax burden is shown both before and after the post-war credit.

TABLE IV.—*Victory tax—amount of gross Victory tax, post-war credit, and net Victory tax*

Gross income	Gross Victory tax	Post-war credit			Net Victory tax		
		Single person, no dependents	Married person, no dependents	Married person, 2 dependents	Single person, no dependents	Married person, no dependents	Married person, 2 dependents
$600							
$700	$3.80	$0.95	$1.52	$1.67	$2.85	$2.28	$2.13
$750	6.30	1.58	2.52	2.77	4.72	3.78	3.53
$800	8.80	2.20	3.52	3.87	6.60	5.28	4.93
$900	13.80	3.45	5.52	6.07	10.35	8.28	7.73
$1,000	18.80	4.70	7.52	8.27	14.10	11.28	10.53
$1,100	23.80	5.95	9.52	10.47	17.85	14.28	13.33
$1,200	28.80	7.20	11.52	12.67	21.60	17.28	16.13
$1,300	33.80	8.45	13.52	14.87	25.35	20.28	18.93
$1,400	38.80	9.70	15.52	17.07	29.10	23.28	21.73
$1,500	43.80	10.95	17.52	19.27	32.85	26.28	24.53
$1,600	48.80	12.20	19.52	21.47	36.60	29.28	27.33
$1,700	53.80	13.45	21.52	23.67	40.35	32.28	30.13
$1,800	58.80	14.70	23.52	25.87	44.10	35.28	32.93
$1,900	63.80	15.95	25.52	28.07	47.85	38.28	35.73
$2,000	68.80	17.20	27.52	30.27	51.60	41.28	38.53
$2,100	73.80	18.45	29.52	32.47	55.35	44.28	41.33
$2,200	78.80	19.70	31.52	34.67	59.10	47.28	44.13
$2,300	83.80	20.95	33.52	36.87	62.85	50.28	46.93
$2,400	88.80	22.20	35.52	39.07	66.60	53.28	49.73
$2,500	93.80	23.45	37.52	41.27	70.35	56.28	52.53
$3,000	118.80	29.70	47.52	52.27	89.10	71.28	66.53
$4,000	168.80	42.20	67.52	74.27	126.60	101.28	94.53
$5,000	218.80	54.70	87.52	96.27	164.10	131.28	122.53
$6,000	268.80	67.20	107.52	118.27	201.60	161.28	150.53
$7,000	318.80	79.70	127.52	140.27	239.10	191.28	178.53
$8,000	368.80	92.20	147.52	162.27	276.60	221.28	206.53
$9,000	418.80	104.70	167.52	181.27	314.10	251.28	234.53
$10,000	468.80	117.20	187.52	206.27	351.60	281.28	262.53
$15,000	718.80	179.70	287.52	316.27	539.10	431.28	402.53

TABLE IV.—*Victory tax—amount of gross Victory tax, post-war credit, and net Victory tax*—Continued

Gross income	Gross Victory tax	Post-war credit			Net Victory tax		
		Single person, no dependents	Married person, no dependents	Married person, 2 dependents	Single person, no dependents	Married person, no dependents	Married person, 2 dependents
$20,000	$968.80	$242.20	$387.52	$426.27	$726.60	$581.28	$542.53
$25,000	1,218.80	304.70	487.52	536.27	914.10	731.28	682.53
$30,000	1,468.80	367.20	587.52	646.27	1,101.60	881.28	822.53
$50,000	2,468.80	500.00	987.52	1,086.27	1,968.80	1,481.28	1,382.53
$60,000	2,968.80	500.00	1,000.00	1,200.00	2,468.80	1,968.80	1,768.80
$80,000	3,968.80	500.00	1,000.00	1,200.00	3,468.80	2,968.80	2,768.80
$100,000	4,968.80	500.00	1,000.00	1,200.00	4,468.80	3,968.80	3,768.80
$150,000	7,468.80	500.00	1,000.00	1,200.00	6,968.80	6,468.80	6,268.80
$250,000	12,468.80	500.00	1,000.00	1,200.00	11,968.80	11,468.80	11,268.80
$500,000	24,968.80	500.00	1,000.00	1,200.00	24,468.80	23,968.80	23,768.80
$750,000	37,468.80	500.00	1,000.00	1,200.00	36,968.80	36,468.80	36,268.80
$1,000,000	49,968.80	500.00	1,000.00	1,200.00	49,468.80	48,968.80	48,768.80
$2,000,000	99,968.80	500.00	1,000.00	1,200.00	99,468.80	98,968.80	98,768.80
$5,000,000	249,968.80	500.00	1,000.00	1,200.00	249,468.80	248,968.80	248,768.80

EFFECTIVE RATES

The effective rates of the Victory tax are shown by the following table:

TABLE V.—*Victory tax effective rates*

Gross income	Gross Victory tax	Net Victory tax: Single person, no dependents	Net Victory tax: Married person, no dependents	Net Victory tax: Married person, 2 dependents	Gross income	Gross Victory tax	Net Victory tax: Single person, no dependents	Net Victory tax: Married person, no dependents	Net Victory tax: Married person, 2 dependents
	Percent	*Percent*	*Percent*	*Percent*		*Percent*	*Percent*	*Percent*	*Percent*
$600					$4,000	4.22	3.16	2.53	2.36
$700	0.54	0.41	0.33	0.30	$5,000	4.38	3.28	2.63	2.45
$750	.84	.63	.50	.47	$6,000	4.48	3.36	2.69	2.51
$800	1.10	.82	.66	.62	$7,000	4.55	3.42	2.73	2.55
$900	1.53	1.15	.92	.86	$8,000	4.61	3.46	2.77	2.58
$1,000	1.88	1.41	1.13	1.05	$9,000	4.65	3.49	2.79	2.61
$1,100	2.16	1.62	1.30	1.21	$10,000	4.69	3.52	2.81	2.63
$1,200	2.40	1.80	1.44	1.34	$15,000	4.79	3.59	2.88	2.68
$1,300	2.60	1.95	1.56	1.46	$20,000	4.84	3.63	2.91	2.71
$1,400	2.77	2.08	1.66	1.55	$25,000	4.88	3.66	2.93	2.73
$1,500	2.92	2.19	1.75	1.64	$30,000	4.90	3.67	2.94	2.74
$1,600	3.05	2.29	1.83	1.71	$50,000	4.94	3.94	2.96	2.77
$1,700	3.16	2.37	1.90	1.77	$60,000	4.95	4.11	3.28	2.95
$1,800	3.27	2.45	1.96	1.83	$80,000	4.96	4.34	3.71	3.46
$1,900	3.36	2.52	2.01	1.88	$100,000	4.97	4.47	3.97	3.77
$2,000	3.44	2.58	2.06	1.93	$150,000	4.98	4.65	4.31	4.18
$2,100	3.51	2.64	2.11	1.97	$250,000	4.99	4.79	4.59	4.51
$2,200	3.58	2.69	2.15	2.01	$500,000	4.994	4.89	4.79	4.75
$2,300	3.64	2.73	2.19	2.04	$750,000	4.996	4.93	4.86	4.84
$2,400	3.70	2.77	2.22	2.07	$1,000,000	4.997	4.95	4.90	4.88
$2,500	3.75	2.81	2.25	2.10	$2,000,000	4.998	4.97	4.95	4.94
$3,000	3.96	2.97	2.38	2.22	$5,000,000	4.999	4.99	4.979	4.975

WITHHOLDING AT THE SOURCE

In the case of wages and salaries, a 5-percent tax on the amount in excess of $624 is paid at the source.

Compensation for the following services is not subject to payment at the source: (1) Services performed by a member of the military or naval forces of the United States other than pensions and retirement pay; (2) agricultural labor; (3) domestic service in a private home, local college club, or local chapter of a college fraternity or sorority;

(4) casual labor not in the course of employer's regular trade or business; (5) services as an employee of a nonresident alien individual, foreign partnership, or foreign corporation, if such persons are not engaged in trade or business in the United States; (6) services as an employee of a foreign government or a wholly owned instrumentality thereof; (7) services performed as an employee while outside the United States unless the major part of the services during the year are performed within the United States.

In computing the tax required to be withheld, there is allowed the following deduction:

Pay-roll period:	*Withholding deduction*
Weekly	$12
Biweekly	24
Semimonthly	26
Monthly	52
Quarterly	156
Semiannually	312
Annually	624

If the pay-roll period is less than a week and the taxpayer receives less than $12 a week from the particular employer, no withholding is required.

At the election of the employer, if his pay-roll period with respect to an employee is weekly, biweekly, semimonthly, or monthly, the employer may collect the tax in accordance with the following table:

TABLE VI

For weekly pay-roll period			For biweekly pay-roll period			For semimonthly pay-roll period			For monthly pay-roll period		
If the wages are over	But not over	The amount of tax to be withheld shall be	If the wages are over	But not over	The amount of tax to be withheld shall be	If the wages are over	But not over	The amount of tax to be withheld shall be	If the wages are over	But not over	The amount of tax to be withheld shall be
$12	$16	$0.10	$24	$30	$0.10	$26	$30	$0.10	$52	$60	$0.20
16	20	.30	30	40	.50	30	40	.40	60	80	.90
20	24	.50	40	50	1.00	40	50	.90	80	100	1.90
24	28	.70	50	60	1.50	50	60	1.40	100	120	2.90
28	32	.90	60	70	2.00	60	70	1.90	120	140	3.90
32	36	1.10	70	80	2.50	70	80	2.40	140	160	4.90
36	40	1.30	80	100	3.30	80	100	3.20	160	200	6.40
40	50	1.60	100	120	4.30	100	120	4.20	200	240	8.40
50	60	2.10	120	140	5.30	120	140	5.20	240	280	10.40
60	70	2.60	140	160	6.30	140	160	6.20	280	320	12.40
70	80	3.10	160	180	7.30	160	180	7.20	320	360	14.40
80	90	3.60	180	200	8.30	180	200	8.20	360	400	16.40
90	100	4.10	200	220	9.30	200	220	9.20	400	440	18.40
100	110	4.60	220	240	10.30	220	240	10.20	440	480	20.40
110	120	5.10	240	260	11.30	240	260	11.20	480	520	22.40
120	130	5.60	260	280	12.30	260	280	12.20	520	560	24.40
130	140	6.10	280	300	13.30	280	300	13.20	560	600	26.40
140	150	6.60	300	320	14.30	300	320	14.20	600	640	28.40
150	160	7.10	320	340	15.30	320	340	15.20	640	680	30.40
160	170	7.60	340	360	16.30	340	360	16.20	680	720	32.40
170	180	8.10	360	380	17.30	360	380	17.20	720	760	34.40
180	190	8.60	380	400	18.30	380	400	18.20	760	800	36.40
190	200	9.10	400	420	19.20	400	420	19.20	800	840	38.40
200	.....	$9.40 plus 5% of the excess over $200.	420	440	20.30	420	440	20.20	840	880	40.40
			440	460	21.30	440	460	21.20	880	920	42.40
			460	480	22.30	460	480	22.20	920	960	44.40
			480	500	23.30	480	500	23.20	960	1,000	46.40
			500	......	$23.80 plus 5% of the excess over $500	500	......	$23.70 plus 5% of the excess over $500.	1,000	......	$47.40 plus 5% of the excess over $1,000.

If the withholding agent is unable to determine the amount of wages which is includible in gross income, the Commissioner of Internal Revenue under regulations prescribed by the Secretary of the Treasury may authorize the tax to be withheld, collected, and paid. The tax withheld shall be allowed as a credit against the Victory tax and if in excess of the Victory tax shall be allowed as a credit against the ordinary income tax.

Receipts

In the case of tax withheld on wages, the employer is required to furnish to the employee a written statement in respect of his period of employment during the calendar year, on or before January 31 of the year following, or if the employment is terminated before the close of the calendar year, on the day on which the last payment of wages is made, showing the period of the employment, the amount of wages paid, and the amount of tax withheld in respect of the wages paid.

Advantages of the Victory Tax

This Victory tax will not be applicable to the very low income-tax groups. The average amount spent for food in the case of all consumer family income levels for 1941 is $561. The average expenditures of families in the United States in this same period with incomes under $500, was $507. This is shown by the following table:

Table VII.—*Average expenditures of all families in the United States for main categories of consumption by income level, 1941*

Income level	Average expenditures per family for—														
	All items	Food	Housing	Household operation	Clothing	Automobile	Medical care	Recreation	Furnishings	Personal care	Tobacco	Transportation other than auto	Reading	Education	Other items
Under $500	$507	$220	$98	$91	$38	$10	$24	$6	$10	$10	$10	$3	$4	$2	$2
$500-$750	714	314	126	85	57	28	30	11	16	14	14	5	6	3	5
$750-$1,000	910	383	162	100	79	44	38	17	27	19	19	9	9	4	4
$1,000-$1,250	1,134	437	203	131	102	71	47	25	38	24	23	11	11	7	6
$1,250-$1,500	1,322	480	231	140	124	93	57	32	48	27	28	14	14	10	7
$1,500-$1,750	1,517	529	267	160	149	123	71	42	57	32	30	16	14	11	10
$1,750-$2,000	1,699	602	302	187	167	157	79	50	69	35	35	18	16	15	8
$2,000-$2,500	1,995	624	351	215	211	207	92	63	77	43	39	22	20	20	11
$2,500-$3,000	2,312	689	402	260	258	250	108	82	87	49	41	24	22	30	11
$3,000-$4,000	2,743	770	483	318	318	301	132	106	106	54	48	30	27	37	13
$4,000-$5,000	3,310	848	565	396	411	418	156	138	118	66	53	35	31	60	18
$5,000-$10,000	4,476	1,030	775	577	558	559	245	208	169	88	63	47	41	82	34
$10,000 and over	10,110	1,740	1,827	1,358	1,421	1,231	493	596	304	104	96	281	94	398	47
All levels	1,844	561	825	216	201	178	86	64	67	37	32	23	18	26	10

Source: Research Division, Office of Price Administration, Consumer Income and Demand Section.

The $624 exemption will also exempt from the Victory tax privates in the armed forces. This tax will be easy to administer, will result in substantially increased revenue to the Government and will eliminate the 5 percent prepayment withholding tax provided under the House bill.

The following table shows that the number of persons with incomes below $750 is decreasing rapidly. Therefore, it is believed that the exemption of $624 is sufficiently low to permit the tax to apply to those with increased incomes due to the war effort.

Comparison of distribution of consumer units by income level, 1941–42

	All families and single consumers		Increase (+) or decrease (−) over 1941
	1941	1942	
Under $500	3,759,000	2,442,000	−1,317,000
$500-$750	4,149,000	2,941,000	−1,208,000
$750-$1,000	4,521,000	3,720,000	−801,000
$1,000-$1,250	4,618,000	3,690,000	−928,000
$1,250-$1,500	4,718,000	3,917,000	−801,000
$1,500-$1,750	3,768,000	4,225,000	+457,000
$1,750-$2,000	3,201,000	3,683,000	+482,000
$2,000-$2,500	4,433,000	5,063,000	+630,000
$2,500-$3,000	3,076,000	4,047,000	+971,000
$3,000-$4,000	3,046,000	4,173,000	+1,127,000
$4,000-$5,000	1,570,000	1,834,000	+264,000
$5,000-$10,000	1,395,000	1,871,000	+476,000
$10,000 and over	790,000	994,000	+204,000

Total Tax Burden on Individuals

The following tables compare the income tax, Victory tax, and total tax burden before and after post-war credit under the Finance Committee bill with that imposed under the existing law and under the House bill; also the effective rates of tax expressed as percentages of tax to gross and net income:

TABLE VIII.—*Comparison of individual income tax and total tax on specified incomes (all income earned) under present law, House bill and Senate Finance Committee bill*

SINGLE PERSON—NO DEPENDENTS

Gross income	Net income before exemptions [1]	Present law—Income tax	House bill			Senate Finance Committee bill				
			Regular income tax	Withholding prepayment of tax due in 1944	Total income and withholding tax	Regular income tax	Victory tax	Total income and Victory tax	Post-war credit	Net tax
$500	$450									
$600	540		$5.20	$2.50	$7.70	$5.20		$5.20		$5.20
$700	630		20.92	7.50	28.42	20.92	$3.80	24.72	$0.95	23.77
$750	675		29.20	10.00	39.20	29.20	6.30	35.50	1.58	33.92
$800	720		37.48	12.50	49.98	37.48	8.80	46.28	2.20	44.08
$900	810	$3.60	54.04	17.50	71.54	54.04	13.80	67.84	3.45	64.39
$1,000	900	11.40	70.60	22.50	93.10	70.60	18.80	89.40	4.70	84.70
$1,100	990	20.04	87.16	27.50	114.66	87.16	23.80	110.96	5.95	105.01
$1,200	1,080	28.68	103.72	32.50	136.22	103.72	28.80	132.52	7.20	125.32
$1,300	1,170	37.32	120.28	37.50	157.78	120.28	33.80	154.08	8.45	145.63
$1,400	1,260	45.96	136.84	42.50	179.34	136.84	38.80	175.64	9.70	165.94
$1,500	1,350	54.60	153.40	47.50	200.90	153.40	43.80	197.20	10.95	186.25
$1,600	1,440	63.24	169.96	52.50	222.46	169.96	48.80	218.76	12.20	206.56
$1,700	1,530	71.88	186.52	57.50	244.02	186.52	53.80	240.32	13.45	226.87
$1,800	1,620	80.52	203.08	62.50	265.58	203.08	58.80	261.88	14.70	247.18
$1,900	1,710	89.16	219.64	67.50	287.14	219.64	63.80	283.44	15.95	267.49
$2,000	1,800	97.80	236.20	72.50	308.70	236.20	68.80	305.00	17.20	287.80
$2,100	1,890	106.44	252.76	77.50	330.26	252.76	73.80	326.56	18.45	308.11
$2,200	1,980	115.08	269.32	82.50	351.82	269.32	78.80	348.12	19.70	328.42
$2,300	2,070	123.72	285.88	87.50	373.38	285.88	83.80	369.68	20.95	348.73
$2,400	2,160	132.36	302.44	92.50	394.94	302.44	88.80	391.24	22.20	369.04
$2,500	2,250	141.00	319.00	97.50	416.50	319.00	93.80	412.80	23.45	389.35
$3,000	2,700	184.20	407.80	122.50	530.30	407.80	118.80	526.60	29.70	496.90
$4,000	3,600	296.10	600.40	172.50	772.90	600.40	168.80	769.20	42.20	727.00
$5,000	4,500	409.50	793.00	222.50	1,015.50	793.00	218.80	1,011.80	54.70	957.10
$6,000	5,400	548.90	1,021.60	272.50	1,294.10	1,021.60	268.80	1,290.40	67.20	1,223.20
$7,000	6,300	698.30	1,250.20	322.50	1,572.70	1,250.20	318.80	1,569.00	79.70	1,489.30
$8,000	7,200	865.70	1,506.80	372.50	1,879.30	1,506.80	368.80	1,875.60	92.20	1,783.40
$9,000	8,100	1,051.10	1,771.40	422.50	2,193.90	1,771.40	418.80	2,190.20	104.70	2,085.50
$10,000	9,000	1,246.50	2,056.00	472.50	2,528.50	2,056.00	468.80	2,524.80	117.20	2,407.60
$15,000	13,500	2,493.50	3,719.00	722.50	4,441.50	3,719.00	718.80	4,437.80	179.70	4,258.10
$20,000	18,000	4,111.50	5,791.00	972.50	6,763.50	5,791.00	968.80	6,759.80	242.20	6,517.60
$25,000	22,500	6,031.50	8,176.00	1,222.50	9,398.50	8,176.00	1,218.80	9,394.80	304.70	9,090.10
$30,000	27,000	8,191.50	10,801.00	1,472.50	12,273.50	10,801.00	1,468.80	12,269.80	367.20	11,902.60

[1] 10 percent of gross allowed in lieu of deductions in arriving at net income.

TABLE VIII.—*Comparison of individual income tax and total tax on specified incomes (all income earned) under present law, House bill and Senate Finance Committee bill*—Continued

SINGLE PERSON—NO DEPENDENTS—Continued

Gross income	Net income before exemptions	Present law—income tax	House bill			Senate Finance Committee bill				
			Regular income tax	Withholding prepayment of tax due in 1944	Total income and withholding tax	Regular income tax	Victory tax	Total income and Victory tax	Post-war credit	Net tax
$50,000	$45,000	$17,931.50	$22,361.00	$2,472.50	$24,833.50	$22,361.00	$2,468.80	$24,829.80	$500.00	$24,329.80
$60,000	54,000	23,306.50	28,676.00	2,972.50	31,648.50	28,676.00	2,968.80	31,644.80	500.00	31,144.80
$80,000	72,000	34,536.50	42,026.00	3,972.50	45,998.50	42,026.00	3,968.80	45,994.80	500.00	45,494.80
$100,000	90,000	46,421.50	56,351.00	4,972.50	61,323.50	56,351.00	4,968.80	61,319.80	500.00	60,819.80
$150,000	135,000	77,356.50	94,381.00	7,472.50	101,853.50	94,381.00	7,468.80	101,849.80	500.00	101,349.80
$250,000	225,000	140,441.50	172,616.00	12,472.50	185,088.50	172,616.00	12,468.80	185,084.80	500.00	184,584.80
$500,000	450,000	307,654.00	370,616.00	24,972.50	395,588.50	370,616.00	24,968.80	395,584.80	500.00	395,084.80
$750,000	675,000	480,396.50	568,616.00	37,472.50	606,088.50	568,616.00	37,468.80	606,084.80	500.00	605,584.80
$1,000,000	900,000	655,139.00	768,616.00	49,972.50	818,588.50	768,616.00	[2] 43,384.00	810,000.00	500.00	809,985.00
$2,000,000	1,800,000	1,305,131.50	1,558,616.00	99,972.50	1,658,588.50	1,558,616.00	[2] 61,384.00	1,620,000.00	500.00	1,619,985.00
$5,000,000	4,500,000	3,523,124.00	3,934,616.00	249,972.50	4,184,588.50	3,934,616.00	[2] 115,384.00	4,050,000.00	500.00	4,049,985.00

[2] Adjusted so that total tax will not exceed 90 percent of net income.

TABLE IX.—*Comparison of individual income tax and total tax on specified incomes (all income earned) under present law, House bill, and Senate Finance Committee bill*

MARRIED PERSON—NO DEPENDENTS

Gross income	Net income before exemptions [1]	Present law—Income tax	House bill			Senate Finance Committee bill				
			Regular income tax	Withholding prepayment of tax due in 1944	Total income and withholding tax	Regular income tax	Victory tax	Total income and Victory tax	Post-war credit	Net tax
$500	$450									
$600	540									
$700	630						$3.80	$3.80	$1.52	$2.28
$750	675						6.30	6.30	2.52	3.78
$800	720						8.80	8.80	3.52	5.28
$900	810						13.80	13.80	5.52	8.28
$1,000	900						18.80	18.80	7.52	11.28
$1,100	990						23.80	23.80	9.52	14.28
$1,200	1,080						28.80	28.80	11.52	17.28
$1,300	1,170						33.80	33.80	13.52	20.28
$1,400	1,260		$7.80	$4.00	$11.80	$7.80	38.80	46.60	15.52	31.08
$1,500	1,350		20.40	9.00	29.40	20.40	43.80	64.20	17.52	46.68
$1,600	1,440		36.96	14.00	50.96	36.96	48.80	85.76	19.52	66.24
$1,700	1,530	$1.80	53.52	19.00	72.52	53.52	53.80	107.32	21.52	85.80
$1,800	1,620	7.20	70.08	24.00	94.08	70.08	58.80	128.88	23.52	105.36
$1,900	1,710	14.16	86.64	29.00	115.64	86.64	63.80	150.44	25.52	124.92
$2,000	1,800	22.80	103.20	34.00	137.20	103.20	68.80	172.00	27.52	144.48
$2,100	1,890	31.44	119.76	39.00	158.76	119.76	73.80	193.56	29.52	164.04
$2,200	1,980	40.08	136.32	44.00	180.32	136.32	78.80	215.12	31.52	183.60
$2,300	2,070	48.72	152.88	49.00	201.88	152.88	83.80	236.68	33.52	203.16
$2,400	2,160	57.36	169.44	54.00	223.44	169.44	88.80	258.24	35.52	222.72
$2,500	2,250	66.00	186.00	59.00	245.00	186.00	93.80	279.80	37.52	242.28
$3,000	2,700	109.20	268.80	84.00	352.80	268.80	118.80	387.60	47.52	340.08
$4,000	3,600	198.60	446.40	134.00	580.40	446.40	168.80	615.20	67.52	547.68
$5,000	4,500	312.00	639.00	184.00	823.00	639.00	218.80	857.80	87.52	770.28
$6,000	5,400	425.40	839.60	234.00	1,073.60	839.60	268.80	1,108.40	107.52	1,000.88
$7,000	6,300	570.80	1,068.20	284.00	1,352.20	1,068.20	318.80	1,387.00	127.52	1,259.48
$8,000	7,200	720.20	1,296.80	334.00	1,630.80	1,296.80	368.80	1,665.60	147.52	1,518.08
$9,000	8,100	893.60	1,561.40	384.00	1,945.40	1,561.40	418.80	1,980.20	167.52	1,812.68
$10,000	9,000	1,079.00	1,826.00	434.00	2,260.00	1,826.00	468.80	2,294.80	187.52	2,107.28
$15,000	13,500	2,246.00	3,425.00	684.00	4,109.00	3,425.00	718.80	4,143.80	287.52	3,856.28
$20,000	18,000	3,819.00	5,448.00	934.00	6,382.00	5,448.00	968.80	6,416.80	387.52	6,029.28
$25,000	22,500	5,694.00	7,791.00	1,184.00	8,975.00	7,791.00	1,218.80	9,009.80	487.52	8,522.28
$30,000	27,000	7,824.00	10,380.00	1,434.00	11,814.00	10,380.00	1,468.80	11,848.80	587.52	11,251.28

[1] 10 percent of gross allowed in lieu of deductions in arriving at net income.

TABLE IX.—*Comparison of individual income tax and total tax on specified incomes (all income earned) under present law, House bill, and Senate Finance Committee bill*—Continued

MARRIED PERSON—NO DEPENDENTS—Continued

Gross income	Net income before exemptions	Present law—Income tax	House bill			Senate Finance Committee bill				
			Regular income tax	Withholding prepayment of tax due in 1944	Total income and withholding tax	Regular income tax	Victory tax	Total income and Victory tax	Post-war credit	Net tax
$50,000	$45,000	$17,499.00	$21,882.00	$2,434.00	$24,316.00	$21,882.00	$2,468.80	$24,350.80	$987.52	$23,363.28
$60,000	54,000	22,849.00	28,172.00	2,934.00	31,106.00	28,172.00	2,968.80	31,140.80	1,000.00	30,140.80
$80,000	72,000	34,043.00	41,480.00	3,934.00	45,414.00	41,480.00	3,968.80	45,448.80	1,000.00	44,448.80
$100,000	90,000	45,919.00	55,784.00	4,934.00	60,718.00	55,784.00	4,968.80	60,752.80	1,000.00	59,752.80
$150,000	135,000	76,823.00	93,786.00	7,434.00	101,220.00	93,786.00	7,468.80	101,254.80	1,000.00	100,254.80
$250,000	225,000	139,954.00	172,000.00	12,434.00	184,434.00	172,000.00	12,468.80	184,468.80	1,000.00	183,468.80
$500,000	450,000	307,084.00	370,000.00	24,934.00	394,934.00	370,000.00	24,968.80	394,968.80	1,000.00	393,968.80
$750,000	675,000	472,819.00	568,000.00	37,434.00	605,434.00	568,000.00	37,468.80	605,468.80	1,000.00	604,468.80
$1,000,000	900,000	654,554.00	766,000.00	49,934.00	815,934.00	766,000.00	[2] 44,000.00	810,000.00	1,000.00	809,000.00
$2,000,000	1,800,000	1,364,738.00	1,558,000.00	99,934.00	1,657,934.00	1,558,000.00	[2] 62,000.00	1,620,000.00	1,000.00	1,619,000.00
$5,000,000	4,500,000	3,522,521.00	3,934,000.00	249,934.00	4,183,934.00	3,934,000.00	[2] 116,000.00	4,050,000.00	1,000.00	4,049,000.00

[2] Adjusted so that total tax will not exceed 90 percent of net income.

TABLE X.—*Comparison of individual income tax and total tax on specified incomes (all income earned) under present law, House bill and Senate Finance Committee bill*

MARRIED PERSON—2 DEPENDENTS

Gross income	Net income before exemptions [1]	Present law—income tax	House bill			Senate Finance Committee bill				
			Regular income tax	Withholding prepayment of tax due in 1944	Total income and withholding tax	Regular income tax	Victory tax	Total income and Victory tax	Post-war credit	Net tax
$500	$450									
$600	540									
$700	630						$3.80	$3.80	$1.67	$2.13
$750	675						6.30	6.30	2.77	3.53
$800	720						8.80	8.80	3.87	4.93
$900	810						13.80	13.80	6.07	7.73
$1,000	900						18.80	18.80	8.27	10.53
$1,100	990						23.80	23.80	10.47	13.33
$1,200	1,080						28.80	28.80	12.67	16.13
$1,300	1,170						33.80	33.80	14.87	18.93
$1,400	1,260						38.80	38.80	17.07	21.73
$1,500	1,350						43.80	43.80	19.27	24.53
$1,600	1,440						48.80	48.80	21.47	27.33
$1,700	1,530						53.80	53.80	23.67	30.13
$1,800	1,620						58.80	58.80	25.87	32.93
$1,900	1,710						63.80	63.80	28.07	35.73
$2,000	1,800						68.80	68.80	30.27	38.53
$2,100	1,890					$11.70	73.80	85.50	32.47	53.03
$2,200	1,980					23.40	78.80	102.20	34.67	67.53
$2,300	2,070		$9.10	$5.00	$14.10	38.88	83.80	122.68	36.87	85.81
$2,400	2,160		20.80	10.00	30.80	55.44	88.80	144.24	39.07	105.17
$2,500	2,250		34.00	15.00	49.00	72.00	93.80	165.80	41.27	124.53
$3,000	2,700	$29.20	116.80	40.00	156.80	154.80	118.80	273.60	52.27	221.33
$4,000	3,600	115.60	282.40	90.00	372.40	320.40	168.80	489.20	74.27	414.93
$5,000	4,500	208.00	463.00	140.00	603.00	507.00	218.80	725.80	96.27	629.53
$6,000	5,400	321.40	655.60	190.00	845.60	699.60	268.80	968.40	118.27	850.13
$7,000	6,300	434.80	860.20	240.00	1,100.20	912.20	318.80	1,231.00	140.27	1,090.73
$8,000	7,200	584.20	1,088.80	290.00	1,378.80	1,140.80	368.80	1,509.60	162.27	1,347.33
$9,000	8,100	733.60	1,321.40	340.00	1,661.40	1,381.40	418.80	1,800.20	184.27	1,615.93
$10,000	9,000	911.00	1,586.00	390.00	1,976.00	1,646.00	468.80	2,114.80	206.27	1,908.53
$15,000	13,500	2,014.00	3,109.00	640.00	3,749.00	3,185.00	718.80	3,903.80	316.27	3,587.53
$20,000	18,000	3,516.00	5,056.00	890.00	5,946.00	5,154.00	968.80	6,122.80	426.27	5,696.53
$25,000	22,500	5,334.00	7,351.00	1,140.00	8,491.00	7,461.00	1,218.80	8,679.80	536.27	8,143.53
$30,000	27,000	7,440.00	9,916.00	1,390.00	11,306.00	10,032.00	1,468.80	11,500.80	646.27	10,854.53

[1] 10 percent of gross allowed in lieu of deductions in arriving at net income.

TABLE X.—*Comparison of individual income tax and total tax on specified incomes (all income earned) under present law, House bill and Senate Finance Committee bill*—Continued

MARRIED PERSON—TWO DEPENDENTS—Continued

Gross income	Net income before exemptions	Present law—Income tax	House bill			Senate Finance Committee bill				
			Regular income tax	Withholding prepayment of tax due in 1944	Total income and withholding tax	Regular income tax	Victory tax	Total income and Victory tax	Post-war credit	Net tax
$50,000	$45,000	$17,043.00	$21,346.00	$2,390.00	$23,736.00	$21,480.00	$2,468.80	$23,948.80	$1,086.27	$22,862.53
$60,000	54,000	22,361.00	27,596.00	2,890.00	30,486.00	27,740.00	2,968.80	30,708.80	1,200.00	29,508.80
$80,000	72,000	33,535.00	40,856.00	3,890.00	44,746.00	41,012.00	3,968.80	44,980.80	1,200.00	43,780.80
$100,000	90,000	45,383.00	55,136.00	4,890.00	60,026.00	55,298.00	4,968.80	60,266.80	1,200.00	59,066.80
$150,000	135,000	76,287.00	93,106.00	7,390.00	100,496.00	93,276.00	7,468.80	100,744.80	1,200.00	99,544.80
$250,000	225,000	139,341.00	171,296.00	12,390.00	183,686.00	171,472.00	12,468.80	183,940.80	1,200.00	182,740.80
$500,000	450,000	306,476.00	369,296.00	24,890.00	394,186.00	369,472.00	24,968.80	394,440.80	1,200.00	393,240.80
$750,000	675,000	479,203.00	567,296.00	37,390.00	604,686.00	567,472.00	37,468.80	604,940.80	1,200.00	603,740.80
$1,000,000	900,000	653,930.00	765,296.00	49,890.00	815,186.00	765,472.00	[2] 44,528.00	810,000.00	1,200.00	809,988.00
$2,000,000	1,800,000	1,363,907.00	1,557,296.00	99,890.00	1,657,186.00	1,557,472.00	[2] 62,528.00	1,620,000.00	1,200.00	1,619,988.00
$5,000,000	4,500,000	3,521,884.00	3,933,296.00	249,890.00	4,183,186.00	3,933,472.00	[2] 116,528.00	4,050,000.00	1,200.00	4,049,988.00

[2] Adjusted so that total tax will not exceed 90 percent of net income.

TABLE XI.—*Comparison of effective rates of individual income tax and total tax on specified gross and net incomes (all income earned) under present law, House bill, and Senate Finance Committee bill*

SINGLE PERSON—NO DEPENDENTS

Gross income	Net income before exemptions[1]	Present law—income tax		House bill				Senate Finance Committee bill					
				Regular income tax		Regular income and withholding tax		Regular income tax		Income and Victory tax		Net tax	
		Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income
$500	$450	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
$600	540	.00	.00	.87	.96	1.28	1.43	.87	.96	.87	.96	.87	.96
$700	630	.00	.00	2.99	3.32	4.05	4.51	2.99	3.32	3.53	3.92	3.40	3.77
$750	675	.00	.00	3.89	4.33	5.23	5.81	3.89	4.33	4.73	5.26	4.52	5.03
$800	720	.00	.00	4.68	5.21	6.25	6.94	4.68	5.21	5.78	6.43	5.51	6.12
$900	810	.40	.44	6.00	6.67	7.95	8.83	6.00	6.67	7.54	8.38	7.15	7.95
$1,000	900	1.14	1.27	7.06	7.84	9.31	10.34	7.06	7.84	8.94	9.93	8.47	9.41
$1,100	990	1.82	2.02	7.92	8.80	10.42	11.58	7.92	8.80	10.09	11.21	9.55	10.61
$1,200	1,080	2.39	2.65	8.64	9.60	11.35	12.61	8.64	9.60	11.04	12.27	10.44	11.60
$1,300	1,170	2.87	3.19	9.25	10.28	12.14	13.49	9.25	10.28	11.85	13.17	11.20	12.45
$1,400	1,260	3.28	3.65	9.77	10.86	12.81	14.23	9.77	10.86	12.55	13.94	11.85	13.17
$1,500	1,350	3.64	4.04	10.23	11.36	13.39	14.88	10.23	11.36	13.15	14.61	12.42	13.80
$1,600	1,440	3.95	4.39	10.62	11.80	13.90	15.45	10.62	11.80	13.67	15.19	12.91	14.34
$1,700	1,530	4.23	4.70	10.97	12.19	14.35	15.95	10.97	12.19	14.14	15.71	13.35	14.83
$1,800	1,620	4.47	4.97	11.28	12.54	14.75	16.39	11.28	12.54	14.55	16.17	13.73	15.26
$1,900	1,710	4.69	5.21	11.56	12.84	15.11	16.79	11.56	12.84	14.92	16.58	14.08	15.64
$2,000	1,800	4.89	5.43	11.81	13.12	15.43	17.15	11.81	13.12	15.25	16.94	14.39	15.99
$2,100	1,890	5.07	5.63	12.04	13.37	15.73	17.47	12.04	13.37	15.55	17.28	14.67	16.30
$2,200	1,980	5.23	5.81	12.24	13.60	15.99	17.77	12.24	13.60	15.82	17.58	14.93	16.59
$2,300	2,070	5.38	5.98	12.43	13.81	16.23	18.04	12.43	13.81	16.07	17.86	15.16	16.85
$2,400	2,160	5.51	6.13	12.60	14.00	16.46	18.28	12.60	14.00	16.30	18.11	15.38	17.09
$2,500	2,250	5.64	6.27	12.76	14.18	16.66	18.51	12.76	14.18	16.51	18.35	15.57	17.30
$3,000	2,700	6.14	6.82	13.59	15.10	17.68	19.64	13.59	15.10	17.55	19.50	16.56	18.40
$4,000	3,600	7.40	8.22	15.01	16.68	19.32	21.47	15.01	16.68	19.23	21.37	18.17	20.19
$5,000	4,500	8.19	9.10	15.86	17.62	20.31	22.57	15.86	17.62	20.24	22.48	19.14	21.27
$6,000	5,400	9.15	10.16	17.03	18.92	21.57	23.96	17.03	18.92	21.51	23.90	20.39	22.65
$7,000	6,300	9.98	11.08	17.86	19.84	22.47	24.96	17.86	19.84	22.41	24.90	21.28	23.64
$8,000	7,200	10.82	12.02	18.83	20.93	23.49	26.10	18.83	20.93	23.44	26.05	22.29	24.77
$9,000	8,100	11.68	12.98	19.68	21.87	24.38	27.09	19.68	21.87	24.34	27.04	23.17	25.75
$10,000	9,000	12.46	13.85	20.56	22.84	25.28	28.09	20.56	22.84	25.25	28.05	24.08	26.75
$15,000	13,500	16.62	18.47	24.79	27.55	29.61	32.90	24.79	27.55	29.59	32.87	28.39	31.54

[1] 10 percent of gross allowed in lieu of deductions in arriving at net income.

TABLE XI.—*Comparison of effective rates of individual income tax and total tax on specified gross and net incomes (all income earned) under present law, House bill, and Senate Finance Committee bill*—Continued

SINGLE PERSONS—NO DEPENDENTS—Continued

Gross income	Net income before exemptions	Present law—income tax		House bill				Senate Finance Committee bill					
				Regular income tax		Regular income and withholding tax		Regular income tax		Income and Victory tax		Net tax	
		Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income
$20,000	$18,000	20.56	22.84	28.95	32.17	33.82	37.57	28.95	32.17	33.80	37.55	32.59	36.21
$25,000	22,500	24.13	26.81	32.70	36.34	37.59	41.77	32.70	36.34	37.58	41.75	36.36	40.40
$30,000	27,000	27.30	30.34	36.00	40.00	40.91	45.46	36.00	40.00	40.90	45.44	39.68	44.08
$50,000	45,000	35.86	39.85	44.72	49.69	49.67	55.19	44.72	49.69	49.66	55.18	48.66	54.07
$60,000	54,000	38.84	43.16	47.79	53.10	52.75	58.61	47.79	53.10	52.74	58.60	51.91	57.68
$80,000	72,000	43.17	47.97	52.53	58.37	57.50	63.89	52.53	58.37	57.49	63.88	56.87	63.19
$100,000	90,000	46.42	51.58	56.35	62.61	61.32	68.14	56.35	62.61	61.32	68.13	60.82	67.58
$150,000	135,000	51.57	57.30	62.92	69.91	67.90	75.45	62.92	69.91	67.90	75.44	67.57	75.07
$250,000	225,000	56.18	62.42	69.05	76.72	74.04	82.26	69.05	76.72	74.03	82.26	73.83	82.04
$500,000	450,000	61.53	68.37	74.12	82.36	79.12	87.91	74.12	82.36	79.12	87.91	79.02	87.80
$750,000	675,000	64.05	71.17	75.82	84.21	80.81	89.79	75.82	84.24	80.81	89.79	80.74	89.72
$1,000,000	900,000	65.51	72.79	76.66	85.18	81.66	90.73	76.66	85.18	81.66	90.00	81.61	90.00
$2,000,000	1,800,000	68.26	75.84	77.93	86.59	82.93	92.14	77.93	86.59	82.93	90.00	82.90	90.00
$5,000,000	4,500,000	70.46	78.29	78.69	87.44	83.69	92.99	78.69	87.44	83.69	90.00	83.68	90.00

TABLE XII.—*Comparison of effective rates of individual income tax and total tax on specified gross and net incomes (all income earned) under present law, House bill, and Senate Finance Committee bill*

MARRIED PERSON—NO DEPENDENTS

Gross income	Net income before exemptions[1]	Present law—income tax		House bill				Senate Finance Committee bill					
				Regular income tax		Regular income and withholding tax		Regular income tax		Income and Victory tax		Net tax	
		Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income
$500	$450	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
$600	540	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00
$700	630	.00	.00	.00	.00	.00	.00	.00	.00	.54	.60	.33	.36
$750	675	.00	.00	.00	.00	.00	.00	.00	.00	.84	.93	.50	.55
$800	720	.00	.00	.00	.00	.00	.00	.00	.00	1.10	1.22	.66	.73
$900	810	.00	.00	.00	.00	.00	.00	.00	.00	1.53	1.70	.92	1.02
$1,000	900	.00	.00	.00	.00	.00	.00	.00	.00	1.88	2.09	1.13	1.25
$1,100	990	.00	.00	.00	.00	.00	.00	.00	.00	2.16	2.40	1.30	1.44
$1,200	1,080	.00	.00	.00	.00	.00	.00	.00	.00	2.40	2.67	1.44	1.60
$1,300	1,170	.00	.00	.00	.00	.00	.00	.00	.00	2.60	2.89	1.56	1.73
$1,400	1,260	.00	.00	.56	.62	.84	.94	.56	.62	3.33	3.70	2.22	2.47
$1,500	1,350	.00	.00	1.36	1.51	1.96	2.18	1.36	1.51	4.28	4.76	3.11	3.46
$1,600	1,440	.00	.00	2.31	2.57	3.18	3.54	2.31	2.57	5.36	5.96	4.14	4.60
$1,700	1,530	.11	.12	3.15	3.50	4.27	4.74	3.18	3.50	6.31	7.01	5.05	5.61
$1,800	1,620	.40	.44	3.89	4.33	5.23	5.81	3.89	4.33	7.16	7.96	5.85	6.50
$1,900	1,710	.75	.83	4.56	5.07	6.09	6.76	4.56	5.07	7.92	8.80	6.57	7.31
$2,000	1,800	1.14	1.27	5.16	5.73	6.86	7.62	5.16	5.73	8.60	9.56	7.22	8.03
$2,100	1,890	1.50	1.66	5.70	6.34	7.56	8.40	5.70	6.34	9.22	10.24	7.81	8.68
$2,200	1,980	1.82	2.02	6.20	6.88	8.20	9.11	6.20	6.88	9.78	10.86	8.35	9.27
$2,300	2,070	2.12	2.35	6.65	7.39	8.78	9.75	6.65	7.39	10.29	11.43	8.83	9.81
$2,400	2,160	2.39	2.66	7.06	7.84	9.31	10.34	7.06	7.84	10.76	11.96	9.28	10.31
$2,500	2,250	2.64	2.93	7.44	8.27	9.80	10.89	7.44	8.27	11.19	12.44	9.69	10.77
$3,000	2,700	3.64	4.04	8.96	9.96	11.76	13.07	8.96	9.96	12.92	14.36	11.34	12.60
$4,000	3,600	4.96	5.52	11.16	12.40	14.51	16.12	11.16	12.40	15.38	17.09	13.69	15.21
$5,000	4,500	6.24	6.93	12.78	14.20	16.46	18.29	12.78	14.20	17.16	19.06	15.41	17.12
$6,000	5,400	7.09	7.88	13.99	15.55	17.89	19.88	13.99	15.55	18.47	20.53	16.68	18.53
$7,000	6,300	8.15	9.06	15.26	16.96	19.32	21.46	15.26	16.96	19.81	22.02	17.99	19.99
$8,000	7,200	9.00	10.00	16.21	18.01	20.38	22.65	16.21	18.01	20.82	23.13	18.98	21.08
$9,000	8,100	9.93	11.03	17.35	19.28	21.62	24.02	17.35	19.28	22.00	24.45	20.14	22.38
$10,000	9,000	10.79	11.99	18.26	20.29	22.60	25.11	18.26	20.29	22.95	25.50	21.07	23.41
$15,000	13,500	14.97	16.64	22.83	25.37	27.39	30.44	22.83	25.37	27.63	30.69	25.71	28.56

[1] 10 percent of gross allowed in lieu of deductions in arriving at net income.

TABLE XII.—*Comparison of effective rates of individual income tax and total tax on specified gross and net incomes (all income earned) under present law, House bill, and Senate Finance Committee bill*—Continued

MARRIED PERSON—NO DEPENDENTS—Continued

Gross income	Net income before exemptions	Present law—income tax		House bill				Senate Finance Committee bill					
				Regular income tax		Regular income and withholding tax		Regular income tax		Income and Victory tax		Net tax	
		Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income
$20,000	$18,000	19.09	21.22	27.24	30.27	31.91	35.46	27.24	30.27	32.08	35.65	30.15	33.50
$25,000	22,500	22.78	25.31	31.16	34.63	35.90	39.89	31.16	34.63	36.04	40.04	34.09	37.88
$30,000	27,000	26.08	28.98	34.60	38.44	39.38	43.76	34.60	38.44	39.50	43.88	37.54	41.71
$50,000	45,000	35.00	38.89	43.76	48.63	48.63	54.04	43.76	48.63	48.70	54.11	46.73	51.92
$60,000	54,000	38.68	42.31	46.95	52.17	51.84	57.60	46.95	52.17	51.90	57.67	50.23	55.82
$80,000	72,000	42.56	47.29	51.85	57.61	56.77	63.07	51.85	57.61	56.81	63.12	55.56	61.73
$100,000	90,000	45.92	51.02	55.78	61.98	60.72	67.46	55.78	61.98	60.75	67.50	59.75	66.39
$150,000	135,000	51.23	56.92	62.52	69.47	67.48	74.98	62.52	69.47	67.50	75.00	66.84	74.26
$250,000	225,000	55.96	62.18	68.80	76.44	73.77	81.97	68.80	76.44	73.79	81.99	73.39	81.54
$500,000	450,000	61.42	68.24	74.00	82.22	78.99	87.76	74.00	82.22	78.99	87.77	78.79	87.55
$750,000	675,000	63.98	71.08	75.73	84.15	80.72	89.69	75.73	84.15	80.73	89.70	80.60	89.55
$1,000,000	900,000	65.46	72.73	76.60	85.11	81.59	90.66	76.60	85.11	81.00	90.00	80.90	89.89
$2,000,000	1,800,000	68.23	75.81	77.90	86.56	82.90	92.11	77.90	86.56	81.00	90.00	80.95	89.94
$5,000,000	4,500,000	70.45	78.28	78.68	87.42	83.68	92.98	78.68	87.42	81.00	90.00	80.98	89.98

Table XIII.—*Comparison of effective rates of individual income tax and total tax on specified gross and net income (all income earned) under present law, House bill, and Senate Finance Committee bill*

MARRIED PERSON—2 DEPENDENTS

Gross income	Net income before exemptions [1]	Present law—income tax		House bill				Senate Finance Committee bill					
				Regular income tax		Regular income and withholding tax		Regular income tax		Income and Victory tax		Net tax	
		Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income
$500	$450	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
$600	540	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00
$700	630	.00	.00	.00	.00	.00	.00	.00	.00	.54	.60	.30	.34
$750	675	.00	.00	.00	.00	.00	.00	.00	.00	.84	.93	.47	.52
$800	720	.00	.00	.00	.00	.00	.00	.00	.00	1.10	1.22	.62	.68
$900	810	.00	.00	.00	.00	.00	.00	.00	.00	1.53	1.70	.86	.95
$1,000	900	.00	.00	.00	.00	.00	.00	.00	.00	1.88	2.09	1.05	1.17
$1,100	990	.00	.00	.00	.00	.00	.00	.00	.00	2.16	2.40	1.21	1.35
$1,200	1,080	.00	.00	.00	.00	.00	.00	.00	.00	2.40	2.67	1.34	1.49
$1,300	1,170	.00	.00	.00	.00	.00	.00	.00	.00	2.60	2.89	1.46	1.62
$1,400	1,260	.00	.00	.00	.00	.00	.00	.00	.00	2.77	3.08	1.55	1.72
$1,500	1,350	.00	.00	.00	.00	.00	.00	.00	.00	2.92	3.24	1.64	1.82
$1,600	1,440	.00	.00	.00	.00	.00	.00	.00	.00	3.05	3.39	1.71	1.90
$1,700	1,530	.00	.00	.00	.00	.00	.00	.00	.00	3.16	3.52	1.77	1.97
$1,800	1,620	.00	.00	.00	.00	.00	.00	.00	.00	3.27	3.63	1.83	2.03
$1,900	1,710	.00	.00	.00	.00	.00	.00	.00	.00	3.36	3.73	1.88	2.09
$2,000	1,800	.00	.00	.00	.00	.00	.00	.00	.00	3.44	3.82	1.93	2.14
$2,100	1,890	.00	.00	.00	.00	.00	.00	.56	.62	4.07	4.52	2.53	2.81
$2,200	1,980	.00	.00	.00	.00	.00	.00	1.06	1.18	4.65	5.16	3.07	3.41
$2,300	2,070	.00	.00	.40	.44	.61	.68	1.69	1.88	5.33	5.93	3.73	4.15
$2,400	2,160	.00	.00	.87	.96	1.28	1.43	2.31	2.57	6.01	6.68	4.38	4.87
$2,500	2,250	.00	.00	1.36	1.51	1.96	2.18	2.88	3.20	6.63	7.37	4.98	5.53
$3,000	2,700	.97	1.08	3.89	4.33	5.23	5.81	5.16	5.73	9.12	10.13	7.38	8.20
$4,000	3,600	2.89	3.21	7.06	7.84	9.31	10.34	8.01	8.90	12.23	13.59	10.37	11.53
$5,000	4,500	4.16	4.62	9.26	10.29	12.06	13.40	10.14	11.27	14.52	16.13	12.59	13.99
$6,000	5,400	5.36	5.95	10.93	12.14	14.09	15.66	11.66	12.96	16.14	17.93	14.17	15.74
$7,000	6,300	6.21	6.90	12.29	13.65	15.72	17.46	13.03	14.48	17.59	19.54	15.58	17.31
$8,000	7,200	7.30	8.11	13.61	15.12	17.23	19.15	14.26	15.84	18.87	20.97	16.84	18.71
$9,000	8,100	8.15	9.06	14.68	16.31	18.46	20.51	15.35	17.05	20.00	22.22	17.95	19.95
$10,000	9,000	9.11	10.12	15.86	17.62	19.76	21.96	16.46	18.29	21.15	23.50	19.09	21.21
$15,000	13,500	13.43	14.92	20.73	23.03	24.99	27.77	21.23	23.59	26.03	28.92	23.92	26.57

[1] 10 percent of gross allowed in lieu of deductions in arriving at net income.

TABLE XIII.—*Comparison of effective rates of individual income tax and total tax on specified gross and net income (all income earned) under present law, House bill, and Senate Finance Committee bill*—Continued

MARRIED PERSON—2 DEPENDENTS—Continued

Gross income	Net income before exemptions	Present law—income tax		House bill				Senate Finance Committee bill					
				Regular income tax		Regular income and withholding tax		Regular income tax		Income and Victory tax		Net tax	
		Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income	Percent of gross income	Percent of net income
$20,000	$18,000	17.58	19.53	25.28	28.09	29.73	33.03	25.77	28.63	30.61	34.02	28.48	31.65
$25,000	22,500	21.34	23.71	29.40	32.67	33.96	37.74	29.84	33.16	34.72	38.58	32.57	36.19
$30,000	27,000	24.80	27.56	33.05	36.73	37.69	41.87	33.44	37.16	38.34	42.60	36.18	40.20
$50,000	45,000	34.09	37.87	42.69	47.44	47.47	52.75	42.96	47.73	47.90	53.22	45.72	50.81
$60,000	54,000	37.27	41.41	45.99	51.10	50.81	56.46	46.23	51.37	51.18	56.87	49.18	54.65
$80,000	72,000	41.92	46.58	51.07	56.74	55.93	62.15	51.26	56.96	56.23	62.47	54.73	60.81
$100,000	90,000	45.38	50.43	55.14	61.26	60.03	66.70	55.30	61.44	60.27	66.93	59.07	65.63
$150,000	135,000	50.86	56.51	62.07	68.97	67.00	74.44	62.14	69.09	67.16	74.63	66.36	73.74
$250,000	225,000	55.74	61.93	68.52	76.13	73.47	81.64	68.59	76.21	73.58	81.75	73.10	81.22
$500,000	450,000	61.30	68.11	73.86	82.07	78.84	87.60	73.89	82.10	78.89	87.65	78.65	87.39
$750,000	675,000	63.89	70.99	75.64	84.04	80.62	89.58	75.66	84.07	80.66	89.62	80.50	89.44
$1,000,000	900,000	65.39	72.66	76.53	85.03	81.52	90.58	76.55	85.05	81.00	90.00	80.998	89.998
$2,000,000	1,800,000	68.20	75.77	77.86	86.52	82.86	92.07	77.85	86.53	81.00	90.00	80.9994	89.9993
$5,000,000	4,500,000	70.44	78.26	78.67	87.41	83.66	92.96	78.67	87.41	81.00	90.00	80.9997	89.9997

III. CORPORATION INCOME AND EXCESS PROFITS TAXES

1. Surtax

Neither the House bill nor your committee bill makes any change in the corporation normal tax rates of the existing law.

The House bill, however, made substantial changes in the corporation surtax. The present surtax on corporations is 6 percent upon the first $25,000 of surtax net income and 7 percent upon surtax net income in excess of $25,000. These rates apply by brackets rather than by totality; that is, the first $25,000 of surtax net income is taxed at 6 percent regardless of the size of the total surtax net income. The House bill fixed the rate on corporation surtax net incomes of not more than $25,000 at 10 percent and on corporation surtax net incomes in excess of $50,000 at 21 percent. A notch was provided for corporations with surtax net incomes of between $25,000 and $50,000 by which the transition from the lower to the higher rate is made gradual. Your committee bill retains this method of applying the rates by totality rather than by brackets but reduces the rate applicable to surtax net incomes in excess of $50,000 from 21 percent to 16 percent. The notch rate is also reduced correspondingly.

The House rate of 21 percent when coupled with the normal tax rate of 24 percent, would make a combined rate of 45 percent upon the normal profits of corporations regardless of whether they are enjoying increased business under the war program or find their business impaired because of wartime restrictions. Your committee believes this rate upon normal profits to be too high and would result in severe hardship on many corporations crippled by priorities and other effects of our war economy. Consequently, by lowering the surtax rate from 21 percent to 16 percent, the combined normal and surtax rate is placed at 40 percent instead of 45 percent.

2. Excess-Profits Tax

The present law allows a specific exemption of $5,000 for excess-profits-tax purposes. The House bill increased this exemption to $10,000. Your committee bill restores the $5,000 exemption of the present law.

The House bill placed a flat rate of 90 percent upon excess profits in lieu of the graduated rates of from 35 to 60 percent in the present law. Your committee concurs in this action. However, in order to cushion the impact of this severe rate in certain unusual cases and to provide incentive for economical corporate management and funds for post-war rehabilitation in the case of all corporations subject to the excess-profits tax, your committee bill contains the following provisions:

(a) *Limitation on the maximum effective rate of the corporation normal tax, surtax, and excess-profits tax.*

The committee hearings disclosed that in the case of a number of corporations, the combined effective rate of the normal tax, surtax, and excess-profits tax would approach 90 percent. These companies have small excess-profits credits but having expanded tremendously in war work find almost all of their income subject to the 90-percent

excess-profits-tax rate. Your committee feels that in no case should more than 80 percent of corporate profits be taken in normal tax, surtax, and excess-profits tax. Consequently, the bill limits the over-all effective rate of these taxes to 80 percent of the surtax net income before its reduction by the credit for the income subject to excess-profits tax. The effect of this provision is to reduce the excess-profits tax in such cases to an amount which when combined with the normal tax and surtax will not exceed the 80-percent limitation.

(*b*) *Post-war credit.*

Your committee bill provides a post-war credit for corporations amounting to 10 percent of their excess-profits tax. This provision is felt desirable in order to encourage efficient and economical corporate management under the stress of war economy and to provide a fund that will be available for the conversion of production facilities after the war to peacetime demands. Under this provision, corporations will pay the full excess-profits tax provided in the bill. Ten percent of this amount constituting the post-war credit will be credited to the taxpayer's account and it will be given bonds payable after the war in the following manner:

	Calendar year (beginning after cessation of hostilities) on last day of which bonds mature
Bonds purchased with the credit for any taxable year beginning:	
Within the calendar year 1942	Second.
Within the calendar year 1943	Third.
Within the calendar year 1944	Fourth.
After December 31, 1944	Fifth.

These bonds will be issued under the authority of and subject to the provisions of the Second Liberty Bond Act, as amended. They will bear no interest, be nonnegotiable and may not be transferred by assignment, pledge, or otherwise.

Thus, under this provision corporations will pay the full excess-profits tax but will have 10 percent of such tax refunded to them after the war. In the meantime, the Government will have the use of this money, interest free.

(*c*) *Credit for debt retirement.*

The post-war credit so determined is available currently for retirement of the taxpayer's indebtedness. Thus, those taxpayers with heavy tax commitments may use their post-war credit currently rather than wait until the termination of the war to meet such commitments. Relief granted is limited to 40 percent of the amounts paid in debt retirement and in no case may exceed the amount of the post-war credit for the taxable year.

For example, a corporation has an excess-profits tax of $900,000. It is entitled to a post-war credit of $90,000. If it retires a principal amount of indebtedness of $100,000 during the taxable year, the post-war credit is reduced to $50,000, the taxpayer being allowed a credit for 40 percent of the $100,000, or $40,000, currently. In effect, its excess-profits tax would be reduced from $900,000 to $860,000 and its post-war credit would be reduced from $90,000 to $50,000.

3. Tax on Foreign Corporations

The rate of tax on foreign corporations not engaged in trade or business within the United States is fixed by the present law at 27½ percent. The House bill increased this rate to 37 percent. Since

this is in effect a tax upon the gross income of such corporations derived from United States sources, your committee has made this rate 30 percent.

IV. TAXATION OF CERTAIN TYPES OF CORPORATION

1. Mutual Insurance Companies Other Than Life or Marine

Under the House bill, mutual insurance companies other than life were to be taxed on the basis of their underwriting and investment income. The objective was a taxing system substantially the same as that which has been applied to stock insurance companies other than life since 1921. In recognition of the quality of mutuality, however, two special deductions were allowed. One of these was dividends to policyholders; the other, surplus apportioned to policyholders. The latter was found to involve concepts generally novel to the business of writing insurance. Dividends to policyholders, moreover, were deductible only to the extent they were paid out of premiums received or surplus apportioned to policyholders; to the extent they were paid out of investment income, they were disallowed. For the purpose of determining their deductibility, dividends were assumed to be paid out of investment income to the extent of such income remaining after the deduction of the tax allocable thereto.

Your committee carefully considered the House bill plan and various modifications of it in attempting to define and tax underwriting income in an equitable manner. No adequate method to accomplish that result was developed.

The committee bill, therefore, proposes to tax mutual insurance companies other than life or marine upon that one of the following two bases which produces the greater tax. One of these bases is net investment income, to which are applied the rates applicable to corporate incomes generally. The other base is the gross amount of income from interest, dividends, rents, and net premiums, less dividends to policyholders and wholly tax-exempt interest. To this base the rate of 1 percent is to apply. Mutual marine insurance companies are taxable under the provisions applicable to stock insurance companies other than life. This is essentially the basis upon which they are taxed under existing law. Reciprocal underwriters and interinsurers are subject to the net investment income tax and not to the 1 percent tax.

It is believed that the plan of taxation recommended by your committee will operate much more equitably than the House bill plan, or any modification thereof incorporating the principle of taxing underwriting income, and will have no regulatory effect upon the industry. At the same time, it offers no unusual administrative difficulties and will yield a considerable amount of revenue.

2. Insurance Companies Other Than Life or Mutual; Mutual Marine Insurance Companies

The committee bill proposes to tax mutual marine insurance companies under the provisions applicable to stock insurance companies other than life. These two classes of companies are taxed on essentially the same basis under existing law.

As in the case of mutual insurance companies, other than life or marine, the allowance of capital losses as a deduction is liberalized to include, subject to certain limitations, those resulting from the liquidation of assets to meet unusual insurance losses.

Dividends to policyholders in their capacity as such are allowed as deductions.

3. Life Insurance Companies

The committee has made certain changes in the plan incorporated in the House bill for the taxation of life insurance companies.

In lieu of the denial to burial and funeral benefit companies of the tax treatment accorded life insurance companies under the House bill, the committee proposes to continue this treatment through the calendar year 1943, after which such of these companies as are engaged directly in the manufacture of funeral supplies or the performance of services in connection with funerals are to be taxed as insurance companies other than life.

The House bill omitted to include in the term "life insurance reserves," in the case of an assessment company, the sums deposited with State officers as a guaranty or reserve funds and any funds maintained by the company exclusively for the payment of insurance written upon the assessment plan. The committee bill restores this provision of existing law.

Under the House bill, capital gain or loss treatment was extended to life insurance companies with respect to assets acquired after the enactment of the revenue bill of 1942. Since the revenue from this source would be very small, and the House provision would require life insurance companies to separate their assets according to the date of purchase, your committee believes it advisable to return to the existing law and ignore capital gains or losses in the taxation of life insurance companies.

The treatment of life insurance reserves for the purpose of computing invested capital has been objected to by insurers on the ground that, even though it should result in no excess profits tax liability, it would prejudice their position that policies in the hands of the insured are not appropriate subjects of taxation under State or local property tax laws. While agreeing with the policy of the House bill in treating such reserves in the same manner as borrowed capital for excess profits tax purposes, your committee desires its action to be interpreted as implying no such prejudice.

4. Western Hemisphere Trade Companies

American corporations trading in foreign countries within the Western Hemisphere are placed at a considerable competitive disadvantage with foreign corporations under the tax rates provided by the bill. To alleviate this competitive inequality, the committee bill relieves such corporations from surtax liability. To obtain this relief 95 percent of the gross income of such companies must be from sources outside the United States. Moreover, 90 percent of their income must be from the active conduct of a trade or business.

V. CAPITAL STOCK AND DECLARED VALUE EXCESS-PROFITS TAX

Repeal of Capital Stock Tax and Declared Value Excess-Profits Tax

Your committee has recommended the repeal of the capital stock tax, effective for the year ending June 30, 1942, and subsequent years, and the declared value excess profits tax, effective for taxable years ending after June 30, 1942. Since these taxes are predicated upon the ability of the taxpayer to guess what his future earnings will be, it is believed that it is inequitable to impose such a requirement upon the taxpayer at this time due to the uncertainty in business conditions caused by the war, priorities, and other factors, beyond the taxpayer's control.

VI. OTHER MAJOR INCOME- AND EXCESS-PROFITS-TAX AMENDMENTS

Fiscal Year Returns

Prior to the Revenue Act of 1934, corporations and individuals reporting on a fiscal-year basis were required to divide their fiscal years into two parts and pay tax on each part under the different acts applicable thereto.

The Revenue Act of 1934 and subsequent acts changed this policy so that the law applies to taxable years beginning after December 31 of the preceding year. Under this system, corporations and individuals will continue to pay under the rates of the existing law for the full fiscal year ending in 1942. For example, a corporation or an individual with a fiscal year ending November 30, 1942, has 11 months of its fiscal year ending in 1942, and will continue to pay on income received during these 11 months under the rates of the 1941 act, instead of under the higher rates provided in the pending bill, whereas corporations and individuals on a calendar-year basis must pay on their entire 1942 income at the higher rates, instead of under the 1941 rates for a portion of the year. Thus, a clear discrimination results between taxpayers because their taxable years end on different dates.

Immediately following the enactment of the 1934 act there was a pronounced increase in the number of corporations using fiscal years as their accounting period, and for filing of income-tax returns. The number has been steadily increasing, as is shown by the following table:

Corporation returns (active companies)

Year	Total returns	Fiscal year returns	Percent fiscal returns	Year	Total returns	Fiscal year returns	Percent fiscal returns
1928	443,611	54,820	12.4	1934	469,804	67,047	14.3
1929	456,021	54,609	12.0	1935	477,113	71,688	15.0
1930	463,036	59,202	12.8	1936	478,857	76,290	15.9
1931	456,896	59,508	13.0	1937	477,838	80,798	16.9
1932	451,884	59,459	13.2	1938	471,032	84,289	17.9
1933	446,842	53,889	12.1	1939	469,617	87,943	18.7

Immediately prior to, and since the enactment of the 1940 Excess Profits Tax Act, a large number of corporations changed to fiscal years ending September 30, October 31, or November 30. It was brought to the committee's attention, that, in some cases, corporations which had fiscal years ending September 30 changed their fiscal year so as to end November 30, apparently to gain the greatest tax advantage possible. This will be noted from the following tables:

Number of corporations granted permission to change accounting period, by fiscal year adopted, 1939-41

Fiscal year adopted	Year			Fiscal year adopted	Year		
	1939	1940	1941		1930	1940	1941
January	150	173	139	September	237	272	340
February	68	60	51	October	199	206	357
March	102	113	118	November	215	237	607
April	105	114	92				
May	131	119	67	Total	1,897	2,048	2,337
June	430	382	284	December [1]	617	463	475
July	146	147	120				
August	114	225	162	Total	2,514	2,611	2,812

[1] Corporations changing from fiscal- to calendar-year basis of reporting.

Corporations with net incomes of $100,000 and over changing accounting periods in 1939, 1940, and 1941

CALENDAR TO FISCAL YEAR

Number of corporations with net incomes of $100,000 and over reported for period—		Year in which change of accounting period was made		
From—	To—	1939	1940	1941
January 1	September 30	8	11	([1])
Do	October 31	4	6	56
Do	November 30	13	14	132
Total		25	31	188

FISCAL YEAR TO LATER FISCAL YEAR

From—	To—	1939	1940	1941
March 1	November 30		1	
April 1	Do	1		6
May 1	Do			1
July 1	October 31	1		
September 1	November 30		1	2
October 1	Do			4
Total		2	2	13

[1] Total number not secured

In 1941 there were 24 individuals with net incomes in excess of $100,000 who changed from a calendar year to a fiscal year basis, and 23 of the 24 changed to a fiscal year ending November 30, which will result in a considerable tax savings to these 24 individuals and a loss of revenue to the Treasury.

The House bill sought to correct this situation by providing that the 1942 rates shall apply to that portion of income for the full fiscal year which the number of months of such fiscal year falling in the calendar year 1942 bears to 12 months, and the 1941 rates shall apply

to that portion of the income for the full fiscal year which the number of months falling within the calendar year 1941 bears to 12 months. Thus, if a corporation or individual has a fiscal year ending November 30, 1942, eleven-twelfths of its income would be taxed at the 1942 rates and one-twelfth at the 1941 rates.

The bill as reported by your committee amends the House bill by providing that in the case of a corporation or an individual with a fiscal year ending after June 30, 1942, the tax is the sum of the following: (*a*) That portion of the tax computed at the 1941 rates which the portion of the taxable year prior to July 1, 1942, bears to the entire taxable year; and (*b*) that portion of the tax computed at the 1942 rates which the portion of the taxable year after June 30, 1942, bears to the entire taxable year.

The committee amendment eliminates the necessity for the taxpayer to make a multiplicity of computations under two different laws as required under the House plan, and, in large measure meets this objection voiced by accountants and taxpayers. It also meets the objections voiced by those corporations whose fiscal year had closed, whose returns were filed, and whose dividends had been declared.

This amendment also meets the objections raised by many taxpayers that the tax would be retroactive, and was being imposed without notice. No increase in tax will result in the case of corporations and individuals with fiscal years ending on June 30, 1942, or prior thereto, this date being after final action was taken by the Committee on Ways and Means, and taxpayers were put on notice of this proposed change of policy.

Your committee, recognizing the competitive and tax avoidance problems involved, feels that the treatment of fiscal year taxpayers as provided by the committee amendment is fair and equitable and will have the effect of discouraging in the future the use of this method to delay the impact of increased taxes.

General Relief Provisions.

Your committee has adopted the provisions of the House bill relating to general relief for excess-profits tax purposes with certain modifications. It is recognized that specific legislation cannot take care of all of the harsh cases which may arise under a high excess-profits tax and that legislation of a general nature is necessary to provide relief for many unforeseen hardships which may arise under the excess-profits tax law.

Under the House bill, taxpayers who are entitled to use the average-earnings basis are permitted to have their base period earnings reconstructed in cases of abnormalities or hardships. In order to secure the benefit of this provision, taxpayers must meet certain specific tests to establish that their actual earnings during the base period are abnormal. This relief is granted to all taxpayers in existence during the base period, even though they computed their excess profits on the invested-capital basis. Taxpayers who did not come into existence until after the base period, are permitted to have their income constructed for the base period on a basis comparable with other taxpayers similarly situated.

To come within the general relief provisions, the taxpayer, in existence during the base period, must show that the excess profits tax (computed without the benefit of this section) was excessive and discriminatory and that the average base period net income was not a fair measure of normal earnings. To be entitled to the benefits of this provision, it must show the following:

(1) Interruption or diminution of production in the base period;

(2) Depression in the base period due to temporary economic circumstances;

(3) Depression due to a profits cycle differing from the general business cycle;

(4) Sporadic and intermittent periods of high production and profits;

(5) That the business was commenced or its character changed during the base period; or

(6) Other factors affecting the business of the taxpayer which may be reasonably considered as resulting in an inadequate standard of normal earnings during the base period if application of the provisions, to the taxpayer would not be inconsistent with the principles, conditions, and limitations of this section.

In the case of taxpayers coming into existence after the base period an average constructive base period net income will be permitted where:

(1) The business of the taxpayer is of a class in which intangible assets not includible in invested capital make important contributions to income;

(2) Where the business of the taxpayer is of a class in which capital is not an important income-producing factor;

(3) Where the invested capital is abnormally low.

Your committee has made the following changes in the House bill:

1. The general relief provision has been made retroactive with respect to all taxable years beginning after December 31, 1939. The provisions of the 1941 act are not as broad in scope and application as the provisions of the pending bill. Most of the returns for 1940 and 1941 which would be subject to the prior laws have not as yet been audited. Therefore, it is believed advisable to substitute for these old provisions the present provisions of this bill. To carry this provision into effect, with respect to the years 1940 and 1941 it is necessary to extend the time for filing application for relief for those years to a period within 6 months after the date of the enactment of the revenue bill of 1942.

2. Under the existing law, as interpreted by the Commissioner of Internal Revenue, it was necessary for the taxpayer to compute his tax without regard to the relief provisions and file a claim for refund for each taxable year. Your committee does not believe that such a procedure should be followed where the taxpayer has had its constructive average base period net income finally determined for any year. Such determination should permit the taxpayer to use the base period net income so determined as a basis in computing its excess profits tax for any future year.

3. Under the provisions of the House bill, the relief provided under this section is not applicable unless the excess profits tax payable

without regard to the relief provisions exceeds 6 percent of the taxpayers' normal tax net income (before the deduction of the excess profits tax) for the taxable year and unless the relief afforded in this section would diminish the excess profits tax otherwise payable by more than 5 percent.

Your committee does not believe it desirable to retain these limitations, as they would have the effect of denying relief to many taxpayers who would otherwise be entitled to relief under this section.

4. Under the House bill, it was provided that in determining the constructive average base-period net income of the taxpayer no regard shall be had to events or conditions affecting the taxpayer, the industry of which it is a member, or taxpayers generally, occurring or existing after December 31, 1939. There was some doubt as to whether or not this provision limits other provisions of this section. Your committee has amended this provision to make it clear that it does not preclude an examination of a taxpayer coming into existence after December 31, 1939, or of a taxpayer, the changes in the character of the business of which properly matured after such date.

5. In the case of taxpayers commencing business or changing the character of the business during the base period, the House bill defines such changes. One such change includes a change in capacity for production, operation or services taking place in any taxable year ending after December 31, 1939, as a result of commitments made prior to January 1, 1940, binding the taxpayer to make the change. Your committee felt that it was the purpose of the provision to afford relief to taxpayers who were committed to a course of action prior to January 1, 1940, and amended the provision accordingly. Such a course of action to which taxpayer was committed may be evidenced by such factors as a contract, action by a board of directors or governing body as to a particular course of action, expenditures in the commencement of such changes or other courses of action clearly indicating the intent to make such changes even though later modified.

The following illustrates certain types of cases which your committee believes properly come within the scope of this section.

(1) A distillery organized in 1935 distilled whisky and was engaged in the base period in aging its product for sale. It had relatively little reserve stock for the market in the base period and its earnings were abnormally low and did not reflect the result of its base period operations. Relief will be extended to this taxpayer under this section.

(2) A taxpayer during the base period, in addition to its regular business of manufacturing dental equipment, in 1937 entered the field of manufacture of custom-built precision parts and instruments for the aviation industry, using surplus capacity for the purpose. Such a change would entitle it to relief, and the normal expansion, including expansion of line of products, which it would have experienced in this new field under the circumstances of the base period had it entered such field two years earlier, would be considered.

(3) A taxpayer during 1936, 1937, and 1938 experienced a severe reduction in the volume of its business due in part to economic conditions but principally to financial mismanagement, suffering a deficit in 1938. New management was provided early in 1939 and

its earnings were greatly increased in that year. Suppose its net earnings were as follows:

	In thousands of dollars
1936	$283
1937	150
1938	−60
1939	461

Since such a taxpayer experienced a change in operation and management in its base period, it would be eligible for this relief and the factors mentioned should be considered in determining the amount of relief to which it is entitled.

For a detailed explanation of this section and other examples of its application, see the detailed discussion of this section under the technical provision discussion of this report.

The determination and redetermination of questions arising under this general relief section are reviewable by a Special Division of the Board of Tax Appeals, to be organized by the Chairman and to consist of not less than three members of the Board. The decisions of the Special Division are not reviewable by the Board of Tax Appeals and are to be the decisions of the Board.

Mining Corporations

In order to encourage production of minerals in connection with the war effort, certain special allowances are granted to mines. These are as follows:

(1) *Special net loss carry-over.*

Corporations which mine metals, coal, and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gravel, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand, silica, slate, soapstone, soda, sulphur, and talc are allowed a special net loss carry-over. This permits such corporations to carry over net losses for 1938 and 1939 against their income for the first taxable year beginning in 1940.

(2) *Excess-profits relief for accelerated production of mines.*

Many mining corporations as a result of the expanding war production, may find themselves with properties substantially or fully exhausted within a relatively short period of time. Your committee, therefore, believes that mining corporations with limited reserves should be given some relief from excess-profits taxation on income arising from such accelerated output.

The bill provides a special deduction in computing the excess-profits net income where the production of the mines in excess of normal exceeds 5 percent of the estimated reserves. The minerals covered by the provision are the metals, coal, and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gravel, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat,

potash, precious stones, refractories, rock phosphate, salt, sand, silica, slate, soapstone, soda, sulfur, and talc. The amount of the deduction is determined by (1) the normal profit per unit of production from the property in the base period, (2) the excess output in the taxable year and, (3) the ratio of the excess output for any taxable year to the estimated reserves at the end of the year plus the excess output for such year. The percentages of the excess production multiplied by the normal unit of profit to be allowed are as follows:

100 percent if the excess output exceeds 50 percent of the estimated recoverable units.
95 percent if such excess output exceeds 33⅓ but not 50 percent of such estimated recoverable units.
90 percent if such excess output exceeds 25 but not 33⅓ percent of such estimated recoverable units.
85 percent if such excess output exceeds 20 but not 25 percent of such estimated recoverable units.
80 percent if such excess output exceeds 16⅔ but not 20 percent of such estimated recoverable units.
60 percent if such excess output exceeds 14² ⁄₇ but not 16⅔ percent of such estimated recoverable units.
40 percent if such excess output exceeds 12½ but not 14² ⁄₇ percent of such estimated recoverable units.
30 percent if such excess output exceeds 10 but not 12½ percent of such estimated recoverable units.
20 percent if such excess output exceeds 5 but not 10 percent of such estimated recoverable units.

It is provided that if a corporation's constructive average base period income is established under section 722, the general relief section, there shall also be determined a fair and just amount to be used as normal output and normal unit of profit.

The following example will illustrate the method of computation as applied to a particular case:

Example

COMPANY X

Unit output:	
Normal unit output......tons..	200, 000
Taxable year unit output......do....	500, 000
Excess over normal......do....	300, 000
Normal unit profit, per ton......	$1
Profit on excess unit output......	$300, 000
Recoverable units: Estimated recoverable units, as defined in the bill......tons..	2, 300, 000
Exempt excess output: Percent excess unit output of estimated recoverable units, as defined in the bill......percent..	13. 04

Since the excess unit output (300,000 tons) exceeds 12½ percent but not 14² ⁄₇ percent of estimated recoverable units (2,300,000), 40 percent of such excess units output measured in terms of normal unit of profit ($300,000), or $120,000, will be allowed as a deduction in computing excess profits net income.

NOTE.—The term "estimated recoverable units" means the estimated number of units of metal, coal, or nonmetallic substances in the estimated recoverable minerals from the mineral property at the end of the taxable year plus the excess output for such year.

(3) *Exemption from excess-profits tax of corporations engaged in mining of strategic metals.*

Under the Revenue Act of 1940, income from the mining of strategic materials was exempt from the excess-profits tax. These metals were tungsten, quicksilver, manganese, platinum, antimony, chromite, and tin. These minerals have been declared to be strategic metals by the War Production Board. This exemption was removed by the Revenue Act of 1941. Your committee was requested by representatives of the War Production Board to restore this exemption, as these minerals are vitally needed for the war effort. In addition to the minerals enumerated above, there has been added sheet mica, tantalum, vanadium, and nickel, at the request of the War Production Board. This amendment has been made retroactive to cover taxable years beginning after December 31, 1940.

SPECIAL RELIEF FOR COAL AND IRON MINES

Your committee has provided special relief for coal and iron mines with accelerated production. Due to the long life of coal mines and due to the fact that the normal production was very low, very little relief will be afforded under the provisions outlined above. This amendment will permit an adjustment to the excess-profits net income of one-half of the excess production in the taxable year over the production in the base period, multiplied by the profit per unit of production for the taxable year. The following example will show how the plan operates:

(1) Average base period output	tons	100,000
(2) Taxable year output	do	190,000
(3) Excess output	do	90,000
(4) Profit per unit of production	cents per ton	10
(5) Product of (3) and (4)		$9,000
(6) 50 percent of (5)		$4,500

The amount allowed in this case in adjusting the excess-profits net income will be $4,500. This will be allowed whether the taxpayer uses the average-earnings basis or the invested-capital basis.

WAR LOSSES

The committee considered the problem of property of taxpayers located within an enemy country or within an enemy controlled area. Such property is for all practical purposes lost to the taxpayer and should be treated as a casualty loss. It is practically impossible to determine the actual disposition of such property, or whether it can be recovered after the war, or what its value would be if recovered. In general the bill provides that such property will be deemed to have been destroyed or seized and such loss may be claimed as a casualty loss in the computation of net income. If the property was within an enemy country or an area controlled by the enemy at the outbreak of the war the loss may be considered to have occurred on the date of declaration of war against such enemy country by the United States. If the property is in an area coming under the control of an enemy country after the declaration of war against such country, it shall be deemed to have been destroyed or seized on any date which falls between the latest date, as established to the satisfaction of the

Commissioner, on which such property may be considered as not destroyed or seized and the earliest date, as established to the satisfaction of the Commissioner, on which such property may be considered as having already been destroyed or seized. Such latest date shall not be later than the latest date determined by the Commissioner as the date on which the area in which the property is located was under the control of the United States or a country not at war with the United States. Such earliest date shall not be later than the earliest date determined by the Commissioner as the date on which such area may be considered under the control of the country which is at war with the United States.

Interests in or with respect to property treated by these provisions will be deemed to have been lost and accorded similar treatment as in the case of the property itself. Such interests as stocks or bonds of a corporation which held such property, and contract rights based on contractual obligations of persons all of whose property is under enemy control, may be considered worthless if all of the underlying property is deemed to have been seized or destroyed.

Any money, and the fair market value of any property, in respect of the property or interest for which loss has been taken in prior years, recovered in the taxable year must be included in income for such year. However, such recoveries are not includible in income until the aggregate of the recoveries exceeds that portion of the aggregate of the deductions taken in prior years which did not result in a reduction of tax.

This treatment is applicable in the case of taxable years beginning after December 31, 1940. However, no loss can be taken under this provision which occurred prior to December 7, 1941.

Amortization of Emergency Facilities

Under the House bill, two important changes were made in the allowance of amortization for emergency facilities.

First. The amortization provision was extended to individuals and partnerships in the case of facilities completed or acquired after December 31, 1939. The increases in individual rates in the House bill lay such a substantial burden upon noncorporate businesses engaged in war production that it seemed only equitable to allow amortization for their emergency facilities as well as those used by corporate businesses. In the case of a facility completed or acquired before January 1, 1942, by a person other than a corporation, the election to take amortization must be made within 6 months after the enactment of the revenue bill of 1942, instead of 3 months as provided in the House bill.

Second. The amortization provision was extended in the case of corporations to cover facilities acquired after December 31, 1939, and before June 11, 1940. The present law confines the allowance in the case of corporations to facilities completed or acquired after June 10, 1940. Election to take amortization with respect to such facilities must be made before the expiration of 6 months after the enactment of the revenue bill of 1942 instead of 3 months as provided in the House bill.

In addition, your committee has inserted a provision which permits a taxpayer in case the proclamation of the President terminating the

emergency is made before the completion of the facility to elect to use an amortization period beginning with the month in which the construction, reconstruction, erection, or installation of the emergency facility was begun and ending as of the end of the month within which such proclamation was issued. This will permit taxpayers who do not have any income in the period subsequent to the President's proclamation to revise their returns embraced in the period beginning with the construction of the facility and take the amortization in their returns for such period.

There are other technical changes which are discussed in the detailed discussion of the technical provisions of the bill.

Relief for Installment-Basis Taxpayers

Your committee has amended the existing law to grant relief to taxpayers reporting on the installment basis. Under the installment method of accounting a large part of the income arising from installment sales is reported in the year in which the installment payments are received instead of in the year in which the sales are made. On the other hand, expenses relating to installment sales are deducted in the year in which the sales are made.

Due to recent regulations of the Federal Reserve Board, increasing the size of the down payments and shortening the payment period on installment contracts and the shifting of certain concerns to war contracts, there is a bunching of incomes in the taxable year without the normal installment selling costs to reduce such income. To overcome this hardship, the House bill provided that taxpayers who establish that the average volume of credit extended to purchasers on the installment plan in the 4 preceding taxable years was more than 125 percent of such credit extended to such purchasers in the taxable year, may elect to report their income from installment sales on the accrual basis with respect to installment sales made after December 31, 1939.

Your committee has changed this provision to grant eligibility for relief if the average volume of credit extended to purchasers on the installment plan during the years 1938, 1939, 1940, and 1941 exceeds 125 percent of the volume of such credit extended in 1942 or subsequent years. However, the taxpayer is given an opportunity to establish eligibility for relief in terms of outstanding accounts receivable as well as in those of the volume of credit extended to purchasers on the installment plan. This change has been made in order that taxpayers who are unable to determine the volume of installment credit extended over any given year will not be denied relief because they do not keep their accounts in a manner which makes such a determination possible.

The House bill also provided that the election to compute gross income from installment sales on the accrual basis shall be irrevocable once it has been made. However, since the effect of Government credit restrictions on the income of installment-basis taxpayers is likely to be felt for no more than a 2- or 3-year period, there appears to be no reason why such taxpayers should be compelled to compute their income on the accrual basis for a longer period of time. Hence, your committee has amended the bill to provide that if a taxpayer establishes that in a taxable year subsequent to the year with respect to which the election has been made it would not be eligible to elect

such accrual method, the taxpayer may elect in its return for such year to abandon the accrual method. This latter election would be irrevocable and would preclude any further elections under this provision of the bill. The installment relief provided under this section is limited to the excess-profits tax.

The following example will show how the provision of the committee amendment will apply:

For example, a taxpayer whose outstanding installment accounts receivable averaged $50,000 at the close of the years 1938, 1939, 1940, and 1941, and whose outstanding installment accounts amounted to $25,000 at the close of 1942, would be eligible to compute its income from installment sales on the accrual basis, for the purposes of the excess-profits tax, both for 1942 and for any preceding taxable years. However, if at the close of any subsequent taxable year, the outstanding installment accounts receivable should be found to exceed $40,000, this taxpayer could elect to return to the installment method of accounting.

Income From Long-Term Contracts

Many contractors under the income-tax law have elected to report their income in the year in which the contract was completed. When the excess-profits tax was enacted, it was recognized that it would be inequitable to compel the taxpayer to report all of its income from a long-term contract in one year. A provision was inserted in the law which had the effect of permitting the taxpayer for excess-profits tax purposes to exclude from its income for the taxable year that portion of the income from the long-term contract attributable to other years. However, under the existing law, if such income was attributable to years in the base period, it was held by the Treasury that such income did not increase the base-period credit used by average earnings corporations in computing their excess-profits tax.

Your committee has amended the existing law to make it clear that in such cases the net income attributable to the base-period years will increase the average earnings credit. Under the committee bill, a taxpayer may compute its income from long-term contracts upon the percentage-of-completion method of accounting under the following circumstances:

1. If it is abnormal for the taxpayer to derive income from contracts the performance of which requires more than twelve months.
2. If the taxpayer normally derives income from such contracts but the amount of such income included in gross income for the taxable year is in excess of 125% of the average amount of the gross income from such contracts for the four previous taxable years, or if the taxpayer was not in existence during all of such years for the taxable years during which the taxpayer was in existence.

The net income of the taxpayer for the base period years is required to be adjusted to conform to this election.

Relief for Taxpayers Employing Last-in First-out Method of Inventory Valuation in Event of Forced Inventory Liquidation

Your committee amendment provides that if the taxpayer using the last-in first-out method of inventory valuation satisfactorily establishes the involuntary nature of his inventory liquidation, and if he

replaces such units at least by the end of the third year after cessation of hostilities, his taxable income should be redetermined for the year or years of involuntary liquidation. His taxable income in such year or years would be reduced or increased, depending on whether the replacement cost was greater or less than the cost of the liquidated inventory units. In other words, the taxpayer is treated as if subsequent replacements of involuntarily liquidated inventory units had been made in the year of liquidation.

The following example illustrates the way in which this provision would operate, on the assumption that replacement costs remain at $2 per inventory unit throughout the period. At the beginning of 1942 the taxpayer had on hand 1,000 inventory units at a cost per unit of $1. By the end of the year, because the taxpayer sold 400 units more than it was possible to replace, the units on hand numbered 600. The cost of these liquidated units would be $400. However, if he could have replaced these units, at a cost of $2 per unit, their cost under the last-in first-out system would have been $400 more, or $800 ($2×400 units). Thus the taxpayer pays taxes on $400 more profit than he would have paid had he been able to replace the units liquidated.

In 1945 it becomes possible for the taxpayer to replace the 400 liquidated units at $2 per unit. Since the replacement cost exceeds the inventory cost by $1, and since 400 units were replaced, taxable income for the year 1942 would be reduced by $400. This leaves taxable income for 1942 equal to what it would have been had the taxpayer been able to maintain his inventory. The amended return which would reduce the tax liability for 1942 would result in a refund being paid to the taxpayer.

Pension Trusts

Your committee has given careful consideration to the criticism and suggestions that have been made at the hearings of the committee and that have otherwise been brought to its attention with respect to the section of the House bill relating to pension, profit-sharing and stock bonus trusts, annuity plans and other plans of deferred compensation.

A number of changes have been made in this respect which liberalize the treatment accorded in the House bill but which, at the same time, in the opinion of your committee, make the provision adequate to prevent abuse and tax avoidance in this field. In addition to a number of minor changes, which are described in detail in the technical part of this report, your committee has made the following major changes in these provisions of the House bill:

(*a*) The existing law which permits an employer to recover contributions made to a trust after all of the liabilities of the trust have been satisfied, is restored.

(*b*) The employer is allowed to designate all of the pension, stock bonus, profit-sharing, and annuity plans which he intends to qualify under these provisions and if all of these plans cover a sufficient proportion of the total employees, it is not necessary that a designated proportion of the employees be included in any one plan.

(*c*) The requirement of the House bill that 70 percent of all employees be covered by the plan is changed to require only that either 70 percent be covered, or that 70 percent be eligible, provided that 80

percent of the eligible employees avail themselves of the plan. Thus, the plan qualifies if 56 percent of the employees are covered.

(*d*) In addition to the 5 percent of total compensation allowed as a deduction under the House bill, additional amounts may be deducted if it is demonstrated that they are actuarially necessary to discharge the liabilities under the plan. In determining such amounts, both past and current service credits allocated as a level amount over the remaining future service of each employee may be considered. If it is desired to take care of past service credits more rapidly, the employer is allowed deduction for amounts paid for pensions with respect to such past services to the extent of 10 percent of the total cost thereof. Moreover, if an employer in a prosperous year pays in more than such maximum amounts, he is allowed to take a deduction for the amount in excess of such 10 percent, prorated over the 5 succeeding taxable years to the extent that payments for pensions in those years do not exceed the maximum amount otherwise allowable.

(*e*) In the case of profit-sharing or stock-bonus plans, the employer is allowed a deduction for amounts paid which are not in excess of 15 percent of the compensation otherwise paid directly to the employees who are covered by the plan. In addition, a carry-over is provided under which an average of 15 percent per year may be deducted.

Base Period Net Income of Lowest Year in Base Period

The bill provides special relief for taxpayers where the excess profits net income in one of the years of the base period was less than 75 percent of the average of the excess-profits tax net income of the other years of the base period. There may be substituted for such year an amount equal to 75 percent of the average of the excess profits net income of such other base period taxable years. The operation of this section may be illustrated as follows:

	Excess profits net income	
	Unadjusted	Adjusted
1936	$50,000	$82,500
1937	100,000	100,000
1938	110,000	110,000
1939	120,000	120,000
Average	95,000	108,125
Excess profits credit (95 percent)	90,250	97,969

For 1936, 75 percent of the average of the 3 better years of the base period ($110,000) or $82,500, is substituted.

Income from the Discharge of an Indebtedness

In the case of a corporation, the existing law excludes from gross income amounts of income attributable to the discharge of the taxpayer's indebtedness, if at the time of such discharge the taxpayer was in an unsound condition. This provision does not apply to such a discharge occurring in a taxable year beginning after December 31, 1942. The House bill extended this date to December 31, 1945, but retained the requirement that the taxpayer be in an unsound financial condition.

Your committee believes these restrictions unnecessarily strict and that they deny the benefits of this section in many meritorious cases. Consequently, the committee bill removes the necessity that the taxpayer be in an unsound financial condition at the time of the discharge of the indebtedness. The present law requires the taxpayer, in order to secure the benefits of this section, to consent to the regulations regarding the adjustment of basis provided in section 113 (b) (3) of the Internal Revenue Code. This requirement is retained in the committee bill. Moreover, as in the House bill, the benefits of this provision are limited to such discharges occurring in taxable years beginning before January 1, 1946.

The provisions above described apply to corporations generally. In the case of railroad corporations which have a modification or cancelation of their indebtedness pursuant to an order of a court in a receivership proceedings or in a proceeding under section 77 of the National Bankruptcy Act such cancelations or modifications of indebtedness are excluded from gross income. Moreover, the basis of the property of such railroad corporations is not reduced through such a transaction.

State and Local Officers and Employees

Under the Public Salary Taxing Act of 1939, the Federal income tax was applied to the compensation of State and local officers and employees for taxable years beginning after December 31, 1938. Some state employees who were on a cash basis did not receive compensation for services rendered prior to December 31, 1938, until 1939.

Your committee does not believe it advisable to subject such officers and employees to the Federal income tax on compensation for services rendered prior to January 1, 1939. Accordingly, the bill amends the existing law to exempt compensation of this type earned prior to January 1, 1939.

Basis of Property Acquired by Bequest or Devise

Under the income-tax law, the beneficiary of property acquired by bequest, devise, or inheritance takes as his basis for income-tax purposes the value of the property at the date of the decedent's death. In many instances, it develops that the executor or administrator has elected under the estate-tax law to value the property of the decedent as of 1 year from the date of death. In such cases, where the executor or administrator has availed himself of this optional valuation date, it is believed that the same date should be used as the basis for computing gain or loss or depreciation by the beneficiary.

Your committee has accordingly amended the law to provide that where the executor or administrator avails himself of the optional valuation date, such valuation shall be used by the beneficiary for income-tax purposes.

Losses on Stock or Securities of Affiliated Corporations

Under the present law, losses by a parent corporation on the stock or securities of a subsidiary corporation becoming worthless are treated as capital losses in the same manner as in the case of other stock or securities held by the taxpayer. The committee bill would permit such losses to be taken in full as ordinary losses by the parent if it owns directly 95 percent of each class of the stock of the subsidiary. Such a parent and subsidiary corporation may file consolidated

returns and to this extent the corporate entity is ignored. Thus the losses of the one may be offset against the income of the other. It is deemed desirable and equitable, therefore, to allow the parent corporation to take in full the losses attributable to the complete worthlessness of the investment in the subsidiary.

Liquidation of Personal Holding Companies

Your committee has adopted a provision, similar to section 112 (b) (7) of the Revenue Act of 1938, which will permit a personal holding company to liquidate without the recognition of gain or loss to the shareholders upon the liquidation with respect to certain classes of property. Shareholders who may avail themselves of the benefits of the provision are divided into two groups (1) shareholders other than corporations and, (2) corporation shareholders. From the group of corporate shareholders, there is excluded a corporation which at any time between April 9, 1942, and the date of the adoption of the plan of liquidation, both dates inclusive, is the owner of stock possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote upon the adoption of such plan of liquidation. Written elections must be made and the transfer of all the property must occur within the month of December 1942. If proper arrangements are made in good faith for the payment after December 31, of unascertained or contingent liabilities and expenses, this section will be deemed complied with.

Gain, in the case of a shareholder entitled to the benefits of the provision, will be recognized only to the extent of the greater of the following: (1) The shareholder's ratable share of the earnings and profits accumulated since February 28, 1913, or (2) the sum of the money received by him, and the fair market value of any stock or securities received which were acquired by the corporation after September 1, 1942. In the case of a corporate shareholder such recognized gain is treated as capital gain. In the case of a shareholder other than a corporation, however, that portion of the recognized gain which is not in excess of his ratable share of the earnings and profits is treated and taxed to him as a dividend and the remainder as a short-term or long-term capital gain, as the case may be.

The amount taxed to the shareholder as a dividend is to be treated as a dividend for all tax purposes. Therefore, in the case of a shareholder which is a partnership or a trust, for example, the tax consequences will be the same as though a dividend had actually been received in ordinary course.

The basis of the property received in the liquidation shall be the same as the basis of the stock canceled or redeemed in the liquidation, increased in the amount of gain recognized to the shareholder and decreased in the amount of any money received by him.

Foreign Tax Credit

Under the provisions of existing law, a credit is allowed to American citizens and domestic corporations against their American income and profit taxes for income or profits taxes paid to a foreign country. Many of the income tax laws of foreign countries, especially those in the Latin American countries provide for taxation on an arbitrary basis in lieu of the tax on net income. Accordingly, your committee

has amended the foreign tax credit provisions, so that the term, "income, war profits, and excess-profits taxes," will include taxes in lieu of a tax upon income, war-profits or excess profit taxes otherwise generally imposed by any foreign country or by any possession of the United States.

The existing law allows income taxes paid to a foreign country to be deducted in computing net income or taken as a credit against the tax. This election must be made, however, at the time the return is filed. Because of his inability to determine when certain losses are allowable, the taxpayer in many cases cannot make a proper election at the time the return is filed. This situation is aggravated by war conditions.

The committee bill affords relief to such cases by permitting the taxpayers to make their election at any time prior to the expiration of the period in which a claim for refund can be made.

Nonrecognition of Loss in Certain Railroad Reorganizations

In recent years, many railroad corporations have been required to go into receivership or into bankruptcy. To continue their operations, it is necessary to reorganize such companies. The question as to whether or not reorganizations of this type constitute tax-free reorganizations for income-tax purposes has caused considerable concern. Recent decisions of the Supreme Court have not clarified this situation. If the reorganization is affected in such a manner as to constitute a tax-free reorganization, the basis of the property in the hands of the reorganized company is the same as its basis in the hands of the old corporation. Thus for the purposes of computing the invested capital of the reorganized corporation under the excess-profits tax the basis of the property paid in to the old corporation for stock would not be diminished. If, however, the reorganization is not tax-free, the invested capital of the reorganized corporation is reduced.

As a result of this situation, many railroad corporations will simply remain in receivership or bankruptcy for extended periods of time. It is felt desirable regardless of whether such reorganizations are taxable or tax-free in the income-tax sense to permit the basis of the property to go over undiminished to the reorganized corporation.

The committee bill provides, therefore, that in the case of such reorganizations in taxable years beginning after December 31, 1939, the basis of the property of the old corporation shall not be reduced if the transfer of the property is in pursuance of an order of a court having jurisdiction of such corporation in a receivership proceeding or in a proceeding under section 77 of the National Bankruptcy Act.

In the case of street, suburban, or interurban electric railway companies which are common carriers in interstate commerce a similar provision is made with respect to property transferred after December 31, 1934.

Compensation for Services Rendered for a Period of 36 Months or More

Under section 107 of the present law and under the amendments made to that section by the House bill, it is required that the personal services for which the compensation is received shall have been completed before the payment is made therefor. This requirement works a severe hardship in cases where payment is received before the com-

pletion of the services, even though such payment satisfies the percentage limitations and even though the services are rendered over the required number of years. Cases were brought to your committee's attention where further services were rendered after the receipt of the payment meeting the percentage requirement but the additional compensation for such further services was not sufficient to violate the percentage requirement. For example, a lawyer works 4 years on a case, but in the third year receives 80 percent or more of the compensation for the entire services. The House bill might deny the treatment accorded under this provision in such a case although such case would seem equally meritorious with that in which such compensation was received upon the completion of such services. Thus the committee bill removes the requirement that the services be completed before the compensation meeting the percentage requirement is received.

CAPITAL GAINS AND LOSSES

Your committee has made the following changes in the capital gains and loss section.

The House bill defined short-term capital gains or losses as those held for 15 months or less. Your committee has reduced the holding period to 6 months. Therefore, gains and losses from assets held over 6 months are treated as long-term gains or losses, and gains and losses from assets held for 6 months or less are treated as short-term gains or losses. The realization of a capital gain is entirely a matter within the discretion of the taxpayer. If the rates are too high, the Government will lose not only income taxes but also stamp taxes upon the transfer of property. The net receipts from capital gains and losses have been steadily declining as shown by the following table:

Estimated net revenue from tax treatment of capital gains and losses of individuals and taxable fiduciaries, 1926–40 [1]

[In thousands]

Calendar year	Estimated net revenue from capital gains and losses	Estimated tax liability on other income	Total tax liability
1926	$225,485	$506,990	$732,475
1927	296,879	533,760	830,639
1928	576,001	588,263	1,164,264
1929	420,971	580,967	1,001,938
1930	−15,226	491,941	476,715
1931	−89,001	335,128	246,127
1932	−79,917	409,879	329,962
1933	16,167	357,953	374,120
1934	17,197	494,203	511,400
1935	85,257	572,182	657,439
1936	201,941	1,012,076	1,214,017
1937	58,188	1,083,381	1,141,569
1938	52,873	712,960	765,833
1939	26,995	901,699	928,694
1940 [2]	12,868	1,481,271	1,494,139

[1] The estimates are restricted to returns with net income, including, however, in 1938–40 taxable deficit returns. Estimated net revenue from capital gains and losses is the difference between (*a*) total tax liability under the provisions of the particular revenue act applicable to each specified income year and (*b*) estimated tax liability on other income if capital gains and losses had been entirely excluded from the tax computation.

[2] Preliminary.

Source: Treasury Department, Division of Research and Statistics, Mar. 9, 1942.

Your committee believes that the lowering of the holding period will have the effect of encouraging the realization of capital gains and thereby result in added revenue to the Treasury. It is believed that a holding period of 6 months will be a sufficient deterrent to the speculator as contrasted with the legitimate investor.

(2) Under the House bill losses from the sale of real property and buildings were treated as capital losses, even though the property was used in the trade or business. Your committee has changed this rule by taking buildings and real estate used in the trade or business of the taxpayer out of the definition of capital assets, and applying to them the same rule which the House bill applies to gains and losses from involuntary conversions from the sale or exchange of certain depreciable property. If the total gains exceed the losses, such gains will be considered as gains from the sale or exchange of capital assets held for more than six months. If the gains do not exceed the losses, such losses will be treated as ordinary gains and ordinary losses instead of capital gains and capital losses.

It is believed that this Senate amendment will be of material benefit to businesses which, due to depressed conditions, have been compelled to dispose of their plant or equipment at a loss.

The bill defines property used in a trade or business as property used in the trade or business of a character which is subject to the allowance for depreciation, and real property held for more than 6 months which is not properly includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. If a newspaper purchased the plant and equipment of a rival newspaper and later sold such plant and equipment at a loss, such plant and equipment, being subject to depreciation, would constitute property used in the trade or business within the meaning of this section.

In the case of an involuntary conversion of property, the present law provides that no gain or loss is realized if the money received upon the conversion is "forthwith" converted into property similar to the property involuntarily converted, or is put into a replacement fund. Because of some inquiries that have arisen in this connection, it may be pointed out that if the taxpayer is unable to replace the property lost or converted because of conditions beyond his control, such as priorities or other wartime restrictions, the creation of the fund will suffice until such time as the property can be aquired. Your Committee is informed that this is the present practice of the Bureau of Internal Revenue and will be continued.

NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

Your committee have agreed to the House provision requiring a nonresident alien or a foreign corporation to be engaged in trade or business within the United States in order to be taxable like American citizens or domestic corporations with respect to the income derived from sources within the United States. Under the present law, this privilege is extended to a nonresident alien individual or a foreign corporation which has an office or place of business in the United States, even though it may not be engaged in business therein. The provision in the House bill is applicable only with respect to taxable

years beginning after December 31, 1941. With respect to prior taxable years, the provisions of existing law, which afford such treatment to a corporation having an office or place of business in the United States will continue to apply even though such corporation is not engaged in trade or business within the United States.

COOPERATIVE APARTMENT OWNERS

The bill provides for a new deduction in section 23 (z) of taxes and interest paid or accrued by a tenant stockholder to a cooperative apartment corporation within the taxable year. The provision applies only to a cooperative apartment corporation which has one class of stock outstanding and all of the stockholders by reason of their ownership of stock are entitled to occupy for dwelling purposes apartments in a building owned or leased by the corporation. Eighty percent or more of the gross income of the cooperative apartment corporation for the taxable year must be derived from the tenant stockholders, and the tenant stockholders who occupy the building must not be entitled to receive any distribution of the earnings or profits of the corporation except upon its complete or partial liquidation. The general purpose of this provision is to place the tenant stockholders of a cooperative apartment in the same position as the owner of a dwelling house so far as deductions for interest and taxes are concerned.

CHARITABLE CONTRIBUTIONS BY CORPORATIONS

Under the existing law, a corporation is entitled to a deduction for charitable contributions only if such contributions are gifts or to be used within the United States or any of its possessions by corporations, trusts, community trust funds, or foundations organized in the United States or in any possession thereof and operated exclusively for religious, charitable, scientific, or educational purposes.

It is believed in view of the present situation that it is unwise to limit this deduction to contributions or gifts used within the United States or any of its possessions. Accordingly, the bill provides that the deduction shall be allowed to corporations created or organized for the purposes described even though such gifts or contributions are used outside of the United States or its possessions.

Your committee also amends the existing law to permit corporations to deduct contributions or gifts made within the taxable year to or for the United States, the several States or the District of Columbia. Under the existing law such deductions are permitted to individuals but not to corporations. Your committee is of the opinion that no sound reason exists why contributions or gifts made to or for the use of the United States and the several States should not be allowed as deductions in the case of corporations.

2-YEAR CARRY-BACK OF NET OPERATING LOSSES AND UNUSED EXCESS-PROFITS CREDIT

The present law permits corporations to carry forward for 2 years their net operating losses. It also allows the unused excess-profits credit to be carried forward for 2 years. These provisions obviously are of benefit only in periods of increasing business activities. Many

corporations will suffer substantially in periods of declining profits, especially at the close of a war economy in which their deductible expenses have been held down to a bare minimum by priorities, rationing, labor shortages, and other factors beyond the control of the taxpayer. For example, a corporation during the war years makes substantial profits which would be considerably reduced if it could make the expenditures possible in a free economy for maintenance, repair, and other deductible expenses. Upon the termination of the war, the materials and labor will once more be available, but the costs and expenses which would otherwise be taken against the wartime profits will fall into the years of lesser profits or of no profits, thereby resulting in small or no tax benefit for the taxpayer.

If the taxpayer would in any case be subject to excess-profits tax for every year of the cycle, no harm results from deductions being taken in years other than those to which they should properly be attributable. This would be equally true if the taxpayer would in any case be subject only to the normal tax and surtax for each of the years in the cycle. If, however, the taxpayer is subject to excess-profits tax in the year to which the deduction should properly be attributable and not subject to excess-profits tax in the year in which the deduction is allowable under the present law, hardship results. The same is true if he is subject to normal tax and surtax in the former year and has a deficit in net income in the latter year.

To afford relief to these hardship cases, where maintenance and upkeep expenses, must, because of wartime restrictions be deferred to peacetime years, your committee has provided a 2-year carry-back of operating losses and of unused excess-profits credit. This provision affords, in effect, the same type of relief in periods of declining profits which the present 2-year carry-forward of operating losses and unused excess-profits credits affords in periods of increasing profits.

TAX-FREE GOVERNMENT BOND INTEREST

For years, many eminent tax authorities have advocated the elimination of the exemption from income tax of the interest on Government securities. The exemption of the interest on securities of State and local governments from the Federal income tax and of the interest on Federal securities from the State income tax stemmed from the doctrine of intergovernmental immunity as declared by the Supreme Court. The Federal income-tax statutes have long specifically exempted the interest on State and local securities from the Federal income tax. Likewise, most State statutes specifically exempt from their income taxes the interest on Federal obligations.

Many recent decisions of the Supreme Court have tended to the view that the intergovernmental immunity doctrine no longer prohibits one level of Government from taxing the interest from the securities issued by the other level. Many Federal securities have been issued which by their terms and by specific statutory declaration exempt their interest not only from taxation by State and local governments but also from the Federal income tax. Other Federal securities are exempt from State income taxation, but with regard to the Federal income tax are exempt only from surtaxes. These are the so-called partially tax-exempt securities.

The Federal Government began to put its own house in order in this respect in the Public Debt Act of 1941. By the terms of that legislation, the interest upon all Federal securities issued after February 28, 1941, is fully subject to the Federal income tax. It has been urged that the Federal income tax should be made applicable to all State and local bond interest regardless of when such bonds were issued. This, your committee feels is inadvisable. The bill would subject to the Federal income tax the interest on all State and local securities issued after December 31, 1942. As a corollary, the bill gives the consent of the Federal Government to State and local governments to lay their income taxes upon the interest on, and the gain from, the sale or other disposition of all Federal obligations issued after December 31, 1942.

RECOVERY OF UNCONSTITUTIONAL FEDERAL TAXES

Considerable hardship has resulted to many taxpayers in cases where taxes, later held to be unconstitutional, were taken as deductions in computing net income in previous years but are later recovered and subjected to tax in years when the rates are considerably higher than those applicable in the year in which the deduction was taken. This is particularly true in the case of the Agricultural Adjustment Administration taxes. For example, a taxpayer paid $100,000 in Agricultural Adjustment Administration taxes in 1935 and took this amount as a deduction in computing net income for Federal income-tax purposes. The income-tax rate on corporations at that time was 13¾ percent. He did not recover this unconstitutional exaction until 1941 when it was subjected to a combined normal and surtax rate of 31 percent and to an excess-profits tax. Thus, because of the delay in the refund of this tax over a period in which the tax rates have risen so substantially, such a taxpayer is severely penalized.

The committee bill would relieve this situation by putting the income attributable to the recovery of an unconstitutional Federal tax into the same year for which the deduction was taken therefor. Thus, in the example given above the tax attributable to the recovery would be measured by the rate applicable in the year of the deduction.

PREFERRED DIVIDENDS PAID BY A UTILITY CORPORATION

Under your committee bill, a public utility is allowed a credit against its surtax net income for dividends paid on its preferred stock. The term, "public utility" means a corporation engaged in the furnishing of telephone service or in the sale of electric energy, gas, or water, if the rates have been established or approved by an agency or instrumentality of the United States or by a public utility or public-service commission or other similar body of the District of Columbia or of any State or political subdivision thereof. Preferred stock is limited to stock issued prior to September 1, 1942, which on September 1, 1942, and during the whole of the taxable year was nonvoting stock, the dividends in respect of which were cumulative, limited to the same amount, and payable in preference to payment of dividends or other stock.

ADJUSTMENT IN CASE OF INCONSISTENT POSITION

Your committee bill makes a number of amendments to section 734 of the Internal Revenue Code of which those of major importance are as follows:

(a) The definition of "predecessor of the taxpayer" has been considerably narrowed so as to include only such predecessors as would be components of the taxpayer for the purposes of section 740 or a predecessor which, on April 1, 1941, was in control of the taxpayer. For this purpose "control" has the same meaning as when used in section 112 (h).

(b) The burden of proof in establishing that the inconsistent position has been taken is placed upon the Commissioner if the net effect of the adjustment would be to increase the taxpayer's income taxes previously determined for prior taxable years, and upon the taxpayer if the net effect of the adjustment would be to decrease such taxes for such prior years.

(c) If the adjustment results in a net decrease of tax the amount of the tax which represents interest is included in gross income for the taxable year in which falls the date prescribed for payment of the excess-profits tax. If the adjustment results in a net increase of tax, the portion of such net increase which represents interest is allowed as a deduction in computing net income for the taxable year in which falls the date prescribed for the payment of the excess-profits tax.

In order to clarify some questions which have arisen while this bill was under consideration by your committee regarding situations in which the inconsistent position is taken inadvertently, it should be made clear that the taxpayer may withdraw or retreat from such a position at any time prior to the final determination of this tax liability for the taxable year.

INCOME FROM SOURCES WITHOUT THE UNITED STATES IN CERTAIN CASES

Under section 116 (a) of the Internal Revenue Code a citizen of the United States residing outside the United States more than 6 months during the taxable year is exempt from tax on his earned income from sources outside of the United States, except in the case of income paid by the United States or any of its agencies. This provision of the present law has suffered considerable abuse in the case of persons absenting themselves from the United States for more than 6 months simply for tax-evasion purposes. To stop this abuse, the House bill repealed section 116 (a).

From cases brought to your committee's attention, the complete elimination of this section would work a hardship in the case of citizens of the United States who are bona fide residents of foreign countries. For example, many employees of American business in South America do not return to the United States for periods of years. Such persons are fully subject to the income tax of the foreign country of their residence. Your committee has adopted a provision which it is believed will effectively terminate the abuse of this section but at the same time will not unduly penalize our citizens who are bona fide residents of foreign countries. It provides that if such citizens establish that they are bona fide residents of a foreign country during the entire taxable year their earned income from sources without the United States will be exempt. If they have been residents of a foreign

country for 2 years or more, this same treatment will be accorded them for the year in which they return to the United States.

DEDUCTIONS FOR CERTAIN RETAIL SALES TAXES

Some State and local sales taxes are upon the purchaser at the retail sale. The purchaser thus becomes the taxpayer and is allowed the amounts of such taxes as a deduction in computing net income for Federal income-tax purposes. In the case of other State and local sales taxes, the tax is upon the seller, usually in the form of a privilege or franchise tax, but is measured by the total volume of sales or the gross receipts. The laws of such States generally provide that the tax is to be passed on to the purchaser and penalities are provided in the case of merchants who claim to absorb the tax. In such cases, the purchaser who bears the tax, which is passed on to him directly by the seller, is denied the deduction for such taxes in computing net income for Federal income-tax purposes. Thus, the deductibility of such taxes in computing net income hinges upon the legal technicality which constitutes the seller as the taxpayer in one instance and the purchaser as the taxpayer in the other. There seems to be no just reason for this distinction.

The committee bill provides that in the case of State and local taxes upon persons selling tangible personal property at retail or in furnishing services at retail, measured by the gross sales price or the gross receipts from the sale, the purchaser is allowed to deduct the amount of such tax if it is separately stated and is actually paid by the purchaser.

VII. ESTATE TAX

INSURANCE EXCLUSION FOR ESTATE TAX

Under the present law, there is excluded from the gross estate of a decedent the first $40,000 of life insurance. In addition, a specific exemption of $40,000 is allowed to each estate regardless of whether the decedent had life insurance. The House bill, in lieu of these exemptions, granted a specific exemption of $60,000 applicable to all estates regardless of whether life insurance was present. This change resulted in a loss of revenue of approximately $15,000,000. Your committee is of the opinion that revenue from this source should not be diminished at this time and accordingly has restored the provisions of existing law allowing a $40,000 exemption for life insurance and a $40,000 exemption for other property.

POWERS OF APPOINTMENT

Under existing law property is included in the decedent's gross estate if it passes under a general power exercised by the decedent. The present provision, because of a number of basic defects, has facilitated the avoidance of estate tax, thus seriously impairing the effectiveness of the tax. The House bill has corrected this situation by providing that appointive property is includible in the estate of the decedent, whether or not the power is exercised, unless the power is of a fiduciary character or is exercisable in favor of a class which is confined to the spouse of the decedent, descendants of the decedent

or of his spouse, spouses of such descendants, and specified charities. Your committee has expanded the class within the latter exempt power to include the spouse of the creator of the power, descendants (other than the decedent) of the creator of the power or of his spouse, and spouses of such descendants.

The House bill provided that existing powers, other than general powers, are not taxable under the amendments if released within two years after the date of enactment of this bill. Your committee has provided instead that existing nongeneral powers are not taxable unless they are exercised after the date of its enactment. This change has been made because of legal impediments in many cases to the release of nongeneral powers. Your committee has also provided that the amendments are inapplicable to an existing general power held by a person under a legal disability if such power is released within six months after the disability ceases.

The House bill contained corresponding gift-tax amendments which are included in your committee bill, as modified in accordance with the changes made with respect to the estate tax. The gift-tax amendments do not affect the scope of the present gift-tax statute.

VIII. EXCISE TAXES

Effective Date

This title, VIII of the bill, is, as under the House bill, to take effect on the first day of the first month which begins more than 10 days after the date of the enactment of the act.

Comparison of rates under existing law, House bill, and Finance Committee bill on certain excise taxes affected by the bill

Subject of tax	Rates		
	Existing law	House bill	Finance Committee bill
Distilled spirits	$4 per gallon	$6 per gallon	$6 per gallon.
Imported perfumes containing distilled spirits.	do	do	Do.
Fermented malt liquors	$6 per barrel	$7 per barrel	$7 per barrel.
Still wines	8 cents per gallon 30 cents per gallon 65 cents per gallon	10 cents per gallon 40 cents per gallon $1 per gallon	16 cents per gallon. 40 cents per gallon. $1 per gallon.
Sparkling wines:			
Natural	7 cents per ½ pint	10 cents per ½ pint	7 cents per ½ pint.
Artificial	3½ cents per ½ pint	5 cents per ½ pint	5 cents per ½ pint.
Liqueurs, cordials, etc	do	do	Do.
Cigarettes	$3.25 per M	$3.50 per M	$3.50 per M.
Cigarettes, large	$7.80 per M	$8.40 per M	$8.40 per M.
Cigars, retailing at—			
A. Not over 2.5 cents	$2 per M	$2.50 per M	$2 per M.
B. 2.6 to 4 cents	do	$3.50 per M	$3 per M.
C. 4.1 to 5 cents	do	$5 per M (C)	$4 per M. (C)
C. 5.1 to 6 cents	$3 per M		
D. 6.1 to 8 cents	do	$7 per M	$7 per M.
E. 8.1 to 11 cents	$5 per M	$10 per M	$10 per M. (E and F)
F. 11.1 to 15 cents	do	$13.50 per M	
G. 15.1 to 20 cents	$10.50 per M	18 per M	15 per M.
H. 20.1 to 30 cents	$13.50 per M	25 per M	20 per M. (H and I)
I. 30.1 and over	do	35 per M	
Cigarette papers and tubes:			
Papers:			
Not over 25 sheets	½ cent per package (not over 50 sheets)	½ cent per 25 papers or tubes or fraction thereof.	½ cent per package (not over 50 sheets).
26 to 50 sheets			
Each additional 50 sheets or fraction thereof.	½ cent		½ cent.
Tubes, package of 50 or fraction thereof.	1 cent per package		1 cent per package.

Comparison of rates under existing law, House bill, and Finance Committee bill on certain excise taxes affected by the bill—Continued

Subject of tax	Rates		
	Existing law	House bill	Finance Committee bill
Smoking tobacco	18 cents per pound	24 cents per pound	18 cents per pound.
Telephone and radio—telephone toll-service charge of more than 24 cents:			
Charge of 25 cents to 50 cents.	5 cents	20 percent of total charge.	20 percent of total charge.
On each additional 50 cents	do		
Telegraph, cable and radio dispatch or message.	10 percent of charge	15 percent of charge	15 percent of charge.
Leased-wire services	do	do	Do.
Local telephone service	6 percent of bill	10 percent of bill	10 percent of bill.
Photographic apparatus	10 percent of manufacturer's sale price.	25 percent of manufacturer's sale price.	10 percent of manufacturer's sale price.
Photographic plates and sensitized paper, and unexposed photographic film.	do	15 percent of manufacturer's sale price.	15 percent of manufacturer's sale price.
Lubricating oils	4½ cents per gallon	6 cents per gallon	6 cents per gallon.
Transportation of persons	5 percent of amount paid.	10 percent of amount paid.	10 percent of amount paid.
Pari-mutuel wagering		5 percent of pool	
Transportation of property		5 percent of amount paid.	

1. Distilled Spirits

Floor-stocks tax.—The House bill requires the taxpayer to make a return and pay the floor-stocks tax on or before the third month following the effective date of title VIII of the act.

Your committee bill changes this provision and requires that the taxpayer make his return on or before the thirtieth day following the effective date of title VIII of the act, but does not change the requirement with respect to the date for payment of the tax.

Manufacturers or producers of designated nonbeverage products.—Your committee bill inserts a new subsection which provides that any person using fully tax-paid spirits in the manufacture of certain products and upon the payment of a special tax of $100 per annum, shall be eligible under certain specified requirements for drawback at the rate of $3.75 on each proof gallon.

Importation of alcohol tax-free.—The extension of the exemption from internal tax to imported alcohol for industrial use should help the war effort and, at the same time, rectify an inconsistency with our international obligations. The amendment does not affect in anyway the customs duty of 15 cents per gallon on foreign alcohol imported for nonbeverage purposes. In normal times, because of this duty and the abundance of domestic alcohol, imports on nonbeverage alcohol have been negligible.

Wine.—The House bill increased the rate on sparkling wines from 7 cents to 10 cents per ½ pint. Your committee bill eliminates this increase.

Floor-stocks taxes on fermented malt liquors and wines.—The provision in the House bill which exempted from the floor-stocks tax fermented malt liquors held on the premises by retail dealers was eliminated, and the dealer is required to make a return on or before the end of the thirtieth day following the effective date of title VIII of the act, and

must pay the tax on or before the first day of the third month following the effective date of the act.

A like provision with respect to making return and payment of tax is made applicable to the floor-stocks tax on wines.

3. TOBACCO

Smoking tobacco.—The House bill increased the rate of 18 cents per pound on smoking tobacco to 24 cents per pound, and imposed a floor-stocks tax at a similar rate.

Your committee bill eliminates this increase and retains the rate of 18 cents per pound as under existing law.

Cigars.—The classifications under existing law and under the House bill of cigars weighing more than 3 pounds per thousand are changed and are set out with your committee's rates in the table below:

Cigars manufactured or imported to retail at—	Rate per thousand
Not more than 2½ cents each	$2
More than 2½ cents each and not more than 4 cents each	3
More than 4 cents each and not more than 6 cents each	4
More than 6 cents each and not more than 8 cents each	7
More than 8 cents each and not more than 15 cents each	10
More than 15 cents each and not more than 20 cents each	15
More than 20 cents each	20

A floor-stocks tax at rates in line with the table above is imposed on cigars weighing more than 3 pounds per thousand.

Cigarette papers and tubes.—Under existing law a tax is imposed upon cigarette papers and tubes at a rate of one-half cent for each 50 sheets or fraction thereof on each package containing more than 25 papers. Packages less than 25 papers are tax-exempt. Cigarette tubes, under existing law, are taxed at a rate of 1 cent for each 50 tubes or fractional part thereof.

The House bill imposed a tax upon cigarette papers and tubes at the same rate of one-half cent for books or sets containing not more than 25 papers or tubes and one-half cent for each additional 25 papers or tubes or fractional parts thereof.

Your committee bill eliminates the changes made by the House bill and retains existing law. It also provides that cigarette papers and tubes shipped or delivered for consumption beyond the jurisdiction of the internal-revenue laws of the United States shall be free of internal revenue tax.

4. TELEPHONE, TELEGRAPH, ETC.

Your committee bill provides that in the case of each international telegraph, cable, or radio dispatch or message the rate of tax will be 10 percent of the amount paid within the United States.

5. PHOTOGRAPHIC APPARATUS

Cameras and lenses, photographic apparatus, and equipment, etc.—The House bill increased the present rate of 10 percent of the manufacturer's sale price to 25 percent of the manufacturer's sale price upon cameras (except cameras weighing more than 4 pounds exclusive of lens and accessories) and lenses, photographic apparatus, and equipment.

Your committee bill reduces the 25-percent rate to 10 percent as in present law and eliminates the exemption for cameras weighing more than 4 pounds.

Unexposed photographic films, photographic plates, and sensitized paper.—The House bill increased the rate of 10 percent of the manufacturer's sale price under existing law to 15 percent of the manufacturer's sale price on unexposed photographic films, photographic plates, and sensitized paper.

Your committee bill makes no change in the rate of 15 percent but does provide an exemption for film and sensitized paper manufactured expressly for use in the reproduction of drawings, specifications, records, and other documents.

6. Transportation of Persons

The House bill increased the present 5-percent tax on amounts paid for transportation of persons and for sleeping or seating accommodations in connection with such transportation to 10 percent.

Your committee bill makes no change in rate but expands the limited exemption from this tax in the existing law which pertains to personnel of the United States Army, Navy, Marine Corps, Coast Guard, authorized cadets and midshipmen, traveling in uniform at their own expense when on official leave, furlough, or pass, to include members of the military or naval forces of any of the United Nations traveling in uniform of such nation.

7. Watches Designed Especially for Use by the Blind

The House bill provided an exemption of certain articles, insignia, etc., from the retail sales tax on jewelry. Your committee extend this exemption to include watches designed especially for use by the blind.

8. Refrigerators, Refrigerating Apparatus, and Air-Conditioners

Your committee bill amends existing law relating to refrigerators, refrigerating apparatus, and air-conditioners by confining the tax imposed at 10 per centum of the manufacturer's sale price to household type refrigerators having, or being primarily designed for use with, a mechanical refrigerating unit operated by electricity, gas, kerosene, or gasoline; and to refrigerating apparatus for, or suitable for use as parts of or with household type refrigerators described above, except when sold as component parts of complete refrigerators or refrigerating or cooling apparatus; and to self-contained air-conditioning units.

A House bill provision amending existing law with respect to exempt leases of water coolers is stricken from the bill as it is no longer necessary under your committee's amendment.

9. Coin-Operated Amusement and Gaming Devices

A tax of $50 each is imposed under existing law on gambling machines. Your committee bill increases this tax to $100 on each gambling machine and provides that the so-called "digger machine" be included in this classification.

Your committee also eliminated from the House bill a provision which would not require the collectors of internal revenue to post for public inspection a list showing persons who had paid the special tax with respect to coin-operated gaming devices.

10. Pari-Mutuel Wagering

Under the House bill a tax was imposed at a rate of 5 percent of the total amount wagered or received into the pari-mutuel or totalizator pool at any racing or sporting event, and was to be paid by the person conducting or having control of such pool.

Your committee bill eliminates this provision from the bill.

11. Transportation of Property

Your committee bill eliminates a House provision which would impose a tax on the transportation of property at a rate of 5 percent of the amount paid. The Office of Price Administration advised that this tax would add greatly to the cost of production and handling of food and other necessaries, which would be reflected in higher prices for the articles, and for that reason would aid inflation.

12. Palm Oil

An amendment made by your committee provides that palm oil used in the manufacture of iron or steel products, or tin plate or terne plate be exempted from processing tax.

13. Cabaret Tax

The existing law with respect to cabaret tax is amended by your committee by subjecting to a 5-percent tax all amounts paid for admission, refreshment, service, or merchandise, at any roof garden, cabaret, or other similar place furnishing a public performance for profit, by or for any patron or guest who is entitled to be present during any portion of such performance. The term "roof garden, cabaret, or other similar place" is clarified, and a performance is to be regarded as being furnished for profit for the purpose of this tax even though the charge made for admission, refreshment, service, or merchandise is not increased by reason of the furnishing of the performance.

14. Toilet Preparations

Your committee amended the existing law with respect to toilet preparations to provide that the sale of an article to a person operating a barber shop, beauty parlor, or similar establishment for resale by him, will not be deemed to be a sale at retail. If a person operating such establishment purchases toilet preparations to be used in the operation of the establishment, the sale will be considered at retail.

Your committee amendment provides further that the use in such operation of any such article purchased by such person for resale on or after the effective date of the amendment, shall likewise be considered a sale at retail by such person at a price equivalent to the amount paid by him for the article.

15. Retail Sales Made by Ship Service Stores and Post Exchanges

An amendment by your committee provides that retail sales of jewelry, furs, or toilet preparations made at ship service stores and post exchanges shall not be subject to the Federal retail sales tax on those articles, as the ship service stores and post exchanges are instrumentalities of the United States.

16. Stamp Tax on Certain Insurance Policies

The House bill broadened the scope of the existing law with respect to stamp taxes on insurance policies, but did not change the existing rate of 4 cents on each dollar, or fractional part thereof, of the premium charged.

Your committee increased this rate of 4 cents to 8 cents on each dollar, or fractional part thereof, of the premium charged for indemnity, fidelity, and surety bonds, and for insurance other than life.

IX. MISCELLANEOUS PROVISIONS

Joint Committee on Compulsory Savings

Your committee has provided for the establishment of a special joint committee to study methods of financing the war to be composed of five members of the Senate Finance Committee, to be appointed by the President of the Senate and five members of the Committee on Ways and Means of the House of Representatives to be appointed by the Speaker of the House. The Secretary of the Treasury is also included as a member of this committee.

It is the duty of the committee to make a full and complete study and investigation of all plans for compulsory savings and other plans, by which money may be raised to assist in the conduct of the war and the avoidance of inflation and plans for payment currently of taxes. The committee is required to report to the President and the Congress the results of its study together with its recommendations on or before December 31, 1942. The committee is given the usual authority to hold hearings, subpena witnesses, and to utilize the services, information, agencies and personnel of the departments, and agencies of the Government. An appropriation of $10,000 or so much thereof as may be necessary is authorized to carry out this provision of the bill.

Joint Committee on Internal Revenue Taxation—Power to Obtain Data

The Joint Committee on Internal Revenue Taxation or the Chief of Staff of such Joint Committee, upon approval of the Chairman or Vice Chairman is given authority to secure directly from the Bureau of Internal Revenue (including the Assistant General Counsel for the Bureau of Internal Revenue), or from any executive department, board, bureau, agency, independent establishment or instrumentality of the Government, information, suggestions, data, estimates, and statistics, for the purpose of making investigations, reports and studies relating to internal revenue taxation.

The Bureau of Internal Revenue Taxation (including the Assistant General Counsel for the Bureau of Internal Revenue), executive departments, boards, bureaus, agencies, independent establishments and instrumentalities referred to are directed to furnish such information, suggestions, data, estimates, and statistics directly to the Joint Committee on Internal Revenue Taxation or to the Chief of Staff of such committee, in accordance with this provision.

Old-Age Insurance

The old age insurance tax has been frozen at the present level of 1 percent on the worker and 1 percent on the employer for the year 1943. Unless the existing law is amended, these rates would be increased to 2 percent on both employers and employees. The reserve which has been created up to the present time is ample to take care of the total requirements for the next 5 years. Therefore, your committee is of the opinion that it is not necessary to apply the 2-percent rate for the year 1943.

Processing Tax Board

Your committee has abolished the Processing Tax Board of Review and transferred its functions to the Board of Tax Appeals. Many of the same questions arising under refund of processing taxes also arise in connection with the tax on unjust enrichment and the Board of Tax Appeals has jurisdiction over the latter tax. It is believed there will be less confusion if the same tribunal has jurisdiction over both of these taxes.

Time for Filing Petitions With the Board of Tax Appeals

Under existing law, where the Commissioner finds a deficiency in income, estate, or gift tax, and mails the taxpayer a notice of such deficiency, the taxpayer is allowed a period of 90 days from the date of mailing of such notice in which to file a petition for appeal with the Board of Tax Appeals. Under the committee bill such taxpayers are allowed a period of 150 days in which to file these petitions if such deficiency notice is mailed to a taxpayer outside the States of the United States or the District of Columbia. Under present conditions the time allowed is insufficient on account of the delays in transmission of the mails.

Time for Performance of Certain Acts Postponed by Reason of War

Your committee bill amends the provisions of the House bill which suspends the time limitations with respect to the performance of certain acts required to be performed with respect to Federal taxes where timely performance is impossible or impracticable by reason of the war. In the case of individuals who are outside the Americas, or in the armed forces, or within an enemy-controlled area, it is impossible or impracticable to perform such acts on account of communication problems.

The provisions as amended are of practically the same effect and purpose as the provisions of the House bill. Under the House provisions the running of interest would have been suspended in the case of certain nonresident alien individuals and certain foreign corporations for a period beginning with the enactment of the legislation. Under your committee amendments the running of such interest is suspended from December 7, 1941, since the conditions preventing the performance of these acts began as of that date.

In general, the suspension is effective for the period beginning after December 6, 1941, to either the 15th day of the third month following the month in which the war with Germany, Italy, and Japan is terminated as proclaimed by the President, or in the case of an individual with respect to whom a period of time is disregarded, to the 15th day of the third month following the month in which an executor, administrator, or a conservator of an estate qualifies.

The provisions apply with respect to time limitations running against the Government, taxpayers, and others whose acts are required to be performed, and in the case of all Federal taxes.

DETAILED DISCUSSION OF THE TECHNICAL PROVISIONS OF THE BILL

TITLE I.—INDIVIDUAL AND CORPORATION INCOME TAXES

PART I.—AMENDMENTS TO CHAPTER 1

SECTION 101. TAXABLE YEARS TO WHICH AMENDMENTS APPLICABLE

As in the House bill, the amendments made by title I of the bill are, except as otherwise expressly provided, applicable only with respect to taxable years beginning after December 31, 1941.

SECTION 102. NORMAL TAX ON INDIVIDUALS

This section is the same as section 102 of the House bill. It amends section 11 of the Code by increasing the rate of normal tax on individuals from 4 to 6 percent.

SECTION 103. SURTAX ON INDIVIDUALS

As in the House bill, the surtax-bracket rates range from 13 to 28 percent, as compared with rates of 6 to 77 percent under the existing law. The maximum rate is applicable to surtax net income over $200,000, in contrast with the present highest bracket of $5,000,000.

SECTION 104. OPTIONAL TAX ON INDIVIDUALS WITH GROSS INCOME FROM CERTAIN SOURCES OF $3,000 OR LESS

Under existing law the option to make a return on the simplified form provided by supplement T is limited to individuals having income from the following sources: Salary, wages, compensation for personal services, dividends, interest, rent, annuities, or royalties. The House bill made no change in this provision. However, because of the imposition of the Victory tax, as proposed by your committee, it is considered advisable to eliminate rents and royalties from the classes of income permitted to be reported on the simplified return. The elimination of these items will enable taxpayers who make their returns under supplement T to compute the Victory tax upon the basis of the same income used for the purpose of the supplement T tax and thus preserve the simplicity of that supplement for taxpayers in the low income brackets.

The House bill introduced in the schedule of rates in section 400 of the Code a new column headed "Married person making separate return" and changed the heading of the present column "Head of family" to read "(1) Married person whose spouse does not make separate return, or (2) Married person making joint return, or (3) Head of family." Your committee, with a view to expressing more accurately the status of those in this column, has changed it to read "(1) Married person whose spouse has no gross income, or (2) Married person making joint return, or (3) Head of family."

In applying this schedule to determine the tax of a taxpayer with one or more dependents, the House bill allowed a deduction from gross income of $440 for each such dependent, the amount representing the $400 credit for dependents plus an allowance of $40 in lieu of deductions and the earned income credit. In view of the reduction from $400 to $300 in the credit for dependents allowed under section 25 (b) of the Code, your committee has changed the deduction under supplement T from $440 to $330 for each dependent.

Under section 120 of the bill a new subsection (k) is added to section 22 of the Code, which provides that in the case of a wife who is divorced or legally separated from her spouse, certain payments of alimony and separate maintenance payments are to be included in the wife's gross income. In like manner a new section (section 171) is added to the Code providing that in such cases of divorce or legal separation certain income from an estate or trust shall be included in the wife's gross income and not in that of the husband. To make the provisions of section 401 of the Code, defining the term "dependent," conform with these newly added provisions, provision has been made that a payment made to a wife which is includible in her gross income by virtue of said sections 22 (k) and 171 shall not be considered a payment to her by her husband for the support of any dependent.

Section 404 of the Code, as amended by the House bill, is slightly changed by a clerical amendment in the interest of clarity. There is no change in substance from the House bill.

SECTION 105. TAX ON CORPORATIONS

The amendments made by this section of the bill, which corresponds to section 105 of the House bill, change both the base and the rates of the corporation income tax. The change in base is made in lieu of the deduction now granted with respect to the excess profits tax imposed by chapter 2E. Section 13 (a) (2) of the Code is amended to allow the amount of the adjusted excess profits net income as a credit in computing normal tax net income. This credit, as specified in section 26 (e) as amended, is likewise provided under section 15 (a) in determining the amount of surtax net income.

Although the credit provided in section 26 (e) is, in general, an amount equal to the corporation's adjusted excess profits net income, as defined in section 710 (b) of the Code, in case the excess profits tax of any corporation is determined as provided in section 721 (relating to abnormalities in income in the taxable period), section 726 (relating to corporations completing contracts under the Merchant Marine Act of 1936), the credit shall be an amount of which the excess profits tax is 90 percent. Corporations engaged in the mining of strategic

minerals, which determine their tax under section 731 as added by section 225 of your committee bill, have been added to this special category. Under a provision added by your committee, it is made clear that for this purpose the excess profits tax means the tax computed without regard to the 80 percent limitation on tax provided in section 710 (a) (1) (B) (as added in section 202 of your committee bill), without regard to the credit provided in section 729 (c) and (d) for foreign taxes paid, and without regard to the adjustments provided in section 734. Corporations reconstructing average base period net income under section 722 have been removed from this special category and, by reason of the amendments made to section 722 by section 221 of your committee bill, will come under the general rule making the credit under section 26 (e) the amount of adjusted excess profits net income. The credit under section 26 (e) is not allowed in the case of any corporation exempt from the excess profits tax under the provisions of section 725 or section 727 of the Code.

Section 23 (c) (1) of the Code is amended by this section of the bill to deny the deduction for excess profits taxes paid or accrued for those years in which a credit is allowed under section 26 (e).

This section makes other technical amendments required as a result of the change in the base of the corporation tax. In the case of corporations subject to tax under section 102 of the Code, the credit provided in section 26 (e) is also allowed by an amendment to section 102 (d) (1). Section 122 of the Code, relating to computation of the net operating loss deduction allowed by section 23 (s) of the Code, is amended so as to allow the excess profits tax paid or accrued within taxable years (subject to certain rules) as a deduction in computing net operating loss for, and net operating loss carry-over and carry-back from, such taxable years. A clerical amendment is made in these provisions by your committee by striking out subparagraph (B) in subsection (e) (3) of this section of the bill as it appeared in the House bill. The amendment made by this subparagraph is now made in section 155 of your committee bill. It is also provided that the credit provided in section 26 (e) will be subtracted from adjusted net income (or net income, in the case of the surtax) before computing the 85 percent limitation upon the credit for dividends received. A technical amendment is also made in section 160 (d) of your committee bill (relating to the limit on foreign tax credit in case of corporations) necessitated by the allowance of the credit provided in section 26 (e) in computing normal tax net income of corporations.

Other technical changes have been made by your committee in this section of the bill. Section 15 (a), relating to surtax on corporations, is amended so as to allow as a credit, in computing corporation surtax net income, the credit provided in the case of a public utility for dividends paid on its preferred stock provided in section 26 (h), as added by section 134 of your committee bill. It is also provided that for the purpose of section 15 (a), dividends received on the preferred stock of a public utility shall be disregarded in computing the credit for dividends received provided in section 26 (b). Section 15 (b) is also amended so as to exempt from the surtax on corporations Western Hemisphere Trade Corporations, as defined in section 109, as added by section 142 of your committee bill.

SECTION 106. TAX ON NONRESIDENT ALIEN INDIVIDUAL

This section corresponds to section 106 of the House bill which would increase from 27½ percent to 37 percent the rate of tax in the case of nonresident alien individuals not engaged in trade or business within the United States. Under existing law if such nonresident alien individual has a gross income of more than $23,000 which is the level at which the average effective rate equals 27½ percent he is subject to the full normal tax and surtax on the gross amount of his fixed or determinable annual or periodical income from sources within the United States. The House bill would adjust this figure to $22,900, at which under the bill there is reached approximately an effective rate of 37 percent. Nonresident aliens engaged in business in the United States are subject to the same rates as applied to American citizens only with respect to income from sources within the United States. Such latter aliens will therefore be subject to the increase in tax applicable to American citizens.

Your committee has amended this section to provide a rate of 30 percent in the case of nonresident alien individuals subject to tax at a flat rate upon fixed or determinable annual or periodical income from sources within the United States. In keeping with such rate the figure of $22,900 appearing in the House bill is adjusted to $15,400 which is the level at which the effective rate equals 30 percent.

Your committee believes it advisable in the interests of good administration to have the increased rates of tax begin upon the date upon which the increased rate of withholding at the source becomes effective. Appropriate language to accomplish such results has been inserted in sections 106 and 107 of the bill. Where, however, the tax liability is ultimately determined under sections 11 and 12 of the Code in the case of gross fixed or determinable income in excess of $15,400, the increased rates with respect to such sections apply to taxable years beginning after December 31, 1941.

SECTION 107. TAX ON FOREIGN CORPORATIONS

This section corresponds to section 107 of the House bill which amends existing law to increase the tax upon foreign corporations not engaged in trade or business in the United States from 27½ percent to 37 percent. Your committee has amended this section to provide for a rate of 30 percent in lieu of 37 percent.

As indicated under section 106, the increased rate will begin upon the date upon which the increased rate of withholding at the source becomes effective under section 108.

SECTION 108. WITHHOLDING OF TAX AT SOURCE

This section corresponds to section 108 of the House bill which provides for withholding of the tax at the source (by means of which the tax in the case of nonresident aliens and nonresident foreign corporations is largely collected) at the rate of 37 percent instead of 27½ percent under existing law. In accordance with the changes under section 106 with respect to nonresident alien individuals, your committee recommends a rate of 30 percent in lieu of that in the House bill. The increased rate of withholding will not go into effect

until the tenth day after the enactment of the act in order to afford a reasonable period within which withholding agents will be informed of the higher rate applicable to payments made to nonresident aliens or nonresident foreign corporations.

Your committee also recommends the amendment of section 143 (b) so as to limit to 27½ percent the rate of withholding at the source in the case of so-called tax-free covenant bonds which were issued prior to January 1, 1934, but the maturity date of which has been extended on or after that date. The change thus proposed will not in any manner affect the liability to the tax imposed upon the nonresident aliens and nonresident foreign corporations with respect to such interest.

SECTION 109. TREATY OBLIGATIONS

This section is the same as section 109 of the House bill which provides that no amendments made by this title shall apply in any case in which its application would be contrary to any treaty obligation of the United States.

SECTION 110. TRANSFERS OF LIFE INSURANCE CONTRACTS, ETC.

This section, for which there is no corresponding provision in the House bill, amends section 22 (b) (2) of the Code. The final sentence of this provision of the Code specifies that in the case of a transfer for value of a life insurance, endowment, or annuity contract, only the actual value of the consideration given for such transfer and the amount of the premiums and other sums subsequently paid by the transferee shall be excluded from gross income upon receipt of payments under the insurance, endowment, or annuity contract. The amendment made by this section renders this sentence inapplicable where the insurance, endowment, or annuity contract or interest therein has a basis for determining gain or loss in the hands of the transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor. Thus, where a corporation transfers an insurance policy to a successor corporation in a tax-free reorganization, the proceeds received under the policy will be exempt from taxation when received by the transferee if they would have been exempt if received by the transferor.

SECTION 111. INCOME RECEIVED FROM ESTATES, ETC., UNDER GIFTS, BEQUESTS, ETC.

This section is basically the same as section 110 of the bill passed by the House, relating to annuity trusts. Although numerous changes have been made by your committee, such changes are designed to give further and more detailed application of the principles of section 110 of the House bill rather than to change its fundamental theory.

Subsection (a) of this section, as in the House bill, amends section 22 (b) (3) of the Code, relating to the exclusion of gifts, bequests, devises, and inheritances from gross income. Your committee has made some technical amendments to this provision of the House bill,

intended only to clarify its meaning. Under existing law, the value of property acquired by gift, bequest, devise, or inheritance, but not the income therefrom, is excluded from gross income by the provisions of section 22 (b) (3) of the Code. This section has been construed as not requiring the exclusion from gross income of amounts received under a gift, bequest, or devise of a right to income from property, *Irwin* v. *Gavit* (268 U. S. 161 (1925)). This construction of the existing law is now written into the bill for the sake of clearness.

The existing law has also been construed, however, as excluding from gross income amounts received under a gift, devise, bequest, or inheritance of recurrent payments to be made in any event, whether or not out of corpus, *Burnet* v. *Whitehouse* (283 U. S. 148 (1931)). Although such amounts are not dependent solely upon income as the source of payment, they may be, and frequently are, by direction under the terms of the gift or bequest, paid in whole or in part out of income. Such cases most frequently arise in the case of trusts described as annuity trusts. Because annuities paid by a trust under the terms of a gift or bequest, if not dependent upon income, are excluded under section 22 (b) (3) from the gross income of the beneficiary, it has been held that the trustee, in computing its net income under section 162, cannot deduct the amount of trust income distributed in payment of such annuity, *Helvering* v. *Pardee* (290 U. S. 365 (1933)). This construction of existing law results in payment of the tax by the trust upon income received by a beneficiary, and, accordingly, in some cases furnishes an instrument for tax avoidance by the beneficiary and in some cases results in hardship to other beneficiaries whose share of trust income is reduced by the taxes paid for the benefit of another.

This section, therefore, changes the treatment of gifts, bequests, devises, and inheritances to be paid in any event by treating them, if under the terms of the gift, bequest, devise, or inheritance the payment, crediting, or distribution thereof is to be made at intervals, as gifts, bequests, devises, or inheritances of income from property to the extent that they are paid, credited, or to be distributed out of income from property. Such change will provide the same treatment for amounts paid by a trustee out of the income of a trust in the case of a gift or bequest in terms of a right to such payments at intervals (regardless of income) as in the case of a gift or bequest in terms of a right to income; in neither case will the amounts paid at intervals out of income be excluded under section 22 (b) (3) from the beneficiary's income. This section is not intended to state a new rule with respect to taxability of trust income between the nominal beneficiary and the creator of the trust where the latter would be taxable under section 22 (a) upon the income of the trust, or with respect to the assignment of earnings or other income where the assignor remains taxable. The section applies only to those cases where the amounts paid or credited at intervals were excluded from the beneficiary's or donee's income by reason of the provisions of section 22 (b) (3).

The operation of the amendment to section 22 (b) (3) made by this section of the bill may be illustrated by the following example: A, by his will, gave his wife an annuity of $50,000 to be paid in advance in quarterly payments. By another clause of his will, A bequeathed the residue of his property in trust with directions to the trustees to collect the income from the property and, after payment of expenses

of the trust, to apply such income in payment of the annuity of $50,000 given to his wife. Under the provisions of section 22 (b) (3), as amended by this section of the bill, the $50,000 will be included in the wife's income each year and, under the provisions of section 162 (b), will be deducted from the income of the trust to the extent of the income of the trust for its taxable year.

The amendment to section 22 (b) (3), however, applies only to such amounts as are to be paid or credited at intervals. Thus a gift or bequest of money or property intended to be paid in a lump sum or at one time is not to be included in the donee's or legatee's gross income, even though the executor may for reasons of convenience or necessity arrange to pay such amount in installments or pay it out of funds traceable as the income of property. However, payments at intervals do not need to be at regular intervals to come within the amendments. Thus, in case of a direction in a testamentary trust to pay $5,000 a year to John for his life but to pay the $5,000 a year to Mary instead of John for any year in which Mary becomes 18, graduates from college, or marries, the $5,000 a year is income to John and Mary, respectively, in the years in which each is to receive it, to the extent it is paid or credited in such years out of income from the trust property.

Subsection (b) of this section of the House bill sets forth a brief statement for determining whether an amount paid, credited, or to be distributed by an estate or trust is out of income of the estate or trust for its taxable year. This provision, proposed to be added as subsection (d) to section 162 of the Code, provided that for the purpose of computing the net income of estates and trusts and their legatees and beneficiaries under section 162 (b) and (c), in cases where the amount paid, credited, or to be distributed can be paid, credited, or distributed out of other than income or out of income other than income of the estate or trust for its taxable year, to the extent that the amount paid or credited or to be distributed to a legatee or beneficiary does not exceed the income allocable to such legatee or beneficiary it shall be considered as income of the estate or trust which is paid, credited, or to be distributed. Your committee has retained the principle of this rule and of the amendment to section 22 (b) (3)—that is, of allocating estate and trust income to legatees and beneficiaries—but has provided with more particularity for its application in various cases.

Your committee bill adds an amendment to section 162 (b) of the Code designed to include in the income of a legatee or beneficiary the income of the estate or trust for its taxable year which, within such taxable year, becomes payable to the legatee or beneficiary, even though it then becomes payable as part of an accumulation of income held until the happening of some event which occurs within the taxable year. Such cases are usually cases where accumulated income of an estate is paid to a residuary legatee upon termination of the estate or where income of a trust is accumulated for distribution upon the beneficiary's reaching a specified age.

The question of whether the income of an estate or trust for the taxable year in which it becomes payable as part of an accumulation is taxable on the one hand to the estate or trust or on the other hand to the legatee or beneficiary has been a source of litigation in certain cases under existing law. This amendment is designed to clarify the

law. Thus, if income of a trust is to be accumulated until A, the beneficiary, reaches his twenty-first birthday, which is December 31, 1942, the income of the trust (assuming it is on a calendar year basis) for the calendar year 1942 is to be included in the income of A for his taxable year in which December 31, 1942, falls, and is to be deducted by the trust under section 162 (b) in computing its net income for 1942. In the case of a similar trust, where the twenty-first birthday of B, the beneficiary, was on July 1, 1942, and the income of the trust was to be accumulated until that date and then to be distributed to B at such time as the trustee in his discretion decides, if the trustee on December 31, 1942, decides to distribute the accumulated income to B, the income becomes payable to B on December 31, 1942, whether distributed to him or not. In such a case, the extent to which such amount is considered to be payable out of income of the trust for its taxable year is determined under section 162 (d) (2) as proposed to be added by your committee.

Section 162 of the Code is proposed to be amended by the addition of a new subsection (d), which contains three paragraphs. Paragraph (1) is similar to section 162 (d) as proposed to be added by section 110 of the bill passed by the House, but provides more detailed rules for allocating income among legatees and beneficiaries in cases in which amounts can be paid, credited, or distributed out of other than income.

Section 162 (d) (1) applies to all cases in which the executor or trustee can or must (by the terms of the trust instrument or will) pay the whole or any part of a gift, bequest, devise, or inheritance out of other than income, except that no income is to be allocated under it to a legatee, heir, or beneficiary of a lump sum gift, bequest, devise, or inheritance. It applies in all cases of annuities where any deficiency in the amount to be paid can be made up by a payment out of corpus of the trust. It also applies in cases where amounts are to be paid or credited at intervals and the executor or trustee has discretion whether to pay or credit such amounts out of income or corpus, regardless of the source (income or corpus) to which the executor attributes such amount. If an annuity is paid, credited, or to be distributed tax-free, that is under a provision whereby the executor or trustee will pay the income tax of the annuitant resulting from the receipt of the annuity, the payment of or for the tax by the executor or trustee will be income to the annuitant under the usual rules for determining constructive receipt of income and under the rules of section 162 (d) (1) to the extent such payment is treated thereunder as out of income.

The method of allocating income of the estate or trust for its taxable year in cases to which section 162 (d) (1) applies is as follows: First, the aggregate of all amounts which can be paid, credited, or distributed out of other than income (except under a gift, bequest, devise, or inheritance not to be paid, credited, or to be distributed at intervals) is obtained. The aggregate of such amounts is considered to be paid, credited, or distributed in such cases out of income of the estate or trust for its taxable year if it does not exceed the distributable income of the estate or trust for its taxable year. If the aggregate of such amounts does exceed the distributable income of the estate or trust for its taxable year, the portion of such amount paid, credited, or to be distributed to a legatee or beneficiary is considered income of the

estate or trust for its taxable year which is paid, credited, or to be distributed in an amount which bears the same ratio to the amount of all distributable income as the amount so paid, credited, or to be distributed to the legatee or beneficiary bears to the aggregate of such amounts so paid, credited, or to be distributed to legatees or beneficiaries for the taxable year of the estate or trust.

This provision introduces a concept of distributable income. This is defined in section 162 (d) (1) as meaning (A) the net income of the estate or trust computed with the deductions allowed under subsections (b) and (c) of section 162 in cases to which subsection (d) (1) does not apply, or (B) the income of the estate or trust minus the deductions provided in subsections (b) and (c) of section 162 in cases to which subsection (d) (1) does not apply, whichever is greater. As thus used "net income" means the statutory net income under the Code; "income" means, in general, the amount which under the applicable law of estates and trusts is considered income available for distribution to the life tenant, legatee, or beneficiary, as the case may be. Such "net income" and "income" for the purposes of section 162 (d) (1) do not include income of a prior taxable year, even though such income may be considered income for the current taxable year of the estate or trust under section 162 (d) (2), as explained below.

Paragraph (2) of section 162 (d) replaces the provisions of section 162 (d), as added by section 110 of the bill as passed by the House, in cases where amounts can be paid out of income other than income of the estate or trust for its taxable year. Section 162 (d) (2) does not apply in any case to which section 162 (d) (1) applies. It provides a rule for allocating income of the estate or trust to the legatees or beneficiaries in cases in which the income of a prior period is paid, credited or to be distributed to the legatees or beneficiaries during the taxable year of the estate or trust. Thus in the case of a trust on a calendar year basis which is to distribute its income to the beneficiary each June 30, the income of the trust from July 1, 1942, through June 30, 1943, will be considered income for the taxable year 1943 which is to be distributed to the beneficiary in the taxable year 1943. The beneficiary will include such income in his income for 1943 and the trust will take a deduction for it in 1943. Thus if the trust in such a case receives $100 of income each month, the trust will include $600 in its income for the taxable year ending December 31, 1942, and will receive a deduction in computing its tax for 1943 of the whole $1,200 which is included in the beneficiary's income for 1943.

The rule also applies in the case of a distribution out of income for a period which does not include any part of the current taxable year. Thus in the case of a trust which accumulates the income in the first year and each year thereafter distributes the prior year's accumulation, the amount to be distributed for 1943 will be considered income of the trust for 1943 which is to be distributed in 1943 to the extent of the 1942 income which becomes payable in 1943. If the prior period, the income of which becomes payable in the taxable year, is a period of more than 12 months, then only the income of the last 12 months thereof is considered to be income which is to be distributed during the current taxable year.

Paragraph (3) of section 162 (d) is designed to remove problems arising in cases in which amounts are paid, credited or to be distributed shortly after the close of the taxable year of the estate or trust. Under

existing law such arrangements give rise to tax avoidance, for example, by placing the tax on the trust for income which is shortly after the close of the taxable year of the trust to be distributed to the beneficiary. Under section 162 (d) as added in the House bill this tax avoidance would be prevented but harsh results might occur in some cases by reason of the full amount to be distributed being considered distributed out of income for the year of the distribution. Section 162 (d) (3) as proposed to be added by your committee provides that in cases in which within the first 65 days of any taxable year of the estate or trust beginning after January 1, 1942, income of the estate or trust for a period beginning before the beginning of the taxable year becomes payable, the income for the part of such period not falling within the taxable year is considered to be paid, credited, or distributed on the last day of the preceding taxable year. If the part of such period beginning before the beginning of the taxable year is more than 12 months, only the income of the last 12 months of such part is considered paid, credited, or to be distributed on the last day of the preceding taxable year.

A similar rule is to be applied in the case of annuities which become payable in the first 65 days of the taxable year of the estate or trust. A proportionate part of the amount which becomes payable within the first 65 days is considered payable on the last day of the preceding year. This proportionate part is that part of the amount of the annuity which becomes payable within the first 65 days as the part of the interval not falling within the taxable year bears to the period of the whole interval. If, however, the part of the interval not falling within the taxable year is a period of more than 12 months the interval is considered to begin on a date 12 months before the end of the taxable year. Thus if $4,250 is to be paid every 2 years on March 1, of the $4,250 which becomes payable on March 1, 1943, three hundred and sixty-five four hundred and twenty-fifths of the amount, or $3,650, is considered to be an amount to be distributed on December 31, 1942. The provisions of section 162 (d) (1) determine the extent to which the amount distributed on March 1 and the amount considered to be distributed on December 31 are paid, credited or to be distributed out of income of the estate or trust for its taxable year.

Certain technical changes are also made by your committee bill in the trust supplement under chapter 1 of the Code. Sections 162 (b) and 164 are amended in order to make the provisions of the trust supplement consistent with respect to references to legatees, heirs and beneficiaries. An amendment is also made in section 162 (b) striking from that section a clause with respect to income of estates and trusts which is to be distributed currently to guardians of infants. This provision under existing law is somewhat ambiguous in section 162 (b) but is properly interpreted in the Commissioner's regulations. The application of sections 161 and 162 in the case of income of estates and trusts which is paid, credited or to be distributed to a guardian for an infant seems to give rise to no difficulty under such regulations and, therefore, the clause in section 162 (b) is stricken out as unnecessary.

Under the bill passed by the House, the amendments made by this section were to be applicable only to income paid or accrued or to be distributed or amounts paid or credited or to be distributed after December 31, 1941. Under your committee bill the amendments

made by this section shall be applicable only with respect to taxable years beginning after December 31, 1941; except that in the case of income paid, credited, or to be distributed or amounts paid, credited, or to be distributed by an estate or trust, such amendments shall be applicable, for the purpose of computing the tax of the beneficiary, heir, legatee, and estate or trust alike, only with respect to such income and such amounts paid, credited, or to be distributed on or after the beginning of the first taxable year of the estate or trust, as the case may be, and beginning after December 31, 1941.

SECTION 112. EXEMPTION OF INTEREST ON PUBLIC OBLIGATIONS

This section, together with sections 509 and 510 of the bill, as added by your committee, provides that interest upon obligations issued after December 31, 1942 (except certain refunding obligations described below) by a State, Territory, or possession of the United States, or a political subdivision thereof, or the District of Columbia, as well as agencies and instrumentalities of one or more of such governments, shall be subject to the Federal income tax. The Federal Government consents reciprocally to the taxation under an income tax, by any duly constituted taxing authority with jurisdiction, of the interest upon obligations and dividends from evidences of ownership issued after December 31, 1942, by the United States, a Territory, possession, or political subdivision of the United States, the District of Columbia, or any agency or instrumentality of one or more of the foregoing.

The amendments to conform certain sections of the Code with the Public Debt Act of 1941, which were made by section 111 of the House bill, have been retained in substance in sections 112 (b) and (c) of the bill, and additional clarifying amendments to sections 25 (a) and 26 (a) of the Code have been made by your committee. These changes, which are merely declaratory of existing law, provide that a credit shall be allowed against net income, for purposes of the normal tax, for interest upon United States obligations only if the interest is included in gross income and if, under the act authorizing the issue of such obligations, as amended and supplemented, such interest is exempt from normal tax. In determining whether the issuing act provides for such exemption, reference must be made to section 4 of the Public Debt Act of 1941.

Subsections (a) and (c) of section 112 relate to the exclusion from gross income of tax-free interest. Subsection (a) amends section 22 (b) (4) of the Code to exclude from gross income interest on public bonds to the extent provided in section 116 (b), as amended by subsection (c). Both section 22 (b) (4) and section 116 (b) classify public obligations into two groups—(A) obligations of the United States or any agency or instrumentality thereof; and (B) obligations of a State, Territory, or possession of the United States, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing.

Group (A) is broader under the proposed amendment than under the corresponding category under existing law, which is limited to "obligations of a corporation organized under act of Congress, if such corporation is an instrumentality of the United States." With reference to group (B), the present law exempts the interest on

obligations of political subdivisions of a State, but does not refer to agencies and instrumentalities of States. It has been a matter of dispute whether the term "political subdivisions" includes certain types of State agencies and instrumentalities. Without affecting the taxability of interest upon outstanding obligations of State agencies and instrumentalities for taxable years beginning prior to January 1, 1942, section 116 (b) (1) expressly excludes from gross income interest upon such obligations for taxable years beginning on or after that date whether or not such agencies and instrumentalities are considered to be political subdivisions.

Section 116 (b), as stated above, prescribes the extent to which the interest on obligations referred to in section 22 (b) (4) is to be exempt. With respect to State and local obligations, this section provides that the interest thereon shall be exempt only in the case of obligations issued before December 31, 1942. The same limitation applies to obligations of Territories, possessions of the United States, and the District of Columbia, which were excepted from the operation of section 4 of the Public Debt Act of 1941. In the case of obligations issued by the United States, or any agency or instrumentality thereof, it is provided, in accord with the Public Debt Act, that only interest on such obligations issued before March 1, 1941, is tax-exempt.

For the purposes of section 116 (b), an obligation shall be considered to be issued after a particular date (1) if any part of the payment therefor is received by the obligor after such date, or (2) if delivery of the obligation is made by the obligor after such date. The tax-exempt status of obligations will not be affected under certain circumstances, such as loss or destruction of the original obligations, or a change in denomination of the obligations.

Paragraph (3) of section 116 (b) contains safeguards designed to make certain that tax exemption will end as contemplated in section 116 (b) (1). Unless these safeguards are adopted, it might be possible for public obligors to issue obligations after the "cut-off" date which, although they would in substance be new issues, might not be considered new issues in form and therefore might be considered tax exempt. Thus, the tax exemption privilege cannot be perpetuated by extending the maturity date of outstanding issues, by increasing the principal amount or rate of interest on such obligations, or by refunding noncallable obligations during the period between the date of enactment of the bill and January 1, 1943.

Under subparagraph (A) of paragraph (3), if an obligor, by agreement with the holders of its securities, extends, at any time, the maturity of obligations issued before December 31, 1942, and maturing after that date according to their terms as of enactment date or the date of issue, whichever is later, it is provided that such obligations shall be considered as issued after the date of the extension or December 31, 1942, whichever date is later. Only the interest on such obligations accruing after such later date will be taxable in such case. A like rule is applicable with respect to increases in the principal amount or interest rate.

Subparagraph (B) deals with the refunding or retirement by a new issue between enactment date and before January 1, 1943, of an outstanding obligation which has on enactment date a maturity later than June 30, 1943. It is provided that, if any part of the proceeds or any obligation of such new issue is used to retire or refund the

outstanding obligation, the new obligation shall be considered as issued after December 31, 1942, as to interest accruing after that date. Tax exemption, however, is not denied with respect to obligations issued before January 1, 1943, to refund or retire obligations maturing on or before June 30, 1943, in order to avoid interference with the completion of refinancing operations which are now in process.

Paragraph 4 of section 116 (b) provides, in effect, that if State and local obligations are refunded after December 31, 1942, under certain circumstances, the interest on the refunding obligations will be exempt until the date of maturity of the refunded obligations. In general, the circumstances specified are that the refunded obligation itself must be a tax-exempt obligation, it must be callable according to its terms, and the principal amount and interest rate of the refunded obligations must not exceed the principal amount and interest rate of the refunded obligation. The limitations are for the purpose of making it easy to identify the refunding obligations which are entitled to the benefits of this paragraph and to impose suitable restrictions so that the permission to refund may not be used to defeat the ultimate eliminations of tax exemptions.

SECTION 113. EXCLUSION OF PENSIONS, ANNUITIES, ETC., FOR DISABILITY RESULTING FROM MILITARY SERVICE

This section, which was not included in the House bill, amends section 22 (b) (5) to exclude from gross income amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country. Although the amendment does not apply to retirement pay not constituting amounts paid on account of personal injuries or sickness, it is not intended to restrict any exemption now provided by any other act such as the act approved August 12, 1935 (49 Stat. 607), entitled "An act to safeguard the estates of veterans derived from payments of pension, compensation, emergency officers' retirement pay and insurance, and for other purposes."

SECTION 114. EXCLUSION OF INCOME FROM DISCHARGE OF INDEBTEDNESS

This section corresponds to section 112 of the House bill, which extends the relief provided by section 22 (b) (9) of the Code for 3 more years. This amendment is retained in the reported bill, and, in addition, your committee has made certain material changes intended to carry out more effectively the policy expressed in section 22 (b) (9).

Section 22 (b) of the Code was amended by the Revenue Act of 1939 by the addition of paragraph (9) in which it was provided, largely with a view to enabling debt-ridden railroads to repurchase their own bonds at a discount without subjecting themselves to a prohibitive tax penalty, that income from the discharge of indebtedness could, at the election of the taxpayer, be excluded from gross income if the taxpayer (1) established that, at the time of such discharge, it was in an unsound financial condition and (2) consented to the application of section 113 (b) (3) to reduce the basis of its property by the amount so excluded. Your committee has added an amend-

ment which, by eliminating the requirement of unsound financial condition and permitting an election under section 22 (b) (9) regardless of the financial condition of the corporate debtor, relaxes the standard established in 1939 and makes it possible for all corporations to have the advantages granted by this section without an impairment of their credit.

Section 22 (b) (9) as amended will not apply retroactively and will be applicable only to taxable years beginning after December 31, 1941, and before January 1, 1946. The provision in section 22 (b) (9) limiting its applicability to securities in existence on a specific date has been eliminated.

Section 22 (b) (9) as amended will not apply to the discharge of indebtedness of a railroad corporation occurring pursuant to an order of the court in a reorganization proceeding under section 77 of the National Bankruptcy Act or in equity receivership proceedings. Subsection (b) of this section adds to section 22 (b) of the Code a new paragraph (10), applicable to taxable years beginning after December 31, 1939, and providing for the exclusion from gross income of the amount of any income realized as the result of the cancelation or modification of indebtedness of a railroad corporation involved in such proceedings. Appropriate provisions in section 143 of the bill respecting the basis of property of the corporation undergoing reorganization in the hands of a railroad corporation organized to effectuate the plan of reorganization are explained elsewhere in the report.

The railroad corporations to which paragraph (10) applies are those defined in section 77m of the National Bankruptcy Act as amended, namely, any common carrier by railroad engaged in the transportation of persons or property in interstate commerce, except a street, a suburban, or interurban electric railway which is not operated as a part of a general railroad system of transportation or which does not derive more than 50 percent of its operating revenues from the transportation of freight in standard steam railroad freight equipment. The term "indebtedness" as used in the new paragraph (10) means an obligation, absolute and not contingent, to pay, on demand or within a given time, in cash or other medium, a fixed amount. Consistent with the policy followed with respect to the amendment of section 22 (b) (9) your committee amendment specifically excludes from gross income the amount of any unamortized premium on the indebtedness canceled and specifically prohibits any deduction on account of any unamortized discount with respect to any indebtedness canceled.

SECTION 115. IMPROVEMENTS BY LESSEE

This section is the same as section 113 of the House bill. In *Helvering* v. *Bruun* (309 U. S. 461 (1940)), it was held that buildings or other improvements made by a lessee constitute income to a lessor to the extent of the value of such improvements at the time the lease is forfeited and the lessor secures control and possession of the property. Your committee believes it advisable to exclude (except in cases in which such improvements represent a liquidation in kind of lease rentals) from the gross income of the lessor, upon termination of the lease through forfeiture or otherwise, income attributable to such improvements. Such exclusion from gross income of the lessor

does not mean that the enhancement in value in the hands of the lessor will not be ultimately taxed. By reason of the fact that the gross income attributable to the value of the improvements is not recognized, the basis of the property in the hands of the lessor will not be increased by such item.

If a lessor has paid in prior years tax upon income realized either upon termination of a lease or during the term of a lease which income was attributable to the value of improvements made by the lessee, the amount of such income will be added to the basis of the property in order to provide a proper adjustment for the income so taxed. Subsection (b) adds a new subsection (c) to section 113 to provide that, while the basis of any portion of real property in the hands of the lessor is not affected by the derivation by such lessor of income of the character excluded from gross income by the operation of subsection (a), the basis of the property in the hands of the lessor shall be increased by any amounts included in gross income of the lessor for such prior years and representing the value of real property attributable to buildings erected, or other improvements made by the lessee.

SECTION 116. RECOVERY OF BAD DEBTS, PRIOR TAXES, AND DELINQUENCY AMOUNTS

With the exception of a clerical change this section is the same as section 114 passed by the House. This section provides for the exclusion from gross income of amounts otherwise includible in gross income which are attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent that such debt, tax, or delinquency amount did not operate to reduce the income tax liability of the taxpayer for any prior taxable year.

The amount of the exclusion from gross income is limited to the amount of the "recovery exclusion" with respect to the debt, tax, or delinquency amount which is recovered. The term "recovery exclusion" is defined as the amount of deductions or credits allowed on account of such bad debt, tax, or delinquency amount, which, in accordance with regulations to be prescribed by the Commissioner with the approval of the Secretary, did not result in a reduction of the taxpayer's income tax liability for any prior taxable year, reduced by the amount excludible in previous taxable years under this section with respect to such debt or tax.

In computing a recovery exclusion in connection with the determination of a tax imposed under chapter 1 (exclusive of section 102), no regard shall be had to whether the prior tax or delinquency amount for the prior taxable year resulted in a reduction of the tax for the prior taxable year under section 102 or subchapter A of chapter 2, or a corresponding provision of a prior revenue act. A recovery exclusion allowed for this purpose shall be also allowed in computing a tax imposed under section 102 or subchapter A of chapter 2 whether or not the prior deduction or credit resulted in a reduction of the section 102 tax or subchapter A tax for the prior taxable year.

In the case of a bad debt, prior tax, or delinquency amount not allowable as a deduction or credit for the prior taxable year under chapter 1 (except section 102) but allowable for the same taxable year under section 102 or subchapter A of chapter 2 (such, for example,

as chapter 1 taxes not allowed as a deduction by section 23 but allowed as a deduction under either section 102 (d) (1) (A) or section 505 (a) (1)), a recovery exclusion shall be allowed for the purposes of such section or subchapter only to the extent that such prior deduction or credit did not result in a reduction of the tax under section 102 or such subchapter A.

For the purposes of this section the term "debt" includes securities as defined in section 23 (k) (3), and the term "bad debt deduction" includes a capital loss deduction allowed under section 23 (k) and a deduction allowed either on account of the worthlessness, or the ascertainment of worthlessness and charge-off, of a "debt." The term "recovery of a tax" includes a refund or credit of a tax previously paid, or the cancelation of a purported tax liability which was accrued and deducted for a prior taxable year but never previously paid. The term "delinquency amount" is defined as meaning an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file a return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file a return with respect to a tax or pay a tax; e. g., interest on delinquent taxes.

The determination of whether or not and to what extent a deduction or credit allowed on account of a bad debt, tax, or delinquency amount did not result in a tax benefit to the taxpayer for a prior taxable year is left to regulations to be prescribed by the Commissioner with the approval of the Secretary. In determining whether and to what extent the deductions and credits on account of bad debts, taxes, and delinquency amounts allowed in a given year did not result in a tax benefit, such deductions and credits are to be regarded as having been the last ones taken and thus as having offset only such gross income or tax as was not offset by the other deductions and credits. A tax benefit may result in a taxable year subsequent to that in which a bad debt, tax, or delinquency amount was deducted under section 23 (c) or 23 (k) by reason of the net operating loss or capital loss carry-over.

Once it is determined what portion of a given deduction or credit resulted in a prior benefit and what portion did not, the taxpayer may exclude from gross income amounts recovered in a given year or years on account of the debt, tax, or delinquency amount for which the deduction or credit was allowed until the amount of such recoveries exceeds an amount equal to the portion of the deduction which did not result in tax benefit.

The amendments made by this subsection do not apply to recoveries on account of bad debts previously charged or chargeable against a reserve, by a taxpayer on the reserve method of treating bad debts, inasmuch as the amount of such recoveries is not taken into income as such but is merely credited to the reserve account and decreases the amount of the addition to the reserve which has previously been taken as a deduction in lieu of a deduction for specific bad-debt items.

The amendments made to the Code by this section shall be applicable with respect to recoveries of bad debts, prior taxes, and delinquency amounts in taxable years beginning after December 31, 1938. These amendments shall also be effective as if they were a part of the Revenue Act of 1938 or any prior revenue act on the date of its enactment.

SECTION 117. ADDITIONAL ALLOWANCE FOR MILITARY AND NAVAL PERSONNEL

This section corresponds to section 115 of the House bill, which amends section 22 (b) of the Code by adding a new paragraph excluding from gross income so much of the amount received during the present war by an individual in the military or naval forces of the United States as salary or compensation for active service in such forces as does not exceed $250 in the case of a single person and $300 in the case of a married person.

Under your committee's proposal the additional exclusion is limited to personnel below the grade of commissioned officer. The $300 exclusion for married personnel below the grade of commissioned officer is extended to include the head of a family. Your committee has also revised the House amendment to describe more clearly the period covered thereby, and to provide that, for the purpose of the exclusion, the determination of the taxpayer's status shall be made as of the end of the taxable year.

This provision is intended to apply only to salary or compensation received by personnel for active service in the military or naval forces during the present war. It does not apply to salary or compensation received subsequent to discharge or release from active service even though such payment may have been made as compensation for services rendered while in active service. Personnel in the military or naval forces of the United States who are absent from duty on account of sickness, wounds, leave, internment by the enemy, or for other lawful cause are covered by your committee bill. Personnel within the scope of the bill include persons in the Marine Corps; the Coast Guard; the Army Nurse Corps, Female; the Women's Army Auxiliary Corps; the Navy Nurse Corps, Female; and the Women's Reserve branch of the Naval Reserve. Personnel in the inactive reserve or on retirement are not entitled to the exclusion, nor are members of the Army Specialist Corps.

SECTION 118. REPORT REQUIREMENT IN CONNECTION WITH INVENTORY METHODS

This section is, except for the change in the effective date, identical with section 116 of the House bill.

Section 22 (d) of the Code, as amended by section 219 of the Revenue Act of 1939, provides an elective inventory method for use by taxpayers in lieu of any method prescribed under section 22 (c). The right to use this elective method for tax purposes was made subject, not only to the general requirement of section 41 that it be in conformity with the method of accounting regularly employed by the taxpayer in keeping his books, but also to the added requirement, among others, that no other procedure be used in reports to shareholders, partners, or other proprietors, or to beneficiaries, or for credit purposes.

It now appears in administration that the report requirement is too exacting insofar as it pertains to reports developed quarterly, semiannually, or at any time prior to the close of the taxable year. Consequently, the report requirement is revised so as to be applicable only to annual reports. Although this change in the House

bill is made applicable with respect to taxable years beginning after December 31, 1940, your committee has made the amendment applicable to taxable years beginning after December 31, 1938.

SECTION 119. LAST-IN, FIRST-OUT INVENTORY

In this new section of the bill, your committee proposes to afford to taxpayers using the elective inventory method authorized by section 22 (d) of the Code a measure of relief from the consequences of the involuntary liquidation of their base stock inventory resulting from prevailing war conditions.

In the case of most taxpayers using the elective inventory method, the base stock inventory has been carried at the relatively low cost figures reflected in the purchases of 1938, 1939, and 1940. Under the elective inventory method, and so long as conditions remained normal and the taxpayer continued in the same business, these low cost figures would never enter, for tax purposes, into the computation of the cost of goods sold. The goods on hand at the close of the taxable year are treated as being those on hand at the beginning of the taxable year.

As the direct consequences of prevailing war conditions beyond the control of taxpayers, many base stock inventories are now being depleted. Taxpayers are not able, or are not permitted by the Government, to maintain their normal stock of merchandise. The enforced liquidation of the low cost base stock inventory would subject the taxpayer under the present provisions of the Code to a tax burden not contemplated by Congress in the enactment of the elective inventory provisions. Your committee believes that the taxpayer should not be subjected to an increased tax burden by reason of the unavoidable liquidation or the change in form of its base stock inventory. It is proposed to permit the taxpayer in years ending subsequent to the year of liquidation, but not later than 3 years after the termination of the war, to replace, for tax purposes, items of merchandise liquidated from its base stock inventory at their original inventory figures, charging to income for the year of liquid tion any excess costs to which it may be subjected in effecting the replacement and adding to income for the year of liquidation any excess of the original inventory figure over the actual replacement costs ultimately incurred. Adjustment of the tax liability for the year of liquidation and for all intervening years shall be made insofar as such years are affected by the replacement adjustment and without regard to any statute of limitations or other restrictions of law other than that of section 3761 of the Code relating to compromises.

It is not intended that any adjustment should be made with respect to the closing inventory of the year of liquidation, or with respect to the opening or closing inventories of intervening years, as an incident to the ultimate replacement. It is intended, however, that the earnings and profits account for the year of liquidation and for all intervening years shall be adjusted in a manner consistent with the increase or decrease of net income provided for with respect to the year of liquidation. Any determination of earnings and profits available for dividend distribution, of the earnings and profits factor in invested capital, and of all related matters shall reflect the proposed adjustments.

Any taxpayer wishing to take advantage of this provision is required to make its election in that respect at the time of filing its income tax return for the year of liquidation and to notify the Commissioner to that effect. The taxpayer is required at the same time to establish to the satisfaction of the Commissioner in such form as the Commissioner may by regulations prescribe the involuntary character of the inventory liquidation reflected by its accounts for the year.

It is intended that the burden shall be upon the taxpayer to establish the involuntary character of the inventory liquidation involved. By involuntary liquidation is meant a depletion of base stock inventory attributable wholly to war conditions beyond the control of the taxpayer, such as enemy capture or control of sources of limited foreign supply, shipping or other transportation shortages, material shortages resulting from priorities or allocations, and labor shortages. If other sources of supply or substitute labor or material were available to the taxpayer, the liquidation shall be deemed not to be involuntary.

The merchandise involved in the most recent inventory liquidations, whether voluntary or involuntary, and whether effected prior or subsequent to the termination of the war, shall be deemed to be the first replaced in any subsequent inventory increases of merchandise of like character. Inventory increases involving merchandise of a different character, subjected to a processing substantially different, manufactured out of a different type of raw material, fabricated along substantially different styles or shapes, or devoted to a substantially different purpose or use shall not be deemed to constitute a replacement of the merchandise liquidated.

SECTION 120. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS

This section, which corresponds to section 117 of the bill passed by the House, amends various sections of the Code and adds a new section to supplement E of chapter 1 in order to provide in certain cases a new income tax treatment for payments in the nature of, or in lieu of, alimony or an allowance for support as between divorced or legally separated spouses.

These amendments are intended to treat such payments as income to the spouse actually receiving or actually entitled to receive them and to relieve the other spouse from the tax burden upon whatever part of the amount of such payments is under the present law includible in his gross income. In addition, the amended sections will produce uniformity in the treatment of amounts paid in the nature of or in lieu of alimony regardless of variance in the laws of different States concerning the existence and continuance of an obligation to pay alimony.

Section 22, relating to the definition of gross income, is amended by inserting at the end thereof a new subsection designated "(k)." This subsection applies only to a wife who is divorced or legally separated under a decree of divorce or of separate maintenance and to the husband from whom she is divorced or legally separated by such decree. Periodic payments, whether or not made at regular intervals, received by the wife subsequent to the decree, in discharge of, or

attributable to property transferred (in trust or otherwise) in discharge of, a legal obligation which, because of the marital or family relationship, is imposed upon or incurred by such husband under such decree or under a written instrument incident to such divorce or separation are defined by section 22 (k) as gross income of the wife. This section applies only where the legal obligation being discharged arises out of the family or marital relationship in recognition of the general obligation to support, which is made specific by the instrument or decree. This section does not apply to that part of any periodic payment attributable to any interest in the property so transferred, which interest originally belonged to the wife, unless she received it from her husband in contemplation of or as an incident to the divorce or separation without adequate and full consideration in money or money's worth, other than the release of the husband or his property from marital obligations.

The full amount of periodic payments received under the circumstances described in section 22 (k) is required to be included in the gross income of the recipient whether such amounts are derived, in whole or in part, from income received or accrued by the source to which such payments are attributable. Thus, it matters not that such payments are attributable to property in trust, to life insurance, endowment, or annuity contracts, or to any other interest in property, or are paid directly or indirectly by the obligor husband from his income or capital. Section 22 (b) (2) is amended to make this result clear with respect to those amounts received from life insurance, endowment, and annuity contracts which otherwise would be excluded from gross income under section 22 (b) (1) and (2). For example, if in order to meet an alimony obligation of $500 a month, the husband purchases or assigns for the benefit of his former wife a commercial annuity contract paying such amount, the full $500 a month received by the wife is includible in her income, and no part of such amount is includible or deductible by the husband.

The above technical features of section 22 (k) contained in the bill passed by the House have been retained by your committee except for a necessary clarification of the rule in the case of installment payments of alimony under section 22 (k). The rule provided in your committee bill is that, in general, installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree or instrument are not considered periodic payments for the purposes of section 22 (k). However, an installment payment is to be considered a periodic payment if such principal sum, by the terms of the decree or instrument, may be or is to be paid within a period ending more than 10 years from the date of such decree or instrument. But in the latter case, such installment payment for the taxable year of the wife (or if more than one such installment payment for such taxable year is received during such taxable year, the aggregate of such installment payments) shall be considered a periodic payment only to the extent that it does not exceed 10 percent of such principal sum. For the purposes of this 10 percent limitation, the portion of a payment of the principal sum which is allocable to a period after the taxable year of the wife in which it is received is considered an installment payment for the taxable year in which it is received. Thus, if under the terms of the decree of divorce the husband is to pay the wife $100,000 in install-

ments of $5,000 a year for 20 years, and in 1942 the husband pays the regular $5,000 installment plus $10,000 in advance installments, only $10,000 is to be considered a periodic payment includible in the wife's income for 1942 and deductible by the husband for 1942. No income or deduction results under section 22 (k) or section 23 (u) from $5,000 of the advance installment payment.

Supplement E is amended by adding a new section, section 171. Section 171 (a) states the rule applicable to trust income after a decree of divorce or of separate maintenance in the case of trusts created prior to the divorce or separation and to which the provisions of section 22 (k) are not applicable. Section 171 (a) is designed to include in the gross income of a wife who is divorced or legally separated from her husband under a decree of divorce or separate maintenance the amount of the income of any trust such wife is entitled to receive which, except for the provisions of section 171, would be includible in the gross income of the husband and to exclude such amount from the gross income of such husband, regardless of section 166, section 167, or any other provision of chapter 1.

The general rules for accounting for the income of a trust or estate, prescribed in supplement E of chapter 1, apply to that part of any periodic payment which is a distribution of income of the trust or estate and which is required under section 22 (k) or section 171 (a) to be included in the income of the individual receiving such payment. For the purpose of clarity, this section provides that the wife entitled to receive the payment is considered as the beneficiary of the trust. If these provisions of section 171 (b) apply to any part of a periodic payment required under section 22 (k) to be included in income of the beneficiary, the whole of such periodic payment shall be included in gross income of the beneficiary in the taxable year in which under the above provisions of section 171 (b) such part is required to be included in her income. It is contemplated under these provisions that the trust or estate will be entitled to a deduction in computing its net income for amounts required to be included in the wife's income under section 22 (k) or section 171 to the extent that such amounts are paid, credited, or to be distributed out of income of the estate or trust for its taxable year.

With respect to the husband, from whom the wife receiving the payments referred to in section 22 (k) and section 171 (a) is divorced or legally separated, provision is made for the exclusion or deduction from his income of any amount included in such wife's income under section 22 (k) or section 171 (a) on account of such payments and which otherwise would be includible in his income. Section 22 (k) provides that, in the case of a divorce or legal separation, periodic payments which are attributable to property transferred in discharge of the legal obligation of such husband shall not be includible in his gross income.

Section 23, relating to deductions from gross income, is amended by adding a new subsection, designated (u), which allows a deduction by the husband in his taxable year in which are paid the amounts includible under section 22 (k) in the gross income of the wife described in section 22 (k). Section 23 (u), as well as section 22 (k), contemplates the treatment of alimony payments as if the husband and wife were on a cash receipts and disbursements basis, that is, the deduction is allowed the husband only for actual payment within his taxable year

and the wife includes in her income for a taxable year under section 22 (k) only such periodic payments described therein as are actually received during such taxable year (including, of course, the constructive receipt or payment of amounts unqualifiedly subject to the demand of the wife or husband, as the case may be). However, the husband is not allowed a deduction under section 23 (u) for any periodic payments, attributable to property transferred in discharge of his legal obligation, which under section 22 (k) or section 171 are stated not to be includible in his gross income. Such periodic payments stated in section 22 (k) or section 171 not to be includible in the husband's gross income are, in some cases, not includible in the husband's income under existing law. Nevertheless, such sections state that such periodic payments are not includible in the husband's income and, accordingly, they are not deductible by him under section 23 (u).

Section 22 (k) and section 171 do not apply to that part of any periodic payment under section 22 (k) and to that part of such trust income under section 171 (a) which, by the terms of the decree or the written instrument under section 22 (k) or of the trust instrument under section 171 (a), is specifically designated as a sum payable for the support of minor children of the husband. If an amount or portion is so fixed but the amount of any periodic payment is less than the amount of the periodic payment specified to be made, then, to the extent of the amount which would be payable for the support of such children out of the originally specified periodic payment, such periodic payment is considered a payment for such support. For example, if the husband is by terms of the decree required to pay $200 a month to his divorced wife, $100 of which is designated by the decree to be for the support of their minor children, and the husband pay only $150 to his wife, $100 is nevertheless considered to be a payment by the husband for the support of the children. If, however, the periodic payments and the trust income are received by the wife for the support and maintenance of herself and of minor children of the husband without such specific designation of the portion for the support of such children, then the whole of such amounts is includible in the income of the wife as provided in section 22 (k) and in section 171.

As a necessary complement to these provisions relating to the support of dependents, section 25 (b) (2), relating to credit for dependents for the purposes of the normal tax and surtax, and section 401 (a) (2), relating to the credit for dependents for the purposes of the optional tax provided in supplement T, are amended so as to provide that payments to an individual's spouse or former spouse which are includible under section 22 (k) or section 171 in the gross income of such spouse or former spouse shall not be considered payments by such individual for the support of the minor children of such persons. Thus, where the portion of such payments for the support of the minor children is not specifically designated, the wife, if actually contributing to the support of the children, is entitled to the credit for dependents, unless it is established that, independently of such amounts paid to the wife, the husband (or some other person upon whom the children are financially dependent) is actually the chief support of such children. The same rules should govern as respects the element of financial support in determining who is entitled to the head of family exemption.

Minor technical changes have been made in this section of your committee bill (in subsection (d) which amends section 22 (b) (2), relating to annuities, etc.; subsection (e) (2) which amended (in the House bill) section 401 (a) (2) relating to the definition of "dependent" under supplement T; and subsection (f) which amends section 3797 (a), relating to definitions) in order to correlate the amendments made by this section with amendments made by sections 164 (b) and 144 (c) of the bill.

The amendments made by this section of the bill are, in general, made applicable only with respect to taxable years beginning after December 31, 1941. However, if the husband's first taxable year beginning after December 31, 1941, does not begin on the same day as the wife's first taxable year beginning after such date, then such amendments are first to become applicable in the case of the husband on the first day of the wife's first taxable year beginning after December 31, 1941, regardless of the husband's taxable year in which such day falls.

SECTION 121. NON-TRADE OR NON-BUSINESS DEDUCTIONS

This section is the same as section 118 of the House bill, except that subsection (c) of that section has been omitted therefrom and now appears as section 163 and a clerical amendment has been made in subsection (b). The amendment made by this section allows a deduction for the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, whether or not such expenses are paid or incurred in carrying on a trade or business, and also allows a deduction for the exhaustion and wear and tear (including a reasonable amount for obsolescence) on property held for the production of income, whether or not such property is used by the taxpayer in a trade or business.

For an expense to be deductible under this section, it must have been incurred either (1) for the production or collection of income, or (2) for the management, conservation, or maintenance of property held for the production of income. Ordinary and necessary expenses so paid or incurred are deductible under section 23 (a) (2) even though they are not paid or incurred for the production or collection of income of the taxable year or for the management, conservation, or maintenance of property held for the production of such income. The term "income" for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property. Expenses incurred in managing or conserving property held for investment may be deductible under this provision even though there is no likelihood that the property will be sold at a profit or will otherwise be productive of income, and even though the property is held merely to minimize a loss with respect thereto. The expenses, however, of carrying on a transaction which does not constitute a trade or business of the taxpayer and is not carried on for the production of income or for the management, conservation, or maintenance of

property, but which is carried on primarily as a sport, hobby, or recreation are not allowable as non-trade or non-business expenses.

Expenses, to be deductible under section 23 (a) (2), must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income, or to the management, conservation, or maintenance of property held for that purpose.

A deduction under this section is subject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23 (a) (1) (A) of an expense paid or incurred in carrying on any trade or business. Section 24 (a) (5), as amended by this section, while continuing to disallow any amount allowable as a deduction, whether under section 23 (a) (2) or otherwise, which is allocable to one or more classes of tax-exempt income, other than interest, has the effect in addition of disallowing a deduction under section 23 (a) (2) for amounts allowable under that section which are allocable to tax-exempt interest.

Subsection (c) of this section amends section 23 (l) of the Code so as to allow, in addition to the deduction allowable under the existing law, a deduction for the exhaustion, wear, and tear of property held by the taxpayer for the production of income, whether or not the property in question is used in the trade or business of the taxpayer, including a reasonable allowance for obsolescence. Except for this, the new allowance is subject to the same limitations and restrictions which have been applicable under this section prior to the present amendment.

The amendments made to the Code by this section are applicable to all taxable years beginning after December 31, 1938. These amendments shall also be effective as if they were a part of the Revenue Act of 1938 or any prior revenue act on the date of its enactment.

SECTION 122. DEDUCTION ALLOWABLE TO PURCHASERS FOR STATE AND LOCAL RETAIL SALES TAXES

This section, for which there is no corresponding section in the House bill, amends section 23 (c) to provide for the allowance of a deduction to the purchaser for certain retail sales taxes, not imposed by law directly on the purchaser to the extent paid by such purchaser other than in connection with his trade or business. The taxes covered by this section are those imposed by any State, Territory, District, or possession of the United States, or any political subdivision thereof, upon persons engaged in selling tangible personal property at retail, which tax is measured by the gross sales price or the gross receipts from the sale, or which is a stated sum per unit of such property sold. The section also covers taxes imposed by such authorities upon persons engaged in furnishing services at retail, which are measured by the gross receipts for furnishing such services.

To provide a safeguard against a purchaser securing a deduction for such taxes which are actually assumed by the seller, your committee bill conditions the right to the deduction upon the tax being separately stated, only the amount so stated and paid being allowable as a deduction. It is not necessary, for the purposes of section 122 that a purchaser be furnished with a bill or invoice upon which the tax is listed

as a separate item. All that is required is that it clearly appear that the tax was paid as such and not merely as a component of the price of the article or service purchased.

SECTION 123. DEDUCTION FOR STOCK AND BOND LOSSES ON SECURITIES IN AFFILIATED CORPORATIONS

This section is new, no corresponding section having appeared in the House bill.

Under existing law section 23 (g) provides that the loss resulting from the worthlessness of securities, defined as shares of stock in a corporation and rights to subscribe for or to receive such shares, shall, if such shares are capital assets, be considered as a loss from the sale or exchange of capital assets. Your committee has added a new paragraph (4) to section 23 (g) so as to provide that, for the purposes of this section, stock in a corporation affiliated with the taxpayer shall not, in the case of such taxpayer, be deemed a capital asset. For the purpose of this new paragraph a corporation is deemed to be affiliated with the taxpayer only if the taxpayer owns directly at least 95 percent of each class of the stock of such corporation, if more than 90 percent of the aggregate of the gross incomes of such corporation for all taxable years has been from sources other than royalties, rents, dividends, interest, annuities, or gains from sales or exchanges of stocks and securities, and if the taxpayer is a domestic corporation.

SECTION 124. DEDUCTION FOR BAD DEBTS, ETC.

This section is substantially the same as section 119 of the House bill.

Your committee has also added a new paragraph (5) to section 23 (k) to provide that bonds, debentures, notes, or certificates, or other evidences of indebtedness issued with interest coupons or in registered form by any corporation affiliated with the taxpayer shall not, in the case of such taxpayer, be deemed capital assets for the purposes of section 23 (k) (2) (which treats the loss resulting from the worthlessness of such securities, if they are capital assets, as a loss from the sale or exchange of capital assets). Section 23 (k) (1) (relating to the deductibility of worthless debts) shall be applicable with respect to debts evidenced by such securities, except that no deduction on account of worthlessness shall be allowed under such section with respect to any such debt which is recoverable only in part. For the purposes of this section, a corporation is deemed to be affiliated with the taxpayer only if the taxpayer owns directly at least 95 percent of each class of the stock of such corporation, if more than 90 percent of the aggregate of the gross incomes of such corporation for all taxable years has been from sources other than royalties, rents, dividends, interest, or annuities, or gains from sales or exchanges of stocks and securities, and if the taxpayer is a domestic corporation. This amendment, inserting section 23 (k) (5) and the related amendments, are made applicable only with respect to taxable years beginning after December 31, 1941.

Under present law ascertainment of worthlessness and charge-off on the books of the taxpayer during the taxable year are prerequisites for the allowance of a deduction for a bad debt. This section amends

section 23 (k) of the Code to allow a deduction for a debt which becomes worthless during the taxable year regardless of the year in which the debt is ascertained to be worthless or charged off. A similar amendment is made to section 204 (c) (6) of the Code with respect to deductions for bad debts allowed insurance companies other than life or mutual. These amendments are made retroactive so as to apply to all taxable years beginning after December 31, 1938.

A new provision is added providing for special treatment of non-business debts, applicable in the case of a taxpayer other than a corporation. If such a debt becomes entirely worthless within the taxable year, the loss resulting therefrom is to be considered a loss from the sale or exchange of a capital asset held for not more than 6 months. The provisions of section 23 (k) (1), as amended by this section, with respect to a debt which has become partially worthless, do not apply in the case of a non-business debt; and a loss with respect to such a debt will be treated as sustained only if and when the debt has become totally worthless. Nor are these provisions with respect to non-business debts applicable in the case of a loss resulting from a security as defined in section 23 (k) (3). A non-business debt is defined as a debt other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business, and other than a debt evidenced by a security as that term is defined in section 23 (k) (3) of the Code. The question whether a debt is one, the loss from the worthlessness of which is incurred in the taxpayer's trade or business, is a question of fact in each particular case, and the determination is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23 (e) is "incurred in trade or business" under paragraph (1) of that section.

The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the debtor, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a non-business debt for the purposes of this amendment.

To illustrate: A, an individual engaged in the grocery business, extends credit on an open account to B in 1941.

(1) In 1942 A sells the business but retains the claim against B. The claim subsequently becomes worthless in A's hands. A's loss is controlled by the non-business debt provisions. While the original consideration was advanced by A in his trade or business, the loss was not sustained as a proximate incident to the conduct of any trade or business in which he was engaged at the time the claim became worthless.

(2) In 1942 A sells the business to C but sells the claim against B to the taxpayer, D. The claim subsequently becomes worthless in D's hands, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the non-business debt provisions, even though

the original consideration was advanced by A in his trade or business.

(3) In 1942 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands. C's loss is not controlled by the non-business debt provisions. While C did not advance any consideration for the claim or acquire it in carrying on his trade or business, the loss was sustained as a proximate incident to the conduct of the trade or business in which he was engaged at the time the debt became worthless.

(4) In 1942 A dies, leaving the business to his son, C, but the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(5) In 1942 A dies and while his executor, C, is carrying on the business, the claim against B becomes worthless. The loss sustained by A's estate is not controlled by the non-business debt provisions. While C did not advance any consideration for the claim on behalf of the estate or acquire it in carrying on a trade or business in which the estate was engaged, the loss was sustained as a proximate incident to the conduct of the trade or business in which the estate was engaged at the time the debt became worthless.

(6) In 1942 A, in liquidating the business, attempts to collect B's claim but finds that it has become worthless. A's loss is not controlled by the non-business debt provisions, since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.

Subsection (c) of this section of the bill amends section 3771 of the Code so as to disallow interest on the overpayment attributable to the deductibility of a bad debt or a worthless security, or the effect of such deductibility on a carry-over, for any period beginning after the expiration of the period of limitation provided in section 322 (b) (1) for filing claim for credit or refund of such overpayment, and ending at the expiration of 6 months after the date on which the claim was filed, or if no claim was filed and the overpayment is found by the Board, ending on the date the petition asserting such overpayment is filed, in cases where credit or refund of such overpayment would not be allowed except for the provisions of section 322 (b) (5), added by section 171 of the bill, or except for clause (2) of section 322 (d), as amended by section 171 of the bill. This amendment is effective with respect to taxable years beginning after December 31, 1938.

This section varies from the corresponding section of the House bill in that a loss resulting from the worthlessness of a non-business bad debt is to be considered a loss from the sale or exchange of capital asset held for not more than 6 months, rather than of a capital asset held for not more than 15 months. This change is made in view of corresponding changes made in section 136 of the House bill (amend-

ing sec. 117 of the Code, relating to capital gains and losses) in order that losses resulting from the worthlessness of non-business bad debts may be treated in the same manner as short-term capital losses are treated under section 117 of the Code. In addition, the provisions with respect to non-business bad debts are now made applicable only to taxable years beginning after December 31, 1942.

SECTION 125. CORPORATE CONTRIBUTIONS TO UNITED STATES, ETC., OR FOR CHARITABLE USE OUTSIDE UNITED STATES DEDUCTIBLE

This amendment, for which there is no corresponding provision in the House bill, broadens section 23 (q) of the Code so as to allow deductions to corporations for contributions or gifts made to or for the use of the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, or any possession of the United States, for exclusively public purposes. Such gifts will be deductible up to 5 percent of net income, as is now the case for charitable contributions by corporations. The amendment also deletes the provision contained in the existing law which limits corporate charitable deductions to those contributions or gifts which are to be used only within the United States or its possessions.

SECTION 126. AMORTIZABLE BOND PREMIUM

This section is the same as section 120 of the House bill with the exception that the definition of "bond" contained in the section is altered to exclude obligations which constitute stock in trade of the taxpayer or obligations which would be includible in an inventory made by a taxpayer at the end of a taxable year.

This section makes provision for the amortization of bond premium by the obligee. It is mandatory with respect to fully tax-exempt bonds (the interest on which is not subject to the income tax), whether the owner is a corporation, individual, or other taxpayer. In the case of fully taxable bonds (the interest on which is subject to the normal tax and the surtax), amortization under this section of the premium thereon is elective, irrespective of the nature of the taxpayer. With respect to partially tax-exempt bonds (the interest on which is subject only to the surtax), the operation of this section depends upon the nature of the taxpayer: if the taxpayer is a corporation, amortization is mandatory; whereas, if the taxpayer is not a corporation, amortization is elective. Inasmuch as the term "bond" is so defined as to exclude bonds held by a taxpayer primarily for sale to customers in the ordinary course of his trade or business, this section is not applicable to dealers in securities.

The operation of this section in respect of fully tax-exempt bonds, fully taxable bonds, and partially tax-exempt bonds, subject to the provisions of this section, may be illustrated as follows: in the case of a fully tax-exempt bond, the amortizable premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bond, as the case may be. Thus, in the event such amount is $1, the basis or adjusted basis is reduced by $1. No deduction is allowed on account of such amortizable premium. In the case of a fully taxable bond, the amortizable premium is both an adjustment to the basis

or adjusted basis of the bond and also a deduction. In the case of a partially tax-exempt bond, a somewhat more elaborate procedure has been adopted. Briefly, it is designed to subject to the surtax only the net yield from the bond. Under this procedure, the amortizable premium for the taxable year is used for three purposes: (1) as an adjustment to the basis or adjusted basis of the bond; (2) as a deduction; and (3) as a reduction to the credit for the interest on the bond. Accordingly, if the interest on a partially tax-exempt bond for the taxable year is $30 and if the amortizable premium thereon for such taxable year is $5, the $30 is taken up in the gross income, the $5 is allowed as a deduction, and the credit on account of such interest is $25 ($30 minus $5), or the net yield from the bond for the taxable year.

The terms "bond premium" and "amortizable bond premium," as used in this section, refer to different amounts. Bond premium, in the case of any bond subject to this section, is the total premium thereon; that is, the excess of the basis of the bond for determining loss over the amount payable at maturity. On the other hand, amortizable bond premium is such part of the total premium on the bond as is attributable to the taxable year. The determinations of the "bond premium" and the "amortizable bond premium" on any bond are required to be made by the taxpayer in accordance with the method of amortization employed by him. If the taxpayer regularly employs a method of amortizing bond premium, as where the taxpayer is subject to the jurisdiction of a State or Federal regulatory agency and is required to amortize bond premium for the purposes of such agency, in accordance with a method prescribed or approved by such agency, such method if reasonable may be used for the purposes of this section. In the case of all other taxpayers, the method of amortization to be used under this section shall be a method which the Commissioner with the approval of the Secretary shall by regulations prescribe. For the sake of brevity, the term "approved method of amortization" or "approved method" is hereinafter used to mean either (1) a method of amortization which is regularly employed by the taxpayer and which is reasonable or (2) a method of amortization prescribed by the Commissioner, with the approval of the Secretary, by regulations made under this section.

The election provided in this section shall be made at such time and in such manner as the Commissioner with the approval of the Secretary shall by regulations prescribe. In the case of a corporation, the election may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election may be made with respect to (1) fully taxable bonds only, or (2) partially tax-exempt bonds only, or (3) both fully taxable bonds and partially tax-exempt bonds. The election shall apply to all bonds, with respect to which it was made, owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. The Commissioner, however, is given the right, upon application by the taxpayer, to permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. In the case of bonds owned by a partnership, common trust fund, or foreign personal holding company, the election shall be exercisable by the partnership, common trust fund, or foreign personal holding company.

The section provides for adjustments proper to reflect unamortized bond premium on any bond for the period prior to the date as of which this section becomes applicable to such bond. The application of such provision may be illustrated by the following examples:

First example: On January 1, 1942, T, on the calendar year basis, owns a fully taxable $100 bond, maturing on January 1, 1952. T purchased this bond on January 1, 1932, for $120. T elects to have this section apply to such bond for 1942 and subsequent taxable years. In determining the amount of premium to be amortized over the remaining 10 years of the life of the bond, T is required, but solely for such purpose, to treat the bond as if he had amortized the premium thereon during the prior 10 years under this section, and to make the proper adjustment in the original premium. Accordingly, T would treat $10 as having been amortized during the first 10 years and would be required to amortize the remaining $10 over the following 10 years. When the bond is redeemed on January 1, 1952, for $100, only the $10 attributable to the second 10 years will actually have been amortized. The $10 attributable to the first 10 years will have been treated as an adjustment to the original premium but will not have been amortized. Consequently, T will have a capital loss in the year of redemption on account of the $10 attributable to the period 1932–42.

Second example: On January 1, 1942, X's father gave him a fully taxable $100 bond maturing on January 1, 1952. X's father had purchased the bond on January 1, 1932, for $120. The fair market value of the bond at the time of the gift was $130. X is on the calendar year basis and elects to amortize the premium on the bond during the period 1942–52. Under section 113 (a) (2) the cost of the bond to X's father constitutes the basis of the bond for determining loss, since such cost is lower than the fair market value of the bond at the time of the gift, and under section 117 (h) (2) X's holding period is deemed to include the 10 years during which his father held the bond. X is required to treat the bond as if it had been amortized during his father's holding period. Thus, X is required to amortize $10 over the period 1942–52 and will in the year of redemption receive a capital loss on account of the $10 attributable to his father's holding period.

The fact that a bond is callable or convertible into stock does not of itself prevent the application of this section. In the case of a callable bond, the earliest call date will, for the purposes of this section, be considered as the maturity date. Hence, the total premium is required to be spread over the period from the date as of which the basis of the bond is established down to the earliest call date, rather than down to the maturity date. In the case of a convertible bond, if the option to convert the bond into stock rests with the owner of the bond, the bond is within the purview of this section.

Capitalized expenses connected with the acquisition of a bond to which this section is applicable may be amortized, along with the premium, if such expenses are treated as being amortizable under the approved method of amortization employed by the taxpayer. By the same token, if such expenses are not amortizable under the taxpayer's approved method, amortization will not be required. In such a case, upon the redemption of the bond, a capital loss will result on account of such expenses.

In the case of a cash basis taxpayer owning a bond to which this section is applicable, if no interest on such bond is received during the taxable year, amortization for such taxable year will not be required. Nevertheless, if the approved method of amortization of such a taxpayer requires amortization in such a case, it will be permitted. With reference to a taxpayer on the accrual basis owning a bond to which this section is applicable, amortization of the premium on the bond is required for each taxable year for which interest thereon is, under sound principles of accounting, properly accruable. In such a case, however, if the approved method of the taxpayer provides for amortization even for taxable years for which interest on the bond is not properly accruable, amortization will be permitted.

The application of this section to bonds (subject thereto) owned by decedents may be illustrated as follows: The cash basis decedent will be considered first. If the bond is fully tax-exempt, the amortizable premium for the period ending with his death should be given effect as an adjustment to the basis or adjusted basis of the bond. If the bond is fully taxable, the interest accruing during such period is, by reason of section 135 of the bill carried over to the estate or legatee, whereas the deduction on account of the amortizable premium for such period remains with the decedent. If the bond is partially tax-exempt, the interest is similarly carried over to the estate or legatee, but the credit therefor will not be reduced on account of the deduction for amortizable premium. The deduction itself remains with the decedent. In the case of an accrual basis decedent owning a partially tax-exempt bond, or a fully taxable bond, subject to this section, both the interest and the deduction for amortizable premium remain with the decedent. In such a case, if the bond is partially tax-exempt, the decedent's credit for the interest accruing during the period ending with his death is required to be reduced by the deduction for the amortizable premium for such period.

If a trust owning partially tax-exempt bonds elects to amortize the premium, thereon, the credits of the trust and the beneficiaries on account of such interest are required to be reduced by the portion of the amortization deduction attributable to their shares. Similar treatment is accorded to bonds owned by common trust funds, partnerships, foreign personal holding companies, and personal service corporations.

SECTION 127. DEDUCTION FOR MEDICAL, DENTAL, ETC., EXPENSES

This section, inserted into the bill by your committee, adds section 23 (x) to the Code to allow a deduction for expenses paid during the taxable year for medical care of the taxpayer, his spouse, or a dependent of the taxpayer. The deduction is limited to such expenses as exceed 5 percent of the net income computed without the benefit of section 23 (x). Where a husband and wife file a joint return the limitation is 5 percent of the aggregate net income of such husband and wife. The maximum deduction for any taxable year in the case of a husband and wife who file a joint return, or a head of a family, may not exceed $2,500, and in the case of all other individuals, $1,250.

The term "medical care" is broadly defined to include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of

disease, or for the purpose of affecting any structure or function of the body. It is not intended, however, that a deduction should be allowed for any expense that is not incurred primarily for the prevention or alleviation of a physical or mental defect or illness.

Although a deduction is denied with respect to such expenses as are compensated for by insurance or otherwise, amounts paid for accident or health insurance are included in the category of medical expenses. Payments for hospitalization insurance, or for membership in an association furnishing cooperative or so-called free-choice medical service, or group hospitalization and clinical care are intended, for purposes of this section, to be included as amounts which may be deducted.

Section 24 (a), relating to items not deductible, is amended by section 127 to conform to section 23 (x), and a technical amendment is made to section 23 (o) to provide that, in computing net income for purposes of the deduction for charitable and other contributions, the deduction for medical expenses shall not apply. Finally, section 22 (b) (5) is amended to include in gross income amounts received for compensation for personal injuries or sickness which are attributable to and not in excess of deductions allowed under section 23 (x) in any prior taxable year.

SECTION 128. LOSSES OF MINING CORPORATIONS FOR 1938 AND 1939

This section is new, no corresponding provision having appeared in the House bill. It adds section 23 (y) to the Code to provide that losses of certain mining corporations for taxable years beginning in 1938 and 1939 should be allowed as deductions in computing net income for the first taxable year beginning in 1940. The computation of the 1938 and 1939 losses shall be made with the exceptions and limitations provided in section 122 (d) of the Code prior to its amendment by this bill. Mining corporations to which this section applies are those corporations engaged in the mining of metals, coal, and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gravel, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand, silica, slate, soapstone, soda, sulfur, and talc.

Any excess of the 1938 and 1939 losses allowed by this amendment, plus the deductions otherwise allowable in 1940 over the income for 1940, can be carried forward through the medium of the net operating loss deduction provided in section 122 of the Code to 1941 and 1942. There is thus, in effect, provided a 4 year carry-over of certain mining losses occurring during 1938 and a 3 year carry-over of similar mining losses occurring during 1939.

A technical amendment has also been made to section 122 (e) so as to provide that the 1939 mining losses shall not be deducted in 1940 both through the net operating loss carry-over and as a deduction under this section.

The amendments made by this section are effective with respect to taxable years beginning after December 31, 1939.

SECTION 129. DEDUCTION OF CERTAIN AMOUNTS PAID TO COOPERATIVE APARTMENT CORPORATION

This section adds to section 23 of the Code, relating to deductions from gross income, a new subsection designated "(z)". No comparable provision is contained in the House bill.

Section 23 (z) allows a tenant-stockholder (as defined in such subsection) to deduct from gross income amounts paid or accrued to a cooperative apartment corporation (as defined in such subsection) within the taxable year of the tenant-stockholder, if such amounts represent such tenant-stockholder's proportionate share of certain real estate taxes, allowable as deductions under section 23 (c) of the Code, paid or incurred by the corporation, or of the interest paid or incurred by the corporation on certain indebtedness. No deduction may be taken under section 23 (z) if such amounts are allowable as deductions to such tenant-stockholder under some other provision of law. The definitions of the terms "cooperative apartment corporation" and "tenant-stockholder" prescribe certain standards which are designed to safeguard the revenue by assuring that the apartment corporations involved are bona fide cooperative apartment corporations and that the individuals entitled to deductions under section 23 (z) are bona fide tenant-stockholders of such corporations.

SECTION 130. DEDUCTION DENIED IF PROCEEDS USED TO PAY FOR INSURANCE

This section is of somewhat more limited application than section 121 of the House bill. It adds to section 24 (a) (relating to items not deductible) paragraph (6) which in effect denies a deduction, under section 23 (b), as well as under any other provision of this chapter, for any amount, whether in the form of interest or in any other form, which has been paid or accrued on an indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. (Compare the provision of section 23 (b) which prohibits the deduction of interest paid or accrued on indebtedness incurred or continued to purchase or carry tax-exempt securities.) By reason of a definition added by your committee a contract shall be considered a single premium life insurance or endowment contract, for the purposes of this paragraph, if substantially all the premiums on such contracts are paid within a period of 4 years from the date on which the contract is purchased.

SECTION 131. TAXES AND OTHER CHARGES CHARGEABLE TO CAPITAL ACCOUNT NOT DEDUCTIBLE BUT TREATED AS CAPITAL ITEMS

The effect of this section, which is substantially the same as section 122 of the House bill, is to permit the taxpayer to treat as chargeable to capital account (either as a component of original cost, for the purposes of section 113 (a), or as an adjustment to basis, for the purposes of section 113 (b) (1) (A)), notwithstanding that they are expressly deductible under section 23, such taxes and carrying charges with respect to property as, under regulations prescribed by the Com-

missioner with the approval of the Secretary, are so chargeable, but expressly to prohibit the deduction of amounts charged to capital account in the exercise of such an election.

The clause with respect to unimproved and unproductive real property has been deleted from section 113 (b) (1) (A) so as to make it clear that the provisions of that subparagraph, to the effect that no adjustment of basis under that section shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years, are not limited to the case of taxes and carrying charges on unimproved and unproductive real property, but apply with equal force whether the property to which account the items are properly chargeable is real or personal, improved or unimproved, productive or unproductive. The term "other items," as used in section 113 (b) (1) (A), comprehends taxes and interest.

SECTION 132. REDUCTION OF PERSONAL EXEMPTION AND CREDIT FOR DEPENDENTS—REQUIREMENT FOR RETURN

This section corresponds to section 123 of the House bill, except that section 25 (b) (2) (A) of the Code is amended to reduce the credit for dependents from $400 to $300 and section 214 of the Code is further amended to provide that alien residents of Canada and Mexico shall be allowed the personal exemption of head of a family or of a married person living with husband or wife in cases where such countries allow similar exemptions to citizens of the United States who reside in the United States.

Subsection (a) of this section amends section 25 (b) (1) to reduce the personal exemption of a single person or a married person not living with husband or wife from $750 to $500, and to reduce the personal exemption of a head of a family or a married person living with husband or wife from $1,500 to $1,200. Subject to the exception in the case of resident aliens of Canada and Mexico, this section also amends section 214 (relating to personal exemption of nonresident alien individuals) and section 251 (f) (relating to personal exemption of citizens entitled to the benefits of section 251) by striking out $750 and inserting in lieu thereof $500 to conform such sections with the changes made in section 25 (b) (1).

Subsection (c) of this section amends section 51 (a) so as to require a return in the case of a single person or a married person not living with husband or wife, if having a gross income of $500 or over, and in the case of a married person living with husband or wife, if having a gross income of $1,200 or over. It also amends section 142 (a) of the Code so as to require a return in the case of a fiduciary where the gross income of a single individual, estate, or trust for which he acts is $500 or more, and where the gross income of a married person for whom he acts is $1,200 or over. Subsection (c) likewise amends section 147 (a) by reducing from $750 to $500 the amount of payments to individuals which requires an information return from the payer of the income.

SECTION 133. COMPUTATION OF NET OPERATING LOSS CREDIT AND DIVIDENDS PAID CREDIT

This section, except for clerical changes, is identical with section 124 of the House bill, except that the amendments have been made retroactive to taxable years beginning after December 31, 1939. It amends the following sections of the Code: Section 26 (c) (1), relating to the amount of net operating loss credit of the preceding year; section 26 (c) (2), relating to the definition of net operating loss; section 27 (b), relating to the definition of basic surtax credit; section 27 (c), relating to dividend carry-over; and section 504 (a), relating to the definition of undistributed subchapter A net income.

Section 26 (c) (1) and section 27 (b) are amended so that the amount of the credit for the net operating loss of the preceding year which is a part of the basic surtax credit and the limitation on the amount of the basic surtax credit shall not be in excess of the section 102 net income for the taxable year, in the case of the tax imposed by section 102, the supplement P net income for the taxable year, in the case of the computations required under supplement P, or the subchapter A net income for the taxable year, in the case of the tax imposed under subchapter A. Under existing law the net operating loss of the preceding taxable year cannot be in excess of the adjusted net income of the taxable year. Section 26 (c) (2) is amended to provide that in the computation of the net operating loss for purposes of the net operating loss credit, the net operating loss deduction provided in section 122 shall not be allowed. Your committee has also made a technical amendment to clarify the amendment made by section 211 (j) of the Revenue Act of 1939 to section 26 (c) (2).

Section 27 (c) is amended to limit the amount of the dividend carry-over for the taxable year, which under existing law is allowed only to personal holding companies, so that in the computations with respect to the previous taxable years subchapter A net income applying only to personal holding companies will be used instead of adjusted net income which is applicable to corporations generally. The proposed amendment to section 27 (c) also includes the situation with respect to the computation of the dividend carry-over in the case of Federal taxes set forth at the end of section 504 (a) of the Code. As this part of section 504 (a) is no longer necessary it has been eliminated.

The amendments made by this section are made applicable by your committee only in determining tax liability for taxable years beginning after December 31, 1939. In computing such tax liability, however, the dividend carry-over, if any, from previous taxable years beginning in 1939 or in any subsequent year is to be ascertained in accordance with the amendments.

SECTION 134. CREDIT FOR DIVIDENDS PAID ON CERTAIN PREFERRED STOCK

This section, for which there is no corresponding provision in the House bill, amends section 26 of the Code (relating to credits allowed to corporations) by inserting at the end thereof a new subsection (h) which allows to public utilities a credit against the corporate surtax of the amount of dividends paid on its preferred stock during the

taxable year. Subsection (h) defines the terms "public utility" and "preferred stock," as used in such subsection and in section 15 (a) of the Code, as proposed to be added by this bill. Under such definitions, public utilities are those engaged in the furnishing of telephone service or in the sale of electric energy, gas, and water, at rates which, with respect to such furnishing or sale, have been established and approved by State or Federal authorities having jurisdiction over such matter; and preferred stock means only stock issued prior to September 1, 1942, and which on that date and during the whole of the taxable year was non-voting stock, the dividends in respect of which were cumulative, limited to the same amount, and payable in preference to the payment of dividends on other stock.

SECTION 135. INCOME IN RESPECT OF DECEDENTS

This section is the same as section 125 of the House bill, with the exception of minor changes discussed herein. Since the Revenue Act of 1934 the revenue laws have contained provisions including in the income of a decedent for the period in which falls the date of his death all income accrued up to the date of his death not otherwise properly includible in respect of such period or a prior period. While such income should be subject to income tax, hardship results in many cases from including in the income for the decedent's last taxable period amounts which ordinarily would be receivable over a period of several years. This section changes the existing law by providing that such amounts shall not be included in the decedent's income but shall be treated, in the hands of the persons receiving them, as income of the same nature and to the same extent as such amounts would be income if the decedent remained alive and received such amounts. Section 22 (b) (3) (excluding from income amounts received by bequest, devise, or inheritance) does not apply to these amounts which are specifically required to be included in income. The right to income is treated in the hands of the decedent differently from his other property, and when his estate or his legatee takes his place with respect to this income, it is proper to continue to treat this right in their hands in the same manner as it would be treated in the hands of the decedent.

Subsections (a) and (b) of this section strike out the present provisions of section 42 (a), requiring the inclusion in the decedent's income of all amounts of items of gross income accrued up to the date of his death, and of section 43 allowing as deductions and credits the amount of all deductions and credits accrued up to the date of his death. These subsections further provide that amounts (other than amounts includible by a partner under section 182 in computing net income) which would be includible in the income of, or allowable as deductions and credits to, a decedent who keeps his books on the basis of the accrual method of accounting solely by reason of his death shall not be included in computing his income for the taxable period in which falls the date of his death. The purpose of this provision is to insure that with respect to the determination of the decedent's income for his last taxable period the death of the decedent will not effect any change in the accounting practice by which the decedent determined his income during his life. Thus, upon the dissolution of a partnership because of the death of a partner the income of the partnership for the year ending with the dissolution, computed only

according to the practice of the partnership in properly keeping its books, is included in the income of the deceased partner. For example, if a law partnership, keeping its books on the accrual basis, is entitled to certain contingent fees which are only accrued upon the completion of the cases involved, such partnership will compute its tax for the year ending with the dissolution without accruing, on account of the death of the partner at such time, any such contingent fees in uncompleted cases.

All amounts of gross income which are not includible in the income of the decedent will, when received, be includible in the income of the person receiving such amounts by inheritance or survivorship from the decedent under section 126, to be added to the Code by subsection (e) of this section. The persons who are placed, with respect to such amounts, in the same position as the decedent are the decedent's estate, which in the great majority of cases will receive such amounts, and, if the estate does not collect such amounts but distributes the right to receive such amounts to the heir, next of kin, legatee, or devisee, who inherited or was bequeathed or devised such right, such heir, next of kin, legatee, or devisee. Also placed in the same position as the decedent with respect to such amounts are those who acquire the right to such amounts by reason of the death of the decedent. An example of the application of this provision is the case of a decedent who owned a defense bond, with his wife as co-owner or beneficiary, and died before the payment of such bond. The entire amount accruing on the bond and not includible in income by the decedent, not just the amount accruing after the death of the decedent, would be treated as income to his wife when the bond is paid. Another example is the case of a partner who contracts in the partnership agreement that his interest in certain partnership assets shall pass to the surviving partners in exchange for payments to be made by them to his widow. On his death, the payments by the surviving partners shall be included in the widow's income to the extent they represent the gain on such sale. If the payments are to be made to the widow as trustee for minor children, and the right to receive such payments is transferred to the children upon their majority, the children are within the provisions of section 126 (a) (1) as receiving the right to such payments by reason of the death of the decedent.

Since this section provides for the treatment of such amounts as income to the persons placed in the same position as the decedent with respect to such amounts, the provisions of section 113 (a) (5) with respect to the basis of property do not apply to these amounts in their hands. Furthermore, section 126 only applies to the amount of items of gross income in respect of a decedent, and items which are excluded from gross income with respect to the decedent under section 22 (b) or section 116 are not within the provisions of section 126.

Section 126 (a) (2) of the Code, as added by subsection (e), provides that if the right to receive an amount described in section 126 (a) (1) is transferred by a person described in such subsection, the fair market value of such right at the date of the transfer shall be included in the income of such person, plus the amount by which any consideration received on such transfer exceeds the fair market value of such right. Thus, if the right to receive the income is disposed of, as by gift, the donor must include the fair market value of such right in his gross income, in view of his benefit from such right. However, if the person

to whom such right is transferred is a person described in section 126 (a) (1) as being entitled to such right by reason of the death of the decedent (for example, the beneficiary of the trust of such right), or by bequest, inheritance, or devise from the decedent (for example, a specific legatee of such right or the residuary legatee of the estate), the fair market value of the right is not included in the income of the transferor, but the transferee must include the amount received in his income under the provisions of section 126 (a) (1), or if he transfers such right to a person not described in section 126 (a) (1), then he must include the fair market value of this right in his income.

Subsection (a) (3) of section 126 provides that the right to receive an amount described in subsection (a) (1) shall be treated in the hands of a person described in that subsection as if it had been acquired in the transaction by which the decedent acquired such right, and shall be considered as having the same character it would have had if the decedent had lived and had received such amount. This provision is designed to place the person described in subsection (a) (1) in the same position with respect to the nature of this income as the position the decedent enjoyed. Thus, if the income to the decedent would have been capital gain from the sale of property, if he had lived and had received it, the income when received, or its fair market value if transferred, shall be treated in the hands of the person described in (a) (1) as capital gain from the sale of the property, in the same manner as if such person had held the property for the period the decedent held it, and had made the sale. Similarly, if the income is interest on United States obligations owned by the decedent, such income shall be treated for the purpose of determining the credit provided by section 25 (a) (1) and (2) in the hands of the person receiving it as interest from United States obligations, as if such person owned the obligations with respect to which such interest is paid. If the amounts would have constituted earned income to the decedent, such amounts shall constitute earned income to the person including such amounts in his gross income to the same extent as if he had engaged in place of the decedent in the transaction in which the amounts were earned. If the amounts are compensation for personal services rendered over a period of 36 months, and would be within the provisions of section 107 if the decedent lived and included such amounts in his gross income, section 107 applies. That is, the tax of the person including this amount in gross income attributable to the inclusion of such amount in his income shall not exceed the aggregate of the taxes of the decendent which would be attributable to such amount if it had been received by the decedent in equal portions in each of the months included in the period in which the personal services were rendered. Similarly, the provisions of sections 105 and 106 apply to any amount included in the gross income, the right to which was obtained by the decedent by a sale or claim within the provisions of those sections. The tax on the person including such amount in gross income attributable to this amount shall not exceed 30 percent of such amount.

Subsection (b) of section 126 relates to the allowance to the persons described in subsection (a) (1) of the deductions and credits in respect of a decedent which are not allowable in respect of the taxable period in which falls the date of his death or a prior period. Thus, the business expenses, interest, and taxes for which the decedent was liable, which were not properly allowable as a deduction to him, are allowed

when paid (A) as a deduction by the estate, or (B), if the estate is not liable to pay such obligation, as a deduction by the person who by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent acquires, subject to such obligation, an interest in property of the decedent. Similar treatment is given to the foreign tax credit provided by section 31. For the purposes of (B), the right to receive an amount of gross income in respect of a decedent is considered property of the decedent. For example, if such income is subject to foreign taxes, the credit provided in section 31 may be allowed to the recipient. Furthermore, for the deduction to be allowable, it is not necessary for the estate or the person paying the obligation to receive income in respect of the decedent, the only requirement being that property subject to the obligation is acquired by survivorship or inheritance from the decedent. Under the specific provisions of subsection (b) (2), the deduction for percentage depletion is allowable to the person who receives the income to which the deduction relates, whether or not such person receives the property from which such income is derived.

Subsection (c) of section 126, added to the Code by this section, provides that the recipient of income in respect of a decedent may deduct that portion of the estate tax levied on the decedent's estate which is attributable to the inclusion of the right to such income in the decedent's estate. Under the House bill, the portion of the estate tax attributable to the inclusion in the gross estate of the right to such income was to be determined under the effective rate of estate tax applicable to the decedent's estate. Your committee has changed this provision so that the portion attributable to the inclusion of such right in the gross estate is the increase in estate tax caused by such inclusion. An example of the determination of this deduction follows:

X, an attorney who kept his books on the basis of the cash receipts and disbursements method of accounting, was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued in his estate at $1,000, and to accrued interest on bonds which was valued at $500. In all, $1,500 was included in his gross estate in respect of income described in section 126 (a) (1). There were deducted as claims against his estate $150 for business expenses for which his estate was liable, and $50 for taxes accrued on certain property he owned, in all, $200 for claims which represent the deductions described in section 126 (b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate is $185,000, and his net estate, computed without deducting any specific exemption, is $150,000, on which the total basic and additional estate tax (reduced by credits against such tax) is $23,625. In the year following the death of X, his estate collected the fee in the amount of $1,200, which amount is included in the income of the estate. The estate may deduct, in computing its net income for such year, $260 on account of the estate tax attributable to such income, computed as follows:

(1) (*a*) Value of income described in section 126 (a) (1) included in computing gross estate	$1,500
(*b*) Deductions in computing gross estate for claims representing deductions described in section 126 (b)	200
(*c*) Net value of items described in section 126 (a) (1)	1,300

(2)	(a) Estate tax (basic and additional estate taxes, less credits against such taxes)	$23, 625
	(b) Less: Estate tax computed without including $1,300 (item (1) (c)) in gross estate	23, 235
	(c) Portion of estate tax attributable to net value of income items	390
(3)	(a) Value in gross estate of income received by estate in taxable year	1, 000
	(b) Value in gross estate of all income items described in section 126 (a) (1) (item (1) (a) above)	1, 500
	(c) Part of estate tax deductible upon receiving the $1,200 fee $\left(\frac{\$1,000}{\$1,500} \text{ of } \$390\right)$	260

Although $1,200 was later collected as the fee, only the $1,000 actually included in the gross estate is used in the above computations. However, to avoid distortion, section 126 (c) provides that if the value included in the gross estate is greater than the amount finally collected, only the amount collected shall be used in the above computations. Thus, if the amount collected as the fee were only $500, the estate tax deductible on the receipt of such amount would be $\frac{\$500}{\$1,500}$ of $390, or $130.

Subsection (f) of section 135 of the bill provides that the amendments to sections 42 and 43 shall become effective with respect to taxable years of decedents beginning after December 31, 1942, and section 126, as added to the Code by subsection (e), shall become effective with respect to the taxable years of the persons therein described which end after December 31, 1942. This latter provision will cover all such persons who have a taxable year in which an amount of income in respect of a decedent dying after December 31, 1942, could be included.

Subsection (g) provides that if the last taxable year of the decedent is still open for the purposes of obtaining a refund of the portion of the tax attributable to income which would not be includible (reduced by deductions and credits which would not be allowable) if provisions corresponding to the provisions of the code as amended by this section were a part of the revenue law applicable to such year, then a refund may be made of such portion of the tax. This refund will be made only if all persons who would be required to include income with respect to such decedent in their gross income file written consents that they will recompute the tax for their taxable years as if, with respect to such amounts, provisions corresponding to the provisions of this section were a part of the revenue law applicable to such taxable years. No interest will be allowed on any refunds caused by the application of these provisions.

Your committee has changed the House bill by adding provisions so that in any case in which the executor and the recipients of the income choose to have this section apply retroactively, and such application results in a deficiency for the last taxable period of the decedent (by the disallowance of accrued deductions and credits for such taxable period, which deductions and credits are allowed in computing the net income of the executor and of such recipients) the assessment of which is otherwise barred by limitations or by any rule of law, such deficiency may nevertheless be assessed and collected. Your committee has also changed the House bill to provide for the determination of the tax of the recipient on account of accrued income

notwithstanding any rule of law which bars such adjustment (such as a judicial determination of the tax for the taxable period of the recipient prior to the filing of the consent).

SECTION 136. RETURNS FOR A PERIOD OF LESS THAN 12 MONTHS

This section is identical with section 126 of the House bill.

If a taxpayer, other than a corporation, changes its accounting period, under section 47 (c) of existing law the income for the short period between the close of his old accounting period and the date designated as the close of the new period is placed on an annual basis by reference to the number of months in the short period. This section amends section 47 (c) to make it applicable not only to individuals but also to corporations that have a short period taxable year because of a change in their accounting period. Although the effect of placing the net income on an annual basis is to place on an annual basis each item used in the computation of the net income, the credit for dividends paid is a credit against net income, not an item in computing net income, and therefore some question may arise as to whether it is placed on an annual basis in the case of the various taxes on corporations which are determined by the use of such credit. Express provisions are therefore added to the effect that the net income shall not be placed on an annual basis in cases where the credit for dividends paid is applicable.

This section further amends section 47 (c) by adding paragraph (2) to provide that the taxpayer may determine its tax by reference to its actual income for the 12 months from the beginning of its short period. Under this provision the taxpayer will compute its tax and file its return by placing its income on an annual basis under the present method. It may then file an application, in such form as the Commissioner may prescribe, to reduce its tax by establishing the amount of its actual net income for the period of 12 months beginning with the first day of the short period, computing the tax on such net income, and taking as its tax such part of the tax so computed as the income determined for the short period is of the income for the 12 months. The taxpayer is to establish the net income for the 12 month period under the same provisions of law as are applicable in determining the net income for the short period, and as if the 12 months constituted an accounting period, although, where the 12 months include part of an actual accounting period, it may be required, in determining certain items such as those dependent on inventory values, to apportion the items in the actual accounting period in order to determine the amount which falls in the 12 month period. For example, if the taxpayer changes from a calendar year to a fiscal year basis ending June 30, and files a return for the short period January 1 to June 30, 1942, the 12 months beginning with the first day of the short period (January 1, 1942) include 6 months (July 1 to December 31, 1942) which fall in the fiscal year ending June 30, 1943. To determine the income for these 6 months, items such as the costs of goods sold, which may in some cases be determinable only at the close of the fiscal year on June 30, 1943, may have to be apportioned, when so determined, between the portion of the fiscal year falling within the 12 month period and the balance of the fiscal year. The Com-

missioner with the approval of the Secretary may prescribe by regulations the method by which such apportionment will most nearly reflect the income for the 12 month period, such as an apportionment on the basis of the number of months involved, or on the basis of the amount of sales or purchases involved, etc., or he may require compliance with such conditions as he deems appropriate for determining such items. For example, he may require the taxpayer to determine its inventory at the end of the 12 month period as if that were the end of an accounting period, and determine its income for the 12 month period on the basis of that inventory. Since the taxpayer is to compute the income for the 12 months as if it were an actual accounting period, all items which fall in such period must be included even if they are extraordinary in amount or of an unusual nature.

If the taxpayer (other than a corporation) was not in existence at the end of the 12 month period, or if the taxpayer is a corporation and prior to the end of the 12 month period it has distributed substantially all its assets, then, in order to determine an actual 12 month income experience, it is necessary to use the 12 month period ending with the last day of the short period. If a corporation ceases business and distributes so much of the assets used in that business that it cannot resume its customary operations with the remaining assets, it has distributed substantially all its assets. A taxpayer using the 12 month period ending with the last day of its short period may claim in its return the benefits of section 47 (c) (2), which provides for the computation of the tax by reference to the net income for the 12 month period, instead of computing the tax on its return under the present method. The taxpayer is not, however, thereby relieved of the requirement that it file the application for the benefits of section 47 (c) (2) prescribed by regulations.

Under this amendment to section 47 (c), the tax cannot be reduced below the amount of tax which would be due if the income for the short period was not placed on an annual basis. The application for the relief prescribed in this amendment, made at such time as the Commissioner prescribes, shall be treated in all respects as a claim for credit or refund, except in a case where the taxpayer claims the benefits of section 47 (c) (2) on its return. In cases where the taxpayer claims the benefits of section 47 (c) (2) on its return, the disallowance of such relief by the Commissioner will, of course, be made in the usual manner for the determination of a deficiency.

Subsection (c) of this section is a technical amendment to section 47 of the Code to define the period covered by the return of a taxpayer which was not in existence throughout a calendar year or fiscal year, on the basis of which its return would otherwise be made. Under existing law, such taxpayers must make a return for such period as the Commissioner requires under administrative regulations but it is now believed proper to provide uniform treatment for all such taxpayers by requiring return only for the period during which the taxpayer was in existence.

Returns under this subsection will not be placed on an annual basis for income tax purposes, since they are not for the short period described in section 47 (a), which only applies to short periods caused by a change in accounting period with the approval of the Commissioner. In the case of a corporate taxpayer, the corporation is not in existence after it ceases business and dissolves, retaining no assets, whether or

not under State law it may thereafter be treated as continuing as a corporation for certain limited purposes connected with the winding up of its affairs, such as for the purpose of suing and being sued. If the corporation has valuable claims for which it will bring suit during this period, it has retained assets, and it continues in existence. Of course, a corporation does not go out of existence if it is merely turned over to receivers or trustees who continue to operate it.

Subsection (d) of this section makes a clarifying amendment to section 48 (a) of the Code, which provides that in the case of a return for a fractional part of a year, the period covered by such return is a taxable year for all purposes.

SECTION 137. DECLARATION THAT RETURN MADE UNDER PENALTIES FOR PERJURY IN LIEU OF OATH

This section, for which there is no corresponding provision in the House bill, amends section 51 of the Code by eliminating the requirement that income tax returns filed by taxpayers or on their behalf must be made under oath. Subsection (a) provides that the return need only contain or be verified by a written declaration that it is made under the penalties of perjury. Subsection (b) amends section 145 of the Code by adding a new subsection thereto prescribing the penalties for an individual who willfully makes and subscribes a return which he does not believe to be true and correct as to every material matter.

SECTION 138. EMPLOYERS' CONTRIBUTIONS TO VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATIONS

This is a new section added to the House bill. Under existing law voluntary employees' beneficiary associations providing for the payment of certain benefits to their members or dependents are exempt from income tax if no part of their net earnings inures to the benefit of any private shareholder or individual and if 85 percent or more of the income consists of amounts collected from members for the sole purpose of making such payments and meeting expenses. This has worked a hardship in the case of some beneficiary associations where the employer is willing by contribution to increase the amount available for making such payments and for meeting expenses of the association. To obviate this hardship, section 101 (16) of the Code has been amended so that 85 percent of income may include amounts contributed to the association by the employer of the members. This section shall be effective as if it were a part of the Code and the Revenue Acts of 1928, 1932, 1934, 1936, and 1938 on the respective dates of their enactment. This section does not affect employment taxes.

SECTION 139. DENIAL OF CAPITAL LOSS CARRY-OVER TO SECTION 102 COMPANIES

This section, which is identical with section 127 of the House bill, eliminates the 1 year net short-term capital loss carry-over from 1941 to 1942 and the 5 year capital loss carry-over for taxable years beginning after December 31, 1941, provided in section 117 (e) in the

case of corporations subject to the tax imposed by section 102. Under existing law, section 102 net income is computed by allowing as a deduction losses from the sale or exchange of capital assets which are disallowed as a deduction by section 117 (d). In computing section 102 net income for any succeeding taxable year such losses should not again be allowed as a carry-over in computing net income.

SECTION 140. COMPENSATION FOR SERVICES RENDERED FOR A PERIOD OF 36 MONTHS OR MORE

This section, which corresponds to section 128 of the House bill, amends section 107 of the Code, relating to the taxation of compensation for personal services rendered over a period of 5 calendar years or more.

The existing law provides that if an individual renders personal services covering a period of 5 calendar years or more and on completion thereof receives at least 95 percent of the compensation therefrom, the tax attributable to such compensation shall not be greater than the aggregate of the taxes attributable to such compensation had it been received in equal portions in each of the calendar years included in such period. It is believed that the use of the term "5 calendar years" results in an inequitable limitation of the scope of such section and that there are also other restrictions in the existing law which prevent a proper application of this relief provision.

As revised by your committee, section 107 (a) provides that, with respect to taxable years beginning after December 31, 1941, if at least 80 percent of the total compensation for personal services covering a period of 36 calendar months or more (from the beginning to the completion of such services) is received or accrued in one taxable year by an individual or a partnership, then the tax attributable to any part of the amount received or accrued in such year, which is included in the gross income of any individual, shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period of the services which precedes the date of such receipt or accrual. Thus, for example, if an individual commences personal services on July 1, 1941, and completes them on July 1, 1944, and is paid $8,000 for such services on April 1, 1943, he is entitled to the benefits of section 107 (a), provided the $8,000 is at least 80 percent of the total compensation paid or to be paid for such services; and the tax attributable to the $8,000 received in 1943 shall not be greater than the tax attributable to such amount, had it been received ratably over the period from July 1, 1941, to April 1, 1943. On the other hand, if such individual receives an additional $5,000 in 1944 for such services, he is not entitled to the benefits of section 107 (a) because he does not include in gross income for one taxable year at least 80 percent of the total compensation for such services. Also, if an individual commences personal services on July 1, 1941, and completes them on July 1, 1947, the total compensation for such services being $100,000, and if he receives $50,000 on August 1, 1944, and $50,000 on August 1, 1947, he is not entitled to the benefits of section 107 (a) for the reason that he does not include in gross income for one taxable year at least 80 percent of the total compensation.

In order for section 107 (a) to be applicable, it is not necessary that the individual who includes in his gross income compensation for such personal services be the person who renders such services. For example, a partner who shares in compensation for such personal services rendered by the partnership may be entitled to the benefits of section 107 (a), notwithstanding that he took no part in the rendering of such services. Likewise, in community property States, the spouse of a person who renders such personal services may be entitled to the benefits of section 107 (a).

It is provided that the same provisions of section 107 (a) shall be applicable to taxable years beginning after December 31, 1940, and before January 1, 1942, except that the specified period shall be 60 months in lieu of 36 months and the specified percentage shall be 75 in lieu of 80.

Under the existing law, authors, composers, inventors, and other individuals who work on artistic, literary, or musical compositions or inventions over an extended period of time and receive the bulk of their compensation for such work in one taxable year are in many instances excluded from the benefits of section 107 because their work, or their patent or copyright covering such work, does not consist of or involve the rendering of personal services. Your committee has revised section 107 (b) so that if, in any taxable year, the gross income of an individual from such an artistic work or invention covering a period of 36 calendar months or more from the beginning to the completion, or from a patent or copyright representing such work, is not less than 80 percent of the sum of (1) the gross income therefrom in the taxable year, and (2) the gross income therefrom in previous taxable years and in the 12 months following the close of the taxable year, then the tax attributable to such gross income in the taxable year shall not be greater than the aggregate of the taxes attributable thereto had it been received ratably over (1) the part of the period of the work which preceded the close of the taxable year, or (2) a period of 36 calendar months, whichever of such periods is the shorter. That part of the gross income from such artistic work or invention, which is taxable as a gain from the sale or exchange of a capital asset held for more than 6 months, is excluded from the benefits of this section. This provision is applicable with respect to taxable years beginning after December 31, 1940; however, as in the case of income subject to section 107 (a), it is provided that the qualifying period for a taxable year beginning after December 31, 1940, and before January 1, 1942, is 60 calendar months in lieu of 36 calendar months and the qualifying percentage for such a year is 75 in lieu of 80.

If an individual takes advantage of the benefits of section 107 in computing his income tax for a particular taxable year, and in a subsequent taxable year receives the required percentage of the total compensation for personal services rendered over the required period of time, all or part of which period is the same as the period of services for which he was compensated in the previous taxable year, he shall, in computing his income tax for such subsequent year, take into consideration the fact that he has previously allocated income to all or a part of the period of services. For example, an individual commenced the performance of personal services on January 1, 1936, and completed them on December 31, 1940. In 1941 he was paid $60,000 in full compensation therefor. In his return for the calendar year

1941, he allocated $1,000 to each of the 60 months in the period of the services and determined his income tax under the provisions of section 107. He also commenced the performance of other personal services on January 1, 1939, and completed them on December 31, 1941. In 1942 he was paid $36,000 in full compensation therefor. If he wishes to take advantage of the benefits of section 107 in his return for the calendar year 1942, he must in allocating $1,000 to each of the 36 months in the period of services and computing the tax attributable thereto, include in his income for the years 1939 and 1940, for the purposes of the tentative computation, the amount of $12,000 previously allocated to each of such years in his return for 1941.

SECTION 141. CERTAIN FISCAL YEAR TAXPAYERS

Section 129 of the House bill relates to any taxable year beginning after December 31, 1940, which is for a period beginning in one calendar year and ending in the following calendar year, if the law with respect to the respective years is different. It provides that the tax for the period shall be computed in a specified manner, which is similar to the old rule of section 105 of the Revenue Act of 1932. In general, the tax for the period would, under the House bill, be the sum of (1) that portion of the tax for the entire period, determined under the law applicable to a taxable year beginning in the first calendar year and at the rates specified for such year, which the portion of the period falling within the first calendar year is of the entire period, and (2) that portion of the tax for the entire period, determined under the law applicable to a taxable year beginning in the second calendar year and at the rates specified for such year, which the portion of the period falling within the second calendar year is of the entire period. The section of the House bill relates to the normal tax, surtax, and excess profits tax.

The bill as reported by your committee strikes out section 129 of the House bill and inserts in lieu thereof this section and section 203. Such sections apply only to a taxable year beginning in the calendar year 1941 and ending after June 30, 1942. This section relates to the normal tax imposed by sections 11, 13, and 14 of the Code and to the surtax imposed by sections 12 and 15 of the Code, while section 203 relates to the excess profits tax imposed by subchapter E of chapter 2 of the Code.

Section 108 of the Code, which is added by this section of the bill, provides that the tax under sections 11, 12, 13, 14, and 15 of the Code for a taxable year beginning in 1941 and ending after June 30, 1942, shall be an amount equal to the sum of (A) that portion of a tentative tax under such sections for the entire taxable year (computed as described below), which the number of days in such taxable year before July 1, 1942, bears to the total number of days in such taxable year, plus (B) that portion of a tentative tax under such sections for the entire taxable year (computed as described below), which the number of days in such taxable year after June 30, 1942, bears to the total number of days in such taxable year. Section 108 further provides in effect that the tentative tax under clause (A) above shall be computed under the law applicable to a taxable year beginning in 1941 (without regard to section 108) and at the rates specified for such a taxable year; and that the tentative tax under clause (B) above shall be computed under the law applicable to a taxable year beginning

in 1941, with certain modifications relating to certain deductions and credits in the case of corporations, but at the rates specified for a taxable year beginning in 1942. The tentative tax under clause (B) above is to be computed without regard to section 108 except as certain provisions of the bill are made applicable by subdivision (B) of section 108 (a) (1) and (2).

Insurance companies subject to the provisions of Supplement G, investment companies subject to the provisions of Supplement Q, and Western Hemisphere Trade Corporations, as defined in section 142 of the bill, are specifically exempted from section 108. In addition, section 108 does not apply to individuals who pay their taxes under Supplement T.

SECTION 142. WESTERN HEMISPHERE TRADE CORPORATIONS

This section, which did not appear in the House bill, exempts from surtax certain corporations deriving their income principally from sources outside the United States and within the Western Hemisphere.

To be entitled, however, to such exemption, it is required that no less than 95 percent of the gross income of such corporations must be derived from sources without the United States, while 90 percent of such gross income must be derived from the active conduct of a trade or business. In addition, the entire trade or business of such corporations must be carried on in the Americas or adjacent areas. However, merely incidental economic contact with other countries outside such geographical sphere will not place such corporations outside the exempt classification. For example, the A corporation is engaged in mining activities in South America and in shipping its products to foreign countries outside the United States including Great Britain. The mere fact that the A corporation ships its goods to England, retaining title to such goods until acceptance of the bill of lading and draft in order to insure collection of the price, will not be considered as carrying on business outside the Western Hemisphere.

SECTION 143. NONRECOGNITION OF LOSS AND DETERMINATION OF BASIS IN CASE OF CERTAIN RAILROAD REORGANIZATIONS

Section 143 of the bill is a new section, no comparable provisions having been included in the House bill. In addition to the amendments to section 22 (b) of the Code (relating to the exclusion of income from the discharge of indebtedness) provided by section 114 of the bill for the relief of debt-ridden railroad corporations, this section provides further relief for railroad corporations reorganized in a proceeding under section 77 of the National Bankruptcy Act, as amended, or in an equity receivership proceeding.

Section 143 (a) of the bill adds paragraph (9) to section 112 (b) of the Code to provide for the nonrecognition of loss if, in pursuance of an order of the court having jurisdiction of the proceeding, the property of a railroad corporation is transferred to another railroad corporation organized or made use of to effect the plan of reorganization approved by the court in such proceeding. It is felt that the nonrecognition of any loss which might be realized as a result of such a transfer is justified by reason of the further amendment by this section of the bill to provide that the basis of the property transferred

shall be the same as it was in the hands of the transferor. The amendment provides only for the nonrecognition of loss and has no application to determine whether or not the gain realized, if any, shall be recognized for tax purposes. In such event, the recognition or nonrecognition of gain will be determined under the appropriate provisions of the Code.

Section 143 (b) adds paragraph (20) to section 113 (a) of the Code (relating to the basis of the property) to provide that the basis of property acquired by a railroad corporation as a result of a transfer made pursuant to an order of the court in a receivership proceeding or in a proceeding under section 77 of the National Bankruptcy Act, as amended, shall be the same as it would have been in the hands of the transferor corporation. Such basis shall be utilized for invested capital computations as well as for the computations affecting income. This provision is applicable even though technically the property was not acquired as a result of a direct transfer by the bankrupt corporation, if the transfer was made in pursuance of an order of the court in order to effectuate the plan of reorganization. If the property was acquired in the manner and under the conditions prescribed in this paragraph, then for the purpose of determining basis the provisions of this paragraph only shall apply, notwithstanding that the transaction may fall within another provision of section 113 (a). As a result of this amendment, the basis of property will be the same whether the reorganization resulted in the continuation of the old corporate entity or the creation of a new corporate entity.

As used in sections 112 (b) (9) and 113 (a) (20), the term "railroad corporation" includes only a railroad corporation as defined in section 77m of the National Bankrupty Act, as amended. This definition is set forth in the portion of the statement dealing with section 114 of the bill. The sections also provide that the term "reorganization" as used therein shall not be limited by the definition contained in section 112 (g) of the Code.

The amendments are made applicable to taxable years beginning after December 31, 1939, and only with respect to transactions occurring after December 31, 1939.

Section 143 (c) adds paragraph (21) to section 113 (a) of the Code to extend to street, suburban, and interurban electric railway corporations engaged as a common carrier in the transportation of persons or property in interstate commerce the same provision respecting basis as provided by section 113 (a) (20), if the property was acquired from a similar railway corporation pursuant to a reorganization under section 77B of the National Bankruptcy Act, as amended. In such case the provisions of section 270 of chapter X of the National Bankruptcy Act, as amended, relating to the reduction of basis by the amount of the indebtedness canceled or reduced in the proceeding, shall not be applied. The rule is made applicable only with respect to property acquired in such a reorganization after December 31, 1934, and only for taxable years beginning after December 31, 1939. Consistent with the provisions of section 113 (a) (20), paragraph (21) is limited to cases in which the property was acquired in pursuance of an order of the court having jurisdiction of the proceeding, and provides that the term "reorganization" as used therein shall not be limited by the definition of the term contained in section 112 (g) of the Code.

SECTION 144. LIQUIDATION OF PERSONAL HOLDING COMPANIES IN DECEMBER 1942

This section, which was not contained in the House bill, provides a special rule, in the case of certain specifically described complete liquidations of personal holding companies, as defined in section 501 of the Code, for the treatment of gain on the shares of stock owned by qualified electing shareholders on the date of the adoption of the plan of liquidation. The effect of the section is in general to postpone the recognization of that portion of a qualified electing shareholder's gain on the liquidation which would otherwise be recognized and which is attributable to appreciation in the value of certain corporate assets unrealized by the corporation at the time such assets are distributed in complete liquidation.

The liquidation must be in pursuance of a plan of liquidation adopted after the date of the enactment of this act, regardless of whether the date of such adoption occurs within the taxable year of the corporation beginning on, before, or after January 1, 1942. The distribution must be in complete cancelation or redemption of all the stock.

The transfer of all the property of the corporation under the liquidation must occur within the month of December 1942, but if proper arrangements are made in good faith for the payment, after December 31, of unascertained or contingent liabilities and expenses, the requirement will be complied with. The assets reserved for this purpose must be in cash and must be reasonable in amount. Though it is not necessary that the corporation dissolve in December 1942, it is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue to the date of dissolution of the corporation.

A corporate shareholder may not be a qualified electing shareholder if at any time between September 1, 1942, and the date of the adoption of the plan of liquidation, both dates inclusive, it is the owner of stock possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote upon the adoption of such plan of liquidation. All other shareholders who may avail themselves of the benefits of the section are divided into two groups: (1) shareholders other than corporations, and (2) corporate shareholders. Any shareholder in either group (whether or not entitled to vote on the adoption of the plan of liquidation) may entitle himself to the benefits of the section as to recognition of gain in respect to shares owned by him at the time of the adoption of the plan of liquidation, if the following conditions are complied with:

(1) The shareholder must have made and filed a written election (which cannot be withdrawn or revoked) to have the benefits of the nonrecognition of gain provided for;

(2) Such written election must be filed by him or by the liquidating corporation with the Commissioner within 30 days after the adoption of the plan of liquidation;

(3) Such making and filing must be in a manner not in contravention of regulations prescribed by the Commissioner with the approval of the Secretary; and

(4) Such elections must have been so filed by shareholders of the same group who are owners of stock possessing at least 80 percent of

the combined voting power of all classes of stock owned by shareholders of the same group on the date of, and entitled to vote upon, the adoption of the plan of liquidation.

Gain, in the case of a shareholder entitled to the benefits of the section, will be recognized only to the extent of the greater of the following: (1) the shareholder's ratable share of the earnings and profits accumulated since February 28, 1913, or (2) the sum of the money received by him and the fair market value of any stock or securities received which were acquired by the corporation after September 1, 1942. In the case of a corporate shareholder such recognized gain is treated as capital gain. In the case of a shareholder other than a corporation, however, that portion of the recognized gain which is not in excess of his ratable share of the earnings and profits is treated and taxed to him as a dividend and the remainder as a short-term or long-term capital gain, as the case may be.

The amount taxed to the shareholder as a dividend is to be treated as a dividend for all tax purposes. Therefore, in the case of a shareholder which is a partnership or a trust, for example, the tax consequences will be the same as though a dividend had actually been received in ordinary course.

This section also provides that the basis of property received in cancelation or redemption of stock with respect to which gain was realized but with respect to which the extent of the recognition of such gain was determined in accordance with the section, shall be the same as the basis of the stock canceled or redeemed in the liquidation, increased in the amount of gain recognized to the shareholder, and decreased in the amount of any money received by him.

SECTION 145. BASIS OF GIFTS

This section is identical with section 130 of the bill as passed by the House.

Under existing law gifts in trust have been held to be governed by section 113 (a) (3), dealing with transfers in trust, and not section 113 (a) (2), dealing with gifts. There is no substantial difference between a gift in trust and other gifts, for purposes of basis. This section amends section 113 (a) (3) to except from its operation gifts created by a transfer in trust, so that the basis of property acquired by gift shall be the same whether the gift is in trust or otherwise.

This section also amends section 113 (a) (2) in order to clarify the existing law.

SECTION 146. BASIS OF PROPERTY IN CASE OF OPTIONAL VALUE FOR ESTATE TAX PURPOSES

This section, for which there is no corresponding provision in the bill passed by the House, amends section 113 (a) (5) of the Code, relating to the basis of property transmitted at death. This section is designed to coordinate the income tax provisions with respect to the basis of such property for determining gain, loss, etc., with the estate tax provisions for determining the value of such property for purposes of valuing the gross estate. Under existing law the basis of property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent is the fair market value of such

property at the time of such acquisition, which is the time of the decedent's death. Under section 811 (j) the executor may, within certain limitations, elect for estate tax purposes to value property included in the gross estate as of the date one year after the decedent's death, or at certain intermediate dates in the case of such property which is distributed, sold, exchanged, or otherwise disposed of during such year.

The amendment made by this section makes the "time of acquisition" for the purposes of section 113 (a) (5), in case of an election by the executor under section 811 (j), the applicable valuation date of the property prescribed by section 811 (j) in determining the value of the gross estate. This rule applies also to the special provision in section 113 (a) (5) with respect to the basis of stock or securities of a foreign personal holding company acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent.

The amendment made by this section is applicable only with respect to property includible in the gross estate of a decedent dying after the date of enactment of this act.

SECTION 147. PERCENTAGE DEPLETION FOR COAL, FLUORSPAR, AND METAL MINES AND SULFUR

This section is identical with section 131 of the House bill.

This amendment provides that fluorspar mines are to be allowed percentage depletion at a rate of 15 percent, subject to the same limitations as are applicable in the case of metal mines. For taxable years beginning after December 31, 1941, the depletion deduction for coal, fluorspar, metal, and sulphur mines may be computed (without regard to any election) either on the percentage basis or on the cost basis, whichever gives the greater deduction.

SECTION 148. EFFECT ON EARNINGS AND PROFITS OF WASH SALE LOSSES

This section is identical with section 132 of the House bill.

Under section 115 (l) of the Code reference is made to the basis of property prescribed by section 113, and unrecognized gains or losses are disregarded, in computing the earnings or profits of a corporation resulting from a disposition by it of such property. While section 118 of the Code disallows a loss from wash sales of securities, and section 113 (a) (10) adjusts the basis of the new securities for the amount of the disallowed loss, no provision in the Code specifies that the disallowed wash-sale loss shall be considered as not recognized for the purposes of computing such earnings and profits. Thus, an improper duplication results in the computation of earnings and profits under section 115 (l), contrary to the uniform practice prior to the enactment of section 501 of the Second Revenue Act of 1940.

Section 132 of the bill amends section 115 (l) by providing that for the purposes of that subsection a wash-sale loss which is disallowed under section 118 shall be deemed to be a nonrecognized loss. The amendment is made applicable to the same taxable years to which section 115 (l) is applicable under the provisions of section 501 (b) and (c) of the Second Revenue Act of 1940.

SECTION 149. DISTRIBUTIONS IN LIQUIDATION

This section corresponds to section 133 of the House bill.

Under existing law the gain realized from a distribution in partial liquidation is treated, despite the provisions of section 117, as a short-term capital gain. This treatment was occasioned by the facility with which ordinary dividends may be distributed under the guise of distributions in partial liquidation, although section 115 (g) makes explicit provision for the treatment of such distributions as ordinary dividends. Inequality results, however, under the existing law in the case of unquestionable bona fide redemptions of stock not equivalent in any way to the distribution of a taxable dividend. It is believed that the proper application of section 115 (g) will prove adequate to prevent taxable dividends disguised as liquidations from receiving capital-gain treatment. Accordingly, this section of the bill eliminates the provision requiring the gain from a partial liquidation to be treated as a short-term capital gain.

This section also eliminates certain provisions with respect to foreign personal holding companies which are obsolete.

SECTION 150. INCOME FROM SOURCES WITHOUT UNITED STATES IN CERTAIN CASES

Section 134 of the House bill, which corresponds to this section, would repeal subsection (a) of section 116 of the Code under which a citizen of the United States, bona fide nonresident of the United States for more than 6 months during the taxable year, was exempt from tax on earned income from sources without the United States.

In lieu of the repeal of this section, your committee recommends that subsection (a) be amended so as to change the test there provided to one of residence in a foreign country or countries during the entire taxable year. In the application of such provision, the tests as to whether a taxpayer is a resident of a foreign country or countries will be those generally applicable in ascertaining whether an alien is a resident of the United States. Vacation or business trips to the United States during the taxable year will not necessarily deprive a taxpayer, otherwise qualified, of the exemption provided by this section. This amendment is applicable to taxable years beginning after December 31, 1942, and the present law is retained for taxable years beginning prior to January 1, 1943.

In addition, subsection (a) of section 116 is amended so that a citizen of the United States, who has been a resident of a foreign country or countries for at least two years before the date on which he changes his foreign residence to a United States residence, shall be exempt with respect to earned income from sources without the United States derived during the period of his foreign residence. This amendment shall be applicable to taxable years beginning in 1942.

SECTION 151. RECIPROCAL EXEMPTION OF COMPENSATION OF EMPLOYEES OF THE COMMONWEALTH OF THE PHILIPPINES

This section is identical with section 135 of the House bill.

Under existing law, compensation of officers and employees (other than citizens of the United States) of a foreign government is, upon

a reciprocal basis, exempt from United States income tax (sec. 116 (h), Internal Revenue Code). Such principle has no application to officers or employees of the Philippine Islands. However, under the laws of the Commonwealth of the Philippines, officers and employees of the United States on duty in the Philippine Islands are exempt from tax on compensation paid by the Government of the United States. Your committee believe that the United States should reciprocate by exempting from our income tax compensation paid by the Commonwealth of the Philippines to its officers or employees for services rendered in the United States. Such exemption would, of course, extend to citizens of the Philippine Islands even though such individuals are also citizens of the United States.

SECTION 152. CAPITAL GAINS AND LOSSES

This section is the same as section 136 of the House bill except that the two classes of capital gains and losses are defined as follows:

1. Short-term gains or losses on the sale or exchange of assets held for not more than 6 months; and
2. Long-term gains or losses on the sale or exchange of assets held for more than 6 months.

The treatment of capital gains and losses has been revised as follows:

All gains and losses from sales or exchanges of capital assets are to be considered together and all losses are deductible only to the extent of any such gains, except that, in order to prevent hardship in the case of taxpayers (other than corporations) having small income and sporadic losses, such taxpayers may deduct any excess of losses over gains to the extent of net income or $1,000, whichever is smaller. The present three classes of gains and losses under section 117 (b) are replaced by two; namely, (1) gains and losses from sales or exchanges of capital assets held for not more than 6 months which are to be taken into account in full in computing net income of all taxpayers, and (2) gains and losses resulting from sales or exchanges of capital assets held for more than 6 months, which are to be taken into account to the extent of 50 percent in the computation of the net income of taxpayers other than corporations, and to be accounted for in full in case of corporations. The alternative tax rate applicable to taxpayers other than corporations under section 117 (c) on net long-term capital gains is increased from 30 percent to 50 percent. While at present corporations are not accorded a similar alternative tax, due to the increase in corporate taxes, section 117 (c) is further revised so as to provide for an alternative rate of 25 percent on their net long-term capital gains. However, in case of all taxpayers, any net long-term capital gain must first be reduced by any net short-term capital loss before the application of this alternative tax. These changes bring the tax on long-term capital gains into closer harmony with suggested increased rates on other income.

Section 117 (e) of the Code provides that any taxpayer having in any taxable year a net short-term capital loss be permitted to carry over such loss, in an amount not in excess of his net income for such year, to the succeeding taxable year, and to apply it to offset any short-term capital gains in such succeeding taxable year not already offset by short-term capital losses. In view of the changes with respect to

capital losses, the committee believes that it is fair to permit taxpayers to carry over the disallowed portion of capital losses to the 5 years following the taxable year in which sustained; the amount so carried over will be allowed to the extent of the excess, if any, of the capital gains over capital losses of the year to which it is carried over, plus, in case of a taxpayer other than a corporation, the net income of the taxpayer or $1,000, whichever is smaller. It is also proposed that if there are carry-overs from more than 1 year the carry-overs are to be allowed in the order in which they arose, that is, the older carry-over is to be offset or exhausted before the later carry-over.

Section 117 (e) (2) has been added to provide that a net short-term capital loss for the taxable year 1941 (not in excess of the net income of such year) shall be a short-term capital loss in 1942 to the extent of the net short-term capital gain of that year. In that way the taxpayer will not be deprived of any net short-term capital loss carry-over from 1941 which he might have had if the law had not been changed.

Section 117 (a) (6) has been amended by deleting that portion pertaining to the net short-term capital loss of the preceding taxable year brought forward under subsection (e) since the term "short-term capital losses for the taxable year" includes any amount brought forward under section 117 (e). Throughout section 117 losses from sales or exchanges of capital assets for the taxable year include such an amount brought forward under subsection (e).

The above changes and the manner of their application to a taxpayer other than a corporation may be illustrated by the following:

For the taxable years 1942 to 1946, inclusive, a taxpayer is assumed to have a net short-term capital loss, net short-term capital gain, net long-term capital loss, net long-term capital gain, and net income as follows:

	1942	1943	1944	1945	1946
Carry-over from prior years:					
From 1942		($50,000)	($20,500)	($20,500)	
From 1944				(19,500)	($13,000)
Net short-term loss (computed without regard to the carry-overs)	($30,000)	(5,000)	(10,000)		
Net short-term gain (computed without regard to the carry-overs)				40,000	
Net long-term loss	(20,500)		(10,000)	(5,000)	
Net long-term gain		25,000			
Net capital gain (computed without regard to the carry-overs)		20,500		36,000	
Net income (computed without regard to capital gains or losses)	500	500	500	1,000	
Net capital loss	(50,000)	None	(19,500)	None	

NET CAPITAL LOSS OF 1942

The net capital loss is $50,000. This figure, computed in accordance with section 117 (b), is the excess of the losses from sales or exchanges of capital assets over the sum of (1) gains from such sales or exchanges, and (2) net income of $500. This amount can be carried forward in full to 1943. However, in 1943 there was a net capital gain of $20,500, as defined by section 117 (a) (10) (B) and limited by section 117 (e) (1), against which this net capital loss of $50,000 is allowed in part. The remaining portion—$29,500—may be carried forward to 1944 and 1945 since there was no net capital gain in 1944.

In 1945 this $29,500 shall be allowed in full against net capital gain of $36,000, as defined by section 117 (a) (10) (B) and limited by section 117 (e) (1).

NET CAPITAL LOSS OF 1944

The net capital loss is $19,500. This figure, computed in accordance with section 117 (b), is the excess of the losses from sales or exchanges of capital assets over the sum of (1) gains from such sales or exchanges, and (2) net income of $500. This amount can be carried forward in full to 1945. However, in 1945 there was a net capital gain of $6,500, as defined by section 117 (a) (10) (B) and limited by section 117 (e) (1), against which this net capital loss of $19,500 is allowed in part. The remaining portion—$13,000—may be carried forward to 1946.

In the case of banks and life insurance companies, a distinction is to be made with respect to losses resulting from sales or exchanges of bonds, debentures, notes or certificates or other evidences of indebtedness which are in excess of gains from sales or exchanges of such assets. In that case the excess is to be considered as an ordinary loss and deductible in full against other income. Life insurance companies take into account in computing net income only gains or losses from sales or exchanges of capital assets acquired subsequent to December 31, 1941.

Sections 336 (c) and 505 (d) of the Code are amended to accord the same treatment to personal holding companies and foreign personal holding companies as ordinary corporations.

SECTION 153. REAL PROPERTY IMPROVEMENTS; INVOLUNTARY CONVERSIONS; ETC.

(A) REAL PROPERTY, USED IN THE TRADE OR BUSINESS, NOT TREATED AS A CAPITAL ASSET

Subsection (a) of this section, in the House bill, included real property improvements, used in the trade or business and subject to an allowance for depreciation, within the definition of "capital assets" in section 117 (a), so that such improvements would have the same character for tax purposes as the land on which they stand. While your committee believes it desirable for the land and the improvements to have the same character, it considers it more appropriate to treat all property used in the trade or business alike, and not to distinguish between land and other property used in the trade or business. Accordingly, this subsection has been changed to provide that land used in the trade or business is not within the definition of "capital assets" in section 117 (a), and will therefore have the same character as improvements subject to an allowance for depreciation, which under existing law are excepted from that definition. In accordance with this policy, changes have also been made in subsection (b) of this section, relating to the treatment of gains and losses on the sale, exchange, and involuntary conversion of depreciable property, to subject to such treatment land used in the trade or business.

(B) GAINS AND LOSSES FROM INVOLUNTARY CONVERSION AND FROM THE SALE OR EXCHANGE OF CERTAIN DEPRECIABLE PROPERTY AND LAND

Section 117 (j), as added to the Internal Revenue Code by subsection (b) of this section, provides special treatment for the gains and losses upon the sale or exchange of depreciable property and of land, held for more than 6 months, and for the gains and losses upon the compulsory or involuntary conversion of such depreciable property and land and of capital assets held for more than 6 months.

The method prescribed is to treat such gains and losses during the taxable year as gains and losses from the sale or exchange of capital assets held for more than 6 months, if the aggregate of such gains exceeds the aggregate of such losses. If, however, the aggregate of such gains does not exceed the aggregate of such losses, such gains and losses shall not be treated as gains and losses from the sale or exchange of capital assets held for more than 6 months. In such a case, some transactions which may perhaps be regarded under existing law as resulting in capital gain or loss, for example, sales of capital assets under threat of condemnation, will instead be treated as resulting in ordinary loss, or in ordinary gain which offsets other losses of the kind described in section 117 (j).

In order that the above result may be obtained in every case, it is necessary in determining whether gains do or do not exceed losses to include the gains and losses to the extent that they would be included if they were all ordinary gains and losses. Thus, the percentage provisions of section 117 (b) do not apply to any such gains and losses in determining whether gains exceed losses, but 100 percent of such gains and losses is taken into account. If, after such computation is made, it is determined that gains exceed losses, the gains and losses are then treated as capital gains and losses, and the percentage provisions of section 117 (b) are then applicable to all such gains and losses. Similarly, the limitations of section 117 (d) on the deductibility of capital losses does not operate to exclude any such losses from the computation as to the excess of gains over losses, but all such losses are included in full. Furthermore, if any loss is not allowed as a deduction in computing net income, or if any gain is not included in computing net income, such gain or loss is not included in making the computation as to whether gains exceed losses. For example, if a loss is sustained on the sale of depreciable property by one member of a family to another, so that the loss is not allowed as a deduction by reason of the provisions of section 24 (b) (1) (A), that loss is not included in the computation.

(C) HOLDING PERIOD OF PROPERTY ACQUIRED IN EXCHANGE FOR PROPERTY INVOLUNTARILY CONVERTED

Section 117 (h) (1) provides that in determining the period for which the taxpayer has held property received on an exchange, which has the same basis in whole or in part in his hands as the property exchanged, there shall be included the period for which he held the property exchanged. Subsection (c) of this section is a clarifying amendment to section 117 (h) (1) to insure that an involuntary conversion described in section 112 (f) will be considered an exchange of the property converted for the property acquired upon the conversion,

so that the holding period of the converted property will be included in determining the holding period of that property acquired upon the conversion which, under section 113 (a) (9), has the same basis, in whole or in part, as the property converted. This provision is made applicable to taxable years beginning after December 31, 1938.

(D) RECOGNITION OF LOSS ON INVOLUNTARY CONVERSION

Section 112 (f) of existing law provides that upon the involuntary conversion of property into property similar or related in service or use to the property so converted, or into money which is forthwith spent in the acquisition of such property, neither gain nor loss is recognized. It is believed more equitable to recognize the loss in such cases. Accordingly, section 153 (d) of the bill amends section 112 (f) to provide that loss shall be recognized upon an involuntary conversion.

(E) PARTIAL FAILURE TO REPLACE PROPERTY

Section 112 (f) provides in part that if property is involuntarily converted into money which is forthwith used to acquire property similar or related in service or use to the property converted, no gain shall be recognized. It further provides that if any part of the money is not so expended, gain shall be recognized to the extent of the money not expended. An undesirable result may result from a decision that if the money received in the taxable year is so expended, the gain in such taxable year will not be recognized, even though the money received in previous taxable years (and not treated as gain since not in excess of the basis of the converted property) was not so expended. *Wilmore S. S. Co., Inc.*, v. *Commissioner* ((C. C. A. 2d, 1935) 78 F. (2d) 667). Section 153 (e) amends section 112 (f) of the Code so as to make clear that the gain shall be recognized to the extent that the money, whenever received, was not expended in the manner provided in section 112 (f).

SECTION 154. HOLDING PERIODS OF STOCK ACQUIRED THROUGH THE EXERCISE OF STOCK RIGHTS

This section is the same as section 138 of the House bill.

Whether or not gain realized upon the sale of stock acquired through the exercise of stock rights constitutes a short-term or long-term capital gain depends, in many instances, upon whether or not the holding period of the stock with respect to which the stock rights were issued is includible in the holding period of the stock sold. The rule developed by the courts as to this question is that shares acquired in the exercise of stock rights consist in part of long-term assets, computed by reference to the date of acquisition of the original stock and representing the stock-right element in the new stock, and in part of short-term assets, computed by reference to the date of exercise of the rights and representing the subscription-price element in the new stock. Hence the gain realized upon sale of the stock would consist in part of short-term capital gains and in part of long-term capital gains. *Wood* v. *Commissioner*, 75 F. (2d) 364 (C. C. A. 1st, 1935).

It is obvious that this rule causes administrative difficulties. In any case where there is a series of stock rights issued by a corporation

and exercised by a shareholder, the rule becomes absolutely unworkable, since, in the case of the later issues in the series, the property element representing the stock right will be computed with reference to old stock which in turn has a holding period computed with reference to other old stock. The result is a pyramiding of stock lots each with a different holding period. It has been estimated that 6 issues of rights, if exercised, will result in no less than 64 different lots.

In view of the desirability of a simple, uniform, and administratively workable solution of this problem, this section provides that the holding period of stock acquired in the exercise of stock rights begins in every case, whether or not the receipt of taxable gain was recognized in connection with the distribution of the rights, with the day upon which the rights to acquire such stock were exercised. This solution is a recognition of the fact that, normally, much the greater proportion of the basis pertaining to stock acquired in the exercise of stock rights is attributable to the subscription price. The stock right represents so small a property element that it can be eliminated from the computation without inequity, and with benefits to taxpayer and Treasury through the elimination of complexities.

SECTION 155. TWO-YEAR CARRY-BACK OF NET OPERATING LOSSES

This section, for which there is no corresponding provision in the House bill, amends section 122 of the Code. For the first time a carry-back of the net operating loss is allowed. The net operating loss for any taxable year beginning on or after January 1, 1942, may be carried back to the 2 preceding taxable years (but not to any taxable year beginning before January 1, 1941), and may be included in computing the net operating loss deduction for each such preceding taxable year. The net operating loss for any taxable year which is not used as a carry-back may be carried forward, as under existing law, to the 2 succeeding taxable years.

The amount which may be carried back or carried forward is limited in the case of each such preceding or succeeding year to the amount which was not used to offset income for any taxable years before such preceding or succeeding year. In determining the amount of the net operating loss which is so used to offset income in any taxable year, the net income for such taxable year is computed without the deduction of any carry-over or carry-back from the year in which the net operating loss arose or from any year subsequent thereto but with certain other adjustments now required under section 122 (d). The net operating loss which is a carry-over or a carry-back to such taxable year is considered to have been applied against the net income so computed.

The following examples illustrate the application of this section. It is assumed that the same taxpayer is involved in each example. The net income described in each example is the net income computed with the exceptions, additions, and limitations provided in section 122 (d) (1), (2), (3), (4), and (6) (that is, the operating net income without the deduction of any net operating loss carry-over or carry-back, and with the deduction of nonbusiness items):

1. The taxpayer has $600 net income for 1941 and $900 net income for 1942. In 1943 he has a net operating loss of $1,000. The $1,000 may be taken as a net-operating-loss deduction in 1941, and will therefore reduce the net income for 1941 to zero. In 1942 the net

operating loss may be taken as a deduction to the extent of $400 (the net operating loss of $1,000 less the net income of $600 for 1941 against which the net operating loss has been applied). The net income for 1942 is therefore reduced to $500. The net operating loss for 1943 has been completely offset by the net income for 1941 ($600) and 1942 ($900), and therefore no part of such net operating loss may be taken as a deduction in 1944 or 1945.

2. In 1944 the taxpayer has a net operating loss of $1,600. This net operating loss may be taken as a deduction in 1942 and will reduce the remaining $500 of net income for 1942 to zero. Since the net income for 1943 was zero (there being a loss for such year), none of the net operating loss for 1944 is used to offset net income for 1943. In 1945, the taxpayer has $300 net income, and in 1946 $1,400 net income. The net operating loss of $1,600 for 1944 has been offset to the extent of $500 by the net income for 1942 (the $900 net income for 1942, less the $400 carry-back from 1943), and may therefore be taken as a deduction in 1945 to the extent of $1,100 ($1,600 less $500). It will therefore reduce the net income for 1945 to zero. Since $300 of the $1,100 deduction is used to offset the $300 net income for 1945, the remaining $800 may be taken as a deduction against the $1,400 net income for 1946. It will therefore reduce the net income for 1946 to $600.

3. In 1947 the taxpayer has a net operating loss of $1,500. This net operating loss may be taken as a deduction in 1945. Since the net income for 1945 has been completely offset by the net operating losses for years prior to 1947 (the $300 net income for such year less the $1,100 carry-over from 1944), the net operating loss is not offset by any net income for 1945, and may be taken in full as a deduction in 1946. It will thus offset the remaining $600 net income for 1946 (the $1,400 net income for 1946 less the $800 carry-over from 1944) and will reduce such net income to zero. The remaining $900 of the net operating loss (the $1,500 net operating loss less the sum of zero, the $300 net income for 1945 reduced by the $1,100 carry-over to 1945 from 1944, and $600, the $1,400 net income for 1946 reduced by the $800 carry-over to 1946 from 1944) may be taken as a deduction in 1948 and 1949 in the same manner as the net operating loss for 1944 was taken as a deduction in 1945 and 1946.

The net operating loss deduction for any taxable year is the sum of the carry-backs and the carry-overs to such taxable year. The amendments made by this section are applicable to all taxable years beginning after December 31, 1940. Thus, in the case of a taxpayer on the calendar year basis, the carry-overs to the taxable year 1941 from the taxable years 1939 and 1940, and the carry-backs to such taxable year from the taxable years 1942 and 1943 will be determined under the amendments made by this section.

A taxpayer entitled to a carry-back of a net operating loss or an unused excess profits credit (see sec. 204 of the bill) will not be able to determine the deduction on account of such carry-back until the close of the future taxable year in which he sustains the net operating loss or has the unused excess profits credit. He must therefore file his return and pay his tax without regard to such deduction, and must file a claim for refund at the close of the succeeding taxable year when he is able to determine the amount of such carry-back. Inasmuch as

any overpayment resulting from the deduction of such carry-back does not occur, as a practical matter, until the net operating loss or the unused excess profits credit for the future taxable year is determined, and inasmuch as it is desirable to insure promptness in the filing of claims to inform the Commissioner that such deductions have been determined, this section provides that no interest will be allowed with respect to any such overpayment for any period before the claim therefor is filed, or a petition asserting such overpayment is filed with the Board of Tax Appeals, whichever is earlier.

SECTION 156. COMMODITY CREDIT LOANS

This section corresponds to section 139 of the House bill and amends section 123 of the Code, relating to the inclusion in income of loans received from the Commodity Credit Corporation, by providing that the election provided for in section 123 (a) of the code with respect to taxable years beginning after December 31, 1938, and before January 1, 1942, may be exercised at, or at any time prior to, the time prescribed for the filing of the taxpayer's return for his taxable year beginning in 1942. Your committee has inserted an additional provision that, in order for a taxpayer to avail himself of the benefits of such amendment, his records must be sufficient to permit an accurate computation of his income for such years and he must consent in writing to the assessment, within such period as may be agreed upon, of any deficiency for such years, even though the statutory period for the assessment of any such deficiency has expired prior to the filing of such consent.

Section 139 of the House bill also amends section 223 (d) of the Revenue Act of 1939, relating to a similar election for taxable years beginning after December 31, 1933, and before January 1, 1939. Your committee has not changed this provision.

SECTION 157. EXTENSION OF DEDUCTIONS FOR AMORTIZATION OF EMERGENCY FACILITIES

This section, which corresponds to section 140 of the House bill, amends section 124 of the Code, relating to the amortization of emergency facilities.

Subsection (a) of this section, which is the same as in the House bill, amends section 124 (a) of the Code so as to extend to individuals the same privileges with respect to the amortization of emergency facilities which are accorded to corporations under existing law. This amendment also clarifies section 124 (a) by showing that the adjusted basis to be used in computing the amortization deduction is the adjusted basis prescribed by existing law for determining gain, rather than that prescribed for determining loss.

Subsection (b) of this section adds at the end of section 124 (b) of the Code a new sentence providing a method by which a corporation which completed or acquired an emergency facility after December 31, 1939, and before June 11, 1940, or a taxpayer other than a corporation who completed or acquired an emergency facility after December 31, 1939, and before January 1, 1942, may elect to take the amortization deductions with respect thereto. This provision is necessitated by the fact that with respect to such a facility the election cannot be made in the income-tax return either for the taxable year 1940 or for the taxable

year 1941, since such returns will have been filed before the enactment of the Revenue Act of 1942. In the House bill it is provided that such election shall be made only by a statement in writing to the Commissioner of Internal Revenue and shall be made within 3 months after the enactment of the Revenue Act of 1942. Your committee has extended the 3-month period to 6 months.

Subsection (c) (1) of this section, which is the same as subsection (c) in the House bill, amends section 124 (d) (3) of the Code so as to conform such provision with the amendment made by subsection (b) of this section. Your committee has added a new subsection (c) (2) which amends section 124 (d) of the Code by inserting at the end thereof a new paragraph (6). This provision permits amortization in the case of a taxpayer which commenced the construction, etc., of an emergency facility during the emergency period but did not complete it before the end of the emergency period. It is provided that in such a case the taxpayer shall use an amortization period beginning with the month in which the construction, etc., was begun and ending as of the end of the month within which the President proclaims the ending of the emergency period, or within which occurs the date on which such emergency facility ceased to be necessary in the interest of national defense during the emergency period, as certified to the Commissioner of Internal Revenue by the Secretary of War or the Secretary of the Navy.

Subsection (d) of this section amends section 124 (e) (1) of the code by enlarging the scope of the term "emergency facility" so as to include (1) facilities acquired or completed by corporations after December 31, 1939, and before June 11, 1940, and (2) facilities acquired or completed by persons other than corporations after December 31, 1939. Under the existing law such term includes only facilities acquired or completed by corporations after June 10, 1940. Under subsection (d), if the construction, reconstruction, etc., by a corporation of an emergency facility occurs partly before June 11, 1940, and partly after June 10, 1940, the part of such facility constructed, etc., after December 31, 1939, and before June 11, 1940, shall be treated as a separate emergency facility and is deemed to have been completed on June 10, 1940, regardless of the fact that the entire facility was not completed until after such date. Your committee has revised subsection (d) of the House bill so that it inserts a new sentence in section 124 (e) (1) of the Code providing that the part of any facility which was constructed, etc., by any person after December 31, 1939, and not earlier than 6 months prior to the filing of an application for a certificate under section 124 (f), and with respect to which part a certificate under section 124 (f) has been made, shall be deemed to be an emergency facility, notwithstanding that the other part of such facility was constructed, etc., earlier than 6 months prior to the filing of such application.

Subsection (d) also amends section 124 (e) (2) of the code so as to change the date of the beginning of the emergency period, for the purposes of section 124, from June 10, 1940, to January 1, 1940. This amendment is in conformity with the amendment made by subsection (e) of this section.

Subsection (e) (1) of this section amends section 124 (f) (1) of the code so as to provide that the adjusted basis of an emergency facility, for amortization purposes, shall include only so much of the amount

constituting such adjusted basis as is properly attributable to construction, etc., or acquisition after December 31, 1939. Under the existing law the controlling date is June 10, 1940. This amendment conforms with the amendment by subsection (d) of this section.

Subsection (e) (2) of this section amends section 124 (f) (3) of the code so as to provide a limitation period for the filing of applications for certificates of necessity (1) in the case of facilities acquired or completed (within the meaning of sec. 124 (e) (1), as proposed to be amended) by corporations after December 31, 1939, and before June 11, 1940, and (2) in the case of facilities acquired or completed by persons other than corporations after December 31, 1939. Under section 124 (f) (3) in its present form, the 6-month period after the acquisition or after the beginning of construction will have expired with respect to case (1), and may have expired with respect to case (2). The amendment, as appearing in the House bill, allows in case (1) a period of 3 months after the date of enactment of the Revenue Act of 1942 within which such corporations may file such applications and in case (2) a period of 6 months after the acquisition or after the beginning of the construction, or a period of 3 months after the date of the Revenue Act of 1942, whichever of such periods ends at a later date. Your committee has revised this provision of the House bill by extending the 3-month period to 6 months. Subsection (e) (2) of this section, as appearing in the House bill, also amends section 124 (f) (3) of the code so as to provide that no amortization deduction shall be allowed unless a certificate of necessity is made (1) in the case of facilities completed or acquired by corporations after December 31, 1939, and before June 11, 1940, within 9 months after the date of enactment of the Revenue Act of 1942, and (2) in the case of facilities completed or acquired by persons other than corporations after December 31, 1939, and before January 1, 1943, within 6 months after the last date on which an application for a certificate of necessity may be filed, or within 9 months after the date of enactment of the Revenue Act of 1942, whichever of such periods ends at a later date. Your committee has revised this provision of the House bill by extending the 6-month period to 9 months and by extending the 9-month period to 12 months.

Subsection (f) of this section, which is the same as in the House bill, adds at the end of section 124 of the code a new subsection (i) providing that in the case of an emergency facility held by one person for life with remainder to another person, the amortization deduction with respect thereto shall be computed as if the life tenant were the absolute owner of the property and shall be allowable to the life tenant. The effect of this amendment is to apply to the amortization of emergency facilities the rule prescribed by existing law with respect to depreciation of property held under such circumstances.

Subsection (g) of this section, which is the same as in the House bill, inserts in the Code a new section 172 extending to estates and trusts the same privileges with respect to the amortization of emergency facilities as is extended to individuals by the amendment proposed in subsection (a) of this section. It is provided that the allowable amortization deduction shall be apportioned between the income beneficiaries and the fiduciary under regulations prescribed by the Commissioner with the approval of the Secretary of the Treasury.

Subsection (h) of this section, which is the same as in the House bill, inserts in the Code a new section 190 extending to partnerships the same privileges with respect to the amortization of partnership emergency facilities as is extended to individuals by the amendment proposed in subsection (a) of this section. It is provided, however, that with respect to partnership facilities such privileges shall not be allowed to the members of a partnership.

Under subsection (i) of this section, which is the same as in the House bill, except for a clerical change, the amendments made by this section are, subject to the provisions of subsections (b) and (e) (2) of this section, given retroactive effect as if they had been enacted as part of the original amortization provisions enacted in the Second Revenue Act of 1940, approved on October 8, 1940.

Subsection (j) of this section, as appearing in the House bill, provides for the credit or refund, without interest, of the amount of tax paid under chapter 1, of the Code, which is in excess of the amount which would have been paid had section 124 of the Code (as previously amended) been enacted on October 8, 1940, to read as amended by this section. It is provided that such credit or refund shall be made in accordance with the law applicable in the case of erroneous or illegal assessment or collection or overpayment of tax. Your committee has revised this provision of the House bill so as to make it applicable to excess profits taxes paid under subchapters B and E of chapter 2 of the Code as well as to income tax paid under chapter 1 of the Code.

SECTION 158. WAR LOSSES

This section, for which there is no corresponding provision in the House bill, provides practical rules for the treatment of property destroyed or seized in the course of military or naval operations during the war, and of property located in enemy countries or in areas which come under the control of the enemy. Two problems are likely to face the taxpayer: One is the determination of when the actual destruction or seizure occurred in cases in which the hostilities in the area prevent the determination of the exact date of the destruction or seizure, and the other is what facts determine the loss in case the property is in an enemy area.

In the case of property situated in an enemy country, or in an area controlled by such country, on the date war was declared on such country by the United States, such property is under this section deemed to have been seized or destroyed on the date the United States declared war on such country. Under present conditions it is frequently impossible to determine when, if at all, the enemy country has formally seized the property located in an area under its control. Furthermore, enemy countries today exercise such control over the property of their enemies within their territory that the loss of such property is in fact sustained whether or not the country undertakes the formality of issuing a sequestration decree or making an actual seizure. It is a matter of conjecture as to what condition the property will be in at the termination of the war. Accordingly, such property is treated as lost upon the date war is declared, and, in view of the nature of this loss, it is treated in the same manner as other casualty losses, that is, as a loss from the destruction or seizure of the property.

Similarly, if after the date war is declared by the United States, the enemy country occupies an area in which the taxpayer's property is located, that property is treated as destroyed or seized upon the date the enemy gains control of the area. In many cases, the exact date of enemy occupation cannot be established. Therefore, the taxpayer is permitted to treat the loss as occurring at any time after the last date on which the United States or a friendly country had complete control of the area and before the earliest date on which the enemy gained complete control. For example, suppose that the military evacuation of an area is begun during the middle of December, and that fighting occurs in that area from that time until the middle of January, when the enemy finally establishes complete control. A taxpayer may treat the loss of his property as occurring either in December or January.

This section also provides similar rules for determining the date of the loss in the case of property actually destroyed or seized in the course of military or naval operations. In any case in which the taxpayer does not know the exact date on which the property was actually destroyed, it may claim the loss on any date between the last date on which it is determined that the property was undestroyed, and the earliest date on which it is determined that the property was already destroyed. Thus, for example, if an area is evacuated during a bombardment, and upon the reoccupation of the area it is determined that the property was destroyed during the bombardment the taxpayer may claim the loss on any date during the period of the bombardment. If before the date on which it is determined that the property was actually destroyed the enemy occupies and gains complete control of the area in which the property is located, the loss cannot be taken on a date later than the date on which the enemy obtains complete control. For the purposes of this section the term "area" does not mean a territory or political unit but means the locality in which the property was situated.

This section also provides that if any interest in or with respect to property deemed to be seized or destroyed under this section (property seized or destroyed in the course of military or naval operations or in an area under the control of the enemy, or an interest in or with respect to such property) becomes worthless, the loss thereon shall be treated as a casualty loss resulting from the destruction or seizure of the interest in such property. Thus, stock in a corporation all of the property of which is located in an enemy country, and bonds issued by such corporation are treated as becoming worthless by reason of the destruction or seizure by the enemy of the property subject to such interests, and the loss resulting therefrom is treated as a casualty loss.

In the case of a taxpayer which owns at least 50 percent of the stock of each class of a corporation, which corporation has property, representing at least 75 percent of the adjusted basis for determining loss of all its property, destroyed or seized in the course of military or naval operations, or located in an area under the control of the enemy, such taxpayer may treat that part of the loss upon the liquidation of such corporation which results from the destruction or seizure of such property as being a casualty loss on account of the destruction or seizure of the stock interest in such property. For this provision to apply, the liquidation must be made within 1 year after the prop-

erty is deemed to be destroyed or seized, or within 6 months after the passage of the bill, whichever is later. In many cases, as in the case of corporations organized under the laws of the enemy country, the corporation will not be able to dissolve. However, if it distributes to its shareholders all its assets, and all its rights to any recovery of assets, it has completely liquidated for the purposes of this provision even though it may not be able to dissolve.

This section also provides that in determining the loss upon the destruction or seizure of the property described in this section, the taxpayer shall ignore those elements of value caused by the possibility that the property will be returned to him at the end of the war, or the possibility that the Government will reimburse him for the property after the war. The taxpayer shall not, of course, ignore his right to reimbursement from insurance or from other similar definite rights which compensate him for the loss. The taxpayer is also permitted to determine the amount of the loss as if any obligations or liabilities with respect to the property were distributed or satisfied out of the property which is seized or destroyed. For example, the property, located in an enemy controlled area, may be subject to a mortgage lien in favor of an enemy national. Although the enemy may seize the property, it is likely that it will use the property to pay its own nationals. Since the taxpayer probably cannot obtain any definite information as to what action the enemy country takes with respect to his property, this section permits him to determine the loss either with or without setting off such obligations which may be discharged from the property.

This section further provides that any money received in respect of property treated as destroyed or seized under this section, the fair market value of any property received in lieu of such property, and the fair market value of the property itself, if it is recovered, shall be included in income for the taxable year when received. Furthermore, the restoration in value of any interest in or with respect to such property, which interest was treated as destroyed or seized under this section, as a result of the recovery of money or property in respect of property to which such interest related, shall be included in income for the taxable year in which such restoration in value occurs. No part of the recoveries is included in income until the aggregate amount of such recoveries exceeds that part of the aggregate allowable deductions on account of war losses in previous years which did not result in any tax benefit. For purposes of this section, a deduction allowable for any taxable year which was not allowed in computing the tax for such taxable year (as in a case in which the taxpayer did not claim such deduction on his return and the Commissioner did not subsequently allow it) shall be considered a deduction which did not result in tax benefit. The excess over such amount is included in income as ordinary income to the extent of that part of the aggregate of the deductions in previous years which resulted in a tax benefit. The excess over this amount is included in income as gain upon the involuntary conversion of property as a result of its destruction or seizure. The portion of the gain which is subject to the provisions of section 112 (f) (relating to the recognition of gain or loss on involuntary conversions) is the excess, upon the recovery of any property or of any money, of such recovery plus the aggregate of all previous

recoveries over the aggregate of the deductions in previous years for war losses. Such excess is the gain on such recovery, and such gain will be recognized or not recognized under the provisions of section 112 (f). The recognized gains of this type are subject to the provisions of section 117 (j), added to the code by section 153 of the bill, which provides for the determination of whether such gains are capital gains or ordinary gains.

The basis of any property recovered in respect of property treated as seized or destroyed under this section is the fair market value of such property reduced by that portion of such fair market value which represents any nonrecognized gain upon the recovery. In order to prevent harsh results, the Commissioner is given the authority in any taxable year, upon application by the taxpayer, to take any group of such recovered properties and allocate their bases among them. This allocation would, of course, be only of the unadjusted basis, and such allocated basis would be subject to the adjustments previously determined with respect to the basis of such property.

The amendments made by this section are applicable to taxable years beginning after December 31, 1940. However, under the terms of this section, no war loss can be sustained prior to December 7, 1941.

SECTION 159. RECOVERY OF UNCONSTITUTIONAL FEDERAL TAXES

This section, for which there is no corresponding provision of the House bill, inserts in the Code a new section designated 128 permitting a taxpayer who, in a prior taxable year or years, has paid unconstitutional Federal taxes for which he has been allowed an appropriate deduction and who subsequently recovers such taxes, to exclude the income (exclusive of interest also recovered) attributable to such recovery from his gross income in the taxable year of recovery, provided certain conditions are fulfilled. To be entitled to the provisions of the new section a taxpayer must file an election in writing to treat the deduction allowed in a prior year as not having been allowable for such prior year and to treat taxes (such as the unjust enrichment tax), and interest with respect thereto, paid or incurred by him in respect of the recovery of such unconstitutional tax, as having been paid or incurred in the taxable year for which the prior deduction was allowed. The taxpayer must also assent to the Commissioner's assessing, in respect of the taxable year of the prior deduction, any deficiency resulting from disallowance of the prior deduction even though the statutory period for the assessment of any such deficiency may have expired prior to the filing of such consent. The word "recovery" as used in this section includes not only refund or credit of taxes paid, but includes also an abatement or cancelation of a tax liability which has been the basis for a deduction on the accrual basis.

SECTION 160. FOREIGN TAX CREDIT

This section corresponds to section 141 of the House bill, which amended subsection (f) of section 131 of the Code, to provide that, where a foreign subsidiary is substantially wholly owned by a foreign parent and a dividend is paid by the foreign subsidiary to the foreign parent, a proportionate part of the foreign tax paid by the

foreign subsidiary shall, subject to the general principles of the existing subsection, be taken into account in determining the amount of foreign tax, in effect, paid by the foreign parent. For example, the A company, a domestic corporation, owns all the stock of the B Company, Ltd., a foreign corporation, which in turn owns all of the stock of the C Company, Ltd., another foreign corporation. The accumulated profits of the B Company amount to $200,000 (including $25,000 received from the C Company, Ltd.) and the foreign income tax with respect to such accumulated profits amounts to $60,000. The C Company, Ltd., has accumulated profits of $150,000 upon or with respect to which the foreign income tax is $45,000. A dividend of $50,000 is paid in 1942 by the B Company, Ltd., to the A Company and in the same year a dividend of $25,000 is paid by the C Company, Ltd., to the B Company, Ltd. Under existing law the tax deemed to have been paid by the A Company with respect to the tax of the B Company, Ltd., would be $\frac{\$50,000}{\$200,000} \times \$60,000$ or $15,000. Under the amendment made by this section, however, there would be added to the $60,000 tax with respect to the accumulated profits of B Company, Ltd., the sum of $\frac{\$25,000}{\$150,000} \times \$45,000$, or $7,500, representing the foreign income tax paid upon that portion of the accumulated profits of the C Company, Ltd., used in the payment of the $25,000 dividend to the B Company, Ltd. Thus, the total tax paid or deemed to have been paid by the B Company, Ltd., with respect to its $200,000 accumulated profits is $67,500 and the amount deemed to have been paid by the A Company with respect to the $50,000 dividend paid by the B Company, Ltd., to the A Company would be $\frac{\$50,000}{\$200,000} \times \$67,500$, or $16,875.

Your committee believes further amendments should be made in section 131. Under that section as it now stands, a credit is allowed against United States tax for income, war profits or excess profits taxes paid or accrued to any foreign country or to any possession of the United States. In the interpretation of the term "income tax," the Commissioner, the Board, and the courts have consistently adhered to a concept of income tax rather closely related to our own, and if such foreign tax was not imposed upon a basis corresponding approximately to net income it was not recognized as a basis for such credit. Thus if a foreign country in imposing income taxation authorized, for reasons growing out of the administrative difficulties of determining net income or taxable basis within that country, a United States domestic corporation doing business in such country to pay a tax in lieu of such income tax but measured, for example, by gross income, gross sales or a number of units produced within the country, such tax has not heretofore been recognized as a basis for a credit. Your committee has deemed it desirable to extend the scope of this section. Accordingly, subsection (f) of section 160 provides that the term "income, war profits and excess profits taxes" shall, for the purposes of sections 131 and 23 (d) (1), include a tax paid by a domestic taxpayer in lieu of the tax upon income, war profits and excess profits taxes which would otherwise be imposed upon such taxpayer by any foreign country or by any possession of the United States. The limita-

tion upon the amount of the credit will, of course, continue to apply, so that it will be allowed only if and to the extent the taxpayer has net income from sources within the foreign country or from sources without the United States, as the case may be.

Subsection (a) of section 160 still further amends section 131 of the Code so as to enable a taxpayer who has paid or accrued foreign income taxes to claim such taxes as a credit against his tax liability or, in the alternative, as a deduction from gross income. Existing law provides that, if "the taxpayer signifies in his return," the tax imposed shall be credited with the foreign tax. On the deduction side, it is provided that the taxpayer may use the foreign tax as a deduction from gross income if he "does not signify in his return his desire to have to any extent" the credit provided in section 131. It is believed desirable to allow the taxpayer the option to say whether he desires a credit or a deduction, or to change such option at any time prior to the running of the statute of limitations against assessment of the tax. However, if a taxpayer is allowed to any extent the credit for foreign tax, no portion of such foreign tax can be allowed as a deduction. It is only where no credit is allowed that any deduction can be taken for foreign tax.

An amendment to subsection (b) of section 131 was found by your committee to be necessary because of the method of computing "normal tax net income" provided in section 105 of the bill, amending section 13 (a) (2) of the Code. Under existing law in computing "normal tax net income" the excess profits tax imposed under chapter 2E is allowed as a deduction. Under the revenue bill of 1942, however, the adjusted excess profits net income is deducted from adjusted net income in the ascertainment of "normal tax net income." To preserve the appropriate ratio between the numerator and the denominator of the limitation fraction under section 131 (b), it is necessary that adjusted net income be not reduced by the amount of the adjusted excess profits net income for the purposes of that section, and section 160 (d) amends section 131 (b) so as to accomplish such result.

Your committee has given careful consideration to a suggested amendment to section 131 which would in substance provide that the credit for foreign taxes on foreign income not reported in the taxable year because of its being blocked should be deferred and allowed in the taxable year in which such income is released and realized for income tax purposes. The committee has not adopted such an amendment for the reason that it believes the amendment to be unnecessary. Under a proper interpretation of existing law, the credit for foreign taxes, as well as the various allowable deductions, follows the income into the taxable year in which it is realized for purposes of the income tax law. The committee feels, in view of the importance of this question to a large number of taxpayers, that the matter is one which it would be appropriate to cover specifically by departmental regulation.

SECTION 161. EXTENSION OF CONSOLIDATED RETURNS PRIVILEGE TO CERTAIN CORPORATIONS

This section is substantially the same as section 142 of the House bill with the exception of changes relating to the inclusion or non-inclusion of certain corporations within the affiliated group.

Section 141 of the Code, as amended by this section, extends the privilege of making consolidated income tax returns, as well as consolidated excess profits tax returns, generally, to all affiliated groups of corporations subject to such taxes. A group electing to take advantage of this privilege for any taxable year must file both consolidated income and excess profits tax returns for such year.

Since certain corporations which are subject to the income tax are exempt from the excess profits tax, the House bill provided that the group making a consolidated income tax return may include corporations not includible in the group making a consolidated excess profits tax return, but that such group for the purposes of the specific tax imposed should include all the eligible corporations subject to such tax. Your committee, however, believes it desirable that the affiliated group of corporations be identical both for consolidated income and for consolidated excess profits tax return purposes. It has therefore amended sections 141, 725, and 727 of the Code so as to provide that any corporation which has joined in a consolidated income tax return shall not be exempt from excess profits tax. Consequently, an includible corporation as defined in section 141 (e) which is a member of a group filing a consolidated income tax return will be required to join in the filing of the consolidated excess profits tax return. This is administratively expedient both from the standpoint of the Government and the taxpayer. In addition, it prevents the disqualification for consolidated excess profits tax return purposes of groups which are eligible for consolidated income tax return purposes in those cases where the common parent corporation would otherwise be exempt from excess profits taxes under sections 725 and 727 of the Code.

Existing law, as well as section 141, as amended by this bill, provides that consolidated returns may be filed by an affiliated group only if all corporations which were members of the group at any time during the taxable year for which such returns are filed consent to the consolidated returns regulations. Under such a rule a group which, without obtaining the required consents, had disposed of an affiliate prior to the time that recommendations were made to Congress by the Treasury Department that consolidated returns should be extended for income as well as excess-profits-tax purposes would not be able to avail itself of this provision. Your committee has therefore provided that a corporation which is not a member of the affiliated group after March 31, 1942, of the last taxable year of the group beginning before April 1, 1942, shall not be considered a member of the group for consolidated income-tax return purposes although it shall be considered a member for consolidated excess-profits-tax-return purposes.

The surtax imposed by section 15 or section 204 upon an affiliated group filing a consolidated income-tax return shall first be computed under such section upon the basis of the consolidated corporation surtax net income and the amount so determined shall then be increased by 2 percent of the consolidated corporation surtax net income. Your committee has retained the $5,000 specific exemption from excess-profits tax in existing law, instead of the $10,000 exemption provided in the House bill, and has made the appropriate amendment in this section to apply this to affiliated groups.

The consolidated normal tax net income, the consolidated corporation surtax net income, and the consolidated capital gains and losses

of the group are among those factors with respect to which the Commissioner, in view of experience with current and past consolidated returns regulations, is expected to prescribe regulations in order to reflect clearly the income and excess profits tax liability of the group and of each member thereof and the various factors necessary for the determination of such liability. In addition to these matters, your committee expects that such regulations will provide for the application of the excess profits relief provisions, and the provisions of section 710 (a) (1) (B) limiting excess profits taxes, in cases where consolidated returns are filed. Although the present regulations with respect to the determination of consolidated net income quite properly limit the deduction of the net operating loss carry-over of a member of a group from years prior to that in which its income is first included in a consolidated return to the amount of the separate income of such member, this section provides that such limitation shall not be applied to prevent the portion of the net operating loss carry-over which is attributable to a 1941 war loss of the member (see sec. 158 of the bill) being taken into account in computing consolidated net income.

An affiliated group is formed when 95 percent of the voting power of all classes of stock and at least 95 percent of each class of nonvoting stock, except nonvoting stock which is limited and preferred as to dividends, of each includible corporation (except the common parent corporation) are owned directly or indirectly by one or more of the other includible corporations, and the common parent corporation owns directly stock possessing at least 95 percent of the voting power of all classes of stock and at least 95 percent of each class of the nonvoting stock, except nonvoting stock which is limited and preferred as to dividends, of at least one of the other includible corporations.

The House bill defined "includible corporations" as in existing law with some exceptions. A corporation which would otherwise not have been an includible corporation because entitled to the benefits of section 251, by reason of receiving a large percentage of its income from sources within possessions of the United States, could elect not to be taxed under such section and to be an "includible corporation." This election was based upon section 134 (b) of the House bill which subjected to tax in the case of certain corporations subject to section 251, income which under provisions of existing law would not have been subject to the tax. Your committee has deleted section 134 (b), and has made a corresponding amendment to section 141 removing this election from section 251 corporations.

The House bill also provided that personal holding companies as defined in section 501 were not includible corporations for either income or excess profits tax purposes. In determining whether the gross income of a corporation satisfied the gross income requirement for personal holding companies for the purposes of section 141, as provided in that bill, income derived from other members of the affiliated group was to be eliminated. However, if the common parent corporation satisfied the stock ownership requirement of section 501 (a) (2), and the gross income requirement of the group satisfied the gross income requirement of section 501 (a) (1), such group might make a consolidated income tax return. In addition, the House bill excluded from the definition of "includible corporations" personal service corporations and, for consolidated excess profits tax return purposes, corporations exempt under section 727 from the excess profits tax. In the light

of its policy to make available the consolidated return privilege to as wide a group of corporations as possible, your committee has deleted these last three exceptions with respect to personal holding companies, personal service corporations, and corporations otherwise exempt from excess-profits tax. In line with this policy, your committee has also stricken out the subsection which made consolidated income tax returns available only to personal holding companies if an affiliated group of which such companies were members satisfied the personal holding company requirements upon a group basis.

The consolidated return privilege is not extended for the purposes of the surtax on personal holding companies imposed by section 500, except in the case of affiliated groups of railroad corporations which would have been entitled to file consolidated returns under section 141 prior to its amendment by this bill.

SECTION 162. ALIENS AND FOREIGN CORPORATIONS TREATED AS NONRESIDENTS

AND

SECTION 211. APPLICATION OF EXCESS PROFITS TAX TO CERTAIN FOREIGN CORPORATIONS

Under existing law nonresident aliens and foreign corporations are divided into two classes: (*a*) Those not engaged in trade or business within the United States and not having an office or place of business therein and (*b*) those engaged in trade or business within the United States or having an office or place of business therein. Those falling within classification (*a*) are generally taxed at a flat rate upon the gross amount of dividends, interest, and other fixed or determinable annual or periodical income from sources within the United States. Those falling within classification (*b*) are subject to tax at the rates generally applicable to individuals and domestic corporations, respectively, but only upon income from sources within the United States.

A tendency has arisen, principally on the part of foreign corporations which are substantial holders of the stock of domestic corporations and, occasionally on the part of nonresident alien individuals, to attempt to establish that they have an "office or place of business" within the United States and hence secure the very different tax treatment accorded taxpayers within class (*b*). Since such corporations and individuals engage in no other economic activities in the United States, they cannot be said to be engaged in trade or business within the United States.

It appears to your committee to be in the interests of good administration to establish but one test (as is done with respect to capital-stock tax in section 1200 of the Code) in ascertaining the classification of foreign entities, namely, whether or not it is engaged in trade or business within the United States. Such amendment narrows sharply the field of uncertainty arising in such cases and removes a possible avenue of tax avoidance to large foreign corporate and other holders of domestic securities.

Accordingly, section 162, which corresponds to section 143 of the House bill, amends sections 14 (c), 119 (a) (1), 143 (a) (1), 143 (b), 144, 204 (d), 211 (a) (1), 211 (b), 211 (c), 219, 231 (a), 231 (b) and

251 (e) relating to the tax imposed by chapter 1 by striking out "and not having an office or place of business therein" or like clause wherever occurring therein. Similar changes are made applicable in section 211, which is identical with section 207 of the House bill, to the excess profits tax imposed by chapter 2 of the Code.

SECTION 163. DEDUCTIONS FOR ESTATE TAX AND INCOME TAX OF ESTATE

This section is a new section inserted to replace the somewhat narrower provisions of subsection (c) of section 118 of the House bill. It amends section 162 (relating to net income of estates and trusts) to provide that unless a specified statement has been filed, no deduction shall be allowed under section 23 (except subsection w, relating to deductions of estate, and so forth, on account of decedent's deductions), in computing the net income of the estate for income tax purposes, on account of amounts allowable as a deduction under section 812 (b) in computing the net estate of the decedent for estate tax purposes. The required statement shall be filed within the time and in the manner and form prescribed by the Commissioner, and shall be to the effect that the amounts in question have not been claimed or allowed as a deduction under section 812 (b) and that the right to have such amounts allowed at any time as a deduction under section 812 (b) is waived. This amendment does not affect the character of the items deductible under section 812 (b).

The amendment made by this section is applicable with respect to taxable years beginning after December 31, 1941, except insofar as it relates to section 23 (a) (2) of the Code, in which case it is made applicable to the same taxable years and to the same revenue laws as the amendments made by section 121 of the bill (relating to nontrade or nonbusiness deductions).

SECTION 164. PENSION TRUSTS

This section corresponds to section 144 of the House bill and amends section 165 of the Code, relating to taxation of employees' trusts, section 23 (p), relating to deduction for an employer's contributions to a pension trust, and section 22 (b), relating to taxation of annuities.

AMENDMENTS TO SECTION 165

Your committee has made several changes in the House amendments to section 165, relating to employees' trusts. Subsection (a) has been amended to provide specifically that it apply to trusts which will benefit employees' beneficiaries as well as the employees themselves. This is in accordance with the interpretation that has for some time been placed on existing law. It is understood that a plan is for the exclusive benefit of employees or their beneficiaries even though it may cover former employees as well as present employees and employees who are temporarily on leave, as, for example, in the military or naval forces. The provision of existing law which permits an employer to recover contributions made to a trust after all the liabilities of the trust have been satisfied has been restored.

Section 165 (a) (3) has been amended to allow an employer to designate several pension, stock bonus, profit sharing, and annuity trusts

and plans as constituting parts of a plan which he intends to qualify under this subsection, and if all of those so designated cover a sufficient proportion of the total employees, the coverage is adequate without requiring a definite proportion of the employees to be included in any one plan. The provision in section 165 (a) (3) (A) requiring 70 percent of all the employees (excluding certain short service, seasonal and part-time employees) has been broadened to permit qualification of a trust covering 80 percent of the eligible employees, if at least 70 percent of all employees are eligible. The permissible exclusion from the computation of the foregoing percentages of employees whose customary employment is not more than 3 hours per day or 3 months per year has been changed to permit the exclusion of employees whose customary employment is not more than 20 hours per week or 5 months per year. If a plan fails to qualify under the foregoing percentage requirements it may still qualify under section 165 (a) (3) (B), provided always that (as required by pars. (3) and (4)) the plan's eligibility conditions, benefits and contributions do not discriminate in favor of employees who are officers, shareholders, supervisory employees, or highly compensated employees. The House bill contained a discrimination test with respect to eligibility conditions different from that imposed with respect to benefits and contributions. This difference has been removed by amending the latter to agree with the former. If several trusts, or a trust and an annuity plan, are designated by the employer as a plan to satisfy the coverage requirements of section 165 (a) (3), then in considering such trusts and annuity plans as one plan there must be no discrimination under section 165 (a) (4).

As stated in the House committee report, one of the purposes of the alternative qualification provision provided in section 165 (a) (3) (B) is to make it possible for plans that supplement the Social Security program to qualify. A new paragraph (5) has been inserted in order to mention in the law itself some of the acceptable provisions found in plans supplementary to the Social Security Act, both with respect to eligibility conditions and as to the scale of benefits and contributions. The acceptable provisions mentioned in the law are not intended to be exclusive: For example, there would also be permitted to qualify under section 165 (a) (3) (B) plans limited to employees who have reached a designated age or have been in the employer's employment for a designated number of years or are employed in certain designated departments or are in other classifications, provided that the effect of covering only such employees does not discriminate in favor of officers, shareholders, supervisory employees, or highly compensated employees.

The provisions with respect to contributions or benefits among employees may vary as long as the effect of the plan as a whole does not favor officers, shareholders, supervising employees, or highly compensated employees over other employees. For example, an employer may have a plan whereby each employee will contribute 2 percent of the first $150 of his regular monthly earnings, 4 percent of the next $100 of such earnings, and 6 percent of such earnings over $250, and the employer will contribute for the benefit of each employee an amount equal to that contributed by the employee. Similarly, a plan might provide for a greater percentage of contributions with respect to earnings of employees in excess of a designated amount

such as $5,000, as long as such greater contributions do not have the effect of creating discriminations in favor of a class of employees consisting of the officers, shareholders, supervising employees, or the highly compensated employees.

The provisions of the House bill with respect to section 165 (b), concerning the taxation of the beneficiary of a trust which meets the requirements of section 165 (a), have not been changed except to take care of the situation where an employee receives the total distributions that he is entitled to under the plan in 1 taxable year on account of his separation from the service. In such a case, it is provided that the amount of such distributions to the extent that it exceeds the amounts contributed by the employee shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months. For example, if under a profit-sharing trust, the total distributions to which an employee is entitled are paid to the employee in the year in which he retires or severs his connection with his employer, or to his widow if he dies during the course of his employment, the amount received by the employee or widow to the extent it exceeds the employee's contributions will be considered a gain from the sale or exchange of a capital asset held for more than 6 months.

With respect to section 165 (c), the House bill provided that if a trust is nonexempt under section 165 (a), contributions made by an employer for an employee whose interest is nonforfeitable, must be included in the gross income of the employee in the taxable year of the employee when the employer's contribution is paid. That provision is retained, but there has been eliminated the additional provision in the House bill to the effect that all past employer's contributions to a nonexempt trust on a forfeitable basis would become taxable to the employee in the single year in which the benefits provided thereby might become nonforfeitable.

AMENDMENTS TO SECTION 23 (P)

The House bill is revised to refer to the employer's payments to or under stock bonus, pension, profit-sharing, or annuity plans as contributions instead of as compensation. Reference to them as contributions is in accord with general usage and the provisions of section 165. This change in language is not intended to modify the provision in section 23 (p) that a contribution to be deductible under section 23 (p) must meet the requirements of section 23 (a).

The House bill limited the employer's deduction in the year of payment to 5 percent of the compensation paid to the employees, with any excess spread over a 5-year period. For plans for which the yearly contribution is not in excess of that limit, that basis is of benefit to both the Treasury and the employer in making it unnecessary for the employer to submit, and the Treasury to review, detailed actuarial calculations. However, to avoid possible abuse, the House bill is revised to have the reasonableness of the deductions claimed made subject to periodical examinations by the Commissioner at not less than 5-year intervals. The House bill is also revised to make clear that the 5 percent in the test is the relationship of the employer's aggregate contributions for all employees under the plan to the aggregate compensation paid to all the employees under the plan, and not a test to be applied separately for each employee.

Further provision is, however, necessary for those plans under which the employer's contributions in any given year may properly exceed 5 percent of compensation. Those plans fall into several general classes. Under one class, the employer's contributions for both past and current service credits are determined actuarially in terms of a level amount, or a level percentage of compensation, over the remaining future service of each employee. This class usually includes pension trust plans whether financed through an invested trust fund or through the purchase of level premium annuity contracts by the trustee. As an illustration, the actuary may determine, on the basis of a study of all the relevant data and appropriate assumptions as to mortality, interest, and other pertinent factors, that if the employer contributes yearly 4 percent of the total compensation of the employees for current service credits and 3 percent for past service credits—making a total of 7 percent, the trust may be expected to have sufficient funds to pay all of the pensions provided by the plan. From time to time the actuary will presumably compare the actual experience with the assumptions he made to determine if the 7 percent contribution rate should be continued unchanged or should be modified to assure that the funds already accumulated in the trust plus future employer and any employee contributions will enable the pensions provided to be paid. The committee feels that for such cases the employer's contributions are a proper deduction, even if in excess of 5 percent. Appropriate revision to that effect has been made, subject to the requirement (in order to avoid possible abuses) that the actuarial computations be on a basis permitted under regulations prescribed by the Commissioner with the approval of the Secretary, and, if three or less employees account for more than 50 percent of the unfunded cost, to require distribution of the unfunded cost for such employers over a period of at least 5 taxable years.

Under another class, in lieu of the level amount or level percentage basis already referred to, the employer may elect to provide during each year of an employee's active employment the cost of the actual pension credit arising out of that year of employment. As that cost for a given amount of pension or annuity credit for a given employee increases as he becomes older, it is obvious that the cost is not distributed as a level amount or level percentage over the remaining future service, but as an increasing amount or percentage. Whether the aggregate amount or percentage for all employees increases, decreases, or remains unchanged from one year to another depends upon the effect of changes in personnel, etc., during the period in question. This particular method is used for most annuity plans under which the employer sets up an employee retirement plan under a master group annuity contract issued by an insurance company. In such case it is obvious that the normal cost in any year is the amount required by the insurance company for the annuity arising out of that year's service.

Since there are in general use different methods for determining the employer's normal cost under acceptable plans, the House bill has been revised to permit an employer to use as an alternative to the 5-percent test with the distribution of any remaining unfunded cost as a level amount or level percentage, any of the other recognized bases of determining normal cost, provided it is done in accord with regulations

prescribed by the Commissioner with the approval of the Secretary. The provision for this alternative also includes a reasonable procedure for the deductibility of the cost of past service credits (not included in the normal cost). The procedure will allow deductions for amounts contributed for past service credits in the year when made, up to an amount not in excess of one-tenth of the cost required to completely fund or purchase the past service credits as of the date they are included in the plan. This deduction is in addition to the normal cost deduction and is also subject to its determination being in accord with the regulations.

The revisions also provide that if an employer contributes in a given year amounts in excess of the maximum deductible under the revised limitations, the excess shall be deductible in the first succeeding taxable year or years in which the employer pays less than the maximum allowable as a deduction.

In the case of employers providing pension plans by the purchase of annuities instead of by contributions to a trust, under section 23 (p) (1) (B), as amended by your committee, if the annuity plan meets the requirements of section 165 (a) (3), (4), (5), and (6), although no trust need be involved as a part of the plan, and if refunds of premiums, if any, are applied within the current taxable year or next succeeding taxable year toward the purchase of such retirement annuities, the maximum employer deductions will be determined in a manner consistent with the case of employer contributions to a pension trust.

The maximum amount deductible in the year of payment in the case of an employer's contributions to a stock bonus or profit-sharing trust has been increased from 5 to 15 percent of the aggregate compensation of the persons who are made the beneficiaries of such contributions. If the employer pays less than such 15 percent in any year, then the difference may be carried forward to increase permissible deductions in subsequent years, subject to certain limitations. If the employer contributes more in any particular year than the maximum amount deductible, the excess may be deducted in the first succeeding taxable year or years in which he pays less than the maximum for that year.

If an employer has a pension trust plan or an annuity plan and in addition a profit-sharing or stock-bonus plan then, unless no employee is a beneficiary under more than one trust, or a trust and an annuity plan, the total amount deductible in a taxable year under such trust and plans shall not exceed 25 percent of the compensation otherwise paid or accrued during the taxable year to the employee beneficiaries. Provision is made, subject to certain limitations, to carry over for the purpose of deduction in succeeding taxable years amounts contributed in any year in excess of 25 percent of such compensation.

If contributions are paid to a trust under a plan and the trust and plan do not meet the requirements of section 165 (a) or are paid for an annuity contract and the annuity contract is not purchased under a plan which meets the requirements of section 165 (a) (3), (4), (5), and (6), the employer will receive no deduction for such amount so paid or accrued unless the employees' rights are nonforfeitable at the time the contributions are made, in which case the employer may be allowed a deduction for the full contribution in the year in which the contribution is made. If the employee's rights are nonforfeitable at the time of the contribution, the employee becomes taxable upon the

amount so paid in the year in which the contributions are made, as provided in the amendments to sections 165 and 22 (b) (2). If an employer on the accrual basis defers paying any compensation to the employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan or similar plan deferring the receipt of compensation, he will not be allowed a deduction until the year in which the compensation is paid. This provision is not intended to cover the case where an employer on the accrual basis defers payment of compensation after the year of accrual merely because of inability to pay such compensation in the year of accrual.

TAXATION OF EMPLOYEES' ANNUITIES

Your committee has not changed the provisions of section 144 (c), of the House bill, relating to employees' annuities, except in two respects. If an annuity contract is purchased for an employee by a religious, educational, or charitable organization, which is exempt under section 101 (6), the employee will not be required to include in his income the amount paid by his employer for such annuity contract until he actually receives or there is made available to him the amounts required to be paid under the annuity contract, regardless of whether the annuity plan meets the requirements of section 165 (a) (3), (4), (5), and (6) and whether the employee's rights are nonforfeitable. The provision in the House bill to the effect that if the rights of the employee change from a forfeitable to a nonforfeitable right, under a plan which does not meet the requirements of section 165 (a), the amount paid by the employer shall be included in income of the employee in the year in which the change occurs, has been stricken. Any amounts contributed by an employer for the benefit of an employee whose rights are forfeitable at the time of the contribution, will not be required to be included in the income of the employee until such amounts are actually received or made available to the employee.

EFFECTIVE DATE OF AMENDMENTS

Your committee has changed the provisions of section 144 (d) with respect to pension, annuity, stock bonus, and profit-sharing plans which were in effect on or before September 1, 1942. Such a plan shall not become subject to the provisions of section 165 (a) (3), (4), (5), and (6) (relating to coverage and discriminations) until the beginning of the first taxable year beginning after December 31, 1942. For the taxable year 1942, a trust under such a plan will be exempt merely by complying with section 165 (a) (1) and (2), which reads substantially the same as in the existing law. The employer in the taxable year 1942 will be allowed as a deduction the amount allowable under section 23 (p) as amended by this act, but not less than the sum of the amounts contributed prior to September 1, 1942, and deductible under section 23 (a) or 23 (p) prior to amendment by this act, and such portion allowable under section 23 (p) as amended as the number of months in the taxable year beginning with September is to 12. The maximum amount allowable as a deduction for such contributions made during that portion of the taxable year beginning with September 1, 1942, and ending with the close of the taxable year, is

such proportion of the maximum amount allowable under section 23 (p), as amended, as the number of months in such period is to 12.

With respect to the taxable year 1943, it s provided that in the case of a plan in effect on September 1, 1942, if it satisfies the requirements of section 165 (a) (3), (4), (5), and (6) by December 31, 1943, it shall be considered as satisfying such requirements for the period beginning with the beginning of the first taxable year following December 31, 1942, and ending December 31, 1943.

In the case of plans not in effect on or before September 1, 1942, the amendments made by section 164 are applicable to all taxable years beginning after December 31, 1941. However, if such plan satisfies the requirements of section 165 (a) (3), (4), (5), and (6) by December 31, 1943, it shall be considered as satisfying such requirements for the period prior to such date.

EFFECT OF AMENDMENTS ON INVESTMENT COMPANY ACT OF 1940

Section 3 (c) (13) of the Investment Company Act of 1940 excludes from the definition of the term "investment company" any employees' stock bonus, pension, or profit-sharing trust which meets the conditions of section 165 of the Internal Revenue Code. Since the bill amends section 165 and incorporates therein requirements which are stricter than those of the existing section 165, such a trust to be excluded from the definition of investment company under the Investment Company Act of 1940 will hereafter be required to meet the tax exemption conditions of section 165, as amended by the bill.

SECTION 165. LIFE INSURANCE COMPANIES

This section is the same as section 145 of the House bill except for certain changes of a technical nature and changes with respect to foreign life insurance companies, burial or funeral benefit companies, capital gains and losses, assessment companies, amortization of premiums and accrual of discount, and adjustment for reserves on nonlife business.

Under existing law life insurance companies pay a comparatively small amount of income tax. There are two main reasons for this situation.

First, under existing law, which taxes only investment income, the companies are allowed an extremely liberal deduction for earnings needed to maintain reserves. This deduction is computed at the rate of 3¾ percent of the mean of the reserves required by law (with respect to some reserves, at 4 percent), although the average rate of interest earned by all life insurance companies is less than 3½ percent, and the average rate of interest assumed in computing reserves is about 3¼ percent.

Second, under existing law life insurance companies are in effect allowed to deduct part of their tax-exempt interest twice. The total amount of tax-exempt interest is excluded from the gross investment income. The remaining taxable part of the gross investment income is then reduced by the allowance for earnings on reserves, computed at 3¾ percent of the mean of the legal reserves. Part of the earnings on reserves is derived from tax-exempt interest; yet the whole allowance for reserve earnings is deducted from taxable investment income. That part of tax-exempt interest used to maintain reserves (which

includes the bulk of tax-exempt income) is therefore deducted twice, once by the exclusion of tax-exempt interest from the tax base, and a second time as part of the reserve earnings deduction.

In order to arrive at an equitable solution of the proper amount to be allowed as a deduction for the earnings needed to maintain the reserves, the bill provides that a "reserve and other policy liability credit" be substituted for the present reserve-earnings deduction, the deduction for interest paid, and the deduction for deferred dividends. This credit is a flat percentage of net investment income after deducting tax-exempt interest. The application of the percentage to net income after deducting tax-exempt interest eliminates the double deduction for such interest allowed under existing law. The percentage is to be the same for all companies and is to be determined on the basis of the aggregate deductions of all companies for reserve earnings, interest paid, and deferred dividends. For example, for 1941, the aggregate deductions of all companies for these items, under the formula for determining them set forth in the bill, amount to approximately 93 percent of the aggregate net investment income after deducting tax-exempt interest, according to preliminary figures subject to revision on the basis of a more complete analysis. The figure for each taxable year is to be determined and proclaimed by the Secretary of the Treasury, based on such data with respect to life insurance companies for the preceding year as the Secretary considers representative for such year.

The application of the reserve and other policy liability credit may be illustrated by the following examples:

Example 1: The X life insurance company for the calendar year 1942 has gross income, consisting of interest and rents, of $4,000,000 of which $700,000 consists of wholly tax-exempt interest. It has investment expenses of $100,000, real estate expenses of $80,000 and depreciation of $20,000. Its net income and its normal tax net income is accordingly $3,100,000 ($4,000,000 less investment expenses, real estate expenses, and depreciation amounting to $200,000 and wholly tax-exempt income of $700,000). Assuming that the Secretary of the Treasury makes no change in the tentative figure for 1941 referred to above (93 percent) the X life insurance company is entitled to a credit of $2,883,000 ($3,100,000×93 percent) and its adjusted normal tax net income as well as its adjusted corporation surtax net income is $217,000 ($3,100,000−$2,883,000).

Example 2: If in example (1) $100,000 of the $4,000,000 gross income of the X life insurance company for the calendar year 1942 consists of partially tax-exempt interest, in addition to the $700,000 of wholly tax-exempt interest, its corporation surtax net income and adjusted corporation surtax net income would be the same as in the above example. Its normal tax net income, however, would be $3,000,000 ($4,000,000 less $200,000 less $700,000 less $100,000), its credit would be $2,790,000 ($3,000,000×93 percent) and its adjusted normal tax net income would be $210,000 ($3,000,000−$2,790,000).

Section 201 (a) (1) (relating to imposition of tax) and (3) (relating to foreign life insurance companies not carrying on an insurance business within the United States) except for technical changes and changes making it a tax imposing section for both normal and surtax is the same as section 201 (b) (1) and (3) of the Code.

Section 201 (a) (2) (relating to foreign life insurance companies) changes the method of taxation of a foreign life insurance company carrying on a life insurance business within the United States so that the tax will not be imposed on its income from sources within the United States, as under the House bill, or on the share of its net income from all sources which reserve funds held on United States business bears to its total reserve funds, as under existing law. Such a company if it qualifies as a life insurance company with respect to its United States business will be taxable in the same manner as a domestic life insurance company except that the determinations necessary for the purposes of chapter 1 will be made on the basis of the income, disbursements, assets, and liabilities reported in the annual statement of its United States business on the form approved for life insurance companies by the National Association of Insurance Commissioners. The effect of this is to tax the United States business on its investment income from all sources as if it were a separate domestic corporation. Canadian life insurance companies, which are the companies chiefly concerned, object to existing law because the rate of interest earned on United States securities in which they are required to invest the reserves and surplus held for the protection of their United States business, is less than that earned on foreign securities. In addition, the prorating, in effect, allows only part of tax-free interest to be exempted. It is contended that the provisions of the House bill are inequitable.

Section 201 (b) (relating to definition of a life insurance company) revises the definition now contained in section 201 (a) of the Code. Burial or funeral benefit companies, which were excluded from the House bill to require payment of taxes on income from the manufacture of supplies and the performance of funeral services, are permitted to continue to qualify as life insurance companies until January 1, 1944, to enable them to rearrange their method of doing business where necessary. For taxable years beginning January 1, 1944, such companies engaged directly in the manufacture of funeral supplies or the performance of funeral services are excluded and are taxed under section 204 or 207 as the case may be. Technical changes are made to distinguish in a clearer manner the types of insurance contracts included and to emphasize the fact that the unearned premiums and unpaid losses on noncancelable life, health, or accident policies, not included in life insurance reserves, are included for purposes of the definition of a life insurance company only. Since noncancelable contracts of health and accident insurance require the accumulation of substantial reserves against increased future risks, the writing of such insurance is analogous to life insurance and the definition has been changed to permit such companies to be taxed as life insurance companies. The unearned premiums and unpaid losses on noncancelable life, health, or accident policies, not included in life insurance reserves, are added to such reserves in determining whether a company is to be considered a life insurance company. The life insurance reserves defined in subsection (c) (2) as they pertain to noncancelable health and accident insurance policies are those amounts which must be reserved, in addition to unearned premiums, to provide for the additional cost of carrying such policies in later years when the insured will be older and subject to greater risk and when the cost of carrying the risk will be greater than the premiums then

being received. As the term is used in the industry, a noncancelable insurance policy means a contract which the insurance company is under an obligation to renew at a specified premium, and with respect to which a reserve in addition to the unearned premium must be carried to cover the renewal obligation. In view of the fact that classification as a life insurance company depends upon whether certain reserves comprise more than 50 percent of its total reserves, the term "total reserves" is defined. This will make it easier to determine whether an insurance company can qualify as a life insurance company.

Section 201 (c) (1) corresponds to section 202 (a) (1) of the Code. Gains from sales or exchanges of capital assets which were included in the House bill are eliminated.

Section 201 (c) (2) is new and defines the term "life insurance reserves." The definition is substantially that contained for many years in the regulations with the addition that the reserves must be based on recognized mortality or morbidity tables, the health and accident reserves must be noncancelable, and unpaid loss reserves on such health and accident contracts are included if computed on a discount basis. The use of mortality or morbidity tables instead of experience tables as in the House bill eliminates any possibility of excluding reserves which are based on sound tables which are not compiled from actual experience. The elimination of contingent claims from the House bill is to permit the liability arising from insurance contracts providing for the payment of the proceeds in installments certain for a specified period and a continuation of their installment payments to a beneficiary so long as he might live, to be classified as a reserve if the contract involved a life contingency even if some part of the liability was held to meet noncontingent claims. It is also made clear that life insurance reserves include reserves for annuity contracts, including life insurance or annuity contracts combined with noncancelable health and accident insurance contracts. The provisions of existing law with respect to reserves of assessment life insurance companies or associations which were omitted in the House bill are inserted.

Section 201 (c) (3) is new and defines the term "adjusted reserves." "Adjusted reserves" is one of the elements to be used in arriving at the figure to be determined and proclaimed by the Secretary under the formula set forth in section 202 (b). Most life insurance companies compute their reserve funds on the basis of a level net premium. A number of life insurance companies, however, especially smaller companies in the early stages of operation, compute their reserve funds by some form of preliminary term method, such as full preliminary term, modified preliminary term (Illinois standard) or select and ultimate. These reserve standards require lower reserves in the earlier years of a policy than does the more usual level net premium method. In order to equalize the computation of the reserve-earnings deduction, an additional amount equal to 7 percent of the life insurance reserves computed on a preliminary-term basis is to be added in computing the adjusted reserves.

Section 201 (c) (4) is new. It defines the term "reserve earnings rate" and sets forth the formula for determining such rate. The reserve earnings rate is one of the elements to be used in arriving

at the figure to be determined and proclaimed by the Secretary under the formula set forth in section 202 (b). The reserve earnings rate is determined by the use of a formula which substitutes for the present interest rate of 3¾ percent a weighted average of 3¼ percent and the actual rate of interest assumed by the company in computing its reserves. The average is computed by giving a weight of 65 percent to the 3¼ percent rate and a weight of 35 percent to the actual assumption rate. In defining the calculation of the average rate of interest assumed in computing life insurance reserves the phrase "applying each assumed rate of interest to," appearing in the House bill, is changed to "multiplying each assumed rate of interest by" for purposes of clarification.

Section 201 (c) (5) defines the term "reserve for deferred dividends." It is taken from section 203 (a) (3) of the Code. The reserve for deferred dividends is one of the elements to be used in arriving at the figure to be determined and proclaimed by the Secretary under the formula set forth in section 202 (b).

Section 201 (c) (6) defines the term "interest paid." It is one of the elements to be used in arriving at the figure to be determined and proclaimed by the Secretary under the formula set forth in section 202 (b). Subparagraph (A) is taken from section 203 (b) (7) of the Code. Subparagraph (B) is new and includes amounts in the nature of interest such as so-called excess-interest dividends as well as guaranteed interest, paid within the taxable year on insurance contracts (or contracts arising out of insurance contracts) which do not involve, at the time of payment life, health, or accident contingencies. The amendment of the House bill to include annuity contracts in the type of contracts covered by this subparagraph recognizes the fact that supplementary contracts not involving life contingencies may arise from basic annuity contracts as well as life insurance contracts. It is to be immaterial whether the optional mode of settlement specified in the insurance contract arises from an option exercised by the insured during his or her lifetime or from an option exercised by a beneficiary after the policy has matured, frequently referred to as a supplementary contract not involving life, health, or accident contingencies; for example, a contract to pay the insurance benefit in 10 annual installments. Under existing law some question has arisen whether such amounts are allowable deductions, in whole or in part, as interest, or whether the capital sums on which such interest is paid come within the definition of reserve funds required by law, of which a specified percentage is allowed as a deduction. In *Penn Mutual Life Insurance Company* v. *Commissioner* (92 F. (2d) 962), *Equitable Life Assurance Society* v. *Commissioner* (44 B. T. A. 293 (No. 53)) and *Commissioner* v. *Pan-American Life Insurance Company* (111 F. (2d) 366), it was held that such capital amounts are not reserve funds required by law and that only the guaranteed interest on contracts where the option was exercised by the beneficiary is deductible as interest. The excess interest dividends were considered in the nature of dividends in the first two cases since the companies were mutual. In Jefferson Standard Life Insurance Company (44 B. T. A. 314 (No. 54)) the same conclusions were reached as to the reserve funds and as to interest where the beneficiary and not the insured exercised the option. The excess-interest dividends, however, were allowed as interest on the ground that since the company was a stock life insurance company

there was no element of a dividend in the excess interest paid. Where the option was elected by the insured the entire payment was held to be a death benefit and not interest.

It is believed that no distinction should be made based on the person choosing the method of payment and that the full amount of the interest paid instead of only the guaranteed interest should be considered as interest paid. The guaranteed interest where the insured exercises the option and the so-called excess interest dividends are in the nature of interest even though they may not come within a strict construction of that term.

Section 201 (c) (7) defines the term "net income." Subparagraphs (A), (C), and (D) (relating to tax-free interest, real estate expenses, and depreciation, respectively) are the same as section 203 (a) (1), (5), and (6) of the Code. Subparagraph (B) (relating to investment expenses) corresponds to section 203 (a) (4) of the Code. The limitation on investment expenses, one-quarter of 1 percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year, where general expenses are allocated thereto, may operate unfairly in the case of life companies with a high interest earning rate. Subparagraph (B) accordingly contains an additional allowance of one-fourth of the amount by which net income computed without any deduction for investment expenses allowed by that subparagraph, or for tax-free interest allowed by subparagraph (A) exceeds 3¾ percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year. This additional allowance is not available as a matter of course but is only permitted if the company can justify it by a reasonable allocation of actual expenses. The addition of tax-free interest to the deduction excluded from net income by the House bill eliminates any possible discrimination against a company holding a large proportion of wholly tax-exempt securities. Subparagraph (E) (relating to capital losses which were allowed as a deduction from net income in the House bill, has been eliminated. Subparagraph (F) (relating to bond premium deductions) included in subsection 201 (c) (7) in the House bill is eliminated and included in a new subsection (e) of section 201, which is explained below.

Section 201 (d) (rental value of real estate) with the necessary changes is the same as section 203 (b) of the Code.

Section 201 (e) of the House bill relating to deductions of foreign corporations is eliminated. This is necessary due to the change made in section 201 (a) (2).

Section 201 (e) (amortization of premium and accrual of discount) is new and provides for the allowance of a deduction for amortization of bond premium in a manner similar to that provided in section 201 (c) (7) (F) of the House bill except that the deduction is to be allowed without the limitations contained in section 125 of the House bill. A new item (accrual of bond discount) is to be included in gross income. The gross income, the deduction for wholly tax exempt interest, and the credit for partially tax exempt interest are to be adjusted by the appropriate amortization of premium or accrual of discount attributable to the taxable year on bonds, notes, debentures, and other evidences of indebtedness held by a life insurance company. Such amortization and accrual are to be determined in accordance with the method regularly employed by the company, if such method is

reasonable, and in all other cases, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary. This treatment of bond discount and premiums will coincide exactly with the existing accounting practice in the life insurance business. The provisions of section 113 are to be applied in any case where it becomes necessary to determine the basis of property with respect to which amortization is allowed, or accrual is required, under this subsection.

Section 201 (f) is new and is designed to prevent a double deduction. For example, it would prevent interest being included twice in the computation of the reserve and other policy liability credit, once as interest paid, and again as a percentage of the mean of adjusted reserves. It corresponds to section 204 (e) of the present law.

Section 201 (g) of the House bill, relating to health and accident insurance, is eliminated. Its provisions are incorporated with some changes in section 202 (c) (adjustments for certain reserves) and is explained under that subsection.

Section 201 (g) (credits for partially tax-free interest and for dividends received) is new. This is a clarifying change to eliminate any question as to the allowance of the credits provided in section 26 of the Code in computing normal-tax and corporation surtax net income.

Section 202 is new. The income subject to normal tax is defined as adjusted normal tax net income. This is the net income as defined in section 201 (c) (7), less partially tax-exempt interest provided in section 26 (a) of the Code, less the credit for dividends received provided in section 26 (b) of the Code, less the credit for income subject to the tax imposed by subchapter E of chapter 2 provided in section 26 (e) of the Code, as amended, less the reserve and other policy liability credit, and plus the adjustment for certain reserves provided in section 202 (c). The reserve and other policy liability credit is an amount computed by multiplying the normal tax net income by a figure to be determined and proclaimed by the Secretary of the Treasury for each taxable year. This figure is to be based on such data with respect to life insurance companies for the preceding taxable year as the Secretary considers representative and is to be computed in accordance with a formula set forth in the bill. The application and effect of this provision are explained above in connection with the proposed solution of the proper amount to be allowed as a deduction for the earnings needed to maintain the reserves.

Subsection (c) of section 202 (relating to adjustment for certain reserves) is new and changes section 201 (g) of the House bill to apply the adjustment for certain reserves to other cancelable contracts as well as cancelable health and accident contracts, and to add the adjustment to the tax base rather than to net income. Such addition to the tax base will offset the reserve and other policy liability credit. Under existing law a life insurance company writing health or accident or other insurance contracts is taxable only on investment income and since there is very little investment income derived from the investment of premiums on such contracts, the real income from the accident and health and other business, which is derived from premiums, is not taxed. Similar contracts written by an insurance company subject to the tax imposed by section 204 are taxable on both investment and underwriting income from such contracts. The segregation of can-

celable health and accident and other insurance business written by life insurance companies and making the income therefrom taxable under section 204 or 207, as the case may be, was considered. However, this was objected to on the ground that it would result in litigation because of the difficulty in determining the proper apportionment of items of expense and income properly allocable to such business and that the segregation for reports to State insurance commissioners is arbitrary and unsatisfactory.

In order to provide a more easily determinable tax base for the cancelable health and accident and other business of life insurance companies, it is provided that interest on the unearned premiums and unpaid losses on cancelable health or accident or other business be included in the tax base as determined for life insurance companies. The interest on these reserves would be computed at 3¼ percent, the average rate of interest that is allowed life insurance companies. In addition, in order to eliminate inequities among companies writing policies requiring unearned premiums of widely varying size, it is provided that unearned premiums be considered to be not less than 25 percent of net premiums written during the taxable year on such policies.

Section 203 is new. The income subject to surtax is the adjusted corporation surtax net income. This is the net income as defined in section 201 (c) (7), less the credit for income subject to the tax imposed by subchapter E of chapter 2 provided in section 26 (e), less the credit for dividends received as provided in section 26 (b) of the Code, as amended, but subject to the limitation provided in section 15 (a), and less the reserve and other policy liability credit, and plus the adjustment for certain reserves provided in section 202 (c). The reserve and other policy liability credit is similar to that provided in section 202 except that it is based on the corporation surtax net income, which includes partially tax-exempt interest, instead of the normal tax net income.

Section 145 (b) contains the necessary technical amendment to section 103 (relating to rates of tax on citizens and corporations of certain foreign countries), which is required by reason of the amendment to section 201. Section 208 (relating to net operating losses) is repealed in view of the amendments to sections 201 and 207. Such losses will be allowed to insurance companies subject to the tax imposed by section 204, by reason of the provisions of section 204 (c) (10) of the Code.

SECTION 166. INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL AND MUTUAL MARINE INSURANCE COMPANIES

This section corresponds with section 146 of the House bill and amends section 204 (a), (b), and (c) of the Code. Subsection (a) is the same as in the House bill, except for technical changes and the inclusion of mutual marine insurance companies. Subsection (b) is new and amends section 204 (b) (5) (relating to premiums earned) by adding a new sentence to provide that unearned premiums shall include life insurance reserves, as defined in section 201 (c) (2), pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by this section and

not qualifying as a life insurance company. This change is to permit a deduction under this section for life insurance reserves for which the company would receive a policy and other liability credit under sections 202 and 203 if it could qualify under section 201 as a life insurance company. Subsection (c) corresponds to subsection (b) of the House bill but contains a new provision amending subsection 204 (c) (relating to deductions) by revising paragraph (5) so that companies subject to the tax imposed by this section will be allowed the same deduction for capital losses provided in section 117 and the same provisions with respect to losses from capital assets sold or exchanged in order to provide funds to meet abnormal insurance losses as are allowed under section 207 to mutual insurance companies other than life or marine. The application of the capital loss carry-over provided in section 117 (e) for the purposes of this section will be subject to the same limitations as in section 207 relating to mutual insurance companies other than life or marine. Subsection (c) eliminates paragraphs (11), (12), and (13) of the proposed amendment to section 204 (c) in the House bill and inserts a new paragraph to provide a deduction for the few participating stock companies which pay dividends and similar distributions to policyholders analogous to the dividends paid by mutual companies. This would also allow a deduction for such distributions made by mutual marine insurance companies.

SECTION 167. MUTUAL INSURANCE COMPANIES OTHER THAN LIFE OR MARINE

This section corresponds to section 147 of the House bill which revised the exemption in section 101 (11) of the Code so that it would be limited to "mutual hail, cyclone, casualty, liability, or fire insurance companies or associations (including interinsurers and reciprocal underwriters) writing insurance contracts solely on a mutual basis, if the mean of the ledger assets held at the beginning and end of the taxable year does not exceed $100,000" and subjected such companies to income tax on the sum of their investment and underwriting income in a manner somewhat similar to that used under section 204 (relating to insurance companies other than life or mutual). Your committee has changed the exemption and completely revised the method of taxing such companies.

Most mutual insurance companies other than life, large as well as small, are given an outright exemption from taxation under the existing section 101 (11), although that section was originally designed to exempt only small and local mutual companies. The remaining mutual companies, with a few exceptions, ordinarily pay no tax under the present method of computing their income even though not specifically exempted from the tax.

The exemption provided in section 101 (11) of the Code, as revised by the House bill, is further revised so that it will be limited to "mutual insurance companies or associations, other than life or marine (including interinsurers and reciprocal underwriters) writing no insurance contracts other than mutual insurance contracts, if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000." The gross amount received from interest, dividends, rents,

and premiums of practically all of the farmers' and other small and local mutual companies is less than $75,000 and accordingly they will not be required to file income-tax returns or pay any income taxes. It is estimated that over 80 percent of all companies will be exempt from filing returns under this provision. In addition, even where such gross amount received exceeds $75,000, and an income tax return must be filed, it is provided under section 207 (a) that no income tax is payable if the corporation surtax net income (which may be greater than, but can never be less than, the normal-tax net income) is $3,000, or less, and the gross amount received from interest, dividends, rents, and net premiums, minus the dividends to policyholders, minus the interest which under section 22 (b) (4) is excluded from gross income is $75,000 or less. Accordingly, these provisions will impose no hardship upon farmers' or other small and local mutual insurance companies other than life or marine.

In the case of mutual insurance companies other than life or marine which are not granted exemption under section 101 (11), it is proposed to subject such companies to income tax at the regular corporate rates on their net investment income or to a special tax of 1 percent on the gross amount received from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus the interest which under section 22 (b) (4) is excluded from gross income, whichever is the greater. It is also proposed to exclude mutual marine insurance companies from the tax imposed by section 207 and to subject such companies to the tax imposed by section 204.

Section 207 (a) imposes a tax upon the income of mutual insurance companies other than life or marine. Companies with corporation surtax net income of $3,000, or less, and with gross amounts received from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest, of $75,000 or less, pay no tax under this section. Companies with normal-tax net income or corporation surtax net income of between $3,000 and approximately $6,000 are taxed under section 207 (a) (1) at a special notch rate of twice the standard rates. Companies with gross amounts received from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt interest, ranging from $75,000 to $150,000 are taxed under section 207 (a) (2) at a special notch rate of twice the ordinary rate of 1 percent. An additional notch provision applies to either of the above taxes where the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is between $75,000 and $125,000. The tax imposed by section 207 (a) is the tax computed under section 207 (a) (1) or 207 (a) (2), whichever is the greater. The amount computed under section 207 (a) (1) or 207 (a) (2) (A) is subject to the adjustment provided in section 207 (a) (3). The tax imposed by section 207 (a) (2) is not applicable to interinsurers or reciprocal underwriters.

The application of section 207 (a) (1), (2), and (3) may be illustrated by the following examples:

Example 1: The X mutual casualty insurance company for the taxable year 1942 has a corporation surtax net income of $3,500, and partially tax exempt income of $600, giving a normal tax net income of $2,900 and the gross amount of income from interest, dividends, rents, net premiums, minus dividends to policyholders, minus wholly

tax-exempt interest is $150,000. Its excess profits net income is $2,900. It is not subject to normal tax as its normal-tax net income does not exceed $3,000. Its surtax is 20 percent of $500 ($3,500—$3,000) or $100 since that amount is less than the surtax computed at the rates provided in section 15 (b). It has no normal tax and, therefore, its total tax under section 207 (a) (1) is $100. Its excess profits net income is less than $5,000 and, therefore, there is no excess profits tax and the tax under section 207 (a) (2) is 1 percent of $150,000 or $1,500. Since the tax under section 207 (a) (2) exceeds the tax under section 207 (a) (1) the tax under section 207 (a) is $1,500, namely, that imposed by section 207 (a) (2).

Example 2: If in the above example the normal tax, corporation surtax, and excess profits tax net income were $2,900, the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) were $90,000 and the gross amount of income from interest, dividends, rents, and net premiums minus dividends to policyholders, minus wholly tax exempt interest were $70,000 the X company would be required to file a return but no tax would be imposed.

Example 3: The Y mutual fire insurance company for the taxable year 1942 has a normal tax net income of $6,000, a corporation surtax net income of $7,000 and an adjusted excess profits net income of $1,000. The gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is $120,000 and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus wholly tax-exempt income is $100,000. Under section 207 (a) (1), without application of section 207 (a) (3), the normal tax would be 30 percent of $3,000, or $900 (since this is less than the tax computed at the rates provided in section 14 (b)); and the surtax would be 10 percent of $7,000, or $700 (since this is less than the tax computed at 20 percent of the excess of the surtax net income over $3,000). The combined tax of $1,600 would then be reduced by applying section 207 (a) (3), since the gross receipts are between $75,000 and $125,000. The final tax under section 207 (a) (1) would be 90 percent of $1,600, or $1,440, since the $45,000 (the excess of $120,000 over $75,000) is 90 percent of $50,000. The excess profits tax on the adjusted excess profits net income of $1,000 at the rate of 90 percent is $900. Under the provisions of section 710 (a) of the Code, as amended by section 205 (a), the excess profits tax is $810 (90 percent of $900) since $45,000 (the excess of $120,000 over $75,000) is 90 percent of $50,000. Under section 207 (a) (2) (A), without reference to section 207 (a) (3), the tax is 2 percent of $25,000 (the excess of $100,000 over $75,000), or $500, since this is less than 1 percent of $100,000. Applying section 207 (a) (3) reduces this to $450, or 90 percent of $500. Since $450 is less than the amount of the excess profits tax of $810 there is no tax under section 207 (a) (2) and the tax under section 207 (a) (1) is applicable. The Y company would accordingly pay a combined normal tax and surtax of $1,440 and an excess profits tax of $810 or a total of $2,250.

Section 207 (a) (4) and (5) are revised to conform to the changes made in the taxation of mutual insurance companies other than life or marine.

Section 207 (b) (1) defines "gross investment income" substantially as "gross income" is defined in section 201 (c) (1) (relating to life insurance companies) except that gains from the sale or exchange of capital assets are included, and provision is made for both the cash and accrual method of accounting.

Section 207 (b) (2) defines "net premiums" in a manner that produces substantially the same effect as in section 204 (b) (5) of the Code, and includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 207 (b) (3).

Section 207 (b) (3) defines "dividends to policyholders" as dividends and similar distributions paid or declared to policyholders. Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual fire-insurance companies.

Section 207 (b) (4) (A), (B), (C), (D), and (E) (relating to tax-free interest, investment expenses, real estate expenses, depreciation, and interest paid or accrued) are defined substantially as those terms are defined in section 201 (c) (7) (A), (B), (C), (D), and (c) (6) (A), respectively, relating to life insurance companies, except that provision is made for both the cash and accrual method of accounting.

Section 207 (b) (4) (F) allows a deduction for capital losses to the extent provided in section 117, plus losses from capital assets sold or exchanged in order to provide funds to meet abnormal insurance losses. Representations were made that insurance companies other than life frequently had no control over the timing of the sale of their assets, since in years of abnormal insurance losses they were forced to liquidate assets in order to be able to pay the losses. The limitation on capital losses imposed on corporations in general is designed to prevent corporations from avoiding tax by timing the taking of losses in such a way as to achieve the maximum reduction in tax. Such a protection is necessary primarily when a taxpayer has control over the timing of the sale of the assets. Under the circumstances that would be met by an insurance company faced with an abnormal loss this would not be the case. Consequently losses on assets sold for this purpose might safely be allowed as a deduction from regular income without possibility of abuse. In attempting to put this principle into effect the major problem is to define sales that will be considered to have been made for the purpose of meeting abnormal insurance losses. This has been done by taking as a normal amount of losses an amount computed on the basis of the experience for the preceding 5 years. Losses in a given year over and above this amount are considered abnormal losses. Sales of capital assets the receipts from which do not exceed the amount of abnormal insurance losses are considered to be sales in order to meet abnormal insurance losses and capital losses on such sales are to be permitted as a deduction from other income. A special rule is set forth for the application of the 5-year capital loss carry-over provisions of section 117 (e) for the purposes of this section in order to prevent capital losses actually used to reduce net income in any year from again being used in a future year as an offset against capital gains in that year.

Section 207 (c) (rental value of real estate) with the necessary changes is the same as in the House bill and is taken from section 203 (b) of the Code.

Section 207 (d) (amortization of premium and accrual of discount) is new. This is the same, except for technical changes, as section 201 (e), relating to life insurance companies, and is explained under that section.

Section 207 (e) (relating to deduction of foreign corporations) and (f) (relating to double deductions) is the same as section 204 (d) and (e) of the Code.

Section 207 (g) (credits for partially tax-free interest and for dividends received) is new. This is a clarifying change to eliminate any question as to the allowance of the credits provided in section 26 of the Code in computing normal tax and corporation surtax net income.

SECTION 168. TECHNICAL AMENDMENT TO DEFINITION OF "DIVIDENDS"

This amendment, with clerical changes, is required by reason of the amendments made in sections 165, 166, and 167 with respect to insurance companies and corresponds to section 148 of the House bill.

SECTION 169. TRANSACTIONS IN STOCKS, SECURITIES, AND COMMODITIES NOT CONSIDERED ENGAGING IN TRADE OR BUSINESS IN CERTAIN CASES

This section, which is identical with section 149 of the House bill, clarifies the meaning of the term "commodities" appearing in section 211 (b), Revenue Act of 1936, and corresponding provisions of subsequent revenue laws by providing that goods and merchandise in the ordinary channels of commerce are not within the scope of this term, so that the gains on transactions involving such goods and merchandise will not be exempt from tax in the case of nonresident aliens and foreign corporations.

SECTION 170. PERIOD FOR FILING PETITION EXTENDED IN CERTAIN CASES

This section does not appear in the House bill.

Under existing law if a notice of deficiency in income tax is mailed to a taxpayer he has 90 days within which to file his petition with the Board of Tax Appeals. In the case of a taxpayer in remote places, such as Hawaii or Alaska, this time limit may possibly work a hardship because of delays in transporting mail that may occur during the present hostilities. To correct this hardship section 272 (a) (1) of the code has been amended to increase the period to 150 days if the notice is mailed to a person outside the States of the Union and the District of Columbia. This extension applies only to deficiency notices mailed after the date of enactment of the act.

SECTION 171. STATUTE OF LIMITATIONS ON REFUNDS AND CREDITS

This section, except for a clerical change, is the same as section 150 of the House bill.

(A) LIMIT ON AMOUNT OF CREDIT OR REFUND

In section 322 (b) of the Code, paragraph (1) provides that unless a claim for credit or refund is filed within 3 years after the return was filed or 2 years after the tax was paid, no credit or refund shall be allowed or made after whichever period expires later. In paragraph (2) the amount of credit or refund which may be allowed or made is limited to the portion of tax paid within 3 years before the filing of the claim for refund, or, if no claim was filed, within 3 years before the allowance of the credit or refund. Paragraph (2) of section 322 (b) is amended by this section of the bill to provide that the amount of credit or refund which may be allowed or made where the claim is valid because filed within 2 years after the tax was paid is limited to the portion of the tax paid within 2 years immediately preceding the filing of the claim, and that the amount of credit or refund which may be allowed or made where no claim was filed and the credit or refund is valid because allowed or made within 2 years after the payment of the tax is limited to the portion of the tax paid in the 2 years immediately preceding the allowance of the credit or refund. Under section 322 (b) as so amended, the amount of the refund will be measured in each case only by those payments for which the claim could be filed, or because of which the credit or refund could be allowed or made, under the provisions of paragraph (1) if there were no later payements.

(B) LIMITATIONS IN THE CASE OF WAIVERS

Under section 276 (b) of the Code, the taxpayer and the Commissioner may agree in writing to extend beyond the period prescribed in section 275 the time within which the Commissioner may make an assessment. Subsection (a) of this section of the bill adds paragraph (3) to section 322 (b) to give the taxpayer the right to file a claim for credit or refund during the extended period and during 6 months thereafter in case an overpayment is discovered after the time for obtaining credit or refund of such overpayment under the provisions of section 322 (b) (1) and (2). The amount of credit or refund which may be allowed in the case of such a claim is limited to that amount which could be allowed if the claim was filed at the time the agreement was executed plus the portion of tax paid after the execution of the agreement and before the filing of the claim. In case a portion of the tax is paid after the extended period, claim may be filed within 6 months after such payment, but if such claim is not filed within 6 months after the extended period the amount of the credit or refund which may be allowed is limited to the portion of the tax paid within 6 months before the filing of the claim. If no claim is

filed under this paragraph, credit or refund may nevertheless be allowed at any time described in this paragraph to the extent that credit or refund could be allowed if claim therefor was filed at such time. Your committee has made a clerical change in the heading to this paragraph in order to indicate that it provides exceptions to the rules laid down in paragraphs (1) and (2) of section 322 (b).

(C) RETURN CONSIDERED FILED ON DUE DATE

If the taxpayer files his return before the last day on which it is due, the period in which he can file a claim for refund under the provisions of section 322 (b) (1), measured from the date the return was filed, will expire sooner than would be the case if he waited until such last day. This section of the bill adds paragraph (4) to section 322 (b) to provide that the period of limitations with respect to credit or refund is measured from the last day prescribed for the filing of the return in cases where the return is filed before such last day. This provision does not apply to taxpayers who are given the benefit of an extension of time in which to file their returns, and file the return before the last day of the extended period. For the purposes of section 322 (b) (2) and (3), and section 322 (d), this paragraph provides that advance payments of tax made at the time an early return was filed shall be treated as having been made on the last day prescribed by law for such payment (not including any extension of time for payment granted the taxpayer). The phrase "an advance payment made at the time such return was filed" in this paragraph includes all advance payments made during the period before the last day prescribed by law for the filing of the early return, not merely the advance payment made on the same day the early return was filed.

(D) SPECIAL PERIOD OF LIMITATION WITH RESPECT TO BAD DEBTS AND WORTHLESS SECURITIES

Paragraph (5) of section 322 (b), added by this section of the bill, provides that if a claim for credit or refund relates to an overpayment on account of the deductibility of a debt as a debt which became worthless, or of a loss from worthlessness of a security as that term is defined in sections 23 (g) (3) and 23 (k) (3), or the effect that the deductibility of a debt or loss described above has on the application by the taxpayer of a carry-over, claim may be filed within 7 years from the date provided by law for filing the return for the year with respect to which the claim is made. In the case of such a claim the amount of the credit or refund may exceed the portion of the tax paid during the period provided in section 322 (b) (2) or (3), whichever is applicable, to the extent of the amount of the overpayment attributable to the deduction of the items described in this paragraph. For example, if the taxpayer filed his return for the taxable year 1942 on March 15, 1943, he may file his claim on March 15, 1950, and the amount of the overpayment which may be credited or refunded on claim therefor is the portion of the tax, if any, paid within 2 years before the filing of the claim plus the amount of that part of the overpayment attributable to the fact that a deduction was not allowed in the taxable year 1942 for the loss from the worthlessness of a corporate bond in such year. The provisions of paragraph (5) do not

apply to an overpayment due to the deductibility of a debt that becomes partially worthless during the taxable year, but only to the deductibility of a debt which becomes entirely worthless within the taxable year. The carry-over referred to relates to such carry-overs as are provided in section 117 (e), concerning the carry-over of a capital loss, and section 122 (c), concerning the net operating loss carry-over. Any extension of the period for filing a return will not have the effect of extending the period in which to file a claim for refund under paragraph (5) of section 322 (b) as amended. As to the limitation on the allowance of interest for an overpayment where a claim is filed under the new paragraph (5), see section 124 (c) of the bill.

(E) OVERPAYMENT FOUND BY BOARD OF TAX APPEALS

Section 322 (d) of the Code provides that no refund of any portion of the tax found by the Board of Tax Appeals to be an overpayment shall be made unless the Board determines as part of its decision that such portion was paid within 3 years before the filing of the claim or the filing of the petition, whichever is earlier, or after the mailing of the notice of deficiency. Subsection (b) of this section of the bill provides amendments to these provisions corresponding to the amendments to section 322 (b) made in subsection (a) of this section of the bill.

There have been some decisions to the effect that the petition referred to in this provision of section 322 (d) which limits the amount of the credit or refund is not necessarily the petition which brings the case before the Board, but is that petition or the amendment thereto which asserts the grounds indicating the overpayment. Under these decisions the period of limitations runs against the taxpayer, while the case is before the Board, until the taxpayer files his petition in which he asserts, or until he amends it to assert, the grounds on which he claims an overpayment. In order to give the taxpayer the privilege to claim an overpayment before the Board by such amendments to his petitions as may be allowed under the rules of the Board, without the period of limitations running against the refund of such overpayment after the notice of deficiency is mailed, subsection (b) of this section of the bill amends section 322 (d) to provide that the period of limitations which determines the portion of the tax which may be credited or refunded is measured from the date the notice of deficiency is mailed, rather than from the date the petition is filed. There is only one notice of deficiency by reason of which the taxpayer goes before the Board, and the use of this date will avoid the confusion which now exists as to the meaning of the term "filing of the petition."

(F) EFFECTIVE DATE

Section 101 of the bill provides that (except when otherwise provided) the amendments made by title I of the bill shall be applicable only with respect to taxable years beginning after December 31, 1941. The amendments made by this section of the bill are therefore applicable only in the case of an overpayment made with respect to a taxable year beginning after December 31, 1941, and the existing provisions of section 322 of the Code continue to apply in cases involving an overpayment with respect to a taxable year beginning

before that date. However, the special period of limitation with respect to bad debts and worthless securities, provided by the amendment inserting paragraph 5 in section 322 (b), is specifically made applicable to overpayments made with respect to a taxable year beginning after December 31, 1938.

SECTION 172. REGULATED INVESTMENT COMPANIES

This section corresponds to section 151 of the House bill and amends sections 361, 362, and 363 of the Code and makes certain other technical amendments to other sections. The principal change made by the House bill was to eliminate the requirement that shareholders shall be entitled to redeem their stock for their proportionate interest in the corporation's properties, or the cash equivalent thereof less a discount not in excess of 3 percent. Thus, investment companies known as closed-end companies under the Investment Company Act of 1940 if they meet the requirements of section 361 (b), as amended, will come within the definition of the term "regulated investment companies" which has been substituted for the term "mutual investment companies." Common trust funds, or similar funds, not included in the definition of a common trust fund in section 169 of the Code and excluded by section 3 (c) (3) of the Investment Company Act of 1940 from the definition of an "investment company," have been included by your committee.

In the bill as reported by your committee, an investment company will not satisfy the requirements of section 361 (b) so as to come within the term "registered investment company" for any taxable year unless it files with its return for the taxable year an election to be a regulated investment company or has made such election for a previous taxable year which began after December 31, 1941. The election once made is irrevocable, and if for any given taxable year the investment company satisfies the other requirements of section 361 (b), it will be considered a regulated investment company. It will then be taxable under supplement Q if it distributes during the taxable year to its shareholders as taxable dividends other than capital gain dividends an amount not less than 90 percent of its net income for the taxable year computed without regard to net long-term and net short-term capital gains, and complies for such year with all rules and regulations prescribed by the Commissioner, with the approval of the Secretary for the purpose of ascertaining the actual ownership of its outstanding stock.

Under the various amendments made by your committee, the election by an investment company to be a regulated investment company will produce, among others, the following tax consequences:

1. In the determination of the earnings and profits of such a company for any taxable year beginning after December 31, 1941, such earnings and profits shall not be reduced by any amount which is not allowable as a deduction in computing its net income for such taxable year. Thus, if a corporation would have had earnings and profits of $500,000 for the taxable year 1942 except for the fact that it had a net capital loss of $100,000, which was not deductible in determining its net income for that year, its earnings and profits for 1942 if it is a regulated investment company would be $500,000. However, in determining its accumulated earnings and profits as of January 1, 1943, the earnings and profits for 1942 to be considered in such compu-

tation would amount to $400,000, assuming there had been no distribution from such earnings and profits. Due to the change made in the concept of earnings and profits of a taxable year of a regulated investment company, if such a company has no accumulated earnings and profits and makes distributions during the taxable year of an amount equal to its net income for that year, it will be allowed a dividends-paid credit equal to its net income and thus be relieved of any income tax for the taxable year provided it otherwise satisfies the requirements of supplement Q. The shareholders, on their part, will receive taxable dividends in the amount of such distributions. For the purpose of the earnings-and-profits concept, it is immaterial whether during the taxable year a regulated investment company is taxable under supplement Q. To illustrate, if it distributes an amount equal only to 50 percent of its net income for the taxable year, computed without regard to net long-term or net short-term capital gains, and thus is not taxable under supplement Q for that taxable year, nevertheless in determining earnings and profits for that taxable year if the corporation satisfies the requirements of a regulated investment company for that year such earnings and profits will not be reduced by any amount which is not allowable as a deduction in computing its net income for such taxable year.

2. Shareholders who receive distributions of capital-gain dividends from a regulated investment company shall treat such dividends as gains from the sale or exchange of capital assets held more than 6 months. A capital gain dividend is defined as any dividend or part thereof which is designated by the regulated investment company as a capital-gain dividend in a written notice mailed to its shareholders 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 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. Thus, if a regulated investment company advised its shareholders as of December 30, 1942, that of a distribution of $500,000 made December 15, 1942, $200,000 constituted a capital-gain dividend, amounting to $2 per share, and it was later discovered that an error had been made in determining the excess of the net long-term capital gain over the net short-term capital loss of the taxable year and that instead of such excess being $200,000 it was $100,000, then instead of each shareholder having received a capital-gain dividend of $2 per share he would have received a capital-gain dividend of $1 per share. This follows from the fact that only the portion of each distribution which shall be a capital-gain dividend is the proportion of the amount so designated, $200,000 in this case, which the excess of the net long-term capital gain over the net short-term capital loss, $100,000 in this case, bears to the aggregate amount so designated, $200,000.

Your committee has added a retroactive provision relating to earnings and profits relating to corporations that filed an income-tax return as a mutual investment company for any taxable year beginning after December 31, 1935, and before January 1, 1942. The amendment provides that the earnings and profits of such cor-

poration for such 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 net income for such taxable year; except that this provision shall not result in earnings and profits in the taxable year in excess of the aggregate of the distributions made by the corporation to its shareholders during the taxable year, exclusive of the amounts, if any, which the corporation advised its shareholders to be nontaxable for Federal income-tax purposes. Thus, if a corporation made a return as a mutual investment company for 1938 showing adjusted net income of $500,000 and a basic surtax credit of $500,000, and subsequently it was found that the company had no accumulated earnings and profits as of January 1, 1938, and its earnings and profits for 1938 amounted to only $450,000 instead of $500,000 due to the fact that there were losses of $50,000 which were not deductible against net income, the company will, nevertheless, be allowed a dividends-paid credit of $500,000 provided it has not advised its shareholders that $50,000 of the distribution was nontaxable. If it had advised the shareholders that $30,000 of the distribution was nontaxable, then the basic surtax credit under the amendment for 1938 would amount to $470,000, and the company would be taxable upon $30,000 of its adjusted net income.

To correspond with other changes made in the bill with respect to corporate income-tax rates, your committee has changed rates applicable to supplement Q net income to 24 percent of the amount thereof, and the rate applicable to supplement Q surtax net income to 16 percent thereof. A tax of 25 percent is also imposed upon 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 capital gain dividends paid during the year.

SECTION 173. AMENDMENTS TO SUPPLEMENT R

This section is substantially the same as section 152 of the House bill.

Supplement R first appeared in the Revenue Act of 1938, and was designed to cover exchanges and distributions which were made in obedience to an order of the Securities and Exchange Commission to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935. It has been found that in a number of instances direct exchange of properties is not feasible, and other methods, such as the sale of assets with the application of the proceeds to the purchase of other property or the retirement or cancelation of stock or securities, must be followed if the order of the Commission is to be executed. Consequently, it is thought desirable to extend the nonrecognition of gain provisions in supplement R to other situations made necessary by compliance with the Commission's orders in this field, and to make corresponding changes in the basis provisions of supplement R, so as not to exempt gains but merely to postpone their recognition. Certain amendments to supplement R have also been found to be desirable in order to clarify ambiguities.

Subsection (a) of this section amends section 371 (b), relating to transfers of property solely for property (other than nonexempt property), so as to provide for nonrecognition of gain where there is a

transfer of property in exchange for any kind of property, including money, if certain conditions are met.

If there is a loss realized upon the transfer of the property, section 371 (b), as amended, does not apply. Unless the transaction is governed by other provisions of supplement R, such as section 371 (d), the recognition of the loss will be determined by the provisions of the Internal Revenue Code outside of supplement R. This is a change from the existing law which recognizes neither gain nor loss in a transaction subject to the provisions of section 371 (b), and is deemed desirable in view of the changes that have been made in section 372 (b) with respect to adjustments in basis required to be made following a section 371 (b) transaction. If any of the nonexempt property received upon the transfer, or any of the amount equal to the fair market value of such property at the time of the transfer, is not exchanged or expended as required by section 371 (b), then the gain, if any, to the extent of the excess not so expended, shall be recognized. It is anticipated that in any case where the expenditure has not been made by the close of the taxable year in which the transfer occurs, the Commissioner, by regulations approved by the Secretary, will require the taxpayer either to furnish a bond in such amount and with such surety as may be required by such regulations, conditioned upon such expenditure within the 24-month period, or to file a waiver of the statute of limitations with respect to assessment of deficiencies for the taxable year of the transfer, or both. If, after the transfer, the transferor corporation does not have property with a sufficient basis to absorb the gain that has not been recognized, then any of the remaining gain after the basis of property has been reduced to zero shall be recognized. Section 372 (a) (2), as amended, sets forth the categories of property, the basis of which is required to be reduced, and the order in which the various kinds of property shall be selected for the purpose of reducing basis.

Section 371 (b), as amended by the bill, continues to have no application to an exchange of property by the transferor corporation directly for its own stock, if such an exchange represents a liquidating dividend. A corporation realizes no gain or loss in the mere distribution of its assets in kind in partial or complete liquidation.

If the transferor corporation sells property for cash and uses the cash or an amount equal to the same in a distribution in cancelation or redemption of the whole or part of its stock, excepting under a committee amendment a distribution having the effect of a dividend, gain will not be recognized upon the sale of the property if the distribution is made within the 24-month period, and the sale otherwise meets the provisions of section 371 (b). In order to take care of the case where a corporation sells property for cash and uses the cash or an amount equal to the same to retire or cancel its own indebtedness, section 371 (b), as amended, provides that there shall be no gain recognized from the sale of such property where the proceeds or an amount equal to the same are so used within the 24-month period.

Subsection (c) of this section amends section 372 (a) so as to make the existing provisions of section 372 (a) applicable only in the case of transfers of property subject to the provisions of section 371 (a) or section 371 (e), as amended. A new provision designated as section 372 (a) (2) covers cases where there are transfers of property subject

to the provisions of section 371 (b), as amended. This covers cases where transfers are made of property either solely for property (other than nonexempt property), solely for nonexempt property, or for nonexempt property and other property. Section 371 (e) is amended by subsection (g) of this section so as to have no application to a transaction covered by section 371 (b), as amended. Instead of property acquired upon the transfer taking the basis of the property transferred by the transferor corporation, the amendment has the effect of reducing the basis of the property of the transferor corporation, including the property acquired upon the transfer, by the amount of the gain not recognized upon the transfer. Section 372 (b) (2), as amended, sets forth the various categories of property the basis of which shall be reduced and the order in which such various kinds of properties shall be selected. Thus, if the taxpayer has any property of a character subject to the allowance for depreciation under section 23 (l), it would be necessary to reduce the basis of that property before reducing the basis of other property. The manner and amount of reduction to be applied to particular property is to be set forth in regulations prescribed by the Commissioner with the approval of the Secretary. In order for a gain not to be recognized under section 371 (b); the taxpayer must consent to such regulations in effect at the time of filing his return for the taxable year in which the transaction occurred. If the taxpayer has no property other than its own stock or securities or that of a corporation of which the transferor is a subsidiary, then any of the gain which has not been used to reduce the basis of other property will be recognized under section 371 (b).

Various amendments have been made in other sections of supplement R to conform to the changes made in section 371 (b) and section 372 (a), and in order to clarify the existing provisions. One important change is the amendment to section 373 (a) by subsection (d) of this section which eliminates the requirement that an order of the Securities and Exchange Commission must have been issued prior to January 1, 1943. Under existing conditions, it is not believed that there should be any time limit provided within which an order must be issued relating to a transaction otherwise subject to the provisions of supplement R.

Your committee has added a new subsection (h) to section 152 which amends section 113 (a) (17) so as to provide that in cases where property was acquired in a taxible year beginning before January 1, 1942, in any manner described in section 372 prior to its amendment by the Revenue Act of 1942, the basis shall be that prescribed in such section (prior to its amendment by such act) with respect to such property.

SECTION 174. TEMPORARY INCOME TAX ON INDIVIDUALS

SUBCHAPTER D. VICTORY TAX ON INDIVIDUALS

PART I. RATE AND COMPUTATION OF TAX

Section 174 of the bill amends the Internal Revenue Code by inserting at the end of chapter 1 a new subchapter D. Part I of this subchapter imposes an additional but temporary income tax on

individuals. Section 450 of this part imposes a Victory tax of 5 percent upon the Victory tax net income of every individual other than a nonresident alien subject to the tax imposed by section 211(a). The Victory tax is applicable with respect to taxable years beginning after December 31, 1942, and, under the provisions of section 476 of this subchapter, expires after the date of cessation of hostilities in the present war.

Section 451 defines the term "Victory tax net income." It consists of the gross income of the taxpayer (excluding capital gains and losses and interest allowed as a credit against net income under section 25 (a) (1) and (2)) less expenses and other allowable deductions connected with a trade or business, or incurred in connection with the production or collection of income, or in connection with the management, conservation, or maintenance of property held for the production of income. The specific deductions are contained in paragraphs 1 to 13, inclusive, of subsection (a) and the rules applicable with respect to similar deductions for purposes of the normal and surtax are also applicable with respect to these deductions. In the event a taxpayer elects to make his return and pay his tax under supplement T, the Victory tax net income is the gross income of the taxpayer. In computing the Victory tax net income the limitations contained in section 24 (relating to items not deductible from gross income) and the provisions contained in supplement J (relating to income from sources within possessions of the United States) shall be applicable; and in the case of nonresident aliens who are subject to the Victory tax the limitations contained in supplement H shall be applicable. In computing the Victory tax net income of a participant in a common trust fund or an individual carrying on business in partnership only the proportionate share of the ordinary net income or net loss of the common trust fund or partnership is to be taken into account. Subsections (e) and (f) of section 451 provide that such ordinary net income or net loss shall be computed as provided in sections 169 (d) and 183 (b).

Section 452 allows a specific exemption of $624 against the Victory tax net income. If a joint return is filed by husband and wife, an exemption of $1,248 is allowed, unless the Victory tax net income of one spouse is less than $624, in which case the specific exemption of both spouses is limited to $624 plus the Victory tax net income of such spouse.

Section 453 allows a credit against the Victory tax for each taxable year for the following expenditures made during the taxable year:

(1) The amount paid by the taxpayer during the taxable year as premiums on life insurance in force on September 1, 1942, upon his own life, the life of his spouse, or the life of any of his dependents specified in section 25 (b) (2) (A). This will cover amounts paid as premiums on life insurance which is a renewal or conversion of life insurance in force on September 1, 1942, to the extent that such premiums do not exceed the premiums payable on such life insurance in force on September 1, 1942.

(2) Amounts paid on indebtedness during the taxable year. This credit is limited to an amount by which the smallest amount of indebtedness of the taxpayer outstanding at any time during the period beginning September 1, 1942, and ending with the close of the preceding taxable year, exceeds the amount of indebtedness of the tax-

payer outstanding at the close of the taxable year. Thus if the taxpayer had a debt of $30 outstanding on September 1, 1942, and on December 31, 1942, and his debt outstanding as of December 31, 1943, was $20, he would be allowed a tax credit of $10 if such amount was not in excess of his post-war credit.

(3) The taxpayer is also allowed a credit against the Victory tax, but not in excess of the post-war credit, for the amount of the obligations of the United States owned by the taxpayer on the last day of the taxable year, which exceeds the greater of, (1) the amount of the obligations owned by the taxpayer on December 31, 1942, or (2) the highest amount of such obligations owned by the taxpayer on the last day of any preceding taxable year after December 31, 1942. For example, assume a taxpayer on December 31, 1942, owned obligations of the United States of $100. On December 31, 1943, he owned obligations of $200. He would be entitled, up to the amount of his post-war credit, to a credit of $100. If in 1944, he sold United States obligations in the amount of $200, and purchased additional obligations of $100, he would not be entitled to any such credit for 1944.

As used in this paragraph the term "owned by the taxpayer" includes the amount of obligations owned solely by the taxpayer and one-half of the amount owned jointly by the taxpayer with another but does not include obligations acquired by the taxpayer by gift or inheritance, or otherwise than by purchase; the term "obligations of the United States" means such obligations of the United States as the Secretary may by regulations prescribe, and as are purchased in such manner and under such terms and conditions as he may specify; and the term "amount of obligations of the United States" means the amount paid for them.

Section 454 allows a post-war credit or refund of the Victory tax in the following amounts:

(1) In the case of a single person, 25 percent of the Victory tax or $500, which ever is the lesser.

(2) In the case of the head of a family or a married person living with husband or wife where a separate return is filed by one spouse and no return is filed by the other spouse, 40 percent of the Victory tax, or $1,000, whichever is the lesser.

(3) In the case of a married person living with husband or wife, where separate returns are filed by each spouse, 40 percent of the Victory tax, or $500, whichever is the lesser.

(4) In the case of a husband and wife filing a joint return 40 percent of the aggregate Victory tax, or $1,000, whichever is the lesser.

(5) In addition to the above amounts, there is also allowed an amount equal to 2 percent of the Victory tax or $100, whichever is the lesser, for each dependent of the taxpayer.

If for any taxable year, the status of the taxpayer with respect to his marital relationship or with respect to his dependents changes, the amount of the post-war credit shall be apportioned according to the number of months before and after such change. In the case of a supplement T taxpayer, his status is to be determined as of July 1 of each year.

As soon as practicable after the cessation of hostilities in the present war, the amount of the post-war credit which has not been absorbed currently will be credited against any income tax or installment thereof then due from the taxpayer, and any balance shall be refunded immediately to him. A period of limitation provides that no post-war credit or refund of any part of the Victory tax shall be allowed or made after 7 years from the date of cessation of hostilities unless claim therefor is filed before the expiration of such date. No interest will be allowed on such credits or refunds. The amount of any credit taken by the taxpayer under section 453 shall reduce the credit allowed under this section by such amount.

Section 455 requires every individual having a gross income in excess of $624 for the taxable year to file a return stating specifically the items of his gross income and the deductions and credits allowed under this subsection. Such returns shall be made in accordance with regulations prescribed by the Commissioner with the approval of the Secretary. Fiduciaries are also required to make such a return for any individual, estate, or trust for which he acts if the gross income of such individual, estate, or trust is in excess of $624 for the taxable year. It is contemplated that returns required by this section will be made as a part of the regular income tax returns required by section 51. But in any case in which a taxpayer is not required to file a return under section 51, a separate return for purposes of the Victory tax will be required under this section.

Section 456 limits the amount of the Victory tax which may be imposed with respect to a taxpayer by providing that the Victory tax shall not exceed the excess of 90 percent of the net income of the taxpayer for the taxable year over the normal tax and surtax. For example, in the case of a married person with no dependents who has a gross income of $2,000,000 and a net income of $1,800,000, the normal tax and surtax will amount to $1,558,000. This will equal 86.56 percent of the net income. The 5-percent Victory tax, if computed without any limitation in such case, will amount to $99,968.80. The total normal tax, surtax, and Victory tax in such case will amount to $1,657,968.80 which will equal 92.11 percent of the net income. Therefore, the limitation will apply and the Victory tax will be reduced to $62,000 making the total tax $1,620,000 or 90 percent of the net income.

PART II. COLLECTION OF TAX AT SOURCE ON WAGES

Section 153 of the House bill provided a system of collection at the source on dividends, bond interest, and wages, the amount collected to be allowed as a credit against the taxes imposed by chapter 1. In lieu of these provisions of the House bill, your committee has substituted provisions coupling collection at the source with the proposed Victory tax on individual income and, in the interest of simplicity and ease of administration, has eliminated dividends and bond interest and limited the application of this system of tax collection to salaries, wages, and other forms of compensation for personal services. The bill provides that the amount of tax collected at the source shall be allowed as a credit against the Victory tax and any excess thereof over the Victory tax shall be allowed as a credit against the other taxes imposed by chapter 1.

Part II of subchapter D consists of sections 465 to 470, inclusive. Section 465 provides definitions for the more important terms used in part II. These definitions are substantially the same as those employed in the House bill except that the terms "recipient of the income," "bond," and "dividends" have been eliminated as unnecessary in your committee's version of collection at the source.

Subsection (a) of section 465 defines the term "pay roll period" to mean the period for which a payment of wages is ordinarily made to the employee by his employer.

The term "wages" is defined in section 465 (b), the definition being the same as that contained in the House bill. With certain specified exceptions, the term is defined to include all remuneration whether designated as salary, wages, fees, commissions, etc., and whether paid in cash or property, if paid for services performed by an employee for his employer. Under the exceptions provided, remuneration for the following services will not be subject to collection at the source: Services performed as a member of the military or naval forces of the United States. This exception does not extend to remuneration in the form of pensions and retired pay, if such remuneration is includible in gross income under the provisions of section 22 of the Code. In connection with this exception, it should be noted that the definition of the term "military or naval forces of the United States," contained in section 3797 (a) (15) of the Internal Revenue Code has been amended to specifically include the Women's Army Auxiliary Corps and the Women's Reserve Branch of the Naval Reserve. Exceptions are also provided with respect to remuneration paid for agricultural labor; domestic service in a private home, local college club, or local chapter of a college fraternity or sorority; and casual labor not in the course of the employer's trade or business. These exceptions are identical with the exceptions extended to such services for Social Security tax purposes and are intended to receive the same construction and have the same scope. These exceptions will relieve farmers, housewives, and others from the burden of collecting and accounting for small amounts of tax and will reduce the administrative burden and cost of collection entailed in the handling of numerous returns involving only nominal amounts. Exceptions are also provided with respect to remuneration for services as an employee of a nonresident alien individual, foreign partnership, or foreign corporation if such employers are not engaged in trade or business in the United States, and remuneration for services as an employee of a foreign government or a wholly owned instrumentality thereof.

In addition to the foregoing, an exception is provided for remuneration paid for services performed as an employee while outside the United States (as defined in sec. 3797 (a) (9)), unless the major part of the services performed during the calendar year by such employee for his employer are performed within the United States. Collection of the tax at source in the case of wages is limited by this exception to wages paid for services performed within the United States, including the District of Columbia and the Territories of Alaska and Hawaii. Under conditions created by the existing emergency, your committee considers it inadvisable to extend the proposed system of collection at the source to wages paid for services performed in our possessions, or leased areas, and other places outside the United States. The exception does not extend to wages paid an employee

whose services are performed partly within and partly without the United States if the major portion of such employee's services during the calendar year are performed within the United States. For instance, an employee who customarily performs services within the United States is temporarily absent from the United States on business of his employer. If he is absent from the United States for less than 6 months of the calendar year, the entire amount of the wages paid such employee for services performed during the calendar year is subject to withholding.

Subsection (c) of section 465 defines the term "withholding agent" to mean any person required, under the provisions of section 466, to withhold, collect, and pay the tax.

In order to avoid administrative difficulties, section 466 (h) provides that if the remuneration paid for services performed during one-half or more of any pay-roll period constitutes wages, all the remuneration paid for such period shall be deemed to be wages; but if the remuneration paid for services performed during more than one-half of such pay-roll period does not constitute wages, then none of the remuneration paid for such period shall be deemed to be wages. The rule prescribed is similar to that adopted for social-security tax purposes. A similar provision was contained in the House bill.

Subsection (d) of section 465 provides that the term "employee" includes any individual (in addition to any individual who is a servant under the law of master and servant) who performs service, of whatever nature, for a person (including the United States, a State, Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing), unless the service is performed by the individual in pursuit of his own independently established business. Subsection (d) also provides that the term "employee" includes an officer of a corporation.

This definition has the effect of requiring collection at the source, both where the master-servant relationship exists, and where, though no such relationship exists, the person performing the services is not performing them in the course of his own independently established business.

The common-law rules for determining whether the relationship of master and servant exists would be unnecessarily restrictive if they stood alone as the test for withholding-tax purposes. The principal inquiry under such rules, which were developed largely in the field of tort law, is whether the person for whom services are performed (the master) has a right to exercise control over the physical activities of the individual performing the services (the servant). Many persons, although not considered servants under the common-law rules, are employees in every real sense, and should not be grouped with those in fact engaged in an independently established business. Thus, in determining for tort purposes whether an individual who sells goods for a commission is an employee, it is important to know the extent of direction and control exercised over him; but the determination as to whether the withholding tax should apply in his case should be dependent upon the more practical test provided in subsection (d) in the definition of the term "employee." If the coverage were limited to the relationship of master and servant, there would be many difficulties in determining whether the common-law criteria

were met. The existence or nonexistence of the common-law relationship can be ascertained in doubtful cases (and there would be many such cases in view of the broad scope of the withholding tax) only after the gathering, in many instances by field investigation, of detailed information in each case.

The definition of "employee" is accordingly drawn to cover all common law servants, and in addition such other individuals performing services as are not in reality independent businessmen or independent practitioners of a profession, whether or not they are independent contractors at common law. Thus under this definition an individual may be an employee even though he is not subject to control. A large number of the cases which would be doubtful under the common-law control test alone involve individuals who are readily ascertained to be employees under the definition because they clearly do not have independently established businesses of their own. The formulation of general rules for determining whether an individual has an independently established business of his own is left to regulations to be prescribed by the Commissioner with the approval of the Secretary.

In the case of an independently established business, for example, that of a private practitioner of law or medicine, remuneration is normally received in small amounts from many persons. For obvious reasons, it is considered desirable to exclude these fees for personal services from the withholding provisions. On the other hand, where the doctor or lawyer is not engaged in his own private practice, but receives a salary from some other doctor or lawyer or some business enterprise such salary would be subject to collection at the source.

Service in the ordinary store is by or on behalf of the owner and is performed in pursuit of such owner's independently established business. But where the store is not independently established by the operator and he is performing his services for a salary, commission, or a share of the profits, under lease or other arrangement with the person whose business is being conducted through such outlet, withholding from the operator's remuneration is required.

In the case of the ordinary insurance solicitor, collection at the source would be made without regard to the existence of the master-and-servant relation between the solicitor and the person withholding, inasmuch as the solicitor has no independently established business.

Subsection (c) of section 465 provides that the term "employer" includes any person for whom an individual performs any service, of whatever nature, as the employee of such person. It is thus made clear that the employer concept is broadened to the extent that the employee concept is broadened under subsection (d) as heretofore explained.

Section 466 provides for collection at the source at a rate of 5 percent upon the wages of every individual to the extent that such wages are includible in gross income. For the purposes of this section, wages are includible in the gross income of the employee even though for income-tax purposes all or a portion of the amount of such wages is includible in the gross income of another person. For example, in the case of wages paid to persons domiciled in the so-called community property States, the amount of the tax to be withheld at the source in respect of each payment of such wages is determined without regard

to the fact that one-half of the amount of such wages may be includible in the gross income of the employee's spouse.

The provisions of section 466 are not applicable to individuals subject to withholding under the provisions of section 143 of the Code except with respect to wages paid to residents of a contiguous country who enter and leave the United States at frequent intervals. Residents of Canada and Mexico who are employed within and receive remuneration for services performed within the United States are subject to the provisions of section 143 under the terms of that section, but, pursuant to authority granted in section 143 (b), the Commissioner has by regulations exempted such persons from the requirement of withholding under such provisions. The effect of this exemption is to make such persons subject to the taxes imposed by sections 11 and 12, the same as in the case of residents of the United States, upon the wages received for services performed within the United States. Such persons are also made subject to the Victory tax imposed under part I of subchapter D. Accordingly, in the interest of simplicity and uniformity, your committee considered it advisable that such persons be treated the same as our own citizens for the purposes of collection at the source under these provisions of the bill. This treatment will relieve employers in the border cities such as Detroit, Buffalo, etc., from the burden of segregating, for the purpose of withholding, their resident and nonresident alien employees and will permit uniform treatment of all employees on the pay roll, regardless of residence.

Subsection (b) of section 466 provides that in the computation of the tax upon wages there shall be allowed as a deduction against the wages paid for each pay-roll period an amount based upon an annual deduction of $624 prorated in accordance with the length of the particular pay-roll period. Under the schedule provided in subsection (b) the amount of the deduction is determined as follows:

Pay-roll period:	Withholding deduction	Pay-roll period—Continued.	Withholding deduction
Weekly	$12	Quarterly	$156
Biweekly	24	Semiannually	312
Semimonthly	26	Annually	624
Monthly	52		

If the pay-roll period is less than 1 week, tax will be based upon the excess of the aggregate of the wages paid during the period of a calendar week over the deduction which would be allowed for a weekly pay-roll period. For example, assume that a person having no dependents is paid on a daily basis at the rate of $5 per day. No withholding is required with respect to the wages paid for the first 2 days of employment in any calendar week. The wages paid for a third day in the same calendar week are subject to withholding on $3, the excess of the aggregate of 3 days' wages ($15) over the weekly deduction ($12). Subsequent wage payments during the same calendar week are subject to withholding on the entire amount of each payment. If wages are paid for any pay-roll period not covered by the schedule set forth in the bill or for any period which does not constitute a pay-roll period, the allowable deduction for each such payment is measured by the amount of the annual deduction, divided by 365 and multiplied by the total number of calendar days in the period. If the amount of the deduction allowable with respect to wages paid for any period of 1 week or more exceeds the amount of wages paid

with respect to such period, the unused portion of the deduction allowable with respect to such period may not be carried over to a subsequent period.

Paragraph (4) of section 466 (b) prescribes the rule for computing the withholding deduction in the case of wages which are paid without regard to any particular period, as, for instance, commissions paid to a salesman upon the completion of a sale. In such cases it is provided that the withholding deduction shall be measured by the deduction allowable for an annual pay-roll period divided by 365 and multiplied by the number of days elapsed since the date of the last payment of such wages by such employer during the calendar year, or the date of commencement of employment with such employer during the calendar year, or January 1 of such year, whichever is the later.

Paragraph (5) of section 466 (b) provides that the total deduction allowed any individual with respect to wages received from any one employer during a calendar year shall not exceed the amount which would have been allowable if such individual had an annual pay-roll period. Thus, the maximum amount of the deduction allowable with respect to wages paid to an employee by any one employer during a calendar year is $624.

If an employee receives wages in the form of salary paid at periodic intervals and, in addition thereto, receives bonuses or commissions paid with respect to a different period or without regard to any particular period, the amount of the withholding deduction allowable with respect to the salary and the amount allowable with respect to such bonus or commission shall be determined independently under the rules applicable to each. In such cases, the limitation provided in paragraph (5) will operate to prevent the allowable deduction from exceeding the maximum deduction allowed an individual for a calendar year. Thus, if a person received a weekly salary for a 26-week period and at the end of such period received a bonus paid with respect to the 6 months' period, he will have been allowed an aggregate withholding deduction of $312 in respect of the weekly wages and will be entitled to a deduction of $312 with respect to the bonus, or a total of $624. Since the maximum allowance for the calendar year in the case of such individual is $624, no deduction will be allowed with respect to any further wages paid by the same employer during the same year.

However, an employee's remuneration may consist of salary in a specified amount plus a bonus or commissions for each pay-roll period. In such event the aggregate of the salary and commissions or bonus constitutes a single wage payment with respect to such period and only one withholding deduction is allowable with respect to each payment of such wages. For example, an individual is employed as a salesman at a monthly salary of $100 plus commissions upon sales made during the month. Such employee would be entitled to a withholding deduction of $52 against each such payment of salary and commissions considered as a single wage payment.

Under the provisions of section 466 (a), the amount of the tax to be withheld at source in respect of each payment of wages is determined by first ascertaining the excess of the wages paid for a particular pay-roll period over the withholding deduction applicable with respect to such period and applying the 5-percent rate to the result thus obtained. The computation thus involves both subtraction and multi-

plication. During the course of the hearings held by your committee, it developed that many employers have expressed a preference for a system of withholding under which the amount of tax to be withheld at source would be ascertained by the use of tables, under which the amount of the tax is determined directly from the gross wages without the necessity for any computation. Such a system, it was indicated, would simplify the process of collection at the source and help to minimize the requirements for additional business machines by employers charged with the duty of collecting and accounting for the tax. Your committee has, accordingly, provided under section 466 (c) that employers making wage payments upon the basis of a weekly, biweekly, semimonthly, or monthly pay period may, at their option, withhold and collect the tax determined in accordance with the tables provided in the bill, such tax to be in lieu of the tax required to be withheld under subsection (a).

Under the provisions of section 466 (d), the Commissioner is authorized to prescribe by regulations appropriate rules for withholding in those cases in which the withholding agent is unable to determine the amount of wages includible in gross income.

Under section 466 (e), payment by the recipient of the income of the tax required to be withheld by the withholding agent relieves such agent from collection of the tax, but does not relieve the agent from liability for interest or additions to the tax imposed under this supplement or under chapter 1 generally. Such interest and additions to the tax shall be computed from the date prescribed for filing the return and payment of the tax by the withholding agent to the date of payment by the recipient of the income.

Section 466 (f) provides that the gross income of the recipient shall include the amount of tax withheld at the source, and neither the recipient nor the withholding agent will be entitled to a deduction for the amount of such tax. The tax withheld at the source, however, is allowed as a credit against the Victory tax imposed upon the recipient of the income and any excess thereof over the amount of the Victory tax shall be allowed as a credit against the tax imposed by sections 11 and 12 or against the tax imposed by section 400, as the case may be. The recipient of the income, for the purpose of the credit provided in subsection (f), is the person subject to the Victory tax or the other taxes imposed by chapter 1 upon the wages from which the tax was withheld. For instance, if in a community-property State husband and wife make separate returns, each reporting one-half of the amount of wages received by the husband for income-tax purposes, each spouse would be entitled to one-half of the credit allowed with respect to the taxes withheld at source.

Subject to the provisions applicable to the refund or credit of the taxes imposed by chapter 1, section 466 (g) provides that refund or credit of tax overpaid under this part shall be made to the recipient of the income except in cases in which the tax was not withheld but was paid by the withholding agent, in which event refund or credit is to be made to the withholding agent.

Under the provisions of section 467, the person having control of the payment of wages is required to collect the tax by withholding from such payments the required amount. The term "person" as here used includes officers and employees of the United States and

also other political entities, and instrumentalities thereof. This includes corporations set up to carry on governmental functions. The duty to collect thus devolves upon the person actually in control of the funds as well as upon the employer for which he acts as agent.

Every withholding agent is made liable for the payment of the tax required to be withheld and collected, and is relieved of liability to any other person for the amount of any such payment. Any errors made by withholding agents either in the collection or payment of the tax for any quarter of a taxable year may be corrected in any subsequent quarter of the same year, under regulations to be prescribed by the Commissioner with the approval of the Secretary.

Section 468 provides that every person required to withhold and collect any tax under this subchapter shall make a return and pay such tax on or before the last day of the month following the close of each quarter of each calendar year. The bill provides that there shall be included with the final return for the calendar year a duplicate copy of each receipt furnished to employees from whom tax is withheld. Every withholding agent is required to keep such records and render under oath such statements as the Commissioner may require under regulations prescribed by him with the approval of the Secretary.

Section 469 requires the issuance of a receipt by the withholding agent to each employee from whom tax is withheld. Every employer must furnish a receipt to such employee on or before January 31 succeeding the calendar year for which the tax was withheld unless the employment is terminated before the close of the calendar year, in which event the receipt must be furnished on the day on which the last payment of wages is made to the employee. The receipts in every instance must set forth the period of employment covered, the wages paid by the employer during such period, and the amount of tax withheld with respect to such wages. Receipts in all cases shall be in such form and contain such further information as the Commissioner, with the approval of the Secretary, may by regulations prescribe. The section further empowers the Commissioner to require, under regulations prescribed with the approval of the Secretary, receipts at times other than those specifically provided by the section. The Commissioner is also authorized to grant by regulations a reasonable extension of time not to exceed 30 days for the furnishing of the receipt required upon termination of employment.

Section 470 provides criminal and civil penalties for the willful failure of any employer to furnish a receipt to the employee showing the information required under this supplement or regulations made pursuant thereto or for furnishing a false or fraudulent receipt. The criminal penalty is a fine of not more than $1,000 or imprisonment for not more than 1 year, or both, in addition to a civil penalty of not more than $50 for each such failure. These penalties are prescribed in lieu of the penalty imposed by section 145 of the Code, and are much less severe than those displaced.

Subsection (c) of section 470 also provides that the addition to the tax required by section 291 for failure to make and file a timely return shall, in case of any such failure by the withholding agent to make and file a return required by this part, be not less than $5.

PART III. EXPIRATION DATE

Part III of subchapter D contains definitions and the expiration date of the taxes imposed by this subchapter.

Section 475 provides that "net income" as used throughout the Code shall be construed to mean "victory tax net income" for the purposes of this subchapter. This section will make all provisions in the Code relating to net income applicable to the Victory tax net income unless otherwise distinctly expressed or manifestly incompatible with the intent thereof. This section defines the term "date of cessation of hostilities in the present war" to mean the date on which hostilities in the present war between the United States and Germany, Japan, and Italy cease, as fixed by the proclamation of the President or a concurrent resolution of both Houses of Congress, whichever is earlier. In the event hostilities between the United States and such governments do not cease at the same time the President is directed to fix an appropriate date for the purposes of this subchapter in the same manner as specified above.

Section 476 provides that the taxes imposed by this subchapter shall not apply with respect to any taxable year commencing after such date of cessation of hostilities.

TECHNICAL AMENDMENTS

Subsection (b) of section 174 of the bill is a clerical amendment to section 3 of the Code adding subchapter D to the classification of the provisions contained therein.

Subsection (c) of such section amends section 103 to permit the President to double the Victory tax in the same manner as he is permitted to double other taxes on citizens of foreign countries when he finds that citizens of the United States are being subjected to discriminatory or extraterritorial taxes by such foreign country.

Subsection (d) of such section amends section 131 (a) of the Code by providing that the foreign-tax credit shall be allowed before the credits for tax withheld at the source. This is merely a clarifying amendment to insure the correct order of application of the foreign-tax credit. In this connection, it should be noted that the foreign-tax credit is not allowed as a credit against the Victory tax by reason of the amendment made to section 131 (a) in section 160 of the bill.

Subsection (e) of such section adds a new paragraph to section 322 (a) of the Code relating to refunds of overpayments of tax. Where the amount of the tax withheld at the source under part II of subchapter D exceeds the tax imposed by this chapter (after deduction of the foreign tax credit, the tax withheld at source under section 143 and the post-war credit against the Victory tax allowed by section 453) the amount of such excess is to be credited against any income tax or installment thereof then due from the taxpayer, and any balance thereof shall be refunded immediately to the taxpayer. If the evidence discloses that the tax has actually been withheld, refund may be made to the recipient even though the tax has not been paid over to the Government by the withholding agent, since the withholding agent acts as the agent of the Government and losses through failure of such agent to pay the tax withheld should be borne by the Government and not by the recipient of the income. Such

subsection further amends section 322 to provide that, in the case of the recipient of the income, tax withheld at source shall be conclusively presumed to be paid on the 15th day of the third month following the close of the taxable year in which such tax is withheld. In the case of a nonresident alien individual, it shall be deemed to have been paid by him on the 15th day of the sixth month following the close of his taxable year. This exception in the case of nonresident aliens follows the provision of section 218 (a) of the Code which allows payment of their tax on the 15th day of the sixth month following the close of their taxable year. These rules are applicable whenever such date is material for tax purposes, as for the computation of interest on overpayments or the determination of the period of limitations on claims for refund, and so forth. The rule is adopted in the interest of certainty and administrative feasibility.

Subsection (f) of such section contains cross-references to various sections of the Code.

Subsection (g) of such section provides that the new subchapter D, and the technical amendments related to it which are contained in this section of the bill, shall take effect on January 1, 1943, and shall be applicable to all wages paid on or after such date.

Part II—Personal Holding Companies

SECTION 181. RATES OF PERSONAL HOLDING COMPANY TAX

This section, which is the same as section 181 of the House bill, increases the rates of personal holding company tax from 71½ and 82½ percent to 75 and 85 percent.

SECTION 182. EXEMPTION OF CERTAIN CORPORATIONS FROM PERSONAL HOLDING COMPANY TAX

This section is the same as in the House bill, except that with respect to licensed personal finance companies the language of existing law is restored, the limitation that a loan or investment corporation must be subject to the supervision of State authority having supervision over financial institutions is removed, and subsection (b) (relating to taxable years to which the section is applicable) makes changes intended to prevent any unfair application of the retroactive provision.

This section amends section 501 (b) of the Code, relating to exemptions from personal holding company tax. Exemption from the tax for taxable years beginning after December 31, 1941, is extended to loan or investment corporations which fall in the same general category as licensed personal finance companies. They exist in most States under various designations such as industrial banks, industrial loan and investment companies, loan corporations, loan and investment companies, banking companies, industrial loan and thrift companies, Morris Plan companies, special plan banks, installment investment companies, and consumer discount companies. These loan companies have many of the characteristics of banks except the right to accept deposits subject to check.

The House bill in the case of licensed personal finance companies and loan or investment companies imposed a limitation that the companies must be "subject to the supervision of State authority having supervision over financial institutions." In the case of licensed personal financial companies existing law requires that they be "under State supervision." The change made by the House bill might operate to deprive certain licensed personal finance companies from exemption since under the laws of some States they are subject to supervision by certain State officials who may not be considered as having supervision over financial institutions. This section is accordingly changed to restore the provisions of existing law with respect to licensed personal finance companies. In the case of loan or investment companies the laws of the various States are not as uniform as they are with respect to licensed personal finance companies. Many loan or investment companies are not under State supervision or subject to the supervision of State authority having supervision over finaneial institutions. In view of the fact that section 501 (b) (7) contains other limitations which appear adequate, this section is changed to eliminate the provision of the House bill that loan or investment companies be "subject to the supervision of State authority having supervision over financial institutions." In the case of these companies the requirement that they be under State supervision or any other similar provision is not believed necessary.

Section 182 (b) is changed so that the amendments shall be applicable to taxable years beginning after December 31, 1941, instead of December 31, 1938, with a proviso that the taxpayer may elect to have the amendments apply retroactively to all taxable years beginning after December 31, 1938, and not beginning after December 31, 1941. This change is necessary since personal holding companies are exempt under section 727 from the excess profits tax which first became applicable to taxable years beginning after December 31, 1939. For taxable years beginning in 1940 and 1941 a loan or investment company in order to avoid liability for personal holding company tax may have distributed its income for those years. If retroactively made subject to excess profits tax for such taxable years, the company might not have funds available to pay such tax. In order to prevent any unfair application of the retroactive provision the change made in the House bill gives the company an option to determine whether it desires retroactive application of the exemption.

SECTION 183. CONSOLIDATED INCOME

This section is the same as section 183 of the House bill, except that the last sentence has been stricken. Since your committee does not exclude personal holding companies from an affiliated group of corporations entitled to file consolidated returns, it is no longer necessary to provide for the determination of the gross income of such corporations for the purpose of the personal holding company income require-
are exempt under section 727 from the excess profits tax which first
ment in case a consolidated return is filed. As amended by this section, section 501 (c) extends the consolidated return privilege for the purposes of the surtax on personal holding companies imposed by section 500 only in the case of affiliated groups of railroad corporations which would have been entitled to file consolidated returns under section 141 prior to its amendment by this bill.

SECTION 184. COMPUTATION OF UNDISTRIBUTED SUBCHAPTER A NET INCOME

This section, which is not contained in the House bill, amends the personal holding company tax by adding a new subsection (d) to section 504 of the Code so as to permit a deduction in computing the undistributed subchapter A net income of amounts distributed before January 1, 1944, in redemption of preferred stock outstanding prior to January 1, 1934 (including preferred stock subsequently issued in lieu thereof), in cases where a corporation for the 4 year period immediately prior to January 1, 1934, in fact operated as a manufacturing, commercial, processing, or service company. The amendment allows a company to retire such preferred stock out of earnings or profits without subjecting the earnings or profits to the high rates of tax imposed on personal holding companies. The amendment is made applicable to taxable years beginning after December 31, 1940.

SECTION 185. DEFICIENCY DIVIDENDS OF PERSONAL HOLDING COMPANIES

This section, which is identical with section 184 of the House bill, amends section 506 of the Code by adding two new subsections. Subsection (g) is applicable with respect to a deficiency established or determined for a taxable year which begins after December 31, 1939, and does not begin after December 31, 1941, and increases the rates to be used in determining the amount of the credit or refund in the case of deficiency dividends from 65 and 75 percent to 71½ and 82½ percent.

Subsection (h) is applicable with respect to a deficiency established or determined for a taxable year which begins after December 31, 1941, and increases the rates to be used in determining the credit or refund in the case of deficiency dividends from 65 and 75 percent to 75 and 85 percent.

These amendments conform such rates to the personal holding company tax rates applicable to the taxable years involved.

SECTION 186. DISTRIBUTIONS BY PERSONAL HOLDING COMPANIES

This section is substantially the same as section 185 of the House bill, except that under subsection (i) (relating to additional credit or refund for prior years) there is a clerical change in the designation of the new subsection, and the period in which relief may be obtained is extended from 90 days to 6 months.

Under existing law a personal holding company having subchapter A net income in excess of its accumulated and current earnings and profits is subject to the personal holding company tax and cannot avoid such tax by making distributions to its shareholders. The primary reason for this result is that section 505 (d) limits capital losses to $2,000 and the dividends paid credit allowed by section 504 (a) is limited to the amount of an actual distribution, or a consent dividend, which is out of earnings or profits. For example, if the ordinary net income of the X corporation for the taxable year beginning January 1, 1940, was $100,000 and the corporation had a long-

term capital loss for such year of $100,000, it would have no net income under chapter 1. Its subchapter A net income, however, due to the limitation of $2,000 on the capital loss, would be $98,000. Although the corporation had no accumulated earnings or profits it would nevertheless be subject to a personal holding company tax and such tax could not be avoided or reduced even though it distributed $98,000 to its shareholders. A similar situation exists under prior revenue laws for taxable years beginning after December 31, 1936.

The amendments made by this section provide that any distribution to shareholders (not in complete or partial liquidation) made on or after the date of enactment of this act by a corporation which, for the taxable year in which such a distribution is made or for the taxable year in respect of which it is made under section 504 (c) of the Code, relating to dividends paid within 2½ months after the close of the taxable year, or section 506 of the Code, relating to deficiency dividends, or corresponding provisions of a prior income tax law, was under the applicable law a personal holding company, will now constitute a taxable dividend even if not paid out of accumulated or current earnings or profits. The corporation is allowed either a deduction for such a distribution for the taxable year in which, or with respect to which, such distribution was made or a deficiency dividends credit, as the case may be. This is in addition to the deduction now allowed for distributions out of earnings or profits. A distribution made as provided in the last sentence of section 351 (d) of the Revenue Acts of 1934 and 1936 does not, however, constitute a taxable dividend. Section 28 (d) (1), relating to shareholders' consents in the case of consent dividends, is amended so that consent dividends are taxable and the consent dividends credit is allowed even if the corporation has no accumulated or current earnings or profits.

This section similarly amends prior laws for taxable years of a corporation beginning after December 31, 1936, but subsection (g) provides that the amendments made by subsection (a) relating to definition of dividend, subsection (b) relating to source of distribution, subsection (c) relating to dividends paid after close of taxable year, and subsection (d) relating to deficiency dividends are not to be given retroactive application with respect to any distribution (including a deficiency dividend and a dividend paid within 2½ months after the close of the taxable year) made prior to the date of enactment of this act, which is a dividend solely by reason of such amendments unless certain specified conditions are met.

If for any such prior taxable year there was no distribution, or an inadequate distribution to shareholders, the corporation, even though it had no accumulated or current earnings or profits, may secure relief from the personal holding company tax for such year by using, within 1 year from the date of enactment of this act, consent dividends under the amendment made by subsection (e). If a deficiency has been determined or established for a prior taxable year some measure of relief may be secured by the use of the deficiency dividends credit or refund provisions as amended by subsection (d).

Subsection (h) provides for the refund or credit of overpayments for the taxable year involved to the extent resulting from the application of subsections (e) and (g) which would otherwise be prevented on the date of enactment of this act or within 1 year from such date.

Such refund or credit is to be made, if claim is filed within 1 year from the date of enactment of this act, notwithstanding the fact that some other provision of law or rule of law (other than compromise), e. g., statute of limitations, closing agreement, Board decision, or rule of res judicata, etc., would on the date of enactment of the act, or within 1 year from such date, prevent such refund or credit. Similar provision is also made for the assessment and collection of any deficiency for any taxable year to the extent resulting from the application of this section. This subsection is not applicable, however, where the refund or credit, and the assessment or collection of the deficiency, can be made within the statutory period of limitations.

Subsection (i) is designed to be used particularly in those cases where the tax has been paid in whole or in part for a prior taxable year. In such a case deficiency dividends cannot be used if the tax was not paid as a deficiency or if the time for claiming a deficiency dividends credit has expired. Furthermore, for various reasons it may not be possible to use consent dividends. Relief may be obtained by making a distribution within 6 months after the date of enactment of this act to shareholders of record as of the date of distribution. If the corporation elects to make such a distribution and files the claim required by section 506 (i), as amended, such distribution will have the same effect as a deficiency dividend, for purposes of computing credits or making refunds. The corporation can thereby secure a refund, without interest, of the personal holding tax; the shareholders to whom the distribution was made must include such distribution as a taxable dividend in their returns for the taxable years in which it is made.

The retroactive application of this section may be illustrated by the following examples:

(1) The X corporation for the calendar year 1937 was a personal holding company with a deficit at the beginning of that year. Its income for the year consisted of interest and dividends in the amount of $50,000, its allowable deductions excluding capital losses were $8,000 and it had capital losses of $40,000, of which only $2,000 were deductible in computing adjusted net income. It paid income taxes for the prior year of $10,000. Its adjusted net income for the year 1937 was $30,000 and it distributed to its shareholders $30,000 although for the taxable year it had no earnings or profits. The stockholders treated the distribution as a taxable dividend and the X corporation claimed a dividends paid credit of $30,000 and paid no personal holding company tax for that year. The Bureau disallowed the claimed credit since it was not paid out of earnings or profits and proposes to assert a deficiency of $22,300 in personal holding company tax. The stockholders thereupon filed claims for refund with respect to the tax they paid by treating the distribution as a taxable dividend. The case of the corporation and its shareholders is pending before the Bureau. Under this amendment if the X corporation within 1 year after the enactment of this act files a claim for the benefit of this section accompanied by signed consents under oath of each of the shareholders to whom such distribution was made agreeing to the inclusion of the amount of such distribution in his gross income as a taxable dividend, the corporate deficiency will be eliminated and the claim for refund filed by the stockholders will be rejected.

(2) If in the above example one of the individual stockholders of the X corporation to whom the distribution was made in 1937 died, and one stockholder was a corporation which had subsequently liquidated, the consent, in the case of each such stockholder, could be made by the duly authorized representative of such individual and corporation respectively.

(3) If in the above example the X corporation made no distributions in 1937 and in its return for that year paid the personal holding company tax of $22,300, subsections (h) and (i) of this section provide two methods by which the X corporation can secure a refund of such tax. It may within 1 year after the date of enactment of this act use the provisions of section 28 of the Revenue Act of 1938, as amended, relating to the consent dividends credit, which for the purposes of this section is made applicable by subsection (e) (2) to the calendar year 1937 and fiscal years beginning in 1937. The X corporation could thereby secure a refund of $22,300, with interest, and the persons who signed the consents (shareholders on December 31, 1937) would be required by reason of subsections (c) and (h) to pay additional taxes based on the amounts included in each consent. Instead of using the consent dividends credit provisions the X corporation, by reason of the amendment made in subsection (i), could within 6 months after the date of the enactment of this act elect to pay a dividend of $30,000 to its present stockholders and to have such dividend treated under the provisions of section 506 (i) as if it were a deficiency dividend. If the dividend is paid within such period and a claim is filed as required by section 506 (i) (1) the X corporation could secure a credit or refund, without interest, of $22,300 and its shareholders receiving the distribution would be required to treat it as a taxable dividend whether or not it had any accumulated or current earnings or profits.

TITLE II.—EXCESS PROFIT TAX

SECTION 201. TAXABLE YEARS TO WHICH AMENDMENTS APPLICABLE

This section, which is identical with section 201 of the House bill, provides that the excess profits tax amendments made by this title of the bill shall be applicable only with respect to taxable years beginning after December 31, 1941, except as otherwise expressly provided.

SECTION 202. RATE OF EXCESS PROFITS TAX

This section corresponds to section 202 of the House bill. It amends section 710 (a) (1) of the Code by inserting in lieu of the rate table now set forth therein a provision imposing the tax at a flat rate of 90 percent of the adjusted excess profits net income. Your committee, however, believes that the sum of the corporate normal tax, surtax, and excess profits tax should not exceed 80 percent of the corporation surtax net income (computed without any credit for income subject to excess profits tax). It has therefore amended this section to provide that the excess profits tax should be the lesser of the following: 90 percent of adjusted excess profits net

income, or an amount which when added to the tax imposed by chapter 1 (other than sec. 102) equals 80 percent of the corporation surtax net income computed without the credit provided in section 26 (e) for income subject to excess profits tax. The only other change made by your committee in the bill as passed by the House is a technical change to correlate the amendment made by this section with section 221 (b), amending section 710 (a) (2) of the Code, and sections 203 and 205 inserting section 710 (a) (3) and section 710 (a) (4), respectively, in the Code.

SECTION 203. CERTAIN FISCAL YEAR TAXPAYERS

The bill as reported by your committee strikes out section 129 of the House bill, relating to fiscal year taxpayers, and inserts in lieu thereof this section and section 141. The House bill relates to any taxable year beginning after December 31, 1940, which begins in one calendar year and ends in the following calendar year, if the law with respect to the respective years is different. The sections of the bill as reported by your committee apply only to a taxable year beginning in the calendar year 1941 and ending after June 30, 1942. Section 129 of the House bill relates to the normal tax, surtax, and excess profits tax. This section relates to the excess profits tax imposed by subchapter E of chapter 2 of the Code, while section 141 relates to the taxes imposed by sections 11, 12, 13, 14, and 15 of the Code.

Paragraph (3) of section 710 (a) of the Code, which is added by this section, provides that the tax under subchapter E of chapter 2 of the Code for a taxable year beginning in 1941 and ending after June 30, 1942, shall be an amount equal to the sum of (A) that portion of a tentative tax under such subchapter for the entire taxable year (computed as described below), which the number of days in such taxable year before July 1, 1942, bears to the total number of days in such taxable year, plus (B) that portion of a tentative tax under such subchapter for the entire taxable year (computed as described below), which the number of days in such taxable year after June 30, 1942, bears to the total number of days in such taxable year. Such paragraph (3) further provides in effect that the tentative tax under clause (A) above shall be computed under the law applicable to a taxable year beginning in 1941 (without regard to paragraph (3) of section 710 (a)) and at the rates (or in the amounts of tax) specified for such a taxable year; and that the tentative tax under clause (B) above shall be computed under the law applicable to a taxable year beginning in 1941, with certain modifications relating to certain deductions and credits, but at the rates (or in the amounts of tax) specified for a taxable year beginning in 1942. The tentative tax under clause (B) above is to be computed without regard to paragraph (3) of section 710 (a) except as certain provisions of the bill are made applicable by subdivision (B) of section 710 (a) (3).

SECTION 204. TWO-YEAR CARRY-BACK OF UNUSED EXCESS PROFITS CREDIT

This section, for which there is no corresponding provision in the House bill, amends section 710 (b) (3) and (c) of the Code. For the first time a carry-back of the unused excess profits credit is allowed.

The unused excess profits credit for any taxable year beginning on or after January 1, 1942, may be carried back and credited against the excess profits net income for each of the 2 preceding years (but not for any taxable year beginning before January 1, 1941), for the purpose of determining the adjusted excess profits net income for such taxable years. The unused excess profits credit for any taxable year which is not used as a carry-back may be carried forward, as under existing law, to the 2 succeeding taxable years. The amount which may be carried back or carried forward is limited in the case of each such preceding or succeeding taxable year to the portion of the unused excess profits credit which was not applied against excess profits net income in determining the adjusted excess profits net income for the taxable years before such preceding or succeeding taxable year. In determining the amount of the unused excess profits credit which was so applied, the adjusted excess profits net income is computed for any such taxable year without the specific exemption of $5,000 allowed by section 710 (b) (1), and without credit of any carry-over or carry-back from the taxable year in which such unused excess profits credit arose or from any taxable year subsequent thereto. The unused excess profits credit, which is a carry-over or a carry-back to such taxable year, is considered to have been applied against the amount so computed.

The following example illustrates the operation of this section: It is assumed that the taxpayer, on the calendar year basis, has an excess profits credit of $100,000. It has $125,000 excess profits net income in 1942, $185,000 excess profits net income in 1943, $55,000 excess profits net income in 1944, $25,000 excess profits net income in 1945, $30,000 excess profits net income in 1946, $160,000 excess profits net income in 1947, and $200,000 excess profits net income in 1948. Since the taxpayer has a $100,000 excess profits credit, and excess profits net income of only $55,000 in 1944, $25,000 in 1945, and $30,000 in 1946, it has an unused excess profits credit of $45,000 in 1944, $75,000 in 1945, and $70,000 in 1946. Such unused excess profits credit will form the basis for carry-backs and carry-overs computed as follows:

1. The amount of the $45,000 unused excess profits credit for 1944 which may be used as a carry-back to 1942 and 1943 and as a carry-over in 1945 and 1946 is computed as follows:

(*a*) For 1942, the carry-back is $45,000 (the amount of the unused excess profits credit).

(*b*) For 1943, the carry-back is $20,000, determined by deducting from the $45,000 unused excess profits credit the adjusted excess profits net income for 1942 computed without the deduction of the specific exemption or any carry-back from 1944 or from any year subsequent to 1944 (the $125,000 excess profits net income for 1942 less the $100,000 excess profits credit for such taxable year, or $25,000).

(*c*) For 1945 and 1946 there is no carry-over from 1944 since all of the unused excess profits credit has been applied against the excess profits net income for 1942 and 1943. To determine the carry-over, the $45,000 unused excess profits credit must first be reduced by the sum of the adjusted excess profits net income for 1942 and 1943 computed

for each such year without the deduction of any $5,000 specific exemption or of any carry-back or carry-over from 1944 or from any year subsequent to 1944 (for 1942, the $125,000 excess profits net income less the $100,000 excess profits credit for such year, or $25,000, plus, for 1943, the $185,000 excess profits net income less the $100,000 excess profits credit for such year, or $85,000, a total of $110,000).

2. The amount of the $75,000 unused excess profits credit for 1945 which may be used as a carry-back to 1943 and 1944, and as a carry-over to 1946 and 1947, is computed as follows:

(*a*) For 1943, the carry-back is $75,000 (the amount of the unused excess profits credit).

(*b*) For 1944, the carry-back is $10,000, determined by deducting from the $75,000 unused excess profits credit the $65,000 adjusted excess profits net income for 1943 computed without the deduction of the $5,000 specific exemption or of any carry-back from 1945 or any year subsequent to 1945 (the $185,000 excess profits net income for 1943, less the $100,000 excess profits credit and the $20,000 excess profits credit carry-back from 1944).

(*c*) For 1946, the carry-over is $10,000, determined by reducing the $75,000 unused excess profits credit by the sum of the adjusted excess profits net income for 1943 and 1944 computed for each such year without the deduction of any $5,000 specific exemption or of any carry-back from 1945 or any year subsequent to 1945 (for 1943, the $185,000 excess profits net income less the $100,000 excess profits credit and the $20,000 carry-back from 1944, or $65,000, plus, for 1944, the $25,000 excess profits net income less the $100,000 excess profits credit, or $0 adjusted excess profits net income).

(*d*) For 1947, the carry-over is also $10,000, since there was no adjusted excess profits net income for 1946, computed without the deduction of the $5,000 specific exemption or of any carry-over from 1945 or of any carry-over or carry-back from any year subsequent to 1945 (the $30,000 excess profits net income for 1946 less the $100,000 excess profits credit) to offset any of the carry-over to such year.

3. The amount of the $70,000 unused excess profits credit for 1946 which may be taken as a carry-back to 1944 and 1945, and as a carry-over to 1947 and 1948, is computed as follows:

(*a*) For 1944, the carry-back is $70,000 (the unused excess profits credit).

(*b*) For 1945, the carry-back is also $70,000, since there was no adjusted excess profits net income for 1944, computed without the deduction of the $5,000 specific exemption or of the carry-back from 1946 or from any year subsequent to 1946 (the excess profits net income of $55,000 for 1944 less the $100,000 excess profits credit and the $10,000 carry-back from 1945) to offset any of such unused excess profits credit for 1946.

(*c*) For 1947, the carry-over is also $70,000, since there was no adjusted excess profits net income in 1944 or 1945 to

offset any of the unused excess profits credit for 1946. The carry-over to 1947 is computed by reducing the $70,000 unused excess profits credit by the sum of the adjusted excess profits net income for 1944 and 1945, computed for each such year without the deduction of any $5,000 specific exemption or of any carry-back from 1946 or from any year subsequent to 1946. (For 1944, the adjusted excess profits net income so computed is $0, that is, the $55,000 excess profits net income for such year less the $100,000 excess profits credit and the $10,000 carry-back from 1945. For 1945, the adjusted excess profits net income so computed is $0, that is, the $25,000 excess profits net income for 1945 less the $100,000 excess profits credit.)

(*d*) For 1948, the carry-over is $20,000, computed by reducing the $70,000 carry-over to 1947 by the adjusted excess profits net income for 1947 computed without the deduction of the $5,000 specific exemption or of the carry-over from 1946 or of any carry-over or carry-back from a year subsequent to 1946 (that is, the $160,000 excess profits net income for 1947 less the $100,000 excess profits credit and the $10,000 carry-over from 1945).

The sum of the carry-backs and carry-overs to any taxable year, which may be credited against the excess profits net income for such taxable year to determine the adjusted excess profits net income, is the "unused excess profits credit adjustment" for such taxable year. Thus, in the above illustration, the "unused excess profits credit adjustment" for 1943 is $95,000, the sum of the $20,000 carry-back from 1944 and the $75,000 carry-back from 1945.

This section also amends section 710 (c) to provide that the unused excess profits credit for a taxable year of less than 12 months shall be reduced to an amount which is such part thereof as the number of days in the taxable year is of the number of days in the 12 months ending with the close of the taxable year. The excess profits credit is designed to apply against the excess profits net income for a 12-month period, and gross distortion results from treating the part not used in a short taxable year the same as the unused credit for a 12-month taxable year. Under existing law, the excess profits net income is placed on an annual basis by reference to the period of time involved in the short taxable year, and the excess over this amount of the excess profits credit is treated as an unused excess profits credit which may be carried over to succeeding taxable years. In effect, this places on an annual basis the excess of the excess profits credit allocable to the short period over the excess profits net income for such period, and permits this distorted amount to be carried over as a credit in succeeding years. For example, the taxpayer, with a $91,250 excess profits credit, changes from the calendar year basis to the fiscal year basis ending January 31. It files a return for the short period, January 1–31, 1942, in which period it has an excess profits net income of $6,200. This excess profits net income, placed on an annual basis under section 711 (a) (3), is $73,000, and the $91,250 excess profits credit for such taxable year exceeds this amount by $18,250. This $18,250 is an unused excess profits credit for the short taxable year under existing law. Since the $91,250 excess profits

credit is designed to apply to a year of 365 days, only $7,750 of the excess profits credit is properly allocable to the 31 day period, and only the $1,550 excess of this amount over the $6,200 excess profits net income should be treated as an unused excess profits credit for the short taxable year. Under the amendment made by this section, therefore, the $18,250 unused excess profits credit determined on an annual basis would be reduced by reference to the period of time included in the short taxable year (that is, $1,550, or $\frac{31}{365}$ of $18,250).

The amendments made by this section are applicable to all taxable years beginning after December 31, 1940. Thus, in the case of a taxpayer on the calendar year basis, the amendments made by this section are applicable in determining the carry-over from the taxable year 1940 to the taxable year 1941, and the carry-backs from the taxable years 1942 and 1943 to such taxable year.

SECTION 205. COMPUTATION OF EXCESS PROFITS AND INVESTED CAPITAL OF INSURANCE COMPANIES

This section corresponds to section 204 of the House bill.

Subsection (a) is new and amends section 710 (a) of the Code by providing a notch provision in the case of a mutual insurance company other than life or marine, where the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is between $75,000 and $125,000.

Subsection (b) is new and amends section 711 (a) (1) of the Code, by adding a new subparagraph providing a deduction from the normal tax net income of a life insurance company of the excess of the product of the figure determined and proclaimed under section 202 (b) and the excess profits net income computed without regard to the provisions of the new subparagraph over the adjustment for certain reserves provided in section 202 (c).

Subsection (c) revises the proposed amendment to section 711 (a) (2) of the Code, contained in the House bill, relating to the excess profits credit computed under invested capital by providing that in the case of a life insurance company there shall be deducted from the normal tax net income 50 percent of the excess of the product of the figure determined and proclaimed under section 202 (b) and the excess profits net income computed without regard to the subparagraph over the adjustment for certain reserves provided in section 202 (c).

Subsections (d) and (e) except for technical changes are the same as subsections (c) and (d) of the House bill. Subsection (d) amends section 718 of the Code to provide that the reserves of an insurance company shall not be included in computing equity invested capital under such section but shall be treated as borrowed capital as provided in section 719 of the Code. The latter section is amended to provide that in the case of an insurance company borrowed capital shall include the mean of the amount of the pro rata unearned premiums determined at the beginning and end of the taxable year, and that in the case of a life insurance company borrowed capital shall include the mean of the amount of the adjusted reserves, and the mean of the amount of the reserves on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which do not involve, at the time with reference to which the computation was made, life, health, or accident contingencies, determined at the beginning and

end of the taxable year. The treatment of insurance reserves as borrowed capital in section 205 is for the purpose of determining invested capital and does not mean that your committee regards these funds as in fact borrowed from the policyholders or believes that the policy contracts are in fact evidences of indebtedness.

SECTION 206. TECHNICAL CHANGES MADE NECESSARY BY CHANGE IN BASE FOR CORPORATION TAX

This section corresponds to section 205 of the House bill.

The change made by section 105 of the bill in the base of the income tax imposed by chapter 1 of the Code through the allowance of adjusted excess profits net income as a credit in computing normal tax net income requires certain technical amendments in computing excess profits net income under section 711 (a) (1) and (2) of the Code, which is based upon normal tax net income. This section of the bill disallows such credit in computing normal tax net income for purposes of both the excess profits net income computed under the income credit and the excess profits net income computed under the invested capital credit.

This section also repeals the provisions of existing law (section 711 (a) (1) (G) and (2) (I) of the Code) disallowing the deduction of the excess profits tax from gross income in determining other deductions which are based upon a percentage of the taxpayer's net income or net income from property. Such provisions of existing law are unnecessary in view of the general disallowance of the excess profits tax as a deduction, as provided by amendments made by section 105 (c) of the bill.

The only change made by your committee in this section of the bill is the elimination from the bill of the provision requiring computation of the excess profits credit carry-over from taxable years beginning in 1940 and 1941 under the law applicable to taxable years beginning in 1942.

SECTION 207. CAPITAL GAINS AND LOSSES IN THE COMPUTATION OF EXCESS PROFITS NET INCOME

In conformity with the changes made by section 152, this section changes the excess profits tax provisions which relate to capital gains and losses so as to treat gains and losses from the sale or exchange of capital assets held for more than 6 months in the same manner as long-term gains and losses are treated for excess profits tax purposes under existing law. The House bill contains similar provisions, but required a 15 month holding period. Both the House bill and this section strike out the special excess profits tax provision excluding from excess profits net income the excess of gains over losses from the sale or exchange of property subject to an allowance for depreciation, since such gains and losses will be excluded if they are treated as capital gains and losses under section 117 (j), added to the Code by section 153. Under existing law income from the retirement or discharge of obligations is excluded from excess profits net income if the obligations have been outstanding for more than 18 months, and your committee has inserted amendments changing this 18 month period to 6 months. In conformity with the changes made by

section 152 of the bill, a technical amendment is made to the provisions of section 711 (b) (2) which permit a net short-term capital loss carry-over in computing base period net income.

SECTION 208. RETROACTIVE TREATMENT OF INVOLUNTARY CONVERSIONS AS CAPITAL TRANSACTIONS

This section, for which there is no corresponding provision in the House bill, provides that gains and losses on the involuntary conversion of property of a character subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, shall be treated for excess profits tax purposes the same as gains and losses from the sale or exchange of such property. Under this amendment the excess of gains from such sales, exchanges, and involuntary conversions over the losses therefrom is excluded from excess profits net income. For the purposes of this section, property is involuntarily converted if it is destroyed in whole or in part, stolen, seized, requisitioned, or condemned. For example if a taxpayer has a gain of $1,000 from the sale of property of a character subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, a gain of $800 from insurance on such property which was destroyed by fire, or $1,800 of gain, and a loss of $600 from the total destruction by fire of such property which was not insured, the excess of $1,800 over $600 is excluded from excess profits net income. This section also provides that the determination of the period for which such property has been held shall be made under the same provisions as are applicable in determining the holding period of capital assets under section 117.

This amendment is applicable only to taxable years beginning after December 31, 1939, and not beginning after December 31, 1941. The amendments made by sections 153 and 207 of the bill, applicable to taxable years beginning after December 31, 1941, make it unnecessary to enact similar provisions with respect to taxable years beginning after December 31, 1941.

SECTION 209. NONTAXABLE INCOME FROM EXEMPT EXCESS OUTPUT OF MINING AND FROM BONUS INCOME OF MINES, ETC.

This section is new, no corresponding section having appeared in the House bill. Your committee has added a new section 735 and new subsections to section 711 (a) (1) and section 711 (a) (2) (relating to the computation of excess profits net income when the excess profits credit is computed under the income credit and under the invested capital credit, respectively) to provide for the exclusion in the computation of excess profits net income of a producer of minerals as defined in section 735, of nontaxable income from exempt excess output of mineral property and nontaxable bonus income provided in section 735.

Section 735 provides that for any taxable year for which the excess output of a mineral property which was in operation during the base period exceeds 5 percent of the estimated recoverable units from such property, nontaxable income from exempt excess output for such

taxable year shall be the exempt excess output for such year multiplied by the normal unit profit. Such amount, however, shall not exceed the net income, computed with the allowance for depletion, attributable to the excess output for such year. In the case of a coal mining or iron mining property which was in operation during the base period, nontaxable income from exempt excess output for any taxable year shall be an amount equal to the excess output of such property for such taxable year multiplied by one-half of the unit net income from such property for such year. The unit net income of a coal mining or iron mining property means the amount ascertained by dividing the net income from the coal or iron recovered from the property during the taxable year by the number of units of coal or iron recovered from such property in such year.

Nontaxable bonus income is the amount of income derived from bonus payments made by any agency of the United States Government on account of the production in excess of a specified quota of a mineral product the exhaustion of which gives rise to an allowance for depletion under section 23 (m), but such amount shall not exceed the net income attributable to the output in excess of such quota. If the income attributable to excess output includes bonus payments, the taxpayer may elect under regulations prescribed by the Commissioner with the approval of the Secretary, to receive the benefits of nontaxable income from exempt excess output or of nontaxable bonus income with respect to that portion of the excess output in excess of the taxpayer's quota.

Excess output is defined to mean the excess of the units of metal, coal, or nonmetallic substance in the minerals recovered from the operation of a mineral property for the taxable year over the normal output from such property. Normal output means the average annual units of metal, coal, or nonmetallic substance in the minerals recovered from the operation of a mineral property in the base period which, for the purposes of this section, means the taxable years beginning after December 31, 1935, but not beginning after December 31, 1939, of the person owning such property, whether or not such person be the taxpayer currently owning the property. The average annual units of metal, coal, or nonmetallic substance in the minerals recovered shall be determined by dividing the aggregate of the units recovered during such base period by the number of months for which the property was in operation during such period, and by multiplying the amount so ascertained by 12. Any property which was in operation for less than 6 months during such base period shall, for the purposes of section 735, not be considered to have been in operation during the base period. A mineral property means a mineral deposit, the development and plant necessary for the extraction of the deposit, and so much of the surface of the land as is necessary for purposes of such extraction.

Minerals are ores of the metals, coal, and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gravel, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand, silica, slate, soapstone, soda, sulfur, and talc.

The term "normal unit profit" means the average profit for the base period per unit of metal, coal, or nonmetallic substance in the minerals recovered from the mineral property during such period, determined by dividing the net income computed with the allowance for depletion computed in accordance with the basis for depletion applicable to the current taxable year, with respect to minerals recovered from the mineral property during the base period by the number of units of metal, coal, or nonmetallic substance in the minerals recovered from such property during the base period. Your committee expects that the Commissioner, with the approval of the Secretary, will prescribe regulations so that in any case in which two or more metals or nonmetallic substances, or one or more metals or nonmetallic substances and coal, exist in the minerals extracted from a mining property, proper allocation will be made of the net income attributable to such minerals among the units of metal, coal, or nonmetallic substances in the minerals.

The estimated recoverable units are the estimated number of units of metal, coal, or nonmetallic substances in the estimated recoverable minerals from the mineral property at the end of the taxable year plus the excess output for such year. This formula should be applicable whether the estimated recoverable units at the end of the year have been computed upon the basis of the estimated number of units at the beginning of the year less the year's output, or whether a new estimate has been made as of the end of the year. In any event, all estimates shall be subject to the approval of the Commissioner, and his determinations, for the purposes of section 735, shall be final and conclusive.

Exempt excess output for any taxable year is the number of units equal to specified percentages of the excess output for such year. These percentages vary from 100 percent if the excess output exceeds 50 percent of the estimated recoverable units, to 20 percent if the excess output exceeds 5 but not 10 percent of the estimated recoverable units. They afford a sliding scale of relief depending upon the rapidity with which the mineral property is being depleted.

The amendments made by this section, insofar as they are applicable to nontaxable bonus income, shall be applicable to taxable years beginning after December 31, 1940.

The provisions of section 711 (a) (1) (I), section 711 (a) (2) (K) and section 735 may be illustrated by the following examples:

1. Assume that for each of three nonferrous metal mines, the normal output during the base period was 100,000 tons, and that the net income with respect to the minerals recovered was $100,000, resulting in a normal unit profit of $1 per ton. During the taxable year, each of the mines produced 210,000 tons at a profit of $1.40 per ton, producing net income from such minerals of $294,000. At the beginning of the year, the reserves of mine A were 300,000 tons, of mine B were 1,000,000 tons, and of mine C were 2,000,000 tons. The adjusted excess profits net income for each mine would be computed as follows:

	Mine A	Mine B	Mine C
1. Net income	$294,000	$294,000	$294,000
2. Normal output (tons)	100,000	100,000	100,000
3. Excess output (tons)	110,000	110,000	110,000
4. Estimated reserves at end of year plus excess output (tons)	200,000	900,000	1,900,000
5. (3) as a percentage of (4)	55.0	12.2	5.8
6. Percentage of (3) which will constitute exempt excess output	100	30	20
7. Exempt excess output (tons)	110,000	33,000	22,000
8. Nontaxable income from excess output ((7) times normal unit profit of $1)	$110,000	$33,000	$22,000
9. Excess profits net income ((1)−(8))	$184,000	$261,000	$272,000
10. Excess profits credit (95 percent of base period earnings) and specific exemption of $5,000	$100,000	$100,000	$100,000
11. Adjusted excess profits net income ((9)−(10))	$84,000	$161,000	$172,000

2. If the previous problem, a quota of 100,000 tons had been established for each mine, and the current profit had included a bonus price of $0.40 per ton, since output in excess of the quota is 110,000 tons nontaxable bonus income would amount to $44,000. Whereas mine A would elect to retain the benefits of the exclusion for nontaxable income from exempt excess output, mines B and C would elect to receive the benefits of a $44,000 exclusion for nontaxable bonus income instead of an exclusion for nontaxable income from exempt excess output which, in the case of mine B, was $33,000, and, in the case of mine C, was $22,000.

3. Assume that the normal output of a coal mine during the base period was 100,000 tons, and the average net income from the property was $5,000. Assume that the output for the taxable year is 190,000 tons producing a net income, at a profit of $0.10 per ton, of $19,000. The excess profits tax of such mine would be reduced by this section by $4,050, as follows:

1. Taxable year net income	$19,000
2. Taxable year output (tons)	190,000
3. Normal output (tons)	100,000
4. Excess output (tons)	90,000
5. Profit per unit of production	$0.10
6. Product of (5) and (4)	$9,000
7. Nontaxable income (50 percent of (6))	$4,500
8. Excess profits net income ((1) less (7))	$14,500
9. Average earnings credit (95 percent of base period average plus $5,000 exemption)	$9,750
10. Adjusted excess profits net income ((8) less (9))	$4,750
11. Excess profits tax at 90 percent without the benefit of sec. 735	$8,325
12. Excess profits tax at 90 percent with the benefit of sec. 735	$4,275
13. Tax reduction	$4,050

SECTION 210. CREDIT FOR DIVIDENDS RECEIVED IN COMPUTATION OF EXCESS PROFITS NET INCOME IN CONNECTION WITH INVESTED CAPITAL CREDIT

This section, which is not contained in the House bill, amends existing law by providing that dividends on stock which is not a capital asset shall be included in full in the computation of excess profits net income of a taxpayer using the excess profits credit based on invested capital.

Under existing law stock is generally treated as an inadmissible asset and subtracted from invested capital. At the same time the dividends are excluded from excess profits net income. Stock which

is not a capital asset, however, is treated as an admissible asset. But dividends on such stock are included only to the extent that they exceed the dividends received credit.

Since stock which is not a capital asset is an admissible asset, and is not subtracted from invested capital through the inadmissible-asset adjustment, the entire amount of dividends upon such stock, and not merely the 15 percent included because of section 26 (b), should be subject to excess profits tax. The amendment made by this section accomplishes this result by providing that, in the case of a taxpayer using the excess profits credit based on invested capital, the credit for dividends received shall not be allowed with respect to dividends on stock which is not a capital asset. Since the result reached under the present law is clearly an oversight, this amendment is made applicable to all excess profits tax taxable years beginning after December 31, 1939.

SECTION 212. EXCESS PROFITS NET INCOME PLACED ON ANNUAL BASIS

This section is identical with section 208 of the House bill.

A corporation filing an excess profits tax return for a taxable year of less than 12 months is required under section 711 (a) (3) of existing law to place its excess profits net income on an annual basis by multiplying it by the number of days in a full year and dividing by the number of days in the short taxable year.

This section of the bill amends section 711 (a) (3) of the Code to provide that a taxpayer having a short taxable year may compute its excess profits tax for the short period with reference to its actual adjusted excess profits net income for a 12 month period. This provision affords relief similar to that granted by the amendments contained in section 136 of the bill with respect to the income tax. In the case of a short taxable year caused by the taxpayer becoming affiliated, or breaking affiliation, with a group filing a consolidated return for the period during which the corporation was affiliated, the regulations with respect to consolidated returns may, of course, make other provision for establishing the adjusted excess profits net income for a 12 month period, such as by requiring the corporation to use as the 12 month period the annual accounting period in which the short taxable year falls.

SECTION 213. INTEREST ON CERTAIN FEDERAL OBLIGATIONS

This section is the same as section 209 of the House bill and provides in effect that in the case of corporations employing the income credit in determining their excess profits tax, the credit for tax free interest on certain obligations of the United States and its instrumentalities provided in section 26 (a) shall be taken into account, along with the deductions and the credit for dividends received, in computing deficits in the base period income under section 713 of the Code.

SECTION 214. BASE PERIOD NET INCOME OF LOWEST YEAR IN BASE PERIOD

This section does not appear in the House bill.

Section 713 (e) of the Code, which provides for the determination of the general average base period net income, authorizes the exclusion of the largest deficit for any taxable year in the base period in such computation. Your committee has amended this section to provide however, that in case the excess profits net income or deficit in excess profits net income for a taxable year in the base period divided by the number of months in such year is less than 75 percent of the aggregate of the excess profits net income (reduced by deficits in excess profits net income) for the remaining years divided by the number of months in such remaining years (called average monthly amount), the base period net income for such year shall be an amount equal to 75 percent of the average monthly amount multiplied by the number of months in such year.

The increase in excess profits net income authorized by this amendment shall be applicable only in the case of 1 year in the base period, and to that year for which the increase in the income will produce the highest base period net income. The benefits afforded by this amendment extend to taxable years of less than 12 months as well as to taxable years of 12 months, and are available to taxpayers which were in existence only for a portion of the base period. However, taxpayers computing the excess profits credit based on income under section 713 (f) of the Code, relating to average base period net income in case of increased earnings in last half of base period, are not entitled as well, to the increase in base period net income provided by this amendment.

SECTION 215. CAPITAL REDUCTION IN CASE OF MEMBERS OF CONTROLLED GROUP

This section, which is identical with section 210 of the House bill, is applicable to taxable years beginning after December 31, 1941, and applies to any taxpayer which is a member of a controlled group and which owns stock in one or more corporations in such controlled group acquired after the beginning of the taxpayer's first taxable year under the excess profits tax. In general, it provides that such stock owned by the taxpayer on any day of the taxable year shall increase the daily capital reduction for such day (or, if the taxpayer has made no previous distributions resulting in daily capital reduction, such stock owned by the taxpayer on such day shall be a daily capital reduction for such day).

Two rules are provided by this section for the determination of the amount of the daily capital reduction on account of such stock for any day of a taxable year beginning after December 31, 1941. The first rule is to the effect that the daily capital reduction on account of such stock for such day shall be the aggregate of the adjusted basis (for determining loss upon sale or exchange) of the stock acquired by the taxpayer after the beginning of the taxpayer's first taxable year under the excess profits tax, minus the aggregate of the adjusted basis (for determining loss upon sale or exchange) of the stock disposed of by the taxpayer prior to such day and after the

beginning of the taxpayer's first taxable year under the excess profits tax. The second rule limits the amount of such daily capital reduction to the excess of the aggregate of the adjusted basis (for determining loss upon sale or exchange) of excluded capital, held by the taxpayer at the beginning of such day, over the aggregate of the adjusted basis (for determining loss upon sale or exchange) of excluded capital, held by the taxpayer at the beginning of its first taxable year under the excess profits tax. The daily capital reduction on account of such stock for any such day shall be an amount equal to the lesser of the amounts determined by the application of the foregoing rules.

In case any stock or obligation referred to in section 215 is disposed of prior to the day for which the computation is being made, its basis shall be determined under the law applicable to the year in which so disposed of. The excluded capital of the taxpayer for any such day shall be reduced by the amount by which the taxpayer's daily capital reduction for such day is increased under this section.

SECTION 216. INVESTED CAPITAL CREDIT

This section, which is identical with section 211 of the House bill, amends section 714 of the Code, relating to the excess profits credit based on invested capital, by changing the existing schedule of percentages of invested capital taken as the invested capital credit. Under existing law the invested capital credit is computed as 8 percent of the first $5,000,000 of invested capital and 7 percent of invested capital over $5,000,000. This amendment provides for a credit determined as 8 percent of the first $5,000,000 of invested capital, 7 percent of the next $5,000,000, 6 percent of the next $190,000,000, and 5 percent of the balance over $200,000,000.

SECTION 217. BASIS OF PROPERTY PAID IN

This section, which is the same as section 212 of the House bill, is designed to correct certain inconsistencies with respect to the basis of property paid in for stock, or as paid-in surplus, or as a contribution to capital.

Section 718 (a) (2) is amended to provide that if property paid in was disposed of before the taxable year, its basis shall be the basis for determining loss applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. This change coordinates the provision dealing with property paid in for stock with the provision dealing with the effect of the disposition of the property upon earnings and profits. Under section 115 (l), which governs the effect upon earnings and profits of the disposition of property for both income and excess profits tax purposes, the effect of the disposition of property upon such earnings and profits is determined by the law applicable to the year of disposition.

The second sentence to be inserted in the Code by this section amends section 718 (a) (2) to take care of the situation in which the property was disposed of prior to March 1, 1913, and provides that in such a case the basis of the property shall be considered to be its fair market value at the time paid in. This is the rule now applied where the taxpayer's basis is cost.

This section also provides that, if the unadjusted basis for determining loss of property paid in (which is the figure at which property paid in is included in equity invested capital) is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115 (l) for the purpose of determining earnings and profits. The change is designed to coordinate the adjustments to be made under section 718 (a) (2) with those entering into the computations under subsection (a) (4) and related provisions of section 718 pursuant to the provisions of section 115 (l).

SECTION 218. DEFICIT IN EARNINGS AND PROFITS OF ANOTHER CORPORATION

This section is new, no corresponding section having appeared in the House bill. Under existing law an operating loss of a corporation can reduce its invested capital through its accumulated earnings and profits but cannot reduce invested capital, if there are no earnings and profits, by being deducted from the money or property paid in to such corporation. Thus, although earnings and profits increase invested capital, deficits in earnings and profits do not decrease invested capital. Under section 751 of existing law, and under section 760 which has been inserted by this bill to amend section 751, for years beginning after December 31, 1941 (relating to invested capital in case of certain tax-free exchanges), invested capital of a "transferee," as defined in such sections, is computed by taking into account the adjusted basis for determining loss in the hands of the transferee of property received from the transferor. Any loss sustained by the transferor will be reflected in the invested capital of the transferee either in a reduced basis of assets received from the transferor or in a reduced amount of property which will be deemed to have been paid in for stock in case the transferor used borrowed funds to pay its losses, since such sections provide for a reduction in the amount of property deemed to be paid in for stock by the amount of indebtedness of the transferor. Thus, the so-called deficit rule is not applicable in the case of such tax-free exchanges and reorganizations.

Your committee has amended section 718 to provide that in certain cases the invested capital of a transferee, which otherwise would reflect a deficit of the transferor, will be increased by the amount of such deficit and that the invested capital of the transferor will be correspondingly reduced. The rule increasing the invested capital of a corporation by the deficit of its transferor will apply only if a corporation, called the transferor, transfers substantially all its property to another corporation called the transferee, which is formed especially to acquire such property, if (*a*) the sole consideration for the transfer of such property is the transfer to the transferor or its shareholders of all the stock of all classes (except qualifying shares) of the transferee; the assumption by the transferee of a liability of the transferor for the acquisition of property subject to such a liability shall be disregarded in determining whether the transfer is solely for stock; (*b*) the basis of the property in the hands of the transferee, for the purposes of this provision, is determined by reference to the basis of such property in the hands of the transferor; (*c*) the transferor is

forthwith completely liquidated in pursuance of the plan under which the acquisition of the property is made; and (*d*) immediately after the liquidation, the stockholders of the transferor own all the stock of the transferee. If these factors are present, the invested capital of the transferee otherwise computed shall be increased, and the invested capital of the transferor shall be decreased by the deficit in earnings and profits of the transferor which is attributable to the property so transferred. It is necessary to insure, however, that the transferee shall be deemed to have a deficit in earnings and profits so that subsequent earnings shall first be reduced by the amount of such deficit before any earnings and profits can be determined to have been accumulated and to increase invested capital, and to insure that the deficit of the transferor (which has been transferred to the transferee) shall not continue at the old amount, but should be reduced by the amount so transferred. Your committee has therefore provided that in computing the equity invested capital for any day after the date of acquisition of the property, the earnings and profits or deficit in earnings and profits of the transferee and the transferor shall be computed as if, immediately before beginning of the taxable year in which such transfer occurs, the transferee had been in existence and sustained a recognized loss, and the transferor had realized a recognized gain, equal to that portion of the deficit in earnings and profits of the transferor which is attributable to the property so transferred.

SECTION 219. AMORTIZABLE BOND PREMIUMS ON CERTAIN GOVERNMENT OBLIGATIONS

This section, which did not appear in the bill as passed by the House, makes a technical amendment to section 720 (d), relating to the treatment of Government obligations as admissible assets. It is designed to give effect to the rules under new section 125 of the Code, as added by section 126 of the bill, for deduction of amortizable bond premium in cases in which interest on bonds is included in income. Under the amendment to section 720 (d), the amount of interest on Government obligations, described in section 22 (b) (4), by which the taxpayer elects to increase its normal tax net income for excess profits tax purposes is to be reduced by the amount of the amortizable bond premium under section 125 attributable to such obligations.

SECTION 220. ABNORMALITIES IN INCOME IN TAXABLE PERIOD

This section, for which there is no corresponding provision in the House bill, makes technical amendments necessary for the proper computation of tax under section 721, relating to abnormalities in income in the taxable period. Section 721 (c) of existing law provides that if any net abnormal income for a taxable year is attributable to a previous taxable year, the tax for the taxable year shall be the tax computed by excluding such portion of the net abnormal income from gross income for such year, plus the increase in tax for the previous taxable year which would have resulted if such portion had been included in the gross income for such previous year. These provisions do not take into account the fact that, due to a carry-over of net

operating loss or of unused excess profits credit from the previous taxable year to another taxable year, the increase in tax as the result of attributing the net abnormal income to the previous taxable year may occur not in the previous taxable year but in a taxable year subsequent thereto. This section amends section 721 (c) to provide that, upon net abnormal income being attributed to a previous taxable year, the increase in tax which would result for any year subsequent to such previous taxable year (including the increase in tax for the current taxable year computed without including the net abnormal income in gross income for such current taxable year) shall be also included in the tax.

Example 1: The taxpayer has in 1940 an unused excess profits credit of $50, which is the basis for an excess profits credit carry-over in 1941. In 1944 the taxpayer has $80 net abnormal income attributable to 1940. The tax for 1944, computed under section 721 (c), is the tax for 1944 determined without including the $80 in gross income for that year, plus the increase in tax which would result if the $80 were included in gross income for 1940, that is, the increase in tax in 1940 which would result from the inclusion of such amount in gross income, and the increase in tax in 1941 which would result from there being no excess profits credit carry-over from 1940 because of the increase in the gross income for 1940 (the $80 attributed to 1940 offsets the $50 unused excess profits credit for such year).

Example 2: The taxpayer has a net operating loss of $200 in 1939 which forms the basis for a $200 net operating loss carry-over to 1940. In 1940 it has $150 net abnormal income which is attributable to 1939. The tax for 1940, computed under section 721 (c), is the tax for such year determined without including the $150 in gross income, plus the increase in tax which would result from the inclusion of $150 in gross income for 1939. Since the excess profits tax is not applicable to the taxable year 1939, there is no increase in excess profits tax for such year as a result of such inclusion. However, an increase in tax in 1940 would result from the $150, included in gross income in 1939, reducing the net operating loss for 1939, and accordingly reducing the carry-over to 1940. The increase in the tax for 1940 as a result of this decrease in the carry-over is included in computing the tax for 1940 under section 721 (c), that is, under that section the tax for 1940 is the tax determined without including the $150 net abnormal income in gross income, plus the increase in the tax so determined which would result from the carry-over from 1939 being reduced by including the $150 net abnormal income in gross income for 1939.

Furthermore, this section provides that if net abnormal income is attributed to a previous taxable year from one taxable year, and then an additional amount of net abnormal income is attributed to the same previous taxable year from a second taxable year, the increase in tax upon attributing the net abnormal income to the previous taxable year from the second taxable year shall be determined as if the net abnormal income attributed to the previous taxable year from the first taxable year remained in the gross income for such previous taxable year. Thus, if the taxpayer has a $100 loss in 1940, and has $100 net abnor-

mal income in 1941 attributable to 1940, and $100 net abnormal income in 1942 attributable to 1940, upon attributing the $100 from 1942 to 1940 the gross income for 1940 will be determined as if the $100 attributed to that year from 1941 remained in gross income for that year. Since the $100 attributable from 1941 would offset the $100 loss for 1940, the inclusion of the $100 from 1942 in gross income for 1940 results in a net income of $100 for that year.

Section 721 (d) also provides for the computation of the tax for future taxable years to which net abnormal income from previous taxable years has been attributed. The portion of the net abnormal income attributable to the future taxable year is included in gross income for such taxable year, but the tax resulting from this inclusion cannot exceed the savings in tax caused by the application of section 721 (c) to the taxable year in which the net abnormal income would be includible were it not for section 721, reduced by the aggregate of the increases in tax in the intervening taxable years caused by including portions of the net abnormal income in gross income for such taxable years. This section amends section 721 (d) in a manner similar to the amendments made to section 721 (c) so that the effects of carry-overs will be taken into account in determining the increases in tax in the intervening taxable years. This section also amends section 721 (d) to provide that, for the purpose of computing the carry-over from a future taxable year to any other taxable year, the net abnormal income attributable to the future taxable year shall not be included in the gross income for such future taxable year if it does not, due to the limitations of section 721, result in any tax for such future taxable year. This change prevents the carry-over from a future taxable year being reduced by those amounts, included in income, which have no tax effect.

This section also provides that in cases in which income from several previous taxable years is attributable to the same future taxable year, the limitations of section 721 (d) will be applied in the case of the portion attributable from the earliest previous taxable year as if that were the only amount attributable to such future taxable year under section 721, and similarly the amounts from other previous taxable years would be treated in chronological order giving effect to the computations with respect to previous amounts. Thus, for example, if $1,000 was attributed from 1940 to 1944, and $2,000 from 1941 to 1944, the limitations of section 721 (d) would be applied to 1944 as if the only net abnormal income attributable to that year was the $1,000 from 1940, the $2,000 from 1941 being treated as ordinary income for 1944. After making the computations under section 721 (d), the limitations of that section would then be applied with respect to the $2,000 from 1941. The tax, before the application of such limitations, would be considered to be the tax determined after applying such limitations with respect to the $1,000 from 1940, and the gross income and other amounts necessary to determine the adjusted excess profits net income are, for the purpose of applying the limitations to the $2,000, considered to be such amounts as would result in the adjusted excess profits net income which would produce such tax.

This section also provides that if in any taxable year net abnormal income from a previous taxable year is attributable to such year, and portions of the income for such year constitute net abnormal income attributable to previous taxable years, so that both section 721 (c)

and section 721 (d) apply to the taxable year, the tax for such taxable year shall be determined by applying the limitations of section 721 (d) first, and then applying the limitations of section 721 (c). This section also makes clear that any amount attributed to a base period taxable year has no effect upon the computation of base period net income, inasmuch as income is attributed to other taxable years only for the purpose of determining increases and decreases in tax which are taken into account in determining the tax under this section. Various other clarifying amendments are made to section 721.

In addition to the foregoing technical amendments, this section adds subsection (f) to section 721 so as to provide that if by reason of taking into account exploration, discovery, prospecting, research, or development of tangible property, patents, formulas, or processes, or any combination thereof extending over a period of more than 12 months, the constructive average base period net income as a result of the application of the relief provisions of section 722 is higher than if such activities had not been taken into account, no net abnormal income resulting from such activities which are of a class described in section 721 (a) (2) (C) shall be attributable to the base period, or to any year other than a taxable year under this subchapter.

The amendments made by this section are applicable to all taxable years beginning after December 31, 1939.

SECTION 221. RELIEF PROVISIONS

Except for certain amendments and additions made by your committee, this section is the same as section 213 of the House bill. Principal among these amendments are the provision making this section retroactive to taxable years beginning after December 31, 1939, and the elimination, explained hereinafter, of the limitations on the application and extent of relief under section 722 as passed by the House.

Constructive Average Base Period Net Income

In the light of the greatly increased excess profits tax rate, it is believed desirable to afford relief in meritorious cases to corporations which bear an excessive tax burden because of an abnormally low excess profits credit. Therefore section 722 which currently extends relief only in a limited class of cases is revised and broadened so as to remove existing inequities and to alleviate hardship in cases where relief cannot now be obtained. Under this revision, corporations satisfactorily establishing eligibility for relief will have their excess profits tax recomputed on the basis of the excess profits credit based on income. This credit will be predicated upon an amount which is a fair and just reflection of the normal earning capacity of the business and which it is entitled to retain before the imposition of an excess profits tax. Such amount will be used as a constructive average base period net income, replacing the actual average base period net income in the recomputation of the tax under this section. In the case of eligible taxpayers not now entitled to use the excess profits credit based on income, provision is made for the use of such credit computed upon the constructive average base period net income. In order to eliminate consideration of the effects of the war, it is

provided that, in determining the constructive average base period net income, no regard shall be had to events or conditions affecting the taxpayer, an industry of which it is a member, or taxpayers generally, occurring or existing after December 31, 1939. Thus high war prices, swollen demand, and other factors which would not be normal prior to the imposition of the excess profits tax shall be eliminated in the computation of the normal or average earnings capacity of the taxpayer. Your committee has provided, however, that in those cases described in the last sentence of section 722 (b) (4), relating to taxpayers the change in the character of the business of which accrued after December 31, 1939, and in section 722 (c), relating to taxpayers which came into existence after December 31, 1939, regard shall be had to the change in the character of the business under section 722 (b) (4) or the nature of the taxpayer and the character of its business under section 722 (c) to the extent necessary to establish the normal earnings to be used as the constructive average base period net income.

Eligibility For Relief

Relief under section 722 is available to two classes of corporations. First, to those entitled to use the excess profits credit based on income under section 713 if such credit does not represent normal earnings because, for certain reasons, the level of business during the base period was unusually low. If the average base period net income of a corporation is computed under supplement A such corporation shall be treated as if the business of any person, for the period for which the income of such person is included in the computation of the average base period net income of the corporation, were a part of the business of the corporation. Second, to those corporations not entitled to use the excess profits credit based on income if the invested capital credit of such corporations is abnormally low.

Taxpayers entitled to use credit based on average earnings.

To be eligible for relief, taxpayers which are entitled to use the average earnings credit under section 713 must establish that the average base period net income is not a fair measure of normal earnings because of one or more of the following reasons:

1. Normal production, output, or operation (including, in the case for example of corporations rendering a service such as advertising agencies, the services rendered) was interrupted or diminished in one or more of the taxable years in the base period because of events unusual or peculiar in the experience of the taxpayer occurring during or immediately prior to the base period. This is an expression of the same situation for which relief is granted under existing law, and is concerned primarily with physical rather than economic events or circumstances. Fires or floods would be events hindering the operations of the business.

2. The business of the taxpayer was depressed in the base period because of temporary economic conditions peculiar to such taxpayer or because it was a member of an industry which was depressed on account of temporary economic circumstances peculiar to such industry. A declining business or industry which was depressed because of economic conditions of a permanent rather than a temporary nature

does not come within this classification. As a general rule, high costs of production because of high costs of material, labor, capital, or other elements, low selling price of the finished product, low volume of sales due to a low demand for such product or the taxpayer's output, or other ordinary economic hazards to which business in general is subject are not sufficient reason to make the taxpayer eligible under this paragraph. Cases may obtain, however, where the presence of one or more of such factors is adequate reason for granting relief. For example, assume that a corporation for a long period of years conducted business with one customer which, during the base period, it lost because such customer decided to manufacture the product it heretofore bought. The corporation would be compelled to develop a new market. The average earnings of such corporation for the period of time during which it was engaged in obtaining new customers might not be a fair reflection of the normal earnings of such corporation and might furnish an unjust measurement for the computation of excess profits. Another illustration of this paragraph would be a corporation which belonged to an industry the members of which were engaged in a price war during several base period years. As a result of sales below cost during those years, the members of the industry sustained losses; when the price war was ended, such members resumed their normal earning level. Relief should be given to the corporation which, except for the unusual temporary economic conditions prevailing in its industry, would have earned normal profits throughout the base period.

3. The business of the taxpayer was depressed in the base period because conditions generally prevailing in an industry of which the taxpayer is a member are such that the taxpayer is subject either to a profits cycle which differs materially in length and in amplitude from the general business cycle, or to sporadic and intermittent periods of high production and profits and such periods are not adequately represented in the base period. The conditions which prevail in industries of the type described in this paragraph are conditions extending over the entire economic history of the industries rather than in the base period alone. Although it is impossible to define, categorically, the general business cycle, it is believed that the period from 1936 through 1939 was a period of moderate prosperity for business in general. If, therefore, the profit cycle of an industry did not coincide with the general business cycle, the base period might not furnish a satisfactory period for the determination of normal average profits of such industry. Consequently the members of the industry should not be penalized by being compelled to use the base period years if such period embraced only the trough of its cycle, but should be given the opportunity to establish the normal average earnings in periods which, with respect to the industry, are comparable to the base period with respect to business in general. The machine-tool industry is a possible example of this type of business with a business cycle different from the general business cycle. Machine tools remain in service for many years, and retooling orders, furnishing the opportunity for profit, do not necessarily occur with every period of business prosperity. Another type of industry, the business cycle of which may vary from the general business cycle, is the building industry.

The second type of taxpayer made eligible for relief is a member of an industry which does not have an earnings experience which can be

segregated into definite cycles, but whose prosperous years occur at irregular intervals and are dependent upon fortuitous combinations of advantageous circumstances. If such years are not sufficiently reflected in the base period, the taxpayer will be compelled to use as a measurement of normal earnings a period which does not represent average earnings. An industry engaged in the preparation and canning of fruit is a possible example of this class of business. Profits are dependent upon the size of the pack and the market price obtainable. Unless the base period reflects good years as well as poor, normal earnings are not adequately portrayed.

In the class of case described in this paragraph, depression during the base period resulted solely from circumstances usual in the case of the industry involved. This fact distinguishes such cases from those described in paragraph 2 wherein the depression is the result of unusual conditions. In order to qualify for relief under this paragraph, it is of course necessary for the taxpayer to show that the conditions which made the base period an inadequate measure for the industry in general also obtained specifically with respect to the taxpayer.

4. The taxpayer, either during or immediately prior to the base period, commenced business or changed the character of the business, and the average base period net income does not reflect the normal operation of the business so commenced or changed for the entire base period of such business. No arbitrary temporal limitations can be set forth upon the commencement of business or change in the character of business "immediately prior to the base period." Generally, an event can be considered to have occurred "immediately prior to the base period" if under normal conditions the effect of such event would not be manifested until sometime during the base period and would be directly related to such occurrence. For example, a corporation, which until 1934 manufactured snuff at a loss, in that year changed to the manufacture of cigars. Due to normal difficulties in establishing trade connections and in establishing its product, it did not realize normal earnings until 1938. Such corporation should be considered to have changed the character of its business "immediately prior to the base period." However, assume that in 1930 a manufacturer of general textiles converted its business to the manufacture of automobile upholstery. It enjoyed earnings for 8 years which were reasonable and stable. In 1938 it made a profitable connection with a large automobile manufacturer and, as a result, realized larger profits. The fact of such connection is not related to the change in the character of the business in 1930, and such change is too remote to have occurred "immediately prior to the base period."

If the business of the taxpayer, so commenced or changed, was growing so that by the end of the base period the taxpayer did not reach the earning level it would have attained had it commenced business or changed the character of its business 2 years before it did, the taxpayer shall be deemed to have commenced business or made the change at such earlier time. Opportunity is thus afforded growing taxpayers to establish within a period of normal earnings a larger earnings capacity as a result of the assumption that such taxpayer commenced business or changed the character of the business 2 years earlier than such events actually occurred. In determining whether such taxpayer was growing, consideration shall be given to the business experience of the taxpayer and to its prospects at the end of the

base period. Events occurring or existing after December 31, 1939, shall not be considered in ascertaining the growth of the taxpayer. For example, a concern which had formerly operated abroad commenced business in the United States in October 1939. Its known market was such that a plant capacity of X units was projected, although the concern had contracted for only half of these units as of December 31, 1939. Contracts for the remaining units were placed in 1940, and the concern was operating X units by the latter part of 1941. If such concern can prove, on the basis of facts existing prior to January 1, 1940, that it was expanding it will be deemed to have commenced business in October 1937. Another example of a growing business would be a corporation which, in 1938, started a delivery route selling food products such as peanuts, potato chips, and similar products. For 1938 it showed a loss. Its earnings for 1939 increased in each quarter-year period. With a record of steady growth such corporation might be deemed to have commenced business in 1936.

A "change in the character of the business" includes (*a*) a change in the operation or management of the business, (*b*) a difference in the products or services furnished, (*c*) a difference in the capacity for production or operation, (*d*) a difference in the ratio of nonborrowed capital to total capital, and (*e*) the acquisition before January 1, 1940, of all or part of the assets of a competitor with the result that the competition of such competitor was eliminated or diminished. Classifications (*b*), (*c*), (*d*), and (*e*) are recapitulations of definitions of change in the character and nature of the business found in existing law. Classification (*a*) is new. It is designed to make available the relief provisions to those corporations which have substantially improved business by the introduction of new processes of manufacture, or through the stimulation of new management running such business. For example, in 1936, a corporation was reorganized and the new directors made drastic changes in the management of the enterprise. The effect of the changes in sales and production policies initiated by the new management was not reflected in the company's earnings until 1939. A "change in the character of the business" has occurred warranting relief under this section. In 1936 a company engaged in coal mining converted from a system of hand loading, under which it lost money, to mechanized loading. As a result of decreased costs, it showed profits for subsequent years. The corporation is entitled to relief under this section. In 1938 a concern which marketed its product from door to door changed such sales methods to direct sales to retailers. As a result, its earnings increased. Such concern is eligible for relief. In all of the above cases the changes were so substantial as to warrant the conclusion that a "change in the character of the business" had occurred.

Paragraph 4 of the House bill contains a provision that if a corporation, prior to January 1, 1940, has made commitments binding it to make changes in the capacity for production or operation, and such changes are effectuated during a taxable year ending after December 31, 1939, the changes shall be deemed to give rise to a change in the character of the business December 31, 1939. Your committee has made a clarifying amendment to this provision to make it manifest that the commitments made need not take the form of legally binding contracts only. The amendment provides that any change in the capacity for production or operation of the business consummated

during any taxable year ending after December 31, 1939, as a result of a course of action to which the taxpayer was committed prior to January 1, 1940, shall be deemed to be a change in the character of the business as of December 31, 1939. The change described shall not be taken into effect in determining the constructive average base period net income with respect to any year prior to that in which the change was completed. A course of action to which the taxpayer was committed may be evidenced by a contract, the expenditure of money in the commencement of the desired changes, or other changes in position unequivocally establishing the intent to make the changes. For example, in 1939 a mining company began the development of a new mine and the construction of a new plant to be used in connection with such mine. Considerable sums of money were expended upon this product during the base period. The mine and the plant were completed and entered production in November 1941. There will be considered to be a change in the character of the business on December 31, 1939, for the purposes of the constructive average base period net income to be determined for the year in which such facilities were completed, and for subsequent years. In determining the amount of the constructive average base period net income, the extent to which the new facilities entered into the business of the corporation for the taxable year shall be considered to be the extent to which the character of the business was changed on December 31, 1939. It is also contemplated that the constructive average base period net income will be computed so as not to duplicate any credit inuring to the corporation on account of the treatment as new capital of such portion of the new facilities, or money or property expended in obtaining such facilities, which may have been paid into the corporation after the base period.

5. The business of the taxpayer during the base period was adversely affected by any other factor, resulting in an average base period net income which is an inadequate standard of normal earnings, and the taxpayer's claim for relief and the application of the relief as provided in this section would not be inconsistent with the principles underlying the eligibility requirements and the conditions and limitations set forth therein. Thus, corporations which do not meet the strict eligibility requirements set forth in this section are not debarred from relief if their case is within the spirit of the statute and if its application would not be inconsistent with its principles and conditions and limitations.

An example which your committee believes illustrates this paragraph would be a taxpayer which shortly before the base period undertook a business involving the manufacture of a product requiring an extensive period for preparation or manufacture, and which had no stocks of such product on hand at the commencement of such business. Since a large portion of the base period would be devoted to preparation of the product for sale, and since sales would consequently be small or nonexistent and would not serve as a measure of the normal operations of the business, the base period would represent an abnormal standard by which to compute excess profits. Although in such a case, it might be said that the business was not depressed during the base period since it was operating at full manufacturing capacity, and thus might not be entitled to relief under paragraph 2, it would seem clear that such a taxpayer is entitled to relief by way

of a constructive excess profits net income based upon more normal operations. For example, assume that a taxpayer was organized in 1935 to distill and sell whisky. It had no reserve whisky stocks on hand. During 1935 and for the greater part of its base period, it was aging the whisky it had distilled. Because of a lack of a marketable product, the sales of such taxpayer, and consequently its base period net income, were abnormally low and do not reflect results of usual operations. Relief should be extended to such taxpayer, the base period net income of which would not have been distorted if it had adequate whisky stocks on hand at the beginning of the base period.

Taxpayers not entitled to use credit based on average earnings.

Under existing law, a taxpayer not entitled to use the excess profits credit based on income is not entitled to relief. This places in a disadvantageous competitive position corporations commencing business after January 1, 1940, as well as other corporations deprived of such credit if the business is of a type showing a high return on invested capital, or if for some reason peculiar to the corporation, the invested capital is unusually low. The privilege of using the excess profits credit based on income is therefore extended to a taxpayer presently not entitled to use such credit, if the excess profits credit based upon the invested capital of such taxpayer furnishes an inadequate standard for the computation of excess profits because of one or more of the following reasons:

1. The business of the taxpayer is of a class in which intangible assets not includible in invested capital under section 718 make important contributions to income. For example, a corporation, which was of a class requiring little invested capital but necessitating the establishment of contacts with the trade which it was its business to supply, commenced business early in 1940. It lost money during its first 2 years of operations but by 1942 began to realize sizable profits. This company would be eligible to receive a constructive average base period net income on the grounds that one of its principal assets, the goodwill of its clientele, was not reflected in invested capital.

2. The business of the taxpayer is of a class in which capital is not an important income-producing factor. An illustration would be a corporation commencing business after January 1, 1940, doing business as fashion consultants. Although the corporation operates with very little capital, it cannot qualify as a personal service corporation because it employs a large technical and professional staff. The invested capital credit might not be an adequate credit for such a company. It would therefore be eligible for relief under this section.

3. The invested capital of the taxpayer is abnormally low. If the type of business done by the taxpayer is not one in which invested capital is small, but the invested capital of the taxpayer is unusually low because of reasons peculiar to itself such taxpayer is eligible for relief. An illustration would be a corporation which commenced business in 1941 with a leased plant valued at $1,000,000, but with invested capital paid in of only $40,000. Since the invested capital of such company is unusually low relative to the size of its operations, it would be subject to an unreasonable tax burden if required to compute its excess profits tax under the invested capital method. It

would therefore be given constructive average base period net income and would be entitled to compute its credit on the average earnings method.

The constructive average base period net income computed in the case of a corporation commencing business after January 1, 1940, is likely to duplicate, in some degree, the credit based upon capital additions. It is therefore provided that, for the purposes of adjustments in the excess profits credit on account of capital changes, the beginning of the taxpayer's first taxable year under the excess-profits tax law shall be the date after which capital additions and reductions are not taken into account in ascertaining the constructive average base period net income. For example, a corporation commenced business on April 1, 1940, with $10,000 of property paid in for stock. By November 1, 1940, $20,000 additional had been paid in, and by the end of its taxable year, December 31, 1940, $10,000 additional had been paid in. It is determined that the corporation is entitled to relief under this section, and a constructive average base period net income of a business of the kind existing on November 1, 1940, is given to the taxpayer. For the purpose of adjustments to the excess profits credit on account of capital additions or reductions, November 1, 1940, rather than April 1, 1940, will be deemed to be the beginning of the taxpayer's first excess profits tax taxable year.

Limitation upon amount of relief.

Your committee has deleted those provisions of the House bill which recapitulate existing law except for a reduction in a rate from 10 percent to 5 percent, and which provide certain limitations to be applied in determining eligibility for relief and in determining the final tax liability after relief has been given. The theory supporting those provisions was that cases involving relatively small tax savings should be excluded from the provisions of this section in order to avoid imposing an undue burden of cases upon the administrative agencies passing upon claims for relief. Your committee believes, however, that in view of the current high excess profits tax rate, no corporation actually entitled to relief should be denied the benefits of this section because its tax saving did not satisfy fixed standards.

ADMINISTRATIVE PROCEDURE

The administrative procedure presently provided for in section 722 is retained. In addition, however, since your committee has made the general relief provisions retroactive and applicable to all taxable years beginning after December 31, 1939, an amendment has been inserted extending the time for filing an application for relief, in the case of taxable years beginning after December 31, 1939, but not after December 31, 1941, to 6 months after the date of the enactment of the Revenue Act of 1942. If an application for relief for such years is not timely filed, any relief will be limited, as in the case of a claim for the current year not timely filed, to the amount of the deficiency finally determined without the application of the relief section. It is contemplated that the Commissioner, under the authority given to prescribe regulations providing for the extent to which the administrative limitations of the relief section may be waived for the pur-

pose of determining excess profits tax for subsequent taxable years, will provide that the constructive average base period net income determined under this section shall, in the absence of substantial evidence requiring a redetermination for future years, be the constructive average base period net income of the taxpayer for all such future years.

MINING CORPORATIONS

In section 209 your committee has amended the Code by inserting section 711 (a) (1) (I), section 711 (a) (2) (K), and section 735 so as to extend relief to certain mining corporations. Such relief is accomplished by exempting from excess profits tax a certain portion of current income. This portion is determined by multiplying the normal unit profit during a defined base period by a specified portion of current production in excess of normal output during such base period, or in the case of coal and iron mines by multiplying current excess production by one-half of the current net income per unit of coal or iron. In case the taxpayer was depressed during the base period, or would otherwise be entitled to relief by way of a constructive average base period net income under the provisions of section 722 there will exist no adequate unit profit and no normal output during the base period to be used in computing the special mining relief. Your committee has therefore added a subsection to section 722 to provide that if the constructive average base period net income of a mining corporation to which section 711 (a) (1) (I) or section 711 (a) (2) (K) applies is established under this section, there shall also be determined the fair and just amount to be used as normal output and normal unit profit for the purposes of section 735.

DEFERMENT OF PAYMENT OF TAX

Except for a technical amendment made to align it with other amendments to the Code, subsection (b) is identical with section 213 (b) of the House bill. Although it is believed advisable to require a taxpayer seeking relief under section 722 to compute and pay its tax without the benefit of such section, there are some cases in which it would be inequitable to compel the taxpayer to pay the entire amount of such tax. Section 710 (a) is therefore amended to provide that if the adjusted excess profits net income (computed without the benefit of sec. 722) for any taxable year in which the taxpayer claims relief under such section is in excess of 50 percent of the normal tax net income for such year (computed without the credit for adjusted excess profits net income) the amount of the tax payable at the time required for payment may be reduced by an amount equal to 33 percent of the reduction claimed in the tax. Thus, at the time required for payment, an eligible taxpayer need pay only 67 percent of that portion of the tax from which it claims relief. Any reduction in tax determined under section 722 in excess of the amount deferred by the taxpayer will have the effect of producing an overpayment of tax. Any determination of tax greater than the total amount paid will produce a deficiency.

ABNORMAL INCOME FOR THE TAXABLE YEAR

Your committee has deleted the provisions of section 213 (c) of the House bill relating to the treatment under section 721 of the Code of current abnormal income in cases where a constructive average base period net income is determined under section 722 of the Code. Provisions with respect to such cases have been provided by your committee in subsections (d) and (f) of this section and in section 220 (a), adding subsection (f) to section 721.

SPECIAL DIVISION OF BOARD OF TAX APPEALS

The provisions appearing in subsection (c) of this section, which corresponds to section 213 (d) of the House bill, have been changed by your committee from the provisions of the House bill. The House bill amended section 732 of the Code to provide for the establishment within the Board of Tax Appeals of a special division which would be the sole division of the Board hearing and determining and redetermining issues arising under section 711 (b) (1) (H), (I), (J), or (K) (relating to abnormal deductions within the base period), section 721 (relating to abnormal income in the taxable period), and section 722 (relating to general relief from discriminatory excess-profits taxes). Your committee believes that the burden upon such division would be too great were it required to hear, as well as to determine or redetermine these relief issues, especially with the abandonment of the limitations upon applications for relief contained in the House bill. Moreover, your committee believes that the involved economic problems inherent in section 722 are not present in cases under section 711 (b) (1) (H), (I), (J), or (K), or section 721 except subsection (a) (2) (C) thereof relating to income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulas, or processes, or any combination of the foregoing, extending over a period of more than 12 months. It believes that although cases under section 722 and section 721 (a) (2) (C) should still be reviewed by the special division of the Board established in the House bill, such cases may be heard initially by the regular divisions of the Board. Abnormality cases under section 711 (b) (1) (H), (I), (J), or (K) or under section 721, except section 721 (a) (2) (C), which on the whole do not involve problems of the nature of those presented by section 722, will, however, be disposed of without any review by the special division, in the same manner in which such cases are currently handled under existing law.

Your committee has therefore amended section 722 so as to provide for the establishment within the Board of Tax Appeals of a special division which shall review the determinations and redeterminations by any division of the Board involving any question arising under section 721 (a) (2) (C) or section 722. Such special division shall be constituted by the chairman and shall consist of not less than three members of the Board. The decisions of this special division shall not be reviewable by the Board, and the decisions upon issues under section 721 (a) (2) (C) and section 722 shall be deemed to be decisions of the Board.

Because of the complicated nature and the economic character of the issues involving relief under section 722, and abnormalities under

section 721 (a) (2) (C), and the broad discretionary powers lodged in the Board in the determination of such issues, it is essential that all such issues be decided by one group familiar with the problems involved. Only by this method can a consistent and uniform application of the principles established be assured in all cases. At the same time there is provided flexible machinery to coordinate cases involving both relief and abnormality issues as well as other questions.

SPECIAL RELIEF

BONUS INCOME OF INDUSTRIES WITH DEPLETABLE RESOURCES

Your committee has transferred the provisions of subsection (e) of section 213 of the House bill, relating to bonus income of industries with depletable reserves, to section 209, which relates to nontaxable income from exempt excess output of mining and from bonus income of mines.

RELIEF FOR INSTALLMENT BASIS TAXPAYERS AND TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS

Subsection (d) of this section corresponds with section 213 (f) of the House bill. Your committee, however, has made certain changes in the provisions relating to installment basis taxpayers and has added provisions extending relief to taxpayers with income from long-term contracts.

INSTALLMENT BASIS TAXPAYERS

Under current business conditions a corporation doing business on the installment plan and reporting income under the installment method of accounting may have a current taxable income which is larger than in previous years. This result is possible (1) because with declining sales income will not fall as rapidly as operating costs, (2) because regulation W, adopted by the Board of Governors of the Federal Reserve System in August 1941, has the effect of increasing the size of down payments and of shortening the payment period on installment contracts, and (3) because concerns which have shifted production to war products will report in the current year income received from prior installment sales as well as income currently accruing on the war contracts.

The House bill added section 735 to the Code to provide that in the case of a taxpayer which reports income on the installment basis and which establishes that the average volume of credit extended to purchasers on the installment plan in the 4 preceding taxable years was more than 125 percent of such credit extended to such purchasers in the taxable year, such taxpayer for excess profits tax purposes may elect in its initial return for such taxable year to compute its gross income from installment sales on the accrual basis. Your committee has renumbered this section as section 736 (a) and has amended the eligibility requirements so as to provide an election to taxpayers which can establish (a) that the average volume of credit extended to purchasers on the installment plan in the 4 taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 percent of such credit extended to such purchasers in the taxable year, or (b) that the average outstanding installment accounts receivable at the end of each of the 4 taxable years preceding

the first taxable year beginning after December 31, 1941, was more than 125 percent of the average of such accounts receivable at the end of the taxable year. If in either case the taxpayer was not in existence for the 4 previous taxable years, the taxable years during which the taxpayer was in existence shall be used; in any event only those years for which the income was computed under the installment method provided in section 44 (a) shall be taken into account. Under the amendment of your committee, the election is to compute income rather than gross income. Under the House bill the election extended by this section, when once made, is irrevocable and applies to all subsequent taxable years. Your committee has amended this provision to provide taxpayers with a new election to resume the reporting of income on the installment basis when the eligibility requirements of this section are no longer satisfied. Under the House bill the gross income from installment sales for each taxable year prior to that with respect to which the election is made to report income on the accrual basis, but beginning after December 31, 1939, as well as for the taxable year in which such election is made, shall be adjusted to conform to such election. Your committee has provided for the computation of income, rather than gross income, upon the accrual basis in such years. However, no amount shall be included in excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940, and the average base period net income shall not be increased by any payment received after the base period and attributable thereto.

If a taxpayer, which has elected to report income on the accrual basis under section 736 (a) establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that in a taxable year subsequent to the year with respect to which such election has been made it would not be eligible to elect the accrual method, the taxpayer may in accordance with such regulations elect in its return for such year to abandon the accrual method. When once made, such election shall be irrevocable and shall preclude any further elections under section 736 (a). For the taxable year in which the election to resume the installment method of accounting is made and for subsequent taxable years, income shall be computed in accordance with section 44 (c) of the Code.

TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS

Your committee has added a new subsection (b) to section 736 to provide relief to taxpayers reporting income from long-term contracts upon the completed contract method of accounting. Such income is bunched in the year in which it is reported and unless it is spread out over the period of the contract under which the work has been performed a distorted picture of the taxpayer's true earnings for such year is presented. Since only one excess profits credit would be allowed in computing adjusted excess profits net income for such year, whereas several excess profits credits would have been utilized if the income from the contract were returned in the years during which the work was being done, an inordinate excess profits tax would be collected from such taxpayer upon such income. Your committee has therefore provided that if it is abnormal for the taxpayer to derive income from contracts the performance of which requires more than

12 months, or if the taxpayer normally derives income from such contracts but the amount of such income included in gross income for the taxable year is in excess of 125 percent of the average amount of the gross income from such contracts for the 4 previous taxable years, or if the taxpayer was not in existence during all of such years, the taxable years during which the taxpayer was in existence, such taxpayer may elect for excess profits tax purposes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, to compute in its return for such taxable year its income from such contracts upon the percentage of completion method of accounting. When once made this election shall be irrevocable and shall apply to all other contracts, past, present, or future, the performance of which requires more than 12 months. The net income of the taxpayer for each year prior to that with respect to which such election was made, including the base period years of the taxpayer, shall be adjusted for excess profits tax purposes to conform to this election. Income from contracts the performance of which requires more than 12 months shall not be considered abnormal income under section 721.

ADJUSTMENT ON ACCOUNT OF CHANGE

Your committee has retained the provisions of the House bill authorizing adjustment of the excess profits net income of the years prior to that with respect to which the elections under this section have been made despite the fact that such adjustments might otherwise have been prevented by any other provision or rule of law (other than set forth in this section and in section 3761 relating to compromises). It has, however, broadened the scope of this provision so as to include within its purview long-term contracts under subsection (b) and adjustments in the tax imposed by chapter 1 stemming from the operation of this section.

TECHNICAL AMENDMENTS

Subsections (e) and (f) of this section are new, no corresponding provisions having appeared in the House bill. Your committee has provided that the amendments by this section to section 722 shall be applicable with respect to taxable years beginning after December 31, 1939. The provisions of section 721 (a) (2) (B) of the existing law relating to abnormalities on account of long-term contracts, are no longer necessary in view of the amendments made by your committee to section 736 (b) with respect to income from contracts the performance of which requires more than 12 months, and have therefore been made inapplicable with respect to taxable years beginning after December 31, 1941.

SECTION 222. EXEMPT CORPORATIONS

This section is the same as section 214 of the House bill, and in addition contains subsections (a) and (b) which were not in the House bill.

It amends section 725 (relating to exemptions of personal service corporations from excess profits tax) and section 727 (relating to corporations exempt from excess profits tax) so as to provide that any cor-

poration which would otherwise be exempt from excess profits tax and which is a member of an affiliated group of corporations which files a consolidated return under section 141 shall not be exempt from the excess profits tax.

In addition, this section amends section 727 (c) and (d) (relating to exemption of certain investment companies from excess profits tax) so as to conform with amendments made by section 172 of the bill, relating to the income tax applicable to regulated investment companies. Under the amendment an investment company that is entitled to the special income tax treatment under supplement Q for its taxable year is exempt from excess profits tax for the same taxable year. However, in order for such an investment company to be exempt from the excess profits tax, it is not required to comply with the provisions of section 361 (b) (3) which requires an amount not less than 90 percent of its net income for the taxable year, computed without regard to net long-term and net short-term capital gains, to be distributed to shareholders as taxable dividends during the taxable year.

SECTION 223. EXCESS PROFITS TAX RETURNS

This section, for which there is no corresponding provision in the House bill, eliminates the requirement of prior law that the return of a taxpayer subject to the excess profits tax must contain two sets of computations of the excess profits credit, one under the income method, the other under the invested capital method. As a corollary to such change, this section also repeals the optional provision which permitted the taxpayer to disclaim either method of computing its credit. These amendments are applicable to taxable years beginning after December 31, 1939.

Under the present amendments, it is intended that a return setting forth the computation of the credit under only one of such methods shall be acceptable. In the case of such a return, it should be audited as filed. The further question whether the use of the other method would result in a lesser tax need not be considered in connection with the audit of the return. Nevertheless, a corporation which files such a return is not, by reason of the fact that only one method was employed, precluded from establishing that such computation resulted in an overpayment of its excess profits tax for the taxable year or from filing a claim for the refund thereof.

Moreover, since the amendments made by section 223 are retroactive to taxable years beginning after December 31, 1939, previous disclaimers are rendered ineffective. Thus, if a taxpayer used one method of computing its credit for a prior year and disclaimed the other method, and if it can establish that the method used resulted in an overpayment of excess profits tax for such year, it may, within the applicable period of limitation, file a claim for the refund of such overpayment.

SECTION 224. CONSOLIDATED RETURNS

This section, which is the same as section 215 of the House bill, amends section 729 (b) by inserting a cross reference to section 141 which contains provisions relating to the privilege of making con-

solidated income and excess profits tax returns. Section 730 of the current law, which provides for such returns for excess profits tax purposes, is therefore unnecessary for years beginning after December 31, 1941, and is made inapplicable with respect to such years.

SECTION 225. EXEMPTION FROM TAX OF MINING OF STRATEGIC METALS

This section does not appear in the House bill. It exempts from excess profits tax that portion of the adjusted excess profits net income which is attributable to the mining by a domestic corporation in the United States of antimony, chromite, manganese, nickel, platinum, quicksilver, sheet mica, tantalum, tin, tungsten, and vanadium. The tax on the remaining portion of the adjusted excess profits net income is an amount which bears the same ratio to the tax computed on the entire adjusted excess profits net income (including the adjusted excess profits net income attributable to the entire adjusted excess profits net income). The amendment made by this section is applicable to all taxable years beginning after December 31, 1940.

SECTION 226. AMENDMENTS TO SECTION 734

This section of the bill reenacts section 734 of the Code with appropriate amendments proposed by your committee in the interest of equity and clarity.

Section 734, added to the Code by the excess profits tax amendments of 1941, authorizes an adjustment to the excess profits tax in certain cases in which the treatment of an item or transaction for excess profits tax purposes is inconsistent with the prior erroneous treatment of such item or transaction for income tax purposes, and correction of the error is prevented by some provision or rule of law such as the statute of limitations, res judicata, etc. Section 734 is an equitable provision designed not to prevent inconsistency but to discourage such inconsistency by depriving the guilty party of any pecuniary benefit therefrom. This purpose is evidenced by the fact that an adjustment is not authorized if the party maintaining the inconsistent position is the party who would derive a pecuniary benefit from the adjustment.

In view of the criticisms of this section presented to your committee, a careful study of the section has been made with special attention to the following problems:

(1) The effect of a previous adjustment under section 3801.

(2) The effect of an inconsistent position in a subsequent excess profits tax taxable year.

(3) Whether consistency with the prior year treatment of an item or transaction is permitted for excess profits tax purposes, although under current rulings and decisions such treatment is erroneous.

(4) The right to withdraw from an inconsistent position.

(5) The meaning of the term "predecessor" as used in the statute.

(6) The character for tax purposes of that portion of an adjustment which represents interest.

(7) The proper treatment of the excess of an adjustment representing a decrease over the excess profits tax for the taxable year.

(8) The computation of interest in determining the amount of an adjustment.

(9) The burden of proof as to whether an inconsistency exists.

With respect to the matters noted under (1), (2), (3), and (4) above, your committee finds that the Commissioner has, by regulations, provided appropriate rules which correctly reflect the purpose and effect of the statute. These regulations provide (*a*) that a previous adjustment under section 3801 shall be taken into account in determining the amount of the adjustment under section 734; (*b*) that no adjustment is authorized by reason of an inconsistent position in an excess profits tax taxable year if an adjustment under the section has been made because of a similar position with respect to the same item or transaction in a prior excess profits tax taxable year; (*c*) that the taxpayer is not required to take an inconsistent position for excess profits tax purposes because of the fact that under current rulings and decisions the previous income tax treatment of the item was incorrect. If the Commissioner in such case requires the correct treatment of the item for excess profits tax purposes, no adjustment is authorized unless such adjustment would result in a reduction of the excess profits tax; and (*d*) that a taxpayer which has taken an inconsistent position may, upon notice to the Commissioner in writing, withdraw from such position. In view of these provisions of the regulations, your committee feels that legislation with respect to these matters is unnecessary.

With respect to the matters noted under (5), (6), (7), (8), and (9) above, your committee has proposed the amendments described in the succeeding paragraphs.

Section 734 authorizes an adjustment where the treatment for excess profits tax purposes is inconsistent with the treatment for income tax purposes either by the taxpayer or by a "predecessor." The term "predecessor" is not defined in the statute. The definition contained in the regulations finds support from the statement and example contained in the Committee Reports (Rept. No. 75, Senate Finance Committee, 77th Cong., 1st sess., pp. 18 and 20). But your committee feels that it is too broad and operates to authorize somewhat inequitable adjustments in cases in which the taxpayer could not be charged with responsibility for the inconsistency. The definition provided by your committee includes only a person which is a component corporation of the taxpayer within the meaning of section 740 and a person which on April 1, 1941 (the date of enactment of sec. 734), or at any time thereafter controlled (as defined in sec. 112 (h) of the Code) the taxpayer and any person which is a predecessor of a person which is a predecessor of the taxpayer under the definition. For the purpose of section 734 a component corporation of the taxpayer within the meaning of section 740 is a predecessor of the taxpayer even though section 740 is not applicable in the determination of the excess profits tax liability of the taxpayer. It is believed that the definition provided by your committee will include only those cases in which there is sufficient identity of interest between the parties to warrant their treatment as one for the purpose of the section and to require an adjustment where the treatment of an item for excess profits tax purposes by the one is inconsistent with the treatment of the item by the other for income tax purposes. The definition will cover most of the cases in which the excess profits tax

liability of the taxpayer is determined by reference to the base period experience of its predecessor or by reference to the basis of property in the hands of its predecessor. The limitation of the definition to the above cases, and the resulting exclusion of other cases, should not be construed to affect the established judicial doctrines commonly known as estoppel, recoupment, set-off, etc., which may be applied by the courts in appropriate cases.

Section 734 is amended by the addition of a new subsection (e) to permit a deduction for that portion of an adjustment representing an increase in tax which consists of interest and also to require the inclusion in gross income of that portion of an adjustment representing a decrease in tax which consists of interest. Under the existing provisions, there has been some doubt as to whether such interest retains its character for tax purposes and the amendment is proposed to resolve this question and to provide appropriate treatment. Under this amendment, such interest will be included in the gross income or allowed as a deduction in computing net income, as the case may be, for the taxable year in which falls the date prescribed for the payment of the tax for the taxable year in respect of which the adjustment is made. This will mean that such interest will be taken into account in computing income for the succeeding taxable year since the date prescribed for the payment of the tax is the 15th day of the third month (15th day of the sixth month in the case of a nonresident alien or nonresident foreign corporation) following the close of the taxable year.

A further amendment with respect to interest relates to the proper method of computing the interest which forms a part of the adjustment. Because of the ambiguity in the statute, it was necessary to prescribe by regulations the correct method of computation in such cases. The proposed amendment embodies in the statute the rule prescribed in the regulations which provides that interest shall be computed to the 15th day of the third month following the close of the excess profits tax taxable year for which the determination is made.

Section 734 (c) is amended by the addition of a new paragraph (4) to provide for the carry-over to exhaustion in subsequent taxable years that portion of an adjustment representing a decrease in the excess profits tax which exceeds the amount of the excess profits tax computed without regard to the adjustment. Under section 734 the amount of the adjustment is added to or subtracted from, as the case may be, the excess profits tax determined without regard to the adjustment. If the amount of such adjustment represents an increase in the tax, the statute provides that "the tax imposed by this subchapter shall in no case be less than the amount of such aggregate net increase." However, in the case of an adjustment representing a net decrease the statute made no provision respecting treatment of the excess of such decrease over the amount of the tax computed without regard to the adjustment. This distinction would appear to be inequitable and has been remedied by your committee amendment. If it should happen that such excesses result from adjustments in two or more excess profits tax taxable years, the amounts to be carried over to subsequent taxable years should be applied in the order of their occurrence. For instance, if excesses occurred in both 1942 and 1943, the excess from 1942 should be carried over to 1944 and subsequent years before applying the excess from 1943.

Section 734 (b) has been amended by the addition of paragraph (3) to provide an appropriate rule respecting the burden of proof in any case in which there may be a dispute as to whether the treatment of an item or transaction is inconsistent with the treatment of such item or transaction in a prior taxable year. The rule provided places the burden of proof upon the Commissioner in those cases in which the net effect of the adjustments would be an increase in the income taxes previously determined for the prior taxable year or years and upon the taxpayer in those cases in which the net effect of the adjustment would be a decrease in the income taxes previously determined for the prior taxable year or years. It is not intended that this provision shall be construed to relieve the taxpayer from liability for the penalties imposed for a false or fraudulent return or for a willful failure to supply the information required by law or regulations made under authority of law.

SECTION 227. RULES FOR INCOME CREDIT IN CONNECTION WITH CERTAIN EXCHANGES

This section corresponds to section 216 of the bill passed by the House. However, it amends only certain sections of supplement A of the Excess Profits Tax Act instead of amending the whole of supplement A and renumbering the sections therein as was done in section 216 of the House bill.

1. SECTION 740 (C)

Under the present amendments to supplement A of the Excess Profits Tax Act, an acquiring corporation computing its average base period net income under such supplement is given the benefit of the base period experience of any component corporation actually in existence before January 1, 1940, irrespective of whether such component was in existence (either actually or constructively through another component corporation) at the beginning of the acquiring corporation's base period. Hence, the concept of a "qualified component corporation" has been abandoned, except for the purposes of section 742 (d). Accordingly, the provision defining the term "qualified component corporation" has been eliminated from the general definitions in section 740 and incorporated in section 742 (d) as the last sentence thereof.

New subsection (c) of section 740 is, in general, designed to prevent more than one corporation from using the same base period experience and the same capital addition or reduction of a particular corporation. The amendments to section 740 (c) made in the bill passed by the House, however, have been substantially revised in your committee bill. As revised, section 740 (c) contains three principal rules which are set forth in new paragraphs (1) and (2) of section 740 (c) and in a new sentence added at the end of such section.

Paragraph (1) of section 740 (c) corresponds to the whole of section 740 (c) as amended by the bill passed by the House, but in your committee bill is subject to the further rule of paragraph (2) of section 740 (c). Paragraph (1) applies only to taxable years beginning after December 31, 1941. Under paragraph (1), if a corporation is a component corporation in, for example, a transaction described in section 740 (a) (1) (A), occurring within the base period, and if the existence of such corporation is not terminated in connection with

such transaction, its base period experience on the day of and before such transaction is, for the purposes of excess profits tax taxable years beginning after December 31, 1941, given exclusively (except for the purpose of applying the growth formula in computing the credit of such component corporation) to the acquiring corporation in such transaction or to an acquiring corporation of which the first acquiring corporation is a component corporation.

The exception in paragraph (1) just referred to, with respect to the application of the growth formula to the component corporation, has been added by your committee bill. If a component corporation continues in existence after the supplement A transaction, it is allowed to take into account its entire base period experience (except as provided in paragraph (2)) for the purpose of the growth formula under sections 713 (f) and 742 (h), except that it cannot take into account such base period experience for the purpose of determining the greatest amount of excess profits net income for any base period year to which the average base period net income or supplement A average base period net income is limited under the growth formula.

Your committee bill also has more clearly defined in section 740 (c) the allocation of base period experience and capital additions and reductions between component and acquiring corporations with respect to the time of the transaction. With the exceptions previously noted, no account is to be taken of the excess profits net income of the component corporation for any period before the day after the supplement A transaction, or of the excess profits net income for any period before the day after such transaction of its component corporations in any supplement A transaction before such transaction, and no account is to be taken of the capital addition or capital reduction of such component corporation either immediately before the supplement A transaction or for any prior period, or of the capital addition or capital reduction either immediately before such supplement A transaction or for any prior period of its component corporations in any such transaction before such transaction.

Consequently, assuming that such component corporation remains in existence and continues business with properties acquired after such transaction, except as provided in paragraph (2) of section 740 (c) and except for the purposes of the growth formula, as previously explained, it will not receive any benefit from its base period experience for any time before the day after such transaction nor from its capital additions or capital reductions immediately before such transaction and for any prior period, nor can such experience or such capital additions or reductions be passed on to another acquiring corporation in a subsequent transaction. The same rules will be applied to each successive transaction described in section 740 (a) to which the corporation is a party as a component corporation and in connection with which its existence is not terminated. Although the provisions of section 740 (c) are primarily intended to apply to transactions in connection with which the complete liquidation of the component corporation is not specifically required, such provisions are not by their terms confined to such transactions and are, therefore, applicable to all transactions described in section 740 (a).

Paragraph (2) of section 740 (c) provides that in case the supplement A transaction occurs in a taxable year of such component corporation beginning after December 31, 1941, for the purposes of computing the

excess profits credit of such component corporation for such taxable year, the amount of its average base period net income or supplement A average base period net income, as the case may be, shall be limited to an amount which bears the same ratio to such average base period net income or supplement A average base period net income, as the case may be, as the number of days in such taxable year before the day after such transaction bears to the total number of days in such taxable year. For the purpose of this limitation, the average base period net income or supplement A average base period net income in the ratio, is computed without regard to paragraph (2) but with the application of paragraph (1) in case of a prior supplement A transaction with respect to such component corporation or a component corporation thereof. Paragraph (2) applies only to taxable years beginning after December 31, 1941.

A new sentence is added at the end of section 740 (c) providing that for the purpose of computing supplement A average base period net income of an acquiring corporation (or of an acquiring corporation of which such acquiring corporation becomes a component) no account shall be taken of the excess profits net income of such component corporation for the day after the supplement A transaction in which it became a component or for any period thereafter. This provision is applicable for the purpose of computing the tax for taxable years beginning after December 31, 1939.

The application of the provisions of section 740 (c) may be illustrated by the following example:

Example: A, B, and C, corporations on the calendar year basis, were in existence on January 1, 1936, and have been in existence since that time. On December 31, 1938, B acquired the properties of A in a transaction described in section 740 (a) (1) (A). A converted into cash the stock in B which it received in such transaction, and with the proceeds of such stock acquired new properties. It operates such properties continuously down to the time C acquires such properties from A on October 19, 1943, in a transaction described in section 740 (a) (1) (A). A continues in business throughout 1943, operating properties which it purchased with the proceeds of the stock in C received in the second transaction. The operation of section 740 (c) under circumstances outlined in this example is as follows:

(a) As to B.—In determining its average base period net income for the purposes of the excess profits taxes for 1942 and 1943, B may take into account A's base period experience for 1936, 1937, and 1938. Inasmuch as the transaction involving B occurs within the base period, there is no capital addition or reduction of A to be transferred to B. See section 743.

(b) As to A.—In determining its average base period net income under the general average method for the purposes of its excess profits tax for 1942, A may take into account its base period experience for 1939, but is denied the right to use its base period experience for 1936, 1937, and 1938. However, in determining its average base period net income under the growth formula, for purposes of its excess profits tax for 1942, A may take into account its base period experience for 1936, 1937, 1938, and 1939, except that such average cannot exceed its excess profits net income for 1939. When A determines its excess profits tax for 1943 it will be permitted to take into account for the purpose of its average base period net income under the general aver-

age method only four-fifths (the ratio of the number of days in January 1, 1943–October 19, 1943, inclusive (292), over the number of days in 1943 (365)) of its base period experience for 1939; for the purpose of the growth formula it will be able to take into account only four-fifths of its average base period experience determined under such formula. It will not be permitted to take into account for the purpose of its tax for 1943 any of its capital addition or reduction attributable to the time immediately before the transaction. Its base period experience for 1936, 1937, and 1938 is given to B and one-fifth of its base period experience for 1939 is given to C. See section 742 (f) (2). A will, however, be entitled to use the credit based on invested capital.

(c) As to C.—Section 740 (c) is first applicable to C with respect to 1943. In determining its average base period net income for the purposes of its excess profits tax for that year C may take into account one-fifth of A's base period experience for 1939. In determining C's average base period net income for the purposes of its excess-profits tax for 1944, C may take into account all of A's base period experience for 1939. Moreover, as the transaction involving C occurs after the close of the base period, A's daily capital addition and reduction as of the time immediately before the transaction will be transferred to C. See section 743.

2. SECTION 740 (d)

Under existing law, the base period of an acquiring corporation computing its average base period net income under supplement A is determined by reference to its current taxable year. So long as the corporation remains on the same taxable year basis, either calendar or fiscal, its base period remains the same; but if the corporation changes its taxable year, or if it is acquired by a corporation with a different taxable year, the base period for the entire enterprise changes accordingly. The amendment to section 740 (d) is designed to prevent this shifting in the base period. Under the amendment, for taxable years beginning after December 31, 1941, the base period is permanently anchored to the 4 calendar years 1936–39. It will not be affected by the fact that the acquiring corporation hereafter changes its taxable year or by the fact that it is acquired by another corporation having a different taxable year.

3. SECTION 740 (f)

Under existing law, an acquiring corporation was not qualified to use supplement A unless it was in existence (either actually or constructively) at the beginning of its base period. The new requirement is that, if the acquiring corporation was in existence before January 1, 1940 (either in its own right or through a component corporation), it may compute its average base period net income under supplement A. Section 740 (f) is amended to accord with such change.

4. SECTION 740 (g)

The changes made in section 740 (g) are of a technical character and are necessitated by the amendments made in section 743 (relating to net capital changes). The changes made in the House bill by the

renumbering of section 742 are stricken from your committee bill since this bill does not renumber the sections in supplement A.

5. REPEAL OF FORMER SECTION 741

Section 712 of the Code applies to any domestic corporation and provides that any such corporation in existence before January 1, 1940, shall compute its excess profits credit on the basis of its average base period income or on the basis of invested capital, whichever credit results in the lesser tax. Now that supplement A is extended to acquiring corporations in existence (actually or constructively) before January 1, 1940, all acquiring corporations entitled to use supplement A fall within the scope of section 712. Accordingly, there is no longer any necessity for a separate provision in supplement A authorizing corporations to use the income or invested capital method of determining their excess profits credits. Hence the provisions of section 741 (a) and (b) of the Code were eliminated in their entirety in the House bill. Your committee, however, has merely made such provisions inapplicable to taxable years beginning after December 31, 1941, and thus has avoided the renumbering of subsequent sections in supplement A.

6. SECTION 742 (FIRST PARAGRAPH)

Section 742 eliminates the express election in the case of acquiring corporations actually in existence before January 1, 1940. Furthermore it no longer contains the mandatory provision as to corporations not actually in existence before such date to the effect that their average base period net income must be computed under supplement A. Under section 742, any corporation entitled to the benefits of supplement A is required, for the purposes of the credit under section 713, to compute its average base period net income under section 713 or under supplement A, whichever is the greater.

In the case of an acquiring corporation which desires to compute its average base period net income under supplement A, section 742 is not intended to require such corporation to include in its return the computations of base period income under section 713 for the purpose of showing that the computations under supplement A result in the greater average base period net income. In other words, it is intended that a return setting forth one set of computations of base-period income shall be acceptable. If a return setting forth only one set of such computations is filed, it should be audited as filed. The further question whether the use of the other computations would result in a greater base period income need not be considered in connection with the audit of the return. If a corporation files a return which contains only one set of computations of base period income, it is not thereby precluded from establishing that the computations used resulted in an overpayment of excess profits tax or from filing a claim for the refund thereof.

7. SECTION 742 (a) (1)

Section 742 (a) (1) is a consolidation of paragraphs (1) and (2) of former section 742 (a). In addition, it liberalizes the former rules as to the taxable years which may be taken into account in determining the average base period net income under supplement A. Section

742 (a) (1) now provides that an acquiring corporation may take into account (a) its own base period experience for its taxable years beginning with or within base period years, and (b) the base period experience of its component corporations for their taxable years beginning with or within base period years. Under these rules, each acquiring corporation will be given the benefit of all excess profits net income which can properly be attributed to its base period.

Section 742 (a) (2) of your committee bill is the same as section 742 (a) (3) of existing law with certain technical amendments necessitated by the consolidation of paragraphs (1) and (2) of section 742 (a) into paragraph (1) of section 742 (a), as amended by your committee bill.

The provisions of section 742 (a), added by the House bill, for placing on an annual basis the excess profits net income for 2 or more taxable years of the taxpayer or the component corporation, as the case may be, beginning with or within a base period year, have been modified in your committee bill. Instead of the requirement that the excess profits net income (or deficit in excess profits net income) for such 2 or more taxable years in such cases be placed on an annual basis, your committee bill provides that such amounts shall be adjusted to such extent as the Commissioner, under regulations prescribed by him with the approval of the Secretary, prescribes as necessary in order that such base period year shall reflect income for a period of 12 months. The specific situations requiring adjustment are complex, requiring detailed rules for adjustment where it is necessary. Accordingly, it seems desirable to authorize the Commissioner to prescribe the manner and the cases in which adjustment is to be made. A rule for guidance has, however, been inserted by your committee to the effect that a taxable year of a component corporation (beginning within the base period) which begins with or within the taxable year of the acquiring corporation in which the acquisition occurred, or which begins with or within the same base period year with which or within which such taxable year of the acquiring corporation begins, shall be considered a taxable year of the acquiring corporation, and such taxable year shall be considered to have begun in the base period year with which or within which such taxable year of the acquiring corporation began.

8. SECTION 742 (b)

Section 742 (b) has been changed by your committee bill so as to apply in determining supplement A average base period net income the same rule provided in section 713 (e) (1) as amended by section 214 of the bill. Under this rule, if the excess profits tax is being computed for a taxable year beginning after December 31, 1941, an adjustment is to be made in the amount of the group excess profits net income (or deficit in excess profits net income) for 1 base period year which is less than 75 percent of the average for the other three years. This average is the sum of the group excess profits net income for the other base period years, reduced by the sum of the group deficit in excess profits net income for the other base period years, divided by three. The low base period year is to be increased to 75 percent of this average.

9. SECTION 742 (d)

For the reasons given above in connection with section 740 (c), the definition of the term "qualified component corporation" is incorporated in section 742 (d) as the last sentence thereof.

10. SECTION 742 (e) (1), (2), AND (3)

Section 742 (e) (1), (2), and (3) accomplishes two purposes: (a) It provides a method for building up income for the enterprise for the part of base period during which neither the acquiring corporation nor any of the component corporations absorbed by it was in existence, comparable to the method provided in section 713 (d) (2); and (b) it eliminates the provisions of paragraph (1) of section 742 (e) of the prior law.

The rule of section 742 (e) (1), as amended in the bill passed by the House, is changed into paragraphs (1) and (2) of section 742 (e) so as to provide clearly for building up of income for "vacant" base period years in the case of a component, which became such in its last taxable year beginning in 1939 but on a day in a taxable year of the acquiring corporation beginning in 1940, on the basis of the invested capital of such component.

Section 742 (e) (2) of the bill passed by the House is renumbered section 742 (e) (3) in your committee bill, and as such is changed to state more clearly the standard for adjustment under regulations prescribed by the Commissioner with the approval of the Secretary for preventing doubling up upon the factor of invested capital for the purposes of section 742 (e) (1) and (2) in cases of cross ownership of stock between corporations. The application of this section from the standpoint of its purpose may be illustrated by the following example:

> O Corporation and P corporation came into existence on January 1, 1938. Both corporations have at all times been on the calendar year basis. On January 1, 1939, O corporation purchased for cash all of the stock in P corporation from the stockholders of the latter corporation. It holds this stock continuously until January 1, 1942, at which time it acquires P corporation in a transaction described in section 740 (a) (2). In view of the fact that assets (cash) left the system in connection with the acquisition of the P corporation's stock, adjustments in the daily invested capital of the corporations for January 1, 1940, must be made in order to prevent a doubling up of such capital. Under section 742 (e) (3) the Commissioner has full authority to prescribe such regulations as may be necessary to eliminate duplication and properly to reflect the invested capital of the corporations as a unit.

Under your committee bill, section 742 (e) (4) is the same as section 742 (e) (3) as it appeared in the House bill.

11. SECTION 742 (f) (1)

Improper duplications of base period income and capital additions and reductions result in cases in which, prior to the transaction which constitutes a corporation an acquiring corporation for the purposes of

supplement A and after December 31, 1935, such corporation uses its assets to acquire stock in the corporation which becomes the component corporation of such acquiring corporation. This section contemplates that, under the detailed rules of the regulations, after the absorption of the corporation whose stock was so acquired, the part of its base period income and deficits for the base period years before the acquisition of its stock which is attributable to such stock shall be excluded by the taxpayer (i) in determining its average base period net income, (ii) in applying the "growth formula" provided in section 742 (h), and (iii) in building up income for "vacant" base period years, and that, in determining the amount of the daily capital addition and reduction of the corporation whose stock was acquired which is to be transferred to the corporation into which the other corporation was absorbed, such daily capital addition and reduction shall be reduced by the portion thereof attributable to the previously acquired stock. The specific situations presented are complex, requiring detailed rules for the necessary adjustments in the computations. The Commissioner is therefore authorized to prescribe in regulations approved by the Secretary the specific situations in which specified adjustments under this section are to be made. If the acquisition of such stock by the corporation is in exchange solely for its own stock, no eliminations or adjustments are necessary, and, accordingly, section 742 (f) (1) is made inapplicable. In case the acquisition is in exchange partly for its own stock and partly for other property, section 742 (f) (1) is applicable only to the part of the acquisition attributable to such other property. Your committee bill also takes out of the operation of this provision cases in which the taxpayer acquires stock which has in the hands of the taxpayer a basis determined with reference to the basis of stock previously acquired by the issuance of the taxpayer's own stock.

12. SECTION 742 (h)

This section provides a growth formula for acquiring corporations using supplement A similar to the growth formula provided in section 713 (f), with such modifications as supplement A makes necessary.

13. SECTION 743

This section corresponds to section 743 under existing law. This section of existing law applies to each acquiring corporation in a supplement A transaction. The new section applies to such an acquiring corporation only if it computes its average base period net income under supplement A.

This section also clarifies the rules to be applied in determining the net capital changes resulting from a supplement A transaction to an acquiring corporation using such supplement.

14. TAXABLE YEARS TO WHICH AMENDMENTS APPLICABLE

Generally speaking, the amendments to supplement A are applicable only to the computation of the excess profits tax for taxable years beginning after December 31, 1941. However, the amendment made by the last sentence of section 740 (c) is made retroactive to taxable

years beginning after December 31, 1939. Each taxpayer is also given the right to elect to have such other amendments (except those which by their terms are limited to taxable years beginning after December 31, 1941), apply retroactively to taxable years of the taxpayer beginning after December 31, 1939. If a taxpayer elects to have the amendments apply retroactively, each such amendment shall apply to each taxable year of the taxpayer beginning after December 31, 1939. Such election must be made within the time and in the manner and subject to such regulations as the Commissioner with the approval of the Secretary may prescribe.

SECTION 228. TERMINATION OF SUPPLEMENT B

Although this section corresponds to section 217 of the House bill, your committee has made substantial changes in the provisions there contained. The House bill provided that since section 752, relating to highest bracket amount, became unnecessary with the elimination of graduation in excess profits tax rates, such section should not apply to any taxable year beginning after December 31, 1941. Your committee, believing that such section has served its purpose of discouraging avoidance of excess profits taxes through corporate split-ups and desiring to eliminate any inequities inherent in its provisions, has repealed section 752 as of the date of the enactment of the Second Revenue Act of 1940. It has also repealed as of such date section 710 (a) (2) which related to the application of the highest bracket amount in the computation of the excess profits tax. Under the House bill, section 751, relating to determination of property paid in, etc., in connection with certain exchanges was repealed as of the date of enactment of the Revenue Act of 1940, and section 760 was added by such bill in replacement. In order to avoid any injustice latent in the retroactive application of section 760 in place of section 751, your committee has made sections 750 and 751 inapplicable with respect to any taxable year beginning after December 31, 1941.

SECTION 229. INVESTED CAPITAL IN CONNECTION WITH CERTAIN EXCHANGES AND LIQUIDATIONS

This section covers the same subject matter as is covered in section 218 of the House bill; your committee, however, has made substantial amendments to the provisions there contained. Supplement C is added to the Code to replace Supplement B with respect to years beginning after December 31, 1941. It contains the rules for determining invested capital as the result of certain tax-free exchanges and "intercorporate liquidations."

SECTION 760

Section 760 provides that in the application of section 718 (a) to a transferee upon an exchange, in determining the amount paid in for stock, or as paid-in surplus, or as a contribution to capital in connection with such exchange, such amount shall be deemed to be the excess of the basis in the hands of the transferee of the property so received from the transferor over the sum of (1) the amount of any liability of the transferor assumed upon the exchange and of any liability subject to which the property was so received; (2) the amount of any

other liability of the transferee constituting consideration for the property so received; and (3) the aggregate of the amount of any money and the fair market value of any other property transferred to the transferor. Your committee has revised and simplified the definition of "exchange" and "transferee upon an exchange" and has added the term "transferor." It has provided that the term "exchange" means a transaction by which one corporation, called the "transferee," receives property of another corporation, called the transferor, and the basis of the property so received, in the hands of the transferee, for the purposes of section 718 (a) (relating to the definition of equity invested capital) is determined by reference to the basis in the hands of the transferor. Your committee has also specifically provided that the basis in the hands of the transferee of the property received upon the exchange from the transferor is to be determined in accordance with the provisions of section 718 (a) (2), namely, the basis (unadjusted) for determining loss, adjusted, with respect to the period before its receipt by the transferee upon the exchange, by an amount equal to the adjustment proper under section 115 (l) for determining earnings or profits. If the property was not disposed of before the taxable year, such unadjusted basis is that prescribed by the law applicable to the taxable year. If the property was disposed of before the taxable year, such unadjusted basis is that prescribed by the law applicable to the year of disposition without regard to March 1, 1913, value.

Since the aggregate of the liabilities to which the transferee was subject, or which it assumed or created, and the money and property transferred to the transferor may be in excess of the basis in the hands of the transferee of the property acquired from the transferor, it is provided that the daily invested capital of the transferee for any dah after the exchange shall be reduced by an amount equal to sucy excess. Section 719 (a) (1) is amended so as to include in borrowed capital the liabilities arising upon an exchange to which section 760 is applicable, and which under existing law are excluded from borrowed capital. Existing rules are applicable with respect to the interest deduction and computation of borrowed invested capital with respect to such liabilities. Believing that it would be inequitable, in many instances, to apply the provisions of this section retroactively, your committee has provided that section 760 will be applicable only to taxable years beginning after December 31, 1941.

SECTION 761

The amendment made by your committee in section 761 makes numerous technical changes in section 761 of the House bill, and provides certain basic rules for the computation of the adjustment to invested capital.

Under section 718 (a) (5) and (b) (4) of existing law, an adjustment is made in equity invested capital in the case of property received by a taxpayer in a complete liquidation under section 112 (b) (6) (other than one to which the provisions of the second sentence of sec. 113 (a) (15) are applicable) in order to reflect in the invested capital the adjusted basis of the property so received. Section 761 of the House bill makes (in terms of equity invested capital) substantially the same adjustment, but only in certain cases. Typical of such cases is the case

of property so received with respect to stock of the liquidated corporation having a substituted basis in the hands of the taxpayer by reason of having been acquired by the taxpayer from individual shareholders in exchange for its own stock in a transaction described in section 112 (g) (1) (B) or the corresponding provision of the prior law. Section 761, as amended by your committee, makes (in terms of adjusted basis) substantially the same adjustment in such cases as is made under existing law.

In other cases (typical of which is the case of property so received with respect to stock acquired by the taxpayer in a cash purchase) section 761 of the House bill changes existing law by providing that a very different adjustment in equity invested capital is to be made; namely, (1) the adjusted basis of the property of the liquidated corporation is to be changed as of the time of the acquisition of control of such corporation by the taxpayer so as to reflect in the adjusted basis of such property at such time the price paid for the stock, (2) a recomputation is to be made (using such changed adjusted basis) of the earnings or profits (or deficit in earnings or profits) of the liquidated corporation attributable to such stock, for the period beginning with the acquisition of control by the taxpayer and ending with the liquidation, and (3) after certain technical adjustments, the amount resulting from the recomputation under (2) is to be treated as an increase or decrease in the earnings and profits of the taxpayer. Section 761, as amended by your committee, makes (in terms of adjusted basis) substantially the same adjustment in such cases.

The principal differences between section 761, as amended by your committee, and section 761 of the House bill, are as follows:

(1) The term "intercorporate liquidation" has been substituted for the term "liquidating transaction" and defined so as to make it clear that (*a*) only a complete liquidation which is wholly or partially tax-free is included (including a liquidation referred to in the second sentence of sec. 113 (a) (15) and not excluding a liquidation the property received in which has a basis described in sec. 113 (b) (2) (B)); (*b*) a complete liquidation to which is applicable section 112 (b) (7), (9, or (10) is excluded, as is one to which is applicable the provisions dealing with reorganization stock or securities, or the stock or securities of specified corporations.

(2) The basic computation to be used in ascertaining the amount of the adjustment is set forth in subsection (b) in terms of adjusted basis.

(3) Certain basic rules are specified in subsection (c) to be used in determining the adjusted basis which the property of the liquidated corporation is considered to have; and "control" is defined. The term "cost basis" is used in order that it may be clear that all cases of a basis determined under the initial clause of section 113 (a) are included.

(4) Authority is given the Commissioner in his discretion to make an adjustment prior to the completion of the liquidation, in order to provide a rule for cases in which circumstances beyond the control of the taxpayer cause the liquidation to extend over a long period, or cases in which the period is prolonged for the avoidance of tax, and

(5) An election is given the taxpayer under which the section becomes applicable to all taxable years beginning after December 31, 1939.

Subsection (f) (as did the House bill) makes provision for the case of a statutory merger or consolidation in which one of the corporations merged or consolidated owns stock in the other corporation merged or consolidated. In such case, a rule is necessary in order to determine whether such stock, or the properties of the other corporation attributable to such stock, have been acquired by the corporation resulting from the merger or consolidation. If such stock represents a cash investment by its owner, it seems inappropriate that the corporation resulting from the statutory merger or consolidation should be deprived of that part of the equity invested capital represented in the purchase price of such stock which is not reflected in the adjusted basis of the property of the other corporation. Subsection (f) therefore provides that the corporation resulting from the statutory merger or consolidation shall be considered to have acquired such stock in such statutory merger or consolidation with a basis in its hands of such stock determined under section 113 (a) (7), with the result that, to the extent to which under sections 718 and 760 such stock is considered to have been paid in for stock of the resulting corporation, the cash investment will be reflected in the equity invested capital of the resulting corporation. The subsection further provides that the properties attributable to such stock shall be considered as having been received by such resulting corporation as a transferee from such other corporation as a transferor in an intercorporate liquidation, with the result that the adjustments prescribed by subsection (d) become applicable.

The section, as amended by your committee, contemplates (as did the House bill) the application of the section under regulations which the Commissioner is directed to prescribe. Because of the variety of situations in which stock or property may be acquired, to which must be applied the general rules of the section, the provisions of subsection (g) have been somewhat expanded in order to make it clear that the subsection contemplates rules on the following matters:

(1) "A series of transferees of the property": The extent to which, if the transferor is in a prior transaction a transferee, such transferor is to stand in the shoes of his transferor in the preceding transaction in determining acquisition of control, adjusted basis, etc.; the application of subsections (c) and (e) in such cases.

(2) "The stock of the transferor is acquired by the transferee from another corporation": The extent to which the transferee is to be regarded as standing in the shoes of such other corporation, in determining cost basis, acquisition of control, adjusted basis, etc.; the application of subsections (c) and (e) in such cases.

(3) "Basis and adjusted basis": The application of the terms "cost basis" and "basis other than a cost basis"; the application of the rules prescribed in the last two sentences of section 718 (a) (2) as amended by the bill; the application of the excess profits tax basis if it be different from the income tax basis; the nonapplication of adjustments authorized in section 113 (a) (11), or other adjustments inappropriate in the computation of equity invested capital; the application of other adjustments necessary to reflect invested capital, or prevent duplication or distortion; the basis to be used under section 720; the assignment to specific property of the aggregate adjusted

basis under subsection (c), adjustments to be made, and the accounting principles to be used in such assignment, or adjustment.

Examples illustrating provisions of section 761 (b), (c), and (d)

I

Corporation P buys all the stock, consisting of 100 shares, of corporation S paying $11,000 cash therefor. Corporations P and S file consolidated returns for 3 years, during which time the parent operated at a gain but the subsidiary had a loss totaling $300 for 2 years and a gain of $400 for 1 year. At the time corporation P bought the stock of S, the latter corporation had assets and liabilities as follows:

Cash	$500	
Operating assets	10, 600	
Total		$11, 100
Liabilities	$1, 000	
Capital stock and earnings and profits	10, 100	
Total		11, 100

At the end of the 3-year period corporation S is liquidated under the provisions of section 112 (b) (6) of the Code. The assets and liabilities of corporation S were as follows on the date of the liquidation:

Cash	$800	
Operating assets	10, 400	
		$11, 200
Liabilities	$1, 000	
Capital stock equity	10, 200	
		11, 200

The adjustment to the earnings and profits account of the parent at the time of the liquidation is equal to the "plus adjustment" computed under section 761 (b) (1)—(sec. 761 (d) (1)). If it is assumed that the excess ($900) paid by corporation P for the stock of S over the book value represented goodwill, not shown on the books of corporation S, the "plus adjustment" is computed as follows:

Money and other property ($11,200 plus $900)		$12, 100
Deduct:		
Cost basis of stock [1]	$11, 000	
Liabilities assumed	1, 000	
		12, 000
Plus adjustment, sec. 761 (b) (1)		100

[1] The basis of the stock should not be reduced on account of losses of the subsidiary reported on the consolidated return.

II

Corporation P, which owns 5 shares of $100 par value of stock of corporation S acquired at a cost of $600 in cash, exchanges shares of its own stock for the remaining 95 shares of stock of corporation S. The latter stock takes a substituted basis (a basis other than a cost basis) of $110 per share in the hands of corporation P.

The books of S at the time of the acquisition of control by corporation P showed the following:

Cash	$500	
Depletable assets (net)	6, 000	
Other assets	4, 600	
Total		$11, 100
Liabilities	$1, 000	
Capital stock	10, 000	
Surplus	100	
Total		$11, 100

One year later the assets and liabilities of corporation S were as follows:

Cash	$800	
Net depletable assets	5,400	
Other assets	5,000	
Total		$11,200
Liabilities	$1,000	
Capital stock	10,000	
Surplus	200	
Total		11,200

In computing profit and loss, corporation S had depleted its depletable assets at 10 percent.

Corporation P liquidates corporation S under the provisions of section 112 (b) (6) of the Internal Revenue Code (an intercorporate liquidation under sec. 761 (a) (1)).[1]

In determining the plus or minus adjustment to the invested capital of corporation P, it is necessary to make two computations, in view of the special rule contained in section 761 (c), for determining the adjusted basis of property applicable to the shares of stock having a "cost basis."

(*a*) The first computation (pertaining to those shares having a "basis other than a cost basis") (see sec. 761 (b) (2) and (3)) follows:

Aggregate adjusted basis of 95 shares stock	$10,450	
Liabilities assumed ($1,000 × 95/100)	950	
		$11,400
Deduct: Basis of property ($11,200×95/100)		10,640
Difference "minus adjustment" (sec. 761 (b) (2) and (3))		760

(Pertaining to 95 shares having a basis other than cost.)

(*b*) The second computation (pertaining to those shares having a "cost basis" of $120 per share) involves the ascertainment of the property, other than money, held by the transferor applicable to those shares of stock. Under the formula provided by section 761 (c) (1) (A) the property applicable to those 5 shares is computed as follows:

Cost per share	$120.00
Multiply by share units	100
Product	12,000
Deduct: Cash	500
Balance	11,500
Add: Liabilities	1,000
Total	12,500
$12,500÷100 (property applicable 1 share)	125
$125×5 (property applicable 5 shares)	625

Assuming that the excess paid for the stock of corporation S over the book value thereof ($95) was applicable to the depletable assets, the assets on hand at the time control was acquired had values attributable to the cost of the stock as follows:

Cash (5/100 of $500)	$25
Depletable assets [2] (5/100 of $6,000)+$95)	395
Other assets	230
Total (reflecting basis of stock plus allocable portion of liabilities)	650

[2] Proportionate basis of asset plus excess paid for stock.

Upon the liquidation of corporation S the assets applicable to the 5 shares of stock (having a cost basis) were as follows (sec. 761 (c) (1) (C)):

Cash (5/100×800)	$40.00
Depletable assets [3] ($395.00−$39.50)	355.50
Other assets ($5,000×5/100)	250.00
Total money and other property	645.50

[3] Adjusted basis minus 1 year depletion at 10 percent.

Computation of adjustment pertaining to 5-shares (sec. 761 (b)):

Basis of stock (5 shares at $120 per share)	$600.00
Liabilities ($1,000×5/100)	50.00
Total	650.00
Total money and other property (see above)	645.50
Minus adjustment (sec. 761 (b) (2) and (d) (1))	4.50

Under the provisions of section 761 (d) (1) the above "minus adjustment" of $4.50, applicable to stock having a cost basis constitutes a reduction of the earnings and profits account of the parent upon liquidation of the subsidiary—whereas the "minus adjustment" ($760) pertaining to those shares having a substituted basis constitutes an amount "includible in the sum specified in 718 (b)" (sec. 761 (d) (2)).

If Corporation S had earned $3 per share the adjustment to the parents earnings account attributable to the 5 shares of stock would have been a "plus adjustment" of $5.50. In such case the assets would have been increased to $655.50, or the liabilities would have been decreased to $45.50, thus changing the figures entering into the foregoing computation.

SECTION 250. POST-WAR REFUND OF EXCESS PROFITS TAX

Section 250, added by your committee to the House bill, adds to subchapter E of chapter 2 of the Code a new part relating to post-war refund of excess profits tax, consisting of sections 780, 781, 782, and 783.

1. Section 780

Section 780 provides for the repayment to taxpayers of part of the excess profits tax paid by them for taxable years beginning after December 31, 1941, but not after the date of cessation of hostilities in the present war. For each such taxable year, the Secretary of the Treasury is authorized and directed to establish a credit to the account of the taxpayer of an amount equal to 10 percent of the tax imposed by subchapter E of chapter 2 for such taxable year. Within 3 months after the payment in full of the amount of the excess profits tax for any such taxable year, as shown to be due on the return of the taxpayer, bonds of the United States are required to be issued to the taxpayer in an aggregate amount equal to 10 percent of the tax paid. The credit for each such taxable year is specifically made available for the purchase of such bonds on behalf of the taxpayer.

The bonds will be issued under the Second Liberty Bond Act, as amended, and the purposes for which bonds may be issued under such act are expressly extended to the purpose for which bonds are required to be issued under section 780.

It is provided that such bonds shall bear no interest, shall be nonnegotiable, shall not be transferable by assignment, pledge, or other-

wise, and shall be redeemable after the date of cessation of hostilities in the present war and before maturity (at the option of the United States) in whole or in part upon 3 months' notice. It is further provided that the proceeds of any such bond upon redemption shall not be included in gross income.

Bonds purchased with the credit for any taxable year beginning within the calendar year 1942 mature on the last day of the second calendar year beginning after the date of cessation of hostilities. Bonds purchased with the credit for any taxable year beginning within the calendar year 1943, within the calendar year 1944, and after December 31, 1944, mature, respectively, 1 year, 2 years, and 3 years, after the date of maturity of bonds purchased with the credit for a taxable year beginning within the calendar year 1942.

2. Section 781

Section 781 prescribes special technical rules for the application of the provisions of section 780. These rules relate to the following: (1) Effect of a deficiency in the excess profits tax for any taxable year for which a credit is provided under section 780; (2) effect of a refund or credit of an overpayment of the excess profits tax for any such year; (3) manner of payment to taxpayers in cases in which tax payments are made by them after or shortly before the date of maturity of bonds; and (4) over-all limitation upon the credit under section 780.

3. Section 782

Section 782 authorizes the Secretary of the Treasury to prescribe, from time to time, such rules and regulations as may be necessary to carry out the provisions of sections 780 and 781.

4. Section 783

Section 783 provides in effect for the current use by the taxpayer of a portion or all of the post-war credit under section 780 (a) for any taxable year ending after September 1, 1942, in certain cases in which there is a net reduction in the taxpayer's indebtedness during the year. The section provides for a credit against the excess profits tax for a taxable year in which the taxpayer pays an amount in repayment of principal of indebtedness, equal to 40 percent of such amount. Certain limitations are prescribed with respect to the credit against tax, including the limitation that it shall exceed neither the amount of the post-war credit with respect to the taxable year (exclusive of any amount accumulated in prior years), nor 40 percent of the net decrease in indebtedness computed in the manner provided in the section. The term "indebtedness" is defined for purposes of the section to mean any indebtedness of the taxpayer or for which the taxpayer is liable evidenced by a bond, note, debenture, bill of exchange, certificate, or other evidence of indebtedness, mortgage, or deed of trust. It is not intended that the term include any obligation of a bank to a depositor.

TITLE III. CAPITAL-STOCK AND DECLARED VALUE EXCESS-PROFITS TAXES

SECTION 301. CAPITAL-STOCK TAX TERMINATED

Section 301 of the House bill provides for annual declarations of capital-stock value in making capital-stock tax returns. Your committee is of the opinion that the capital-stock tax should be repealed. Accordingly, by amendment of section 301, the capital-stock tax is made inapplicable with respect to the year ended June 30, 1942, and subsequent years.

SECTION 302. DECLARED VALUE EXCESS PROFITS TAX TERMINATED

Section 302 of the House bill made technical amendments to sections 600 and 601 of the Code relating to the declared value excess-profits tax to conform these sections to the amendments made by section 301 to allow annual declarations of capital-stock value. The purpose of the excess-profits tax is to obtain reasonable declarations of capital-stock value. The committee amendment of section 301 which terminates the capital-stock tax makes the declared value excess-profits tax nugatory. Therefore your committee has amended section 302 to make the declared value excess profits tax inapplicable to years ending after June 30, 1942, to correspond to the committee amendment of section 301 making the capital-stock tax inapplicable to the year ended June 30, 1942, and subsequent years.

SECTION 303. DECLARED VALUE EXCESS PROFITS TAX FOR TAXABLE YEARS OF LESS THAN TWELVE MONTHS

Although section 302 of this bill makes the declared value excess profits tax inapplicable to years ending on or after June 30, 1942, your committee is of the opinion that the provisions of section 303 of the House bill, relating to the declared value excess profits tax for taxable years of less than 12 months, should be applicable to those income tax taxable years beginning after December 31, 1939, to which this tax is applicable. This section, applicable to such years, is identical with section 303 of the House bill, except that in the House bill this section was not retroactive. It amends section 601 of the Code by striking the provision for the proration of the declared value in the case of a short income tax taxable year, and inserts instead a new section 605 (a) for placing the income for such a short taxable year on an annual basis, determining the tax thereon, and prorating a part of the tax so determined to the short income tax taxable year. Since the short income tax taxable year may not involve complete months, as in the case of a corporation which incorporates after the first day of the month, and files its return for a taxable period ending on the last day of the month, the income is placed on an annual basis, and the tax thereon prorated, on the basis of the ratio of the number of days in the short income tax taxable year to the number of days in a full year, rather than on the basis of the ratio of the number of months in the short income tax taxable year to 12 months.

In general, section 605 (b), relating to the manner in which the taxpayer may obtain relief from the tax computed under section 605 (a), contains provisions similar to those contained for income tax purposes in section 136 of the bill, and for excess profits tax purposes in section 212 of the bill.

TITLE IV—ESTATE AND GIFT TAXES

PART 1—ESTATE TAX

SECTION 401. ESTATES TO WHICH AMENDMENTS APPLICABLE

This section of the bill, which is the same as section 401 of the House bill, provides that, except as otherwise expressly provided, the amendments made by this part, relating to estate taxes, shall be applicable only with respect to estates of decedents dying after the date of enactment of this act.

SECTION 402. COMMUNITY INTERESTS

This section, which corresponds to section 402 of the bill passed by the House, eliminates special estate tax privileges enjoyed by virtue of the community property system. The corresponding section of the House bill amended only section 811 (e) of the Code, relating to joint interests. Your committee bill adds an amendment to section 811 (d) relating to revocable transfers. A new paragraph (5) is added to section 811 (d), providing that for the purposes of section 811 (c) and (d), a transfer of property held as community property by the decedent and surviving spouse shall be considered to have been made by the decedent, except such part thereof as may be shown to have been received as compensation for personal services actually rendered by the surviving spouse or derived originally from such compensation or from separate property of the surviving spouse. A new paragraph (2) is added to section 811 (e) after the existing paragraph dealing with joint estates and estates by the entirety, which is now made paragraph (1). Such paragraph (2), relating to community property of husband and wife, provides that such property is includible in the gross estate with the exception of such part thereof as may be shown to have been received as compensation for personal services actually rendered by the surviving spouse or derived originally from such compensation or from separate property of the surviving spouse.

The amendments thus make due provision for the exclusion from the gross estate of that portion of the community property which is economically attributable to the survivor. Section 811 (e) (2), however, is subject to the provision that in no case shall the value of the property included in the gross estate of the decedent be less than the value of such part of the community property as was subject to the decedent's power of testamentary disposition. Property "derived originally from" compensation or from separate property of the surviving spouse includes (1) property acquired in exchange for property received as compensation or in exchange for separate property, (2) community income yielded by such property and property acquired with such income, and (3) property which may be traced back to

property received as compensation, separate property, income from property received as compensation, or income from separate property. The statute establishes a uniform Federal rule for apportioning the respective contributions of the spouses regardless of varying local rules of apportionment. State presumptions are therefore not operative against the Commissioner.

SECTION 403. POWERS OF APPOINTMENT

This section is essentially the same as section 403 of the bill as passed by the House. It revises extensively section 811 (f) of the Code, which has been found to be extremely inadequate in scope and an outstanding device for the avoidance of estate tax. The amendment provides that property with respect to which the decedent has at the time of his death a power of appointment is includible in the gross estate whether or not such power is exercised.

Section 811 (f), as amended, defines a power of appointment to mean any power to appoint with the exception of two designated types of powers. In the House bill it is provided that if either of the excepted powers to appoint is exercised by the creation of another power to appoint, the power which is exercised shall not be considered as excepted from the definition of a power of appointment. Your committee bill makes this provision applicable, however, only to the extent of the value of the property subject to the second power to appoint. For the purposes of this rule, the value of the property subject to such second power to appoint shall be its value unreduced by any precedent or subsequent interest not subject to such power to appoint. Thus, if the decedent has a power to appoint a fund of $100,000 within a class consisting only of his children (which is one of the excepted powers) and by his will exercises such power by giving one child a power to appoint $25,000 of such fund and by making an outright appointment of $75,000, only $25,000 is includible in the decedent's gross estate. If, however, the decedent had appointed the income from the entire fund to such child for life with power in such child to appoint the remainder in his will, the whole $100,000 would be included in the decedent's gross estate. It will be noted that under the statute this proviso applies regardless of whether the newly created power to appoint falls within either of the two excepted types of powers.

The term "power of appointment" includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and local property law connotations. The term includes powers to appoint, exercisable only during the decedent's lifetime and terminable at his death. A power of appointment is deemed to exist at the date of the decedent's death where the time for the exercise of the power is determined by the date of his death.

The first excepted power to appoint provided in the House bill is a power to appoint within a class which does not include any others than the spouse of the decedent, descendants of the decedent or of his spouse, spouses of such descendants, and charitable donees described in sections 812 (d) and 861 (a) (3). As used in this exception, the term "descendant" includes adopted and illegitimate descendants, and the term "spouse" includes former spouse. Your committee bill expands this class so as to include also in the group (1) the spouse of the

creator of the power, (2) descendants (other than the decedent) of the creator of the power or of his spouse, and (3) spouses of such descendants. The limitation excluding the decedent from the excepted group of descendants of the creator of the power or his spouse, is not intended to exclude from the excepted group the spouse of the decedent, who is expressly included in the group. The description of these persons as an excepted class is intended to be construed so as to give uniform Federal application. The treatment of adopted and illegitimate descendants as descendants is intended to include adopted and illegitimate children (and their descendants and their adopted and illegitimate children) as descendants, if such children would be descendants had they been born as natural legitimate children in the station to which they are adopted or born.

The second excepted power to appoint is a power to appoint within a restricted class if certain other conditions are present. This provision applies to a power possessed by a disinterested trustee or one occupying a similar status to appoint within a relatively small class. For example, a power to appoint within a class composed of A's children would be a power to appoint within a restricted class. On the other hand, a power to appoint to anyone except A and his family would not be a power confined to a restricted class. Moreover, a power to appoint is not confined to a restricted class because the power is not exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, or all of them.

Section 811 (f) (1) of the new provision imposes a tax with respect to a power of appointment which is released in contemplation of death or by a disposition intended to take effect in possession or enjoyment at or after death or retaining for the decedent certain control or enjoyment of the income of the property. A release of a power of appointment need not be express or formal in character. For example, the failure to exercise a power of appointment within a specified time, resulting in the termination of the power of appointment, is taxable if other conditions imposed by section 811 (f) (1) are present.

This section provides that property includible in the gross estate under section 811 (f) shall, for the purposes of the subsections relating to deductions for contributions to charity, be considered a bequest of the decedent. The rules governing the deduction of bequests to charity are thereby made applicable to property required to be included in the gross estate under section 811 (f) as amended, where such property is appointed to charity or is received or held by charity upon the release or nonexercise of the power. This amendment is clarifying with respect to property passing to charity under a general power of appointment exercised by the decedent and includible in the gross estate. A similar provision is contained in section 407 amending sections 812 (c) and 861 (a) (2) of the Code relating to the deduction for property previously taxed which was received by gift, bequest, devise, or inheritance.

A new subsection (d), added to section 826, entitles the executor to recover from the recipient of appointive property the portion of tax allocable to such property. The decedent, however, may provide otherwise in his will. This section applies where the recipient takes or holds the property upon the decedent's exercise, nonexercise, or release of the power, regardless of local rules with respect to the receipt of the property from the creator of the power. The purpose

of this amendment is to achieve a fair and equitable apportionment of the tax burden attributable in part to appointive property. Your committee bill makes a technical change in this provision to coordinate it with section 826 (c) relating to the liability of life insurance beneficiaries, as amended by section 404 (b) of your committee bill.

Your committee bill revises extensively the rules for existing powers with respect to which the amendments made by this section are not applicable. The amendments made by this section are not applicable to powers of appointment, other than general powers, created on or before the date of enactment of this act, unless such power is exercised after such date. This provision replaces the provision in the House bill exempting such powers only if released within 2 years after the date of enactment of the act or if exercised on or before such date. A power exercised by a decedent dying after the date of enactment of this act in a will executed prior to such date is considered to be exercised after such date. A new provision has also been added by your committee making such amendments inapplicable with respect to general powers of appointment created on or before the date of enactment of this act if at such date the donee of such power is under a legal disability to release such power. In such cases the amendments become applicable upon the expiration of 6 months after the termination of such legal disability. Such legal disability is generally determined under local law; it may include the disability of an insane person, a minor, or an unborn child. For the purpose of this provision, it is expressly provided that an individual in the military or naval forces of the United States at the date of enactment of this act shall, until the termination of the present war, be considered under a legal disability to release a power to appoint. As under the House bill, the amendments are also inapplicable to all powers of appointment released prior to the date of enactment of this act.

SECTION 404. PROCEEDS OF LIFE INSURANCE

This section is designed to clarify the status of proceeds of life insurance under the estate tax. The phrase "policies taken out by the decedent", which has produced confusion and unnecessary litigation, has been eliminated. The section retains the classification under existing law of life insurance proceeds (1) payable to the executor and (2) payable to all other beneficiaries. The $40,000 exemption applicable under existing law to the latter class of proceeds, which was eliminated in the House bill, is restored in your committee bill, along with the $40,000 specific exemption under the additional estate tax, which had been replaced by a $60,000 specific exemption in section 413 of the House bill.

Proceeds payable to the executor are includible in the decedent's gross estate regardless of whether the decedent or another person paid the premiums or other consideration for the life insurance policy. Proceeds are payable to the executor if they are receivable by the executor or administrator or payable to the decedent's estate, or in fact receivable by or for the benefit of the estate.

The inclusion in the gross estate of proceeds which are payable to beneficiaries other than the executor is to be determined for the purposes of this section by criteria set forth therein. These criteria are (1) the payment of premiums or other consideration by the decedent

for the insurance, and (2) incidents of ownership possessed by the decedent at death. If either of these criteria is satisfied the proceeds are includible in the gross estate. The section provides with respect to the premium payments test that insurance purchased with premiums, or other consideration, paid directly or indirectly by the decedent, shall be included in the gross estate in proportion that the amount so paid by the decedent bears to the total premiums paid for the insurance.

The section also contains a formula for determining the portion of proceeds includible in the gross estate where the decedent transfers, by assignment or otherwise, a policy to another. It is, however, expressly provided that the proceeds receivable under a transferred policy are not includible in whole or in part, by virtue of the premiums or other consideration paid by the decedent, if the transfer did not constitute a gift, in whole or in part, under chapter 4 relating to the gift tax, or, in case the transfer was made at a time when chapter 4 was not in effect, would not have constituted a gift, in whole or in part, under such chapter had it been in effect at such time. Thus, if the decedent transferred a policy to creditors in consideration of the discharge of his obligations, and there was no element of donative intent in the transfer, no part of the proceeds would be includible in the gross estate. If the transfer is a gift in whole or in part within the meaning of chapter 4, the formula for determining the portion of proceeds includible in the gross estate is applicable.

Payments of premiums or other consideration by the decedent include payments made by him directly or indirectly. This provision is intended to prevent avoidance of the estate tax and should be construed in accordance with this objective. For example, if the decedent transfers funds to his wife so that she may purchase insurance on his life, and she purchases such insurance, the payments are considered to have been made by the decedent even though they are not directly traceable to the precise funds transferred by the decedent. A decedent similarly pays the premium or other consideration if payment is made by a corporation which is his alter ego or by a trust whose income is taxable to him, as, for example, a funded insurance trust. Payment is also made by the decedent if the decedent's employer makes payment as compensation for services. These examples merely illustrate the concrete application of the provision.

There is no specific enumeration of incidents of ownership, the possession of which at death forms the basis for inclusion of insurance proceeds in the gross estate, as it is impossible to include an exhaustive list. Examples of such incidents are the right of the insured or his estate to the economic benefits of the insurance, the power to change the beneficiary, the power to surrender or cancel the policy, the power to assign it, the power to revoke an assignment, the power to pledge the policy for a loan, or the power to obtain from the insurer a loan against the surrender value of the policy. Incidents of ownership are not confined to those possessed by the decedent in a technical legal sense. For example, a power to change the beneficiary reserved to a corporation of which the decedent is sole stockholder is an incident of ownership in the decedent. Your committee bill has added a provision designed to take reversionary interests out of the category of "incident of ownership" for the purpose of applying section 811 (g) (2) (A). This provision seems necessary in view of the treatment of

a reversionary interest as an incident of ownership under existing law and under subsection (c) of this section of the bill.

Subsection (c) states that the amendments made by this section are applicable only to estates of decedents dying after the date of the enactment of this act. The House bill contains a special rule with respect to payments made by the decedent on or before January 10, 1941, the date of approval of Treasury Decision 5032. Your committee bill clarifies the language of the House provision in order to continue in effect the rule provided in such Treasury Decision. Under this rule if the decedent at no time after January 10, 1941, possessed an incident of ownership, in determining the proportion of the premiums or other consideration paid directly or indirectly by the decedent (but not the total premiums paid) for the policy, the amount so paid by the decedent on or before January 10, 1941, shall be excluded. A reversionary interest is an incident of ownership in accordance with the treatment of such an interest under existing law.

This section, like the present provisions in section 811 (g), does not constitute the only section under which life insurance is includible in the gross estate. For example, a decedent who does not pay any of the premiums upon a policy upon his own life but who possesses incidents of ownership therein may not escape tax by a transfer of all rights in such policy in contemplation of death or by a transfer reserving a reversionary interest whereby the insurance proceeds are made payable to the estate of the decedent if the beneficiaries of the policy do not survive him. In both cases the insurance proceeds are includible in the gross estate under section 811 (c) of the Code.

This section contains a paragraph with respect to premiums or other consideration paid with community property. The provision is similar to the amendment made by section 402 relating to community property. The same paragraph also provides that the term "incidents of ownership" includes incidents of ownership possessed by the decedent at his death as manager of the community.

A new provision is added by your committee bill as subsection (b) of this section, amending section 826 (c) of the Code, relating to liability of life insurance beneficiaries. The amendment made by this subsection replaces the amendment made by section 413 (b) of the House bill. Your committee bill makes a number of technical amendments to section 826 (c), the principal one providing that the apportionment of liability for the tax against life insurance beneficiaries shall be in the ratio which the insurance proceeds in excess of $40,000 bear to the sum of the net estate and the amount of the exemption allowed in computing the net estate, determined under section 935 (c).

SECTION 405. DEDUCTIONS NOT ALLOWABLE IN EXCESS OF CERTAIN PROPERTY OF ESTATE

This section, which, except for a clerical change, is identical with section 405 of the House bill, amends section 812 (b) of the Code in order to overcome the construction of existing law that the full amount of the claims against a decedent's estate is deductible in computing the statutory net estate without reference to the value of the property subject to payment. Since the gross estate determined for estate tax purposes contains many items of property which are not in the hands of the executor for local probate purposes, the

allowance as deductions of claims in excess of the value of property subject thereto reduces the statutory net estate by claims which do not actually reduce the gross estate and permits the tax-free transfer of assets to the decedent's beneficiaries.

Under section 812 (b), as amended by this section, amounts otherwise deductible under section 812 (b) are disallowed to the extent that they exceed the value at the time of the decedent's death of property subject to claims. "Property subject to claims" is defined as property includible in the gross estate of the decedent which, or the avails of which, would, under the applicable law, bear the burden of the payment of such deductions in the final adjustment and settlement of the estate. For example, if the decedent's estate includes a piece of property valued at $1,000 upon which there is a mortgage for $2,000, the excess of which is not enforceable against other property of the estate, the mortgage will be allowed as a deduction only to the extent of $1,000. Likewise, in a case where the gross estate is composed of real estate valued at $500,000, and proceeds of life insurance in the amount of $500,000 which is exempt from general claims, if the only deductions under section 812 (b) are claims of creditors totaling $600,000, only $500,000 of such claims will be allowed as deductions. If deductible losses are incurred during the settlement of the estate from fires, storms, shipwrecks, or other casualties, or from theft, in determining the value of property subject to claims, the value of the property is first to be reduced by the amount of such deductions attributable to such property.

The same principles are applied in amending sections 812 (c) and 861 (a) (2), relating to the deduction for property previously taxed. Under existing law, in order to prevent double deductions, the amount otherwise deductible under section 812 (c) for property previously taxed is reduced by the proportionate part of other deductions allowable against the gross estate (under section 812 (a), (b), and (d)). The amendments made by this section are designed to give effect to the fact that, under the applicable law, in the final adjustment and settlement of the estate some deductions under section 812 (b) are claims enforceable only against specified property and some property is exempt from claims of creditors.

Generally, the amount otherwise deductible is to be reduced, under this section, by an amount which bears the same ratio to the amounts allowed as deductions under section 812 (a) and (d) and the amount of general claims allowed as a deduction under section 812 (b) as the amount otherwise deductible bears to property subject to general claims. This general rule may be illustrated by the case of a gross estate consisting of Blackacre valued at $100,000, Whiteacre valued at $120,000, and insurance proceeds, exempt from creditors' claims, in the amount of $100,000, and deductions allowed under section 812 (a), (b), and (d) totaling $170,000, including a $20,000 mortgage enforceable only against Blackacre. If the estate is entitled to a deduction under section 812 (c) by reason of the inclusion of Whiteacre in the estate of the prior decedent at a value of $120,000, under section 812 (c), as amended, the amount allowable as the deduction is $30,000, computed by reducing $120,000 by $\frac{\$150,000}{\$200,000}$ of $120,000.

In some cases, however, the previously taxed property (or the property received in exchange therefor) itself may not be wholly

subject to general claims. In such cases it is first necessary to reduce the deduction by the amount of the deductible items under section 812 (b) which, under the applicable law, in the final adjustment and settlement of the estate may be enforced only against such property. Then the balance, if any, of the deduction is to be reduced as previously indicated, this time, however, substituting for the full amount of "the amount otherwise deductible" only that part of such amount which is subject to general claims. Thus, if in the example previously given, Blackacre instead of Whiteacre were the property previously taxed, the deduction would be $20,000, computed by first reducing the $100,000 otherwise deductible by $20,000, the amount of the mortgage enforceable only against Blackacre, and then by reducing the balance, $80,000, by $\frac{\$150,000}{\$200,000}$ of $80,000.

Frequently the value included in the gross estate with respect to property previously taxed is different from the amount otherwise deductible because of changing property values. In such cases a proportionate part of any exemption from creditors' claims or of specific claims with respect to such property is attributed to the amount otherwise deductible.

SECTION 406. CHARITABLE PLEDGES

This section is the same as section 406 of the House bill. At the present time a claim founded upon a promise or agreement of the decedent to make a contribution or gift to or for the use of any donee described in section 812 (d) or section 861 (a) (3), and enforceable against the estate of the decedent, is not deductible to the extent that such claim was not contracted for an adequate and full consideration in money or money's worth (*Taft* v. *Comm.*, 304 U. S. 351 (1938)). Section 812 (b), as amended by this section, permits the deduction of such claim to the extent that it would be allowable as a deduction under section 812 (d) if the promise or agreement constituted a bequest. Section 861 (a) (1), relating to estates of nonresidents not citizens of the United States, is similarly amended. These amendments do not change the law with respect to other promises or agreements, which must be supported by an adequate and full consideration in money or money's worth, and are therefore not deductible if they are essentially donative in character.

SECTION 407. DEDUCTION ON ACCOUNT OF PROPERTY PREVIOUSLY TAXED

This section, which is identical with section 407 of the House bill, except for a minor change described below, provides a number of technical amendments to section 812 (c) and section 861 (a) (2), relating to the deduction for property previously taxed.

A provision is added with respect to property previously taxed under the power of appointment provisions of the Code, sections 811 (f) and 1000 (c). This provision states that for the purposes of the deduction, property includible in the gross estate of the prior decedent or in total gifts of the donor under such sections, received by the decedent described in section 812 (c) or section 861 (a) (2), shall be considered

a bequest of such prior decedent or a gift of such donor. Of course, the decedent described in section 812 (c) or 861 (a) (2) must be the appointee under the exercise of the power or taker (or remainderman) in default upon the release (or nonexercise) of the power by the prior decedent or donor in order to be entitled to the deduction. The only change made by your committee is a technical change in the abovementioned provision, designed to correct a reference to property includible in gifts of the donor under section 1000 (c), relating to powers of appointment under the gift tax, from "net gifts" to "total gifts." This continues the construction of existing law that "previously taxed property" does not embrace any portion of a gift excluded under the provisions of section 1003 (b) of the Code or the corresponding provisions of prior gift tax statutes.

This section is also designed to correct a defect originating in section 606 (a) of the Revenue Act of 1932, amending section 303 (a) (2) and (b) (2) of the Revenue Act of 1926, and carried over into the above sections of the Code. The above sections of the Revenue Act of 1926, as previously amended, literally do not allow the deduction for property previously taxed where only the additional estate tax imposed by the Revenue Act of 1932 was paid by the estate of the prior decedent. The above sections of the Code similarly allow the deduction where the basic estate tax under subchapter A of chapter 3 of the Code, the Revenue Act of 1926, or any prior act of Congress was paid by the prior estate but not where only the additional estate tax under subchapter B of chapter 3 was paid. By these amendments the deduction is also allowed where only the additional estate tax was paid by the estate of such prior decedent.

The corresponding amendments to the Revenue Act of 1926, as amended, are made effective with respect to the estates of decedents dying after the enactment of the Revenue Act of 1932, and the amendments to the Internal Revenue Code are made effective as if such amendments had been part of the Internal Revenue Code on the date of its enactment, February 10, 1939. Refund or credit of any overpayment resulting from the application of the amendments made by this section of the bill will be made with interest in accordance with the usual procedure for refund or credit of erroneously collected estate taxes. If the refund or credit of any overpayment, to the extent resulting from the application of the amendments made by this section of the bill, is prevented on the date of enactment of this act or within 1 year from such date by any provision of law or rule of law (such as the expiration of the period of limitations for filing claims for refund) then, notwithstanding such provision or rule of law (other than the limitations provided in this section of the bill and other than the provisions of law relating to compromises), such overpayment shall be refunded or credited in the same manner as in the case of an estate tax erroneously collected if claim therefor is filed within 1 year from the date of enactment of the act.

This section also makes technical amendments designed to disallow the deduction for property previously taxed in every case where a deduction on account of property previously taxed was taken with respect to the same property (or property given in exchange therefor) in the estate of the prior decedent. A clerical amendment, retroactive to the date of enactment of the Code, is

also made in the first sentence of the second paragraph of section 812 (c).

SECTION 408. DEDUCTION FOR DISCLAIMED LEGACIES PASSING TO CHARITY

This section amends sections 812 (d) and 861 (a) (3) to provide that any interest falling into a bequest, legacy, devise, or transfer to charity by reason of an irrevocable disclaimer of such interest by another beneficiary is deductible from the gross estate as a part of such bequest, legacy, devise, or transfer to charity, if the disclaimer is made prior to the date prescribed for the filing of the estate tax return. A disclaimer is a complete and unqualified refusal to accept the rights to which one is entitled. If the beneficiary uses these rights for his own purposes, as by receiving a consideration for his formal disclaimer, he has not refused the rights to which he was entitled. There can be no disclaimer after an acceptance of such rights, expressly or impliedly. Your committee has changed the House draft of this section to provide that the disclaimer, if otherwise proper, need not be irrevocable prior to the date prescribed for the filing of the estate tax return, provided that it becomes irrevocable (for example, in cases in which the disclaimer by a beneficiary not under disability is not irrevocable when made, by a distribution of the bequest from the estate to the charity) before the expiration of the applicable period of limitations for the redetermination of the estate tax.

The amendment made by this section is applicable to estates of decedents dying after February 10, 1939, that is, all estates subject to the provisions of the Code.

SECTION 409. DENIAL OF DEDUCTION ON BEQUEST TO CERTAIN PROPAGANDA ORGANIZATIONS

This section is the same as section 409 of the House bill.

Sections 812 (d) and 861 (a) (3), relating to the deduction for bequests, etc., to charity, provide that such deduction is allowed only if the donee corporations therein described do not engage to a substantial extent in carrying on propaganda, or otherwise attempting, to influence legislation. This section amends these sections by adding similar provisions with respect to the other types of donees described therein. This amendment is declaratory of existing law, under the provisions of which a bequest, etc., to an organization carrying on propaganda or otherwise attempting to influence legislation is not considered a bequest for the charitable purposes described in these sections.

SECTION 410. PRIORITY OF CREDIT FOR LOCAL DEATH TAXES

This section is the same as section 410 of the House bill.

Under existing law the credit against the basic estate tax for death taxes paid to the States is deducted after deducting the credit allowable for payments of Federal gift taxes. The priority thus accorded the deduction of the credit for gift taxes reduces the amount of the

basic estate tax against which is then applied the credit for the local death taxes, thereby in some instances materially reducing the amount of the latter credit. In order to eliminate this inequity the order of the two credits is reversed. This section provides that the credit for local death taxes shall be deducted before, rather than after, the deduction of the credit for payments of gift taxes. With respect to the priority of the credit for the gift taxes paid under the Revenue Act of 1924 and gift taxes paid under the Revenue Act of 1932 and chapter 4 of the Code, this section provides for allowance of the credit for the gift taxes under the 1924 act first after the allowance of the credit for State death taxes paid. The amendments made by this section are effective only with respect to estates of decedents dying after the date of enactment of this act.

SECTION 411. LIABILITY OF CERTAIN TRANSFEREES

This section, which is identical with section 411 of the House bill, clarifies and amends provisions of the Internal Revenue Code relating to the estate tax lien and transferee liability. Section 827 (a) of the Code imposes a lien upon the gross estate of the decedent. The following subsection provides for a like lien upon assets received by certain persons. The latter provision is unnecessary and it is therefore eliminated. Subsection (b), as amended, contains a cross reference to the lien imposed by subsection (a), which continues to be applicable.

Section 827 (b), as it now appears in the Code, in imposing personal liability for the tax refers only to transfers in contemplation of death or intended to take effect in possession or enjoyment at or after death, and life insurance in favor of a specific beneficiary. However, all the assets referred to in section 811 are treated equally for purposes of inclusion in the gross estate and the holders or recipients of all such assets are accordingly placed on the same plane of personal liability for the tax.

This section also makes more specific the definition of "transferee" in section 900 (e) of the Internal Revenue Code, which, however, is not all-inclusive.

SECTION 412. EXEMPTION OF ESTATES OF NONRESIDENTS NOT CITIZENS

This section is identical with section 412 as passed by the House, except for a clerical change made by your committee.

Under existing law there is no allowance of a specific exemption in computing the net estate of a nonresident not a citizen of the United States. The revenue yielded by very small estates does not compensate the Government for the cost of administration imposed by such estates. This section, therefore, amends section 861 (a) of the Internal Revenue Code by adding a new paragraph (4) allowing a specific exemption of $2,000. At the same time section 864 (a) (1) is amended to provide that the executor of an estate of a nonresident not a citizen of the United States is required to file a return if any part of the gross estate situated in the United States exceeds the amount of such specific exemption. There is also included a related technical

amendment with respect to the computation of the deduction for previously taxed property.

SECTION 413. PERIOD FOR FILING PETITION EXTENDED IN CERTAIN CASES

This section does not appear in the House bill.

Under existing law if a notice of deficiency in estate tax is mailed to an executor he has 90 days within which to file his petition with the Board of Tax Appeals. In the case of an executor in remote places, such as Hawaii or Alaska, this time limit may possibly work a hardship due to delays in transporting mail which may occur during the present hostilities. To correct this hardship section 871 (a) (1) of the Code has been amended to increase the period to 150 days if the notice is mailed to an executor outside the States of the Union and the District of Columbia. This extension applies only to such deficiency notices mailed after the date of enactment of the act.

SECTION 414. OVERPAYMENT FOUND BY THE BOARD

This section, which is identical with section 414 of the House bill, amends section 912 of the Code, relating to overpayments found by the Board, to provide that the period within which the portion of the tax credited or refunded must have been paid is measured from the mailing of the notice of deficiency and not from the filing of the petition. This will avoid the confusion which now exists as to whether the term "the filing of the petition" means the filing of the original petition or the amendment thereto in which the overpayment is claimed.

PART II—GIFT TAX

SECTION 451. GIFTS TO WHICH AMENDMENTS APPLICABLE.

This section, which is identical with section 451 of the House bill, provides that the amendments to the gift tax made by the bill shall be applicable only with respect to gifts made in the calendar year 1943 and in succeeding calendar years, except in the case of any amendment containing an express provision to the contrary.

SECTION 452. POWERS OF APPOINTMENT

This section, which corresponds to section 452 of the bill as passed by the House, amends section 1000 of the Code by adding a new subsection relating to powers of appointment. This amendment is coextensive with the estate tax amendment by section 403. In view of the provision that an exercise or release of a power of appointment shall be deemed a transfer of property by the individual possessing such power, there is no need to include an amendment similar to subsection (b) of section 403, relating to the deduction of appointive property under section 812 (d) or section 861 (a) (3).

Your committee bill has made some technical changes in this section in accordance with changes made in section 403 of your committee bill amending the estate tax provisions with respect to powers of appointment. Particularly, the rule with respect to powers to

which the amendments made by this section are applicable has been modified in accordance with the corresponding provision of section 403. It is further provided in section 451 that the amendments do not apply to powers of appointment released or exercised before January 1, 1943. The future applicability of the amendments made by this section, and the limitations upon the amendments made by section 403, however, should not be construed as a limitation upon the application of the existing gift tax law with respect to the exercise or release of a power of appointment.

SECTION 453. GIFTS OF COMMUNITY PROPERTY

This section amends section 1000 of the Internal Revenue Code by adding a new subsection relating to gifts of community property. This amendment is similar to the estate tax amendment made by section 402. Your committee has made a technical change in this section in order to make its provisions correspond more closely with the estate tax amendment relating to community property.

SECTION 454. EXCLUSION FROM NET GIFTS REDUCED

This section corresponds to section 454 of the bill as passed by the House.

Under existing law the first $4,000 of gifts (other than gifts in trust or of future interests in property) made to any person by the donor during the calendar year 1939 and subsequent calendar years is excluded from the total amount of gifts made during such years in computing net gifts. This section of the House bill limits the application of the $4,000 exclusion to such gifts made after 1938 and prior to 1943 and reduces the exclusion in the case of gifts made in 1943 and thereafter to $3,000. Your committee bill adopts these amendments and adds an additional amendment to section 1000 (b) (3), as added by the House bill, so as to allow the exclusion in the case of gifts in trust made in 1943 and thereafter. Since the Supreme Court has decided, in *Helvering* v. *Hutchings* (312 U. S. 365 (1941)), that the beneficiaries of the trust rather than the trustee or the trust are the donees of a gift in trust, it is no longer necessary to discriminate against gifts in trust by disallowing the exclusion in such cases (except in cases of gifts of future interests in property) to prevent gift tax avoidance through the device of multiple trusts for the same beneficiary.

SECTION 455. SPECIFIC EXEMPTION OF GIFTS REDUCED

This section, which is the same as section 455 of the House bill, makes the specific exemption allowed in computing net gifts for the purpose of the tax for 1943 and subsequent calendar years $30,000, instead of $40,000 which is allowed under existing law. The policy of existing law is continued by reducing the exemption by the aggregate of the amounts claimed and allowed as specific exemption in the computation of gift taxes for the calendar year 1932 and all calendar years since that date and by applying the $30,000 exemption in all computations in respect to the calendar year 1942 and previous calendar years for the purpose of computing the tax for the calendar year 1943 and any calendar year thereafter.

SECTION 456. PERIOD FOR FILING PETITION EXTENDED IN CERTAIN CASES

This section does not appear in the House bill.

Under existing law if a notice of deficiency in gift tax is mailed to a donor he has 90 days within which to file his petition with the Board of Tax Appeals. In the case of a donor in remote places, such as Hawaii or Alaska, this time limit may possibly work a hardship due to delays in transporting mail which may occur during the present hostilities. To correct this hardship section 1012 (a) (1) of the Code has been amended to increase the period to 150 days if the notice is mailed to a donor outside the States of the Union and the District of Columbia. This extension applies only to deficiency notices mailed after the date of enactment of the act.

SECTION 457. OVERPAYMENT FOUND BY THE BOARD

This section, which is the same as section 456 of the House bill, amends section 1027 (d) of the Code, relating to overpayments found by the Board, to provide that the period within which the portion of the tax credited or refunded must have been paid is measured from the mailing of the notice of deficiency, and not from the filing of the petition. This will avoid the confusion which now exists as to whether the term "the filing of the petition" means the filing of the original petition, or the amendment thereto in which the overpayment is claimed.

SECTION 458. DEFINITION OF PROPERTY IN THE UNITED STATES

This section, which is the same as section 457 of the House bill, makes a technical amendment to section 1030 (b), relating to the definition of property within the United States, by changing the term "nonresident" to the term used in section 1000 (b), "nonresident not a citizen of the United States." The amendment does not affect the proper interpretation to be accorded related estate and gift tax sections.

TITLE V—AMENDMENTS TO PRIOR REVENUE ACTS

SECTION 501. ADDITIONAL CREDITS FOR UNDISTRIBUTED PROFITS TAX

This section is the same as in the House bill, except that a new paragraph to section 26 (c) has been added, providing for an additional credit in cases of corporations having a deficit in accumulated earnings and profits and prohibited by law from paying dividends, and except that a new subsection has been added providing for a stock redemption credit.

Section 501 amends section 14 (a) (2) of the Revenue Act of 1936, relating to the definition of undistributed net income, and section 26 of that act, relating to credits of corporations, and grants relief from the undistributed-profits tax for taxable years beginning after Decem-

ber 31, 1935, and prior to January 1, 1938, by allowing as an additional credit in computing undistributed net income the portion of the adjusted net income which, in certain instances, could not be distributed as a taxable dividend. Relief is also granted in the situation where, for example, the Y corporation in February, 1936, sold stock upon condition that the proceeds of the sale be used to retire certain preferred stock, and could not secure any deduction for the amount so used in computing its undistributed-profits tax. To the extent that the amounts paid may have been a dividend under section 27 (f) of the Revenue Act of 1936, no credit could be allowed since the distribution was a preferential dividend under section 27 (g) of that act. The sale and retirement were consummated prior to the President's message of March 3, 1936, to Congress, which was the first suggestion of an undistributed-profits tax applicable to the year 1936. After the enactment of the undistributed-profits tax the corporation did not have sufficient assets remaining which could be used to make distributions so as to prevent the application of such tax.

Under section 14 of the Revenue Act of 1936 corporations in general were subject to surtax at various rates from 7 to 27 percent of their undistributed net income. In some instances State law or an order of a public regulatory body prohibited payment of dividends during the existence of a deficit even though the corporation had current earnings and profits which would constitute undistributed net income under the definition thereof in section 14 (a) (2). Such corporations were, therefore, subject to undistributed profits surtax even though they were prohibited by law from paying dividends. The addition of the new paragraph 3 to subsection (c) of section 26 to provide an additional credit in the amount of the deficit in accumulated earnings and profits as of the close of the preceding taxable year is intended to give relief in certain of these cases.

Also under section 14 of the Revenue Act of 1936, it was possible that the undistributed net income of a corporation might exceed accumulated and current earnings and profits. In such case the tax could not be avoided even if distributions were made to shareholders. This result was primarily due to the fact that section 117 (d) of the Revenue Act of 1936 limited capital losses to $2,000 and section 27 (a) and (b) operated to disallow any credit where a distribution did not constitute a taxable dividend. Section 115 of the act provided that the term "dividend" means a distribution from earnings or profits, either those accumulated after February 28, 1913, or those realized during the current taxable year. The purpose of the undistributed profits tax was to force the payment of taxable dividends. Where a corporation has no earnings or profits, it cannot make a taxable distribution which would constitute a dividend allowable as a dividends-paid credit in computing the undistributed net income subject to the surtax.

The application of the deficit credits provided by these amendments may be illustrated by the following examples:

(1) The X corporation for the calendar year 1936 had an adjusted net income of $200,000 but had a deficit in accumulated earnings and profits as of the close of the preceding calendar year of $20,000. By reason of a State law in effect prior to May 1, 1936, with respect to deficit corporations, only $180,000 of this adjusted net income could be distributed as dividends. Under section 14 of the Revenue Act

of 1936, X corporation would be subject to undistributed-profits surtax on $20,000 even though it paid out the entire amount which it could have distributed without violating the State law—namely, $180,000, as taxable dividends. Under the amendment to section 26 (c), X corporation would be allowed a credit of $20,000, and would not be liable for any undistributed-profits tax for the calendar year 1936.

(2) Assume in the above example that the deficit in accumulated earnings and profits is $20,000 for income tax purposes, but the deficit in accumulated earnings and profits on the corporation's books by reason of a prior capitalization of surplus in the course of a nontaxable reorganization amounts to $250,000. In this case, although the State law would probably prohibit payment of any dividends, the credit allowed under the amendment to section 26 (c) is limited to $20,000, which is the deficit in accumulated earnings and profits for income tax purposes. X corporation, therefore, will be liable for undistributed profits surtax on $180,000 of its adjusted net income.

(3) If in the example (1) above there was in addition to the deficit of $20,000, a contract prohibiting the payment of dividends in excess of $150,000, under the existing paragraph (1) of section 26 (c) the corporation would be entitled to a credit of $50,000, that being the amount of adjusted net income in excess of the net income which may be distributed without violating the contract. Since the credit of $50,000 allowable under paragraph (1) is greater than the credit of $20,000 allowable under paragraph (3) in the section as amended, the former credit is the one to be used as provided in amended paragraph (4).

(4) The X corporation for the calendar year 1936 had a gross income of $300,000, miscellaneous deductions of $98,000, and capital losses of $100,000, but only $2,000 of the capital losses were deductible due to the provisions of section 117 (d) of the Revenue Act of 1936. Its adjusted net income was therefore $200,000 ($300,000 less $98,000 less $2,000) while its earnings or profits were $102,000 ($300,000 less $98,000 less $100,000). Assuming that the X corporation had no accumulated earnings or profits as of the beginning of the calendar year 1936 and in 1936 paid the entire amount it could distribute as taxable dividends, namely, $102,000, its undistributed net income subject to tax under section 14 of the Revenue Act of 1936 would be $98,000. Under subsection (f) of this amendment the X corporation would be allowed an additional credit of $98,000, the amount by which the adjusted net income of $200,000 exceeded the earnings and profits of the taxable year of $102,000, and would not be liable for any undistributed-profits tax for the calendar year 1936.

(5) If in the above example there was a contract in existence prior to May 1, 1936, under which the X corporation could not distribute dividends in excess of $150,000 during the calendar year 1936, section 26 (c) (1) of the Revenue Act of 1936 is applicable and allows a credit of $98,000, namely, an amount equal to the excess of the adjusted net income, $200,000, over the aggregate of the amounts which can be distributed within the taxable year as dividends, $102,000. Accordingly, the new deficit credit is unnecessary in such a case, as the X corporation would not be liable to any undistributed-profits tax for the year 1936 under existing law.

(6) Assume in example (4) that X corporation had a deficit of $20,000 in accumulated earnings and profits as of the close of the calendar year 1935, and the State law prohibited dividend distributions during the existence of a deficit in accumulated earnings and profits. X corporation distributed only $82,000 as taxable dividends, that being the total amount which was available for distribution by reason of the capital losses and the prohibition of the State law. In addition to the deficit credit of $98,000 provided in this amendment by subsection (f), paragraph (3) of section 26 (c) of this amendment provides a credit in the amount of the deficit in accumulated earnings and profits as of the close of the preceding taxable year or, in this case, $20,000. Thus corporation X by distributing as taxable dividends the sum of $82,000 would be relieved from payment of undistributed-profits surtax.

The section contains a provision permitting the refund or credit with interest of any overpayment for the taxable years involved to the extent resulting from the application of the section, if claim is filed within 1 year from the date of enactment of this act. Such refund or credit is to be made notwithstanding the fact that some other provision of law or rule of law (other than compromise)—for example, statute of limitation, closing agreement, board decision, or rule of res judicata, etc.—would, on the date of enactment of this act, or within 1 year from such date, prevent such refund or credit.

SECTION 502. STAMP TAX ON CERTAIN INSURANCE POLICIES

This section broadens section 1804 with respect to stamp taxes on insurance policies to include indemnity, fidelity, and surety bonds, and insurance with respect to hazards, risks, losses, or liabilities.

The tax is imposed at the rate of 8 cents, instead of 4 cents as provided in the House bill, on each dollar, or fractional part thereof, of the premium charged for indemnity, fidelity, and surety bonds, and for insurance other than life, and at the rate of 1 cent on each dollar, or fractional part thereof, of the premium charged for life insurance, accident policies, annuity contracts, or contracts of reinsurance. The tax is based upon the premium charged for the making, continuing, or renewal of the insurance or obligation. Merely continuing a policy or bond in effect after the effective date of the amendment does not give rise to any tax unless there is a premium charged for continuing the insurance or obligation, as in the case of a premium charged annually if the insurance is to be kept in effect from year to year.

SECTION 503. SUIT AGAINST COLLECTOR BAR IN OTHER SUITS

This section, which is the same as section 503 of the House bill, amends section 3772 of the Code to provide that a suit against a collector, whether instituted before or after the effective date of this act, will be treated the same as a suit against the United States in applying the doctrine of res judicata in all suits and proceedings instituted after June 15, 1942, in respect of any internal revenue tax. This amendment is designed to overcome the decision of the

Supreme Court in *United States* v. *Nunnally Investment Co.*, decided May 11, 1942, that a judgment in a suit against a collector is not a bar in a subsequent action upon the same claim against the United States. In the interest of reciprocity, the rule is made available to taxpayers as well as to the United States. This amendment will apply in the case of suits against a collector, an acting collector, a former collector and the personal representatives of any such persons. It is not necessary to provide by statute for the converse situation where the first suit is against the United States, in view of the decision of the Supreme Court in *Tait* v. *Western Maryland Ry. Co.* (289 U. S. 620 (1933)).

SECTION 504. REQUIREMENT OF FILING NOTICE OF LIEN

This section is the same as section 505 of the House bill.

The Treasury Department has consistently taken the position that section 3672 of the Code and the corresponding provisions of prior law authorize the State or Territory only to designate the local office for the filing of the notice of the lien. This section of the bill, which clarifies section 3672 (a), as amended, by expressly providing that the lien shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed in the office in which the filing of such notice is authorized by the law of the State or Territory in which the property subject to the lien is situated, if the State or Territory has by law authorized the filing of such notice in an office within the State or Territory, is merely declaratory of the existing procedure and in accordance with the long-continued practice of the Treasury Department, which has been questioned in the courts.

SECTION 505. MISCELLANEOUS AMENDMENTS TO STAMP TAX PROVISIONS

This section as it passed the House was section 507 and amended section 1808 of the Code by adding thereto a new subsection (g) which conferred stamp tax exemption in connection with certain orders of the Securities and Exchange Commission. Your committee has enlarged this section so that it now consists of subsections (a) to (h) inclusive, the original section now appearing as subsection (e) in which subsection your committee has also included a provision relative to common trust funds not included in the House bill. Subsection (h) states when the other subsections become effective. The purposes of the other subsections are as follows:

(*a*) *Bonds, etc., issued by receiver.*—Subsection (a) of this section amends Code section 1801 which makes bonds and other instruments issued by corporations taxable. To overcome court decisions holding instruments issued by receivers of corporations not taxable because not issued by the corporations, the amendment provides that obligations described in section 1801 issued by any receiver, trustee in bankruptcy, assignee, or other person having custody of property or charge of the affairs of any corporation shall for the purposes of the chapter be deemed to be issued by the corporation. Subsection (h) (1) limits the application of subsection (a) to obligations issued after the date of passage of the act. However, under the language of section 3481 (a) of the Code, all transfers of such obligations

after such date will be taxable whether issuance of the obligations occurs before or on or after such date.

(*b*) *Transfers by operation of law.*—Subsection (b) of this section is intended to avoid legal and administrative difficulties which have developed out of the rule administratively established in connection with the stamp taxes on transfers of stocks and bonds and similar instruments that tax does not apply to transfers wholly by operation of law. Subsection (b) adds subsection (c) to Code section 1802, applicable to transfers of capital stock and similar instruments, and also adds subsection (b) to Code section 3481 applicable to transfers of bonds. These additions to the Code abolish operation of law as a basis of exemption and allow certain specified exemptions which appear appropriate. Included among the exemptions are transfers from a foreign country or national thereof to the United States or any agency thereof, including transfers by vesting in a designated agency or person, and transfers to the Government of any foreign country, as may be directed by the President, pursuant to the authority conferred upon him by section 5 (b) of the Trading with the Enemy Act as amended by the First War Powers Act, United States Code, supplement 1, title 50, appendix, section 5 (b) (1).

By subsection (h) (2) of this section the amendments made by subsection (b) thereof are made applicable in respect of deliveries and transfers made on or after the thirtieth day after the date of passage of the act. This postponement is necessary because of the provision of subsection (b) that for the exemption to apply the transfer or delivery must be covered by a certificate setting forth such facts as regulations shall prescribe.

(*c*) *Stamp tax exemption of cooperative banks, etc.*—Subsection (c) of this section amends Code section 1808 (c) which now extends an exemption from stamp tax with respect to stocks and bonds issued by certain domestic building and loan associations. As amended, section 1808 (c) exempts from stamp tax the issuance and transfer of stocks and bonds issued by building and loan associations, savings and loan associations, cooperative banks, and homestead associations, if substantially all the business done is confined to making loans to members.

(*d*) *Stamp tax exemption of railroad and corporate reorganizations in bankruptcy, etc.*—Subsection (d) of this section amends Code section 1808 (e) and (f) of the Code, which now exempt from the stamp taxes imposed by Federal law the use of documents to make effective the reorganization under the National Bankruptcy Act of railroads engaged in interstate commerce and certain other corporations. The amendment made by subsection (d) of section 505 combines subsections (e) and (f) of Code section 1808 as subsection (e), and extends the exemption from Federal stamp taxes to the issuance, transfer, etc., of instruments after the date of enactment of the act, in reorganizations and adjustments approved in equity receivership proceedings either before or on or after the date of passage of the act.

Under the amendment, an issuance, transfer, etc., after the effective date of the act, to be exempt must occur within 5 years from the date of confirmation or approval of the reorganization or adjustment, whether such confirmation or approval is prior to or on or after the effective date of the act. The 5-year limitation applies whether the issuance, transfer, etc., would have been exempt without the amend-

ment or not. Section 267 of the National Bankruptcy Act, United States Code, title 11, section 667, confers exemption, in corporate reorganizations under the National Bankruptcy Act, from Federal and State stamp taxes. To make sure that the 5-year limitation shall apply not only to section 1808 (e) as amended but to section 267 and all other applicable exemption provisions, it is provided by section 505 (h) (4) that in case of issuance, transfer, etc., after the effective date of the act, any other provisions, to the extent that exemption from stamp tax is thereby conferred after 5 years from the date of confirmation or approval, shall be inapplicable.

(*e*) *Exemptions in connection with certain orders of the Securities and Exchange Commission and in the case of common trust funds.*—Subsection (e) of this section adds to Code section 1808, a new subsection (f) which exempts from documentary stamp tax liability the issuance, transfer, or exchange of securities and the making or delivery of conveyances to make effective an order of the Securities and Exchange Commission pursuant to the Public Utility Holding Company Act. Legislation alleviating the hardship of income-tax liability arising from compulsory transactions pursuant to orders of the Securities and Exchange Commission has already been enacted in supplement R, chapter 1, of the Code. The granting of relief from stamp taxes arising from such transactions has been proposed by the Securities and Exchange Commission and approved by the Treasury Department. Subsection (h) (5) (A) of this section makes subsection (e) applicable only where the issuance, transfer, or exchange of securities or making or delivery of conveyances occurs after the date of passage of the act.

One of the conditions upon which the exemption is granted is that the order of the Securities and Exchange Commission specifies and itemizes the securities and other property ordered to be issued, transferred, etc. This may require amendment of prior orders to secure exemption with respect to subsequent transactions.

Subsection (e) of this section also adds to Code section 1808 a new subsection (g) which exempts shares or certificates of a common trust fund as defined in Code section 169 from the stamp tax imposed by Code section 1802 (a) on original issue of shares or certificates of stock or of profits or of interest in property or accumulations by any corporation or investment trust or similar organization holding or dealing in stocks, bonds, and other enumerated instruments. Code section 169 (a) defines a "common trust fund" as a fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian. Common trust funds as entities are exempt from income tax (participants in a fund being required in computing their net income to include income of the fund), and it seems consistent that they should also be exempt from stamp tax on issuance of the instruments indicated.

(*f*) *Exemption of United States, etc., from stamp tax.*—Subsection (f) of this section is intended to settle questions of stamp tax liability in cases where an agency of the United States is a party to a taxable instrument to which a private person is also a party. In such situation the subsection holds the private party or parties only liable for the tax. However, it is expedient in some cases for the governmental agency to attach the stamps. To prevent a person able to pay the tax

from shifting the burden thereof to the Government it is provided that affixing of stamps by the governmental agency without payment or reimbursement therefor by a party liable for the tax shall not relieve the private party or parties from liability for the tax.

(*g*) *Transfer of bonds on reorganization taxable.*—Subsection (g) of this section strikes out language of Code section 3481 (a) extending an exemption in respect of bond transfers and deliveries in connection with a reorganization as defined in section 112 of the Revenue Act of 1932 if gain or loss is not recognized under the income-tax law applicable to the year in which the delivery or transfer is made. This exemption, now dependent upon a definition of the Revenue Act of 1932, and application of present income-tax provisions of the Code, becomes more incongruous as time passes. Any stamp-tax exemption dependent upon absence of liability under the income-tax laws is incongruous. The stamp tax on delivery or transfer of instruments is due at the time the delivery or transfer occurs. Whether income-tax liability arises from the transaction is ordinarily not determined until a considerable time after the event. Under subsection (h) (7) of this section the withdrawal of the exemption is effective as to deliveries and transfers made after the date of passage of the act.

SECTION 506. TIME FOR PERFORMING CERTAIN ACTS POSTPONED BY REASON OF WAR

The provisions of this section for the most part have the same purpose and effect as the corresponding provisions contained in section 508 of the House bill. Your committee recommends that section 506 of the House bill be stricken, and that the subject matter of such section be included within the scope of this section. Section 506 of the House bill would have relieved certain alien nonresident individuals and certain foreign corporations from interest upon income tax for taxable years beginning after December 31, 1939, for a period beginning with the date of enactment of the bill. It is believed that such taxpayers should be relieved from interest for the period beginning with December 7, 1941, which may be accomplished under this section as reported by your committee.

This section has for its purpose the suspension of time limitations, running against the Government, taxpayers, and others in certain cases where, by reason of the war, timely performance of acts affecting Federal tax liabilities and rights is impossible or impracticable. For example, in the case of individuals outside the Americas, both the individuals and the Government in many cases find it difficult or impossible by reason of impairment or stoppage of transportation or communications to perform acts affecting taxes of such individuals within the time prescribed therefor. In some cases, assets and essential records of taxpayers are in an enemy country or enemy controlled territory, which circumstance may preclude timely compliance with certain tax requirements. Similarly, it may be impossible for members of the military or naval forces of the United States who are stationed within some parts of the Americas, or serving on sea duty therein, to perform such acts.

The section affects all Federal taxes, those imposed by the Code as well as by prior internal-revenue laws.

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Subsection (a) of this section adds sections 3804 and 3805 at the end of chapter 38 of the Code. Subsection (b) relates to the effect of the new section 3804 upon periods fixed under laws other than the Code. Subsection (c) relates to the retroactive effect of sections 3804 and 3805, and provides for certain refunds and credits.

Section 3804 (a), as amended, relates exclusively to the tax liability of individuals who are continuously outside the Americas (as defined in sec. 3804 (e) (1)) for more than 90 days at any time after December 6, 1941. It provides that any period of time after such date during which the individual is continuously outside the Americas for more than 90 days, and the next 90 days thereafter, shall be disregarded in making certain determinations under the internal-revenue laws with respect to the performance of certain listed acts. These acts include, among others, filing returns and making payments of income tax (with certain exceptions), filing certain petitions with the Board of Tax Appeals, filing claims for credit or refund of any tax, and assessing or collecting any tax. Acts not listed in the section may be added by regulations prescribed thereunder. It is intended that the date of departure be excluded and the date of return be included as an entire day in determining the duration of any period during which an individual is continuously outside the Americas. The provision of section 3804 (a) of the House bill relating to individuals within a locality in the Americas besieged or occupied by the enemy has been deleted therefrom by your committee and a substitute provision having a similar purpose inserted in section 3804 (b).

Section 3804 (b), as it is recommended that it be amended, provides that, under regulations which may be prescribed pursuant thereto, a period of time may be disregarded in determining whether any of the acts specified in section 3804 (a) (1) (including acts not expressly listed but authorized to be specified under section 3804 (a) (1) (K)) was performed within the time prescribed therefor, in cases in which a period of time would not be disregarded under section 3804 (a). The periods of time to be disregarded, and the persons (including individuals, trusts, and corporations) with respect to whom and circumstances under which such periods are to be disregarded are left to regulations. The authority under section 3804 (b) is, however, limited to cases in which it is impossible or impracticable, as determined by the Commissioner, to perform one of the listed acts (1) by reason of any individual being outside the Americas, or (2) by reason of any locality (within or without the Americas) being an area of enemy action or control, as determined by the Commissioner, or (3) by reason of an individual in the military or naval forces of the United States being outside the States of the Union and the District of Columbia.

Section 3804 (c) prescribes a limitation on the time disregarded under section 3804, geared to the termination of the war, and, in the case of an individual, the qualification of an executor, administrator, or conservator of the estate of such individual. This section, as it is recommended that it be amended, adds one more day which may be disregarded under the limitation, having the effect of permitting timely performance on the fifteenth day of the month. Under the House bill, the limitation would have caused the period for timely performance to have expired at the expiration of the fourteenth day of the month. A clerical change is also made in this section.

The changes made by your committee in section 3804 (d) are of a clerical nature. This section contains exceptions permitting the Commissioner to make jeopardy and transferee assessments and to close the taxable year in the case of a person to whom subsection (a) or (b) applies. The scope of section 146 is broadened so as to make it possible to collect tax thereunder for years earlier than the year next preceding the taxable period declared closed under the section. In addition, section 3804 (d) (1) authorizes steps to be taken to protect the revenue, as, for example, by collection by distraint, or by making a demand for payment and filing a notice of lien, in cases where after the making of an ordinary assessment the Commissioner finds that collection would be jeopardized by delay. A method for giving or making notice or demand is provided where the person's address is in an area for which, by reason of the war, post offices refuse to accept mail for delivery. Another exception would validate proceedings to collect taxes from a person where it has not been ascertained that he is entitled to the benefits of section 3804.

Section 3804 (d) (3) provides that section 3804 (a) and (b) shall not operate to extend the time for the assessment of tax, the giving or making by the Government of notice or demand, collection of tax, or the bringing of a suit by the Government in respect of a tax, if such time under the law in force prior to the date of enactment of the section expired prior to such date.

Section 3804 (e) (1) defines the term "Americas" to mean North, Central, and South America (including the West Indies but not Greenland), and the Hawaiian Islands. For example, the Aleutian Islands, Newfoundland, and Bermuda are included, but not Iceland.

Section 3804 (e) (2) and (3) in certain cases suspends, until notice is received by the Commissioner, the running of time limitations against the assessment or collection of tax, the giving or making by the Government of notice or demand, and the bringing of a suit by the Government in respect of a tax. The purpose of the change recommended by your committee in section 3804 (e) (2) is to make clear that notice need be given the Commissioner by an individual only if a period of time is disregarded under the section. The change in section 3804 (e) (3) is clerical.

Section 3805 fixes new income tax due dates in case of China Trade Act corporations.

Subsection (b) of section 508 of the House bill provided that section 3804 of the Code, added to the Code by subsection (a), shall not be construed to shorten any period fixed under certain provisions of law. Those provisions are contained in sections 13 and 14 of the act approved March 7, 1942 (Public Law 490, 77th Cong.) (relating to the time for filing income-tax returns and paying income tax in case of certain members of our armed forces serving on sea duty or outside the continental United States, and in case of certain civilian employees of the United States detained by enemy governments or besieged by enemy forces), and in section 513 of the Soldiers' and Sailors' Civil Relief Act of 1940 (authorizing the deferment of collection of income tax from any member of our armed forces whose ability to pay the tax is materially impaired by reason of his service in such forces). Section 506 (b) (1) and (2) (A), as recommended by your committee, contains the same provisions as in the House bill, except for formal changes.

No provisions corresponding to section 506 (b) (2) (B) and (C) were included in the House bill. Such subparagraphs (B) and (C), respectively, add a new section 207 and a new section 701 to the Soldiers' and Sailors' Civil Relief Act of 1940. Such section 207 provides that section 205 of the Relief Act (providing for disregarding the period of military service of an individual in computing periods of limitations applicable to suits and proceedings before courts and governmental agencies) shall not apply with respect to any period of limitation prescribed by or under the internal revenue laws of the United States. Thus, for Federal tax purposes the extent to which periods of time are to be disregarded because of the war, including cases involving persons in the armed forces, would be left to section 3804 of the Code, added by section 506 (a) of the bill, which is directly geared to Federal tax procedures and under which ample relief may be provided, from the standpoint of both the taxpayer and the Government. The new section 701 of the Relief Act would require applications to courts for Federal tax relief under such act to be made in the Federal courts only.

Section 506 (c), added by your committee to the House bill, provides that sections 3804 and 3805 shall take effect as of December 7, 1941, and provides for the refund or credit of interest, penalty, additional amount, or addition to the tax, where amounts thereof are collected, but liability therefor was in reality not incurred by reason of such sections. No interest may be allowed or paid by the United States upon any amount so refunded or credited.

SECTION 507. MITIGATION OF EFFECT OF DISALLOWANCE OF REIMBURSEMENT ON CONTRACTS WITH THE UNITED STATES

In I. T. 3577, I. R. B. 1942-37, page 5, the Bureau of Internal Revenue has taken the position that in cases in which Government war contracts are renegotiated by reductions applied retroactively to prior taxable years for which returns have been filed, no refund or abatement of the Federal income and excess profits taxes for such prior years shall be made by reason of such renegotiation and that such taxes are to be applied as a credit or offset against the amounts to be repaid pursuant to the renegotiation. By such ruling a similar position is taken in respect of cases involving a cost-plus-a-fixed-fee contract where an item for which the taxpayer has been reimbursed is disallowed as an item of cost chargeable to such contract and the taxpayer is required to repay to the United States the amount disallowed. The general purpose of the amendment made by this section is to make certain that the rule applied by the Bureau shall be applicable in the cases involving cost-plus-a-fixed-fee contracts, to provide specifically for the method of computing the amount of taxes to be credited in respect of barred years, to provide a rule as to interest, and to authorize a credit or refund of taxes allowable but not allowed as a credit against the amount to be repaid to the United States.

Section 3805, as added by this section of the bill, provides that where an item for which the taxpayer has been reimbursed is disallowed as an item of cost chargeable to a cost-plus-a-fixed-fee contract and in a taxable year beginning after December 31, 1941, the taxpayer is required to repay to the United States the amount disallowed (or

the amount disallowed is applied as an offset against other amounts due the taxpayer) the amount of the reimbursement previously received or accrued by the taxpayer shall be reduced by the amount disallowed; but the amount repaid to the United States does not constitute a deduction for the year in which it is paid or incurred. For example, if in the year 1942 a taxpayer having a cost-plus-a-fixed-fee contract received reimbursements in the amount of $1,000,000 and in the year 1943 an item of $100,000 which is included in the $1,000,000 is disallowed and the taxpayer is required in 1943 to repay the $100,000 to the United States, the reimbursements for the year 1942 are considered to be only $900,000. No part of the $100,000 is deductible in 1943. The reduction in the amount of the reimbursements for the year 1942 will result in a corresponding decrease in the amount of tax for such year. Assuming that such decrease in tax amounts to $60,000, such $60,000 is to be credited against the $100,000 repayment due from the taxpayer, and the taxpayer will pay to the United States the net amount of $40,000.

If at the time the taxpayer makes the repayment to the United States, refund or credit of the Federal income and excess-profits taxes for the prior year is prevented (except for the provision of section 3801) by any provision of the internal revenue laws other than section 3761 (relating to compromises), or by rule of law, the amount by which the tax for the prior year is decreased is to be computed in accordance with certain specified rules which require that the amount of the decrease in tax shall be determinable only by reference to the amount of the item which is disallowed as cost and which is repayable to the United States on account of the disallowance.

No interest is to be allowed on the amount of the Federal taxes in determining the amount thereof to be credited against the amount which the taxpayer is to repay to the United States as a result of the disallowed item of cost, except that if interest is charged by the United States on account of the disallowance, interest is allowable in respect of the taxes in accordance with the special rule provided in section 3805 (b) (3).

If the amount of taxes allowable as a credit under the procedure described above exceeds the amount allowed, provision is made for a refund or credit by the Bureau of Internal Revenue of the amount of such excess. The statutory period of limitation for such refund or credit begins to run at the time the taxpayer is required to repay to the United States the amount disallowed as an item of cost.

SECTION 508. AMENDMENT TO THE PUBLIC SALARY TAX ACT OF 1939

This section does not appear in the House bill.

Title I of the Public Salary Tax Act of 1939 imposed Federal income tax on the compensation of all State and local officers and employees for taxable years beginning after December 31, 1938. Inasmuch as rules provided by the applicable revenue laws as to the period for which income must be reported were unaffected by any provision of the Public Salary Tax Act of 1939, it followed that where the taxpayer was on a cash basis, compensation of a State or local officer or employee received in a taxable year beginning after December 31, 1938, was

taxable notwithstanding the fact that such compensation was for services rendered prior to January 1, 1939. Your committee has amended section 203 of the Public Salary Tax Act of 1939 by adding a new subsection (b) thereto which provides, in substance, that such compensation (other than pensions, retirement pay, or other similar allowances) is not taxable if the collection or retention of tax on such compensation would result in the application of the doctrine of the *Therrell*, *Gerhardt* and *O'Keefe* cases. Where, however, such compensation was subject to tax apart from the doctrine of these cases prior to the enactment of the Public Salary Tax Act of 1939, no relief is given.

SECTION 509. TAXATION OF OBLIGATIONS OF UNITED STATES AND ITS INSTRUMENTALITIES

This section is a correlative to sections 112 and 510 of the bill, all of which relate to the elimination of the exemption of interest on public obligations. Under subsection (a) the United States consents to the taxation, under an income tax imposed by any duly constituted taxing authority, of interest upon obligations and income from evidences of ownership, and gains from the sale or other disposition of such obligations and evidences of ownership, issued after December 31, 1942, by the Federal Government. The same consent applies to obligations issued after December 31, 1942, by any Territory, possession, or political subdivision of the United States, the District of Columbia, or any agency or instrumentality of any one or more of the foregoing or of the United States. Any duly constituted taxing authority having jurisdiction may tax such interest, gains, or other income, if such tax does not discriminate against such income because of its source. This section, together with section 510, will effectively eliminate for the future tax exemption which may have been accorded to any obligations by an act of Congress. It is provided, however, that obligations issued in the future by the Maritime Commission and the Federal Housing Administration in compliance with guaranty contracts entered into prior to January 1, 1942, are to be treated as obligations issued before that date and are not to be affected by this consent.

At present section 5 of the Second Liberty Bond Act, as amended, provides that no loss from the sale or other disposition of Treasury bills shall be allowed as a deduction or otherwise recognized for the purpose of any tax imposed by any of the possessions of the United States. The disallowance of such a loss for the purpose of the Federal income tax was eliminated by section 4 of the Public Debt Act of 1941, and section 509 (a) removes such limitation for the purpose of tax laws of any possession of the United States.

Subsection (b) amends section 4 (a) of the Public Debt Act of 1941 to make interest upon obligations and income from evidences of ownership, including gain from the sale or other disposition of such obligations and evidences of ownership, issued after December 31, 1942, by Territories or possessions of the United States, the District of Columbia, or any political subdivision thereof, or by any agency or instrumentality of any one or more of the foregoing, subject to taxation by the Federal Government to the same extent as obligations and evi-

dences of ownership issued by the United States or an agency or instrumentality of the United States.

Section 509 prescribes the same tests for determining the date of issuance of obligations and evidences of ownership as are provided in section 112 of the bill. An obligation or evidence of ownership is considered as issued after December 31, 1942, if any part of the payment therefor is received or delivery thereof is made by the obligor after such date. It is further provided, as in section 112, that obligations shall not be considered as different from obligations which they replace in the case of certain formal exchanges and replacements.

Subsection (c) provides that this section shall, with respect to any obligation, be considered as amendatory of and supplementary to respective acts or parts of acts authorizing the issuance of such obligation, as amended and supplemented.

SECTION 510. TAX STATUS OF OBLIGATIONS ISSUED UNDER AUTHORITY OF THE UNITED STATES HOUSING ACT OF 1937

This section, which does not appear in the House bill, is necessary in order to eliminate prospectively the tax exemption of interest upon obligations issued by certain public housing agencies.

Section 5 (e) of the United States Housing Act of 1937 (50 Stat. 890) provides that obligations, including interest thereon, issued by public housing agencies in connection with low-rent-housing or slum-clearance projects, shall be exempt from taxation imposed by the United States. This section amends such section 5(e) so as to limit the tax-exemption privilege to such of these obligations as are issued prior to January 1, 1943.

An obligation is considered as having been issued after December 31, 1942, if any part of the payment therefor is received by the obligor after such date, or if delivery thereof is made by the obligor after such date. Obligations issued after December 31, 1942, merely to replace obligations existing on or before such date are considered as having been issued on or before such date.

SECTION 511. JOINT COMMITTEE ON COMPULSORY SAVINGS

This section, which is added to the House bill, provides for a joint committee of five members of the Committee on Finance of the Senate, five members of the Committee on Ways and Means of the House of Representatives, and the Secretary of the Treasury, to study and investigate all plans for compulsory savings and other plans by which money may be raised to assist in the conduct of the war and the avoidance of inflation. The committee is to report the results of its study and its recommendations to the President and the Congress by December 1, 1942. Provisions are made for the committee to hold hearings, obtain evidence and information, employ assistance, and make such expenditures as it deems advisable. The committee may use the services, information, facilities, and personnel of the departments and agencies of the Government. For carrying out the provisions of this section, the sum of $10,000 is appropriated.

SECTION 512. ABOLITION OF BOARD OF REVIEW AND TRANSFER OF JURISDICTION TO BOARD OF TAX APPEALS

On June 22, 1936, the Congress enacted title VII of the Revenue Act of 1936, providing an administrative procedure for the refund of amounts paid by or collected from persons as tax under the Agricultural Adjustment Act. The premise of title VII of the Revenue Act of 1936 is that those persons who paid taxes under the Agricultural Adjustment Act may secure refunds only to the extent that they establish that they bore the burden of such taxes and did not shift such burden to others. Section 906 (b) of title VII of the Revenue Act of 1936 created in the Treasury Department a Board of Review composed of nine members to review the allowance or disallowance by the Commissioner of claims for refund, and to determine the amount of refund due claimants with respect to such claims.

The provisions of this amendment (1) abolish the Board of Review and transfer the jurisdiction vested in it by section 906 (b) to the Board of Tax Appeals with respect to all matters pending before the Board of Review as of the close of business on December 31, 1942, and with respect to all future petitions for review involving the allowance or disallowance by the Commissioner of claims for refund of amounts paid by or collected from taxpayers as processing tax; and (2) conform, as nearly as may be, the applicable procedure to the present procedure of the Board of Tax Appeals in cases over which it now has jurisdiction. It is provided that the time allowed for the filing of a petition with the Board of Tax Appeals shall be governed by existing law if the Commissioner has prior to January 1, 1943, mailed notice by registered mail that the refund has been disallowed in whole or in part. Provision also is made to retain the existing procedure applicable to appeals as to all cases decided by the Board of Review prior to January 1, 1943, or pending in appellate courts on such date. If, however, any such case is remanded by an appellate court for further proceedings, the procedure of the Board of Tax Appeals, as provided for in the amendment, is to prevail.

SECTION 513. DEFINITION OF MILITARY OR NAVAL FORCES OF THE UNITED STATES

This section, for which there is no corresponding provision in the House bill, amends the definition of military or naval forces of the United States contained in section 3797 (a) (15) of the Code so as to include the Women's Army Auxiliary Corps and the Women's Reserve branch of the Naval Reserve. By this amendment it is made clear that the additional allowance for military and naval personnel provided for in section 117 of your committee bill will apply to the Women's Army Auxiliary Corps and the Women's Reserve branch of the Naval Reserve.

SECTION 514. JOINT COMMITTEE ON INTERNAL REVENUE TAXATION—POWER TO OBTAIN DATA

This section, which has been added to the bill by your committee, relates to the powers of the staff of the Joint Committee on Internal Revenue Taxation in obtaining information, data, estimates, and

statistics for the purpose of making investigations, reports, and studies relating to internal revenue taxation.

TITLE VI—EXCISE TAXES

SECTION 601. EFFECTIVE DATE

This section, which is the same as section 601 of the House bill, fixes the effective date of title VI, which relates to excise taxes. Since the excise taxes are paid monthly and covered by monthly returns, it is desirable that changes with respect thereto shall take effect on the first day of a selected month. It is also desirable that there shall be reasonable opportunity for preparation by taxpayers, as well as by the Bureau of Internal Revenue, to conform to the new requirements. Accordingly section 601 provides that title VI shall take effect on the first day of the first month which begins more than 10 days after the date of enactment of the act.

SECTION 602, 603, AND 604. DISTILLED SPIRITS, FERMENTED MALT LIQUORS, AND WINES

Sections 602, 603, and 604 of the House bill increase the rates of tax on distilled spirits, fermented malt liquors and wines, respectively, and impose floor stocks taxes in respect of such articles equal to the differences between the present and proposed rates. Section 602 also: (1) increases the rate of tax on imported perfumes containing distilled spirits; (2) makes such tax applicable to imported bitters of all kinds containing distilled spirits; and (3) increases the rate of draw-back on distilled spirits for export in original packages to keep pace with the tax increase. The rates of tax and draw-back contained in the House bill are retained without change. Each of these sections provides that persons required to pay the respective floor stocks taxes shall, on or before the 1st day of the third month following the effective date of title VI of the bill, make their returns and pay the tax. Your committee was of opinion that the making of the returns should not be delayed for as long as 3 months because of the hazard to the revenue inherent in such a delay, and further, that if the returns are made as soon after the effective date of the floor stocks tax as is practicable the problems of the revenue officers charged with the checking of the returns will be simplified. Your committee has, therefore, reported sections 602, 603, and 604 with amendments requiring the filing of the floor stocks tax returns within 30 days after the effective date of title VI. No change is made, or recommended, in respect of the present requirement of the sections that the floor stocks taxes due shall be paid on or before the 1st day of the third month following the effective date of the title unless, upon the filing of a bond, such payments are extended to a date not later than the 1st day of the tenth month following the effective date of the title.

Section 603 (b) of the House bill, in respect of fermented malt liquor, provides for an exemption from the floor-stocks tax of $1 per barrel of 31 gallons in favor of retail stocks of fermented malt liquor held by a person on premises as to which such person has incurred occupational tax as retail dealer in liquors or retail dealer in malt liquors for a period beginning on July 1, 1942, but as to which premises

no other occupational tax with respect to dealing in distilled spirits or fermented malt liquors has been incurred by such person for a period beginning on such date; in other words, an exemption in favor of retail dealers. Your committee was of opinion that the exemption in respect of retail dealers should be eliminated.

Section 604 of the House bill increases the rate of tax on sparkling wines from 7 cents on each one-half pint or fraction thereof, to 10 cents; your committee has retained the present rate of tax.

A new subsection lettered (e) has been added by your committee to section 602 of the House bill to amend part II of subchapter C of chapter 26 (relating to industrial alcohol) of the Code by the addition of a section numbered 3125 to permit the withdrawal from customs custody of imported alcohol of 160° proof, or greater, under regulations, and in bond, without payment of the internal-revenue tax imposed upon the act of importing such alcohol. The purpose of the section is to relieve any shortage in industrial alcohol for the duration of the emergency by permitting the importation of foreign alcohol without payment of tax. The section provides that the alcohol so imported shall be subject from the time of its withdrawal from customs custody to all the applicable provisions of part II of subchapter C of chapter 26 of the Code. Provision is made for the withdrawal of the alcohol, in bond, from customs custody, without payment of the internal-revenue tax, for transfer to industrial alcohol plants, alcohol bonded warehouses, and denaturing plants for redistillation or denaturation and withdrawal, or withdrawal without redistillation, either free of tax or upon payment of the tax, as the case might be, for all the purposes authorized by the said part II. Since alcohol imported for nonbeverage purposes is subject to a customs duty of 15 cents per gallon and alcohol which is imported for beverage purposes is subject to a duty at a higher rate, provision is made in the section that if alcohol imported into the United States and introduced into industrial alcohol plants, alcohol bonded warehouses, or denaturing plants is withdrawn from such plants or warehouses for beverage purposes, that is, upon payment of the tax, there shall be paid in respect of such alcohol upon such withdrawal an additional tax equal to the duty which would have been paid had such spirits been imported for beverage purposes, less the duty already paid thereon.

Subsection (b) of the proposed new section provides that imported alcohol may be withdrawn from customs custody by the United States or any governmental agency thereof for its own use free of internal-revenue tax, under such regulations as may be prescribed.

Provision is further made that notwithstanding the provisions of section 601 of the House bill, that title VI of the bill, relating to excise taxes, shall take effect on the 1st day of the first month which begins more than 10 days after the enactment of the act, subsection (e) of section 602 shall take effect on the day following the date of the enactment of the act.

Your committee added another subsection lettered (f) to section 602 of the House bill for the purpose of amending section 3250 of the Code by adding at the end thereof a new subsection lettered (l), which will establish a tax differential in favor of the users of fully tax-paid distilled spirits (either imported, or domestically produced), when such tax-paid distilled spirits are used in the manufacture or production of

medicines, medicinal preparations, food products, flavors, or flavoring extracts which are unfit for use for beverage purposes and which are sold or otherwise transferred for use for other than beverage purposes, upon filing of a claim as set forth in the section. The section provides that the persons so using the fully tax-paid distilled spirits in the manufacture or production of the article mentioned shall be eligible for a draw-back at the rate of $3.75 on each proof gallon used as provided in the new section, when they have paid a special tax of $100 per annum. Paragraph 2 of the section requires claimants under the section to register annually with the Commissioner; to keep such books and records as may be necessary to establish the fact that distilled spirits purchased by them and fully tax-paid were used in the manufacture or production of medicines, medicinal preparations, food products, flavors, or flavoring extracts which were unfit for use for beverage purposes and were sold or otherwise transferred for use for other than beverage purposes; and makes such persons (claimants) subject to such rules and regulations in relation thereto as the Commissioner, with the approval of the Secretary, shall prescribe to secure the Treasury of the United States against frauds.

Paragraph 3 of the added section authorizes the Commissioner, operating through any officer or employee of the Bureau of Internal Revenue, including the field service, designated by him for that purpose, to examine any books, papers, records, or memoranda bearing upon the matters required to be alleged in the claim, and to require the attendance of the person filing the claim or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and to take the testimony of such persons, officers, and employees with reference to any matter covered by the claim, with power to administer oaths to such person or persons. The powers given to the Commissioner by this paragraph will enable him to make the necessary investigations to prevent frauds upon the revenue through false claims under the section. The authority granted to the Commissioner is similar to the authority now vested in the Commissioner by sections 3614 and 3615 of the Code in respect of his inquiries in determining the liability of taxpayers and transferees.

Paragraph 4 establishes the draw-back or refund at the rate of $3.75 on each proof gallon of fully tax-paid distilled spirits used as provided in the section; requires the filing of a proper claim (i. e., a claim in the manner and form required by the Commissioner in his regulations); provides for the payment of the claims on the basis of the quarters of the fiscal year (every 3 months), and provides that no claim under the section shall be allowed unless filed with the Commissioner within the 3 months next succeeding the quarter of a fiscal year for which the draw-back or refund is claimed.

SECTION 605. CIGARS AND CIGARETTES

Section 605 of the bill as passed by the House amends section 2000 of the Code to increase the rates of tax with respect to smoking tobacco, cigars, cigarettes, and cigarette papers, and to eliminate the present exemption from tax of cigarette papers made up into packages containing 25 papers or less.

Subsection (a) of the House bill increases the rate of tax on smoking tobacco from 18 to 24 cents per pound. Your committee has eliminated this increase.

Subsection (b) of the House bill, changed to subsection (a) by your committee, increases the rates of tax with respect to cigars weighing more than 3 pounds per thousand. Your committee has reduced some of the rates fixed by the House bill. The rates fixed by the House, by your committee, and by the present law, are as follows:

Tax rates approved by House			Tax rates approved by committee			Present tax rates		
Class	Made to retail at (cents)	Rate per M	Class	Made to retail at (cents)	Rate per M	Class	Made to retail at (cents)	Rate per M
A	Not more than 2.5 each.	$2.50	A	Not more than 2.5 each.	$2.00			
B	More than 2.5 and not more than 4.	3.50	B	More than 2.5 and not more than 4.	3.00	A	Not more than 5 each.	$2.00
C	More than 4 and not more than 6.	5.00	C	More than 4 and not more than 6.	4.00	B	More than 5 and not more than 8.	3.00
D	More than 6 and not more than 8.	7.00	D	More than 6 and not more than 8.	7.00			
E	More than 8 and not more than 11.	10.00	E	More than 8 and not more than 15.	10.00	C	More than 8 and not more than 15.	5.00
F	More than 11 and not more than 15.	13.50						
G	More than 15 and not more than 20.	18.00	F	More than 15 and not more than 20.	15.00	D	More than 15 and not more than 20.	10.50
H	More than 20 and not more than 30.	25.00	G	More than 20	20.00	E	More than 20	13.50
I	More than 30	35.00						

Subsection (c) of the House bill, changed to subsection (b) by your committee, increases the rate of tax on small cigarettes from $3.25 to $3.50 per thousand and on large cigarettes from $7.80 to $8.40 per thousand.

Subsection (d) of the House bill increases the rate of tax on cigarette papers and imposes the tax on all papers made up into packages, books, or sets, regardless of the size, thereby eliminating the present tax exemption of packages, books, or sets containing 25 papers or less. Your committee has eliminated this amendment, thus allowing the present law to remain unchanged.

Subsection (e) of the House bill, changed to subsection (c) by your committee, imposes a floor-stocks tax equal to the increase in tax made by the bill as it passed the House on smoking tobacco, large cigars and cigarettes, and small cigarettes, held for sale on the day the increased rates of tax on such articles take effect. Your committee has eliminated the floor-stocks tax on smoking tobacco to correspond to the elimination by it of the increase in tax imposed on smoking tobacco by the House bill.

Subsection (f) of the House bill, changed to subsection (d) by your committee, amends section 2100 (a) (1) of the Code, relating to the sizes of tobacco and snuff packages, to permit packages with one-eighth ounce gradations between 2 and 3 ounces.

Subsection (e) added by your committee amends Code section 2197 (b) to include cigarette papers and tubes among the articles listed therein which when shipped or delivered for consumption beyond the jurisdiction of the internal revenue laws of the United States are deemed to be exported within the meaning of the internal revenue laws applicable to the exportation of such articles without payment of

internal revenue tax. Code section 2135 (a) (3) provides for tax-free exportation of cigarette papers and tubes. This will make it possible to procure cigarette papers and tubes tax-free for use as sea stores.

SECTION 606. TELEPHONE, TELEGRAPH, ETC.

This section increases the rate of tax on telephone toll charges to 20 percent of the amount paid for such service, and puts the tax on a straight ad valorem basis. On investigation it developed that the ad valorem base is much simpler of administration. While the new rate of 20 percent is higher than the effective rate of the present tax, the present tax is measured by the charge for each separate conversation, message, etc., separately, whereas the new tax, where a bill is rendered, is measured by the sum of all such charges included in the bill. A similar provision for computing the tax on the basis of the total charges covered by a bill is included as to the tax on telegraph, etc., messages also. However, your committee has made changes relative to the tax on telegraph, cable, and radio dispatches and messages. The House bill increased the present rate of 10 percent to 15 percent. Your committee restored the present rate of 10 percent with respect to international dispatches or messages, and provided for separate computation with respect to domestic and international messages in case both are covered by a single bill.

In computing the tax upon telephone-toll service for which payment is made by inserting coins in coin-operated telephones, one-half or a greater fraction of 5 cents shall be treated as 5 cents, and a smaller fraction shall be ignored.

Under existing law, which taxes each conversation, message, etc., originating in the United States, irrespective of the place where payment is made, there is a "charge without a tax" with respect to collect calls coming into the United States, and a "tax without a charge" in the case of collect calls going outside the country. The amendment imposes a tax on amounts paid within the United States for toll-telephone service. In the case of telegraph, cable, and radio messages the tax is also made applicable to amounts "paid within the United States" for such service rather than to messages which originate within the United States.

The rate of tax with respect to leased wire, teletypewriter, and talking circuit special service has been increased from 10 to 15 percent. The tax applicable to wire and equipment service, including stock quotation and information services, burglar-alarm and fire-alarm service, and all similar services, is continued at the 5-percent rate. It is specifically provided that the 15-percent tax shall not apply to an amount paid for leased wire, teletypewriter, or talking circuit special service used exclusively in rendering wire and equipment service subject to the 5-percent tax, and it is also provided that the 5-percent tax shall not apply to leased wire, teletypewriter, or talking circuit special service subject to the 15-percent tax.

The rate of tax with respect to local telephone service has been increased from 6 to 10 percent. With respect to semipublic coin-operated telephone service the "local service" tax is made applicable only to the amount of the subscriber's guaranty, plus any fixed periodic charge.

SECTION 607. PHOTOGRAPHIC APPARATUS

Section 607 of the House bill amends Code section 3406 (a) (4) relating to tax on photographic apparatus. Under present law the tax is 10 percent of the price for which sold by the manufacturer, producer, or importer. By amendment made by the House bill there was exempted from the tax cameras weighing more than 4 pounds, exclusive of lens and accessories. The rate on lenses, photographic apparatus and equipment, and any apparatus or equipment designed especially for use in the taking of photographs or motion pictures or in developing, printing, or enlarging photographs or motion pictures, was increased from 10 to 25 percent, and the tax on unexposed photographic films (including motion-picture film but not including X-ray film), photographic plates and sensitized paper was increased from 10 to 15 percent. Your committee has amended the section to eliminate the exemption as to cameras weighing more than 4 pounds exclusive of lens and accessories, decrease the 25-percent rate to 10 percent, and exempt from tax under section 3406 (a) (4) sensitized paper manufactured expressly for use in the reproduction of drawings, specifications, records, and other documents.

SECTION 608. LUBRICATING OILS

This section, which is the same as section 608 of the House bill, amends section 3413 of the Code to increase the present rate of tax on lubricating oils sold by the manufacturer or producer from 4½ cents per gallon to 6 cents per gallon.

SECTION 609. TRANSPORTATION OF PERSONS

This section, which corresponds to section 609 of the House bill, amends section 3469 (a) and (c) of the Code to increase the rate of tax imposed with respect to the transportation of persons and berths and seats connected therewith from 5 to 10 percent of the amount paid. Code section 3469 (f) (2) provides a limited exemption from these taxes in the case of United States Army, Navy, Marine Corps, and Coast Guard personnel, including authorized cadets and midshipmen, traveling in uniform at their own expense when on official leave, furlough, or pass. Your committee has amended section 3469 (f) (2) of the Code to extend a like exemption to members of the military and naval forces of any of the United Nations traveling in uniform of such nation.

SECTION 610. ORGANS UNDER CONTRACT BEFORE OCTOBER 1, 1941

This section, which is the same as section 610 of the House bill, exempts from the 10-percent tax on musical instruments, organs sold under written contracts entered into prior to October 1, 1941, which is the effective date of the tax.

SECTION 611. TERMINATION OF CERTAIN EXCISE TAXES

This section, which is identical with section 611 of the House bill, terminates the following excises:

1. The tax with respect to neon-tube signs, electric signs, and electric advertising devices, imposed by section 3406 (a) (5) of the Code.
2. The tax with respect to articles of which rubber is the component material of chief weight, imposed by section 3406 (a) (7) of the Code.
3. The tax with respect to washing machines of the kind used in commercial laundries, imposed by section 3406 (a) (8) of the Code.
4. The tax with respect to optical equipment, imposed by section 3406 (a) (9) of the Code.

SECTION 612. AFFIXING OF CIGARETTE STAMPS IN FOREIGN COUNTRIES

This section is the same as section 612 of the House bill.

Under the amendment of section 2112 (c) of the Code made by this section the importer of cigarettes into this country may have the United States internal-revenue stamps attached in the foreign country if in case of importation into such foreign country of cigarettes of United States manufacture, the foreign country allows its revenue stamps to be attached in this country.

SECTION 613. EXEMPTION OF INSIGNIA, ETC., USED IN CONNECTION WITH UNIFORMS OF THE ARMED FORCES FROM JEWELRY TAX

This section as it passed the House amended Code section 2400, which imposes a tax on jewelry and other articles sold at retail, so as to exempt from the tax a smoker's pipe if the only parts of the pipe which consist of precious metals are essential parts not used for ornamental purposes, and buttons, insignia, cap devices, chin straps, and other devices officially prescribed for use in connection with the uniforms of the armed forces of the United States. Your committee has amended section 613 so as to add to the articles exempted from the tax, watches designed especially for use by the blind.

SECTION 614. REFRIGERATORS, REFRIGERATING APPARATUS, AND AIR-CONDITIONERS

Section 614 of the bill as it passed the House amended Code section 3405 so as to exempt from the tax on the sale or lease of refrigerators, refrigerating apparatus, etc., imposed under that section, the lease or renewal of a lease of a water cooler leased by a manufacturer, producer, or importer prior to October 1, 1941. Your committee has deemed it advisable to limit still further the scope of section 3405. Accordingly, section 614 has been redrafted so as to limit the application of the tax imposed under Code section 3405 to mechanical refrigerators of the household type, certain components of such refrigerators, and

self-contained air-conditioning units, including in each case parts and accessories therefor sold on or in connection with the sale thereof. The amendment removes water coolers from the scope of the tax. The special provision of the House bill relative to water coolers is therefore unnecessary and is eliminated. The amendment made by section 614 will take effect on the effective date of title VI of the bill. The amendment will afford no basis for exemption from taxes due under section 3405 prior to the effective date of the amendment.

SECTION 615. EXEMPTION OF CERTAIN CASH REGISTERS

This section, which is identical with section 615 of the House bill, amends section 3406 of the Code, to exempt from tax cash registers of the type used in registering over-the-counter retail sales.

SECTION 616. EXEMPT TRANSPORTATION OF OIL BY PIPE LINE

This section, which is the same as section 616 of the House bill, amends section 3460 of the Code by limiting the meaning of the term "transportation," and thereby exempting from the tax on transportation of oil by pipe line any movement through lines of pipe within the premises of a refinery, bulk plant, terminal, or gasoline plant, if the movement is not a continuation of a taxable transportation.

SECTION 617. COIN-OPERATED AMUSEMENT AND GAMING DEVICES

Section 617 of the House bill amends subsection (b) of Code section 3267 added by the Revenue Act of 1941. Section 3267 imposes special (annual) taxes with respect to the operation of coin-operated gaming and amusement devices. The present law imposes a tax of $10 per year with respect to so-called pinball and other similar amusement machines operated by means of the insertion of a coin, token, or similar object, and $50 a year with respect to so-called slot machines which operate by means of insertion of a coin, token, or similar object and which, by application of the element of chance may deliver, or entitle the person playing or operating the machine to receive, cash, premiums, merchandise, or tokens. The amendment of section 3267 (b) made by the House bill subjected to the $10 instead of the $50 tax rate a vending machine operated by means of insertion of a 1-cent coin which when it dispenses a prize, never dispenses a prize of a retail value of, or entitles a person to receive a prize of a retail value of, more than 5 cents. Your committee has retained this amendment, but has added a requirement that in the case of such machine the only prize dispensed shall be merchandise and not cash or tokens. The amendment made by the House bill also added to section 3267 a new subsection (e) which made inapplicable to coin-operated gaming devices, i. e., all those subject to the $50 rate, Code section 3275 which requires each collector of internal revenue to maintain conspicuously in his office for public inspection an alphabetical list of all persons who shall have paid special taxes within his district, and requires him upon

application of any prosecuting officer of any State, county, or municipality to furnish a certified copy thereof for a prescribed fee. Your committee has eliminated from section 617 the provision adding subsection (e) to section 3267, thus leaving section 3275 applicable to persons operating coin-operated gaming machines the same as to other special taxpayers, and has increased the tax rate applicable to such machines to $100.

A clarifying amendment has been made to section 617 (c). In the case of machines on which the rate of tax is increased, the amendment is applicable beginning July 1, 1943. Where machines have not been subject to tax prior to these amendments, no tax shall be payable with respect to any period before the effective date of the act. With respect to machines, if the limitation on the amount of the prize dispensed is 5 cents, the amendment shall be applicable beginning July 1, 1942.

SECTION 618. SALE UNDER CHATTEL MORTGAGE

This section, which is the same as section 619 of the House bill, amends section 2405 of the Code to allow the taxpayers, in the case of articles sold under chattel mortgage arrangements, to pay the retail sales tax as installments of the purchase price are paid. This treatment is similar to that now allowed in the case of articles sold under conditional and installment sales contracts. A similar amendment is made with respect to section 3441 (c) (1) relating to the manufacturers' sales tax.

SECTION 619. REPEAL OF CERTAIN PROVISIONS RELATING TO MIXED FLOUR

This section, which is identical with section 620 of the House bill, repeals chapter 18 and part IV of subchapter A of chapter 27 of the Code, imposing taxes relating to mixed flour.

SECTION 620. EXEMPTION FROM PROCESSING TAX OF PALM OIL USED IN MANUFACTURE OF IRON OR STEEL PRODUCTS

This section, which does not appear in the House bill, amends section 2477 of the Code. The latter section relates to the tax imposed by section 2470 of the Code on the first domestic processing of coconut and various other oils. Section 2477 provides that the term "first domestic processing" means the first use in the United States, in the manufacture or production of an article intended for sale, of the article with respect to which the tax is imposed, but does not include the use of palm oil in the manufacture of tin plate or terne plate, or any subsequent use of palm oil residue resulting from the manufacture of tin plate or terne plate. By the amendment made by your committee the definition of section 2477 likewise excludes the use of palm oil in the manufacture of iron or steel products or any subsequent use of palm oil residue resulting from the manufacture of iron or steel products.

SECTION 621. CABARET TAX

This section, which has been added to the bill as passed by the House, amends section 1700 (e) (1) of the Code. This provision of the Code imposes the 5 percent tax on amounts paid for admission, refreshment, service, or merchandise at any roof garden, cabaret, or similar place furnishing a public performance for profit.

In order to allay possible questions under the present statute, the amendment specifies that the tax, levied on amounts paid by or for any patron or guest entitled to be present during any portion of the performance, shall be applicable although no increase is made in the charges for admission, refreshment, service, or merchandise by reason of the furnishing of the performance. Thus the tax will be collected although a cabaret does not increase its prices for food or beverages while its floor show is in progress. The amendment confirms the Treasury Department's interpretation of the present statute by stating that the tax is applicable in the case of any room in any hotel, restaurant, hall, or other public place where music and dancing privileges or any other entertainment, except instrumental or mechanical music alone, are afforded the patrons in connection with the serving or selling of food, refreshment, or merchandise.

SECTION 622. SALE AND USE OF TOILET PREPARATIONS BY BEAUTY PARLORS, ETC.

This section, which is not contained in the House bill, amends section 2402 of the Code. Section 2402 (a) now imposes a tax with respect to toilet articles sold at retail. Subsection (b) provides that a sale of a toilet article to any person operating a barber shop, beauty parlor, or similar establishment is considered a sale at retail, and that a resale by such person is subject to the tax as a sale at retail. In the latter case, there shall be credited against the tax payable by such person with respect to such resale the amount of tax paid on the sale to such person.

Under the amendment made by your committee the sale of an article to a person operating a barber shop, beauty parlor, or similar establishment for resale by him will not be deemed a sale at retail. However, the sale of an article to such person for use in such operation, and not for resale, will be considered a sale at retail. The amendment further provides that the use in such operation of any such article purchased by such person on or after the effective date of the amendment for resale, shall likewise be considered a sale at retail by such person at a price equivalent to the amount paid by him for the article.

SEC. 623. TAX-FREE RETAIL SALES AT POST EXCHANGES AND SHIPS' SERVICE STORES

This section, which has been added to the bill as passed by the House, amends section 2406 of the Code, which grants exemptions from the taxes on furs, jewelry, and cosmetics sold at retail, to include an additional exemption covering sales of such articles to a member of the military or naval forces of the United States or to a member of the military or naval forces of any of the other United Nations when

in uniform and delivered to him on the premises of the post exchange or ships' service store for his exclusive use.

TITLE VII. SOCIAL SECURITY TAXES

SECTION 701. AUTOMATIC INCREASE IN 1943 RATE NOT TO APPLY

This section, which was added by your committee to the House bill, postpones the increase in the rates of the taxes imposed by the Federal Insurance Contributions Act (subch. A of ch. 9 of the Code). Under existing law, the rate of the income tax on employees imposed by section 1400 increases from 1 percent to 2 percent on January 1, 1943; and the rate of the excise tax on employers of one or more imposed by section 1410 also increases from 1 percent to 2 percent on such date. In the case of each such tax the amendment provides that the 1-percent rate shall remain in force through the calendar year 1943, and that the 2-percent rate shall be applicable to wages paid and received during the calendar years 1944 and 1945.

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THE REVENUE BILL OF 1942

OCTOBER 7 (legislative day, OCTOBER 5), 1942.—Ordered to be printed

Mr. LA FOLLETTE, from the Committee on Finance, submitted the following

INDIVIDUAL VIEWS

[To accompany H. R. 7378]

There can be no denying the fact that an all-out war effort calls for an all-out tax program, one that goes to the limit of every taxpayer's ability to pay.

It is estimated that Federal expenditures for the current fiscal year will exceed $77,000,000,000. Present taxes are capable of producing only $17,000,000,000 net Federal revenue at existing business levels. Even with the additional revenue proposed in H. R. 7378, as amended by the Senate Finance Committee, it is not unreasonable to expect a deficit of $55,000,000,000 for this fiscal year which will have to be met by further borrowing. The public debt, which amounted to $72,000,000,000 on July 1, therefore promises to reach $127,000,000,000 by next July.

In the face of such astronomical Budget requirements it is absolutely imperative that tax revenues be increased in every way possible without impairing national health, morale, and fighting efficiency.

H. R. 7378 with amendments as reported by the Finance Committee commits a double offense against sound national policy in the present emergency:

1. It fails to raise a reasonable maximum of revenue which is available without undue sacrifice. It fails to plug the loopholes of the present law and tax sources of revenue now escaping through technicalities and special privileges. It fails to tax heavily enough certain classes of individual and corporate incomes well able to carry a heavier share of the tax burden, and it likewise fails to impose a proper share of the tax burden upon inheritances.

2. It places an unfair and dangerous share of the increased tax burden upon the lower-income groups, encroaching upon subsistence standards of living and in effect taxing bread out of people's mouths. It is in the Nation's interest to recognize that any tax which cuts

into the necessary subsistence of a citizen or his family exceeds his capacity to pay taxes and undermines health and morale. The paramount importance of health and morale is recognized in providing for the men in the armed forces. It must also be recognized in protecting the men and women who fight the battles of production on the farm and in the factory.

ADDITIONAL REVENUE AVAILABLE

Joint return.

Under the terms of existing law, husband and wife are allowed to report their respective incomes on separate returns and share their personal exemptions. Where the aggregate family surtax net income falls in any except the lowest surtax bracket, this divided return results in a lower rate of tax on the income, a gain for the taxpayer and a revenue loss to the Government.

The legal doctrine that prevails in the eight community-property States further extends this privilege by holding that the wife shares equally in the husband's income regardless of her actual earnings. This arrangement offers extensive opportunity for tax avoidance in these States through the use of divided returns.

In the common-law States a similar purpose is achieved so far as investment income is concerned, by dividing income-bearing property between husband and wife through gift and then reporting the income on separate returns.

Under present tax rates a family in a common-law State whose only breadwinner is the husband earning $10,000 net income, before personal exemption, would be subject to Federal income tax of $1,305. If the aggregate net income is the same, but the wife earns half of it and reports it on a separate tax return, the tax would be only $966. In a community-property State the tax would only be $966 whether the wife earned any of the income or not.

There is no justification for such discrepancies in the application of the Federal income tax to different families with equal ability to pay. The family is an economic unit, and its ability to pay can properly be based upon the aggregate net income of both husband and wife. The tax then should be assessed on the basis of a joint return, and the law should require the filing of joint returns.

Compulsory joint returns would increase Federal revenue about $300,000,000 annually.

TABLE No. 1

Net income of husband and wife (no dependents) before personal exemption	Amount of normal and surtax				Loss to Government from split return under existing rates	Loss to Government from split return under H. R. 7378
	Under present law		Under H. R. 7378			
	Separate returns income equally divided	Joint return	Separate returns income equally divided.	Joint return		
$3,200	$157	$157	$301	$301	$0	$0
$3,300	167	167	379	382	0	3
$3,500	186	186	416	425	0	9
$3,600	196	199	434	446	3	12
$5,000	330	375	692	746	45	54
$10,000	966	1,305	1,788	2,152	339	364
$50,000	14,448	20,439	19,004	25,328	5,991	6,324
$100,000	41,764	52,704	51,052	64,060	10,940	13,008

Removal of tax exemption on State and local securities.

There are approximately $20,000,000,000 of State and local securities outstanding bearing tax-exempt interest amounting to more than $700,000,000 annually. On June 30, 1941, $12,200,000,000 of these securities were held by tax-exempt institutions, but there is a noticeable tendency of such securities to grativate toward individuals with large incomes subject to high tax rates at which they provide scandalous tax exemptions.

TABLE No. 2.—*State and local government securities as a percent of gross estate, by size classes of net estate, estate tax returns filed in 1928–40.*

Filing year	Net estate [1] (in thousands of dollars)				
	100 under 200	200 under 300	300 under 500	500 under 1,100 [2]	1,100 and over
	State and local government securities as percent of gross estate [3]				
	Percent	*Percent*	*Percent*	*Percent*	*Percent*
1928	1.6	2.3	2.7	4.3	6.2
1929	1.6	1.8	2.2	4.5	6.0
1930	1.4	2.4	3.0	3.6	7.3
1931	1.9	2.5	4.2	4.8	9.2
1932	2.2	2.6	5.0	8.3	13.3
1933	2.9	5.1	6.6	11.2	21.9
1934	3.4	4.4	5.8	10.0	23.9
1935	3.6	5.7	6.7	11.0	14.4
1936	3.0	5.4	6.3	8.2	12.5
1937	3.1	5.3	5.7	9.2	11.4
1938	2.9	4.4	5.3	8.0	16.1
1939	3.2	4.4	7.1	11.6	22.7
1940	3.1	3.6	6.2	8.8	15.1

[1] Before specific exemption.
[2] Includes securities of Territories and insular possessions.
[3] Gross estate includes tax-exempt insurance.

Source: Compiled from Statistics of Income.

TABLE No. 3.—*Gross annual yields from a taxable security equivalent to specified yields from a wholly tax-exempt security* [1]

Net income from other sources [2]	Gross annual yield from a taxable security equivalent to a tax-exempt yield of—							
	2½ percent		3 percent		3½ percent		4 percent	
	1941 rates	Proposed rates [3]	1941 rates	Proposed rates [3]	1941 rates	Proposed rates [3]	1941 rates	Proposed rates [3]
$1,000	2.50	2.50	3.00	3.00	3.50	3.50	4.00	4.00
$2,500	2.77	3.09	3.32	3.70	3.87	4.32	4.42	4.94
$5,000	2.87	3.21	3.45	3.85	4.02	4.49	4.60	5.13
$10,000	3.33	3.70	4.00	4.55	4.67	5.30	5.33	6.06
$20,000	4.31	5.21	5.17	6.25	6.03	7.29	6.90	8.33
$50,000	6.10	8.06	7.32	9.68	8.54	11.29	9.76	12.90
$100,000	7.81	14.71	9.38	17.65	10.94	20.59	12.50	23.53
$500,000	10.42	20.83	12.50	25.00	14.58	29.17	16.67	33.33
$1,000,000	11.36	20.83	13.64	25.00	15.91	29.17	18.18	33.33

[1] It is assumed that both the taxable and the tax-exempt security are bought at par; and that the income from additional investments, if taxable, would not be large enough to become subject to a higher rate than that applicable to the first dollar of the additional income. The calculations apply to a married person with no dependents, and take into account variations in the personal exemption and earned income credit as well as in tax rates. The earned income credit is assumed to be unaffected by the additional taxable income except in those cases where by statutory definition all net income is deemed earned.
[2] Before personal exemption.
[3] On the basis of the Senate Finance Committee version of H. R. 7378, victory tax excluded.

As income-tax rates increase, the importance of these tax-exempt securities as a means of tax avoidance for individuals in the upper income brackets will likewise increase. The revenue loss to the Government will accordingly become still greater if the exemption is allowed to continue.

TABLE No. 4.—*Tax liability assuming interest from State and local government securities (a) tax-exempt and (b) taxable under present and proposed individual income tax rates, for 25 selected individuals*

[In thousands of dollars]

Case	State and local interest	Taxable net income from other sources [1]	Total income	Present rates			Proposed rates [2]		
				Tax liability		Revenue loss from tax exemption	Tax liability		Revenue loss from tax exemption
				Interest exempt	Interest taxable		Interest exempt	Interest taxable	
1	221.9	601.9	823.8	424.2	595.7	171.5	504.4	609.6	105.3
2	236.2	207.9	444.1	126.4	301.2	174.8	157.0	364.9	207.9
3	260.4	148.9	409.3	87.0	276.8	189.8	106.2	334.9	228.6
4	230.9	1,337.5	1,568.4	999.2	1,181.6	182.4	1,151.1	1,354.3	203.2
5	226.9	1,081.0	1,307.9	796.8	975.8	179.2	925.3	1,125.0	199.7
6	215.0	147.8	362.8	83.6	241.8	158.0	105.4	294.0	188.6
7	349.5	144.2	493.7	82.6	339.6	257.0	101.1	407.9	306.8
8	820.7	835.6	1,656.3	605.0	1,251.6	646.6	710.0	1,432.2	722.2
9	162.7	249.8	412.5	158.1	279.2	121.1	194.5	337.7	143.2
10	351.7	275.1	626.8	175.9	442.7	266.8	216.2	525.7	309.5
11	330.7	373.6	704.3	249.9	503.0	253.1	303.5	594.5	291.0
12	773.0	765.1	1,538.1	549.4	1,157.7	608.3	647.4	1,327.6	680.2
13	668.7	305.9	974.6	198.6	712.8	514.2	243.3	831.7	588.4
14	817.4	288.9	1,106.3	186.6	817.2	630.6	229.0	948.2	719.3
15	394.6	376.6	771.2	250.7	553.2	302.5	304.7	651.9	347.3
16	296.5	603.0	899.5	423.2	653.0	229.8	503.7	764.6	260.9
17	404.3	160.1	564.4	94.8	395.3	300.5	116.0	471.4	355.4
18	316.3	915.1	1,231.4	666.8	915.8	249.0	780.0	1,058.3	278.3
19	313.4	278.7	592.1	179.2	416.6	237.4	220.0	495.7	275.8
20	356.5	135.4	491.9	75.1	336.9	261.8	94.8	407.6	312.8
21	1,083.7	4,321.4	5,405.1	3,380.3	4,251.3	871.0	3,770.9	4,730.6	953.7
22	172.6	170.7	343.3	102.2	227.2	125.0	125.2	276.8	151.6
23	226.2	166.9	393.1	99.5	204.5	105.0	121.9	320.6	198.7
24	314.8	331.7	646.5	217.5	457.3	239.8	205.5	542.5	277.0
25	424.8	218.9	643.7	136.2	366.3	230.1	184.9	558.8	373.9
Total	9,969.4	14,441.7	24,411.1	10,348.8	17,914.1	7,565.3	12,088.0	20,857.0	8,769.3

[1] Exclusive of net long-term capital gains and losses.
[2] As included in Senate Finance Committee version of H. R. 7378, victory tax excluded.

Source: Income items from returns on Form 1040 for 1940.

It is evident that the State and local governments will gain no benefit from the continued exemption of the interest from these securities now outstanding. Whatever benefit may accrue from their enhanced value as sources of tax-exempt income will accrue to the present holders or future sellers.

A sound and just tax system should apply the ability-to-pay standard to the individual taxpayer regardless of the source of his income. There is ample legal foundation for discarding the exemption hitherto granted income from these securities.[1] With the urgent need for wartime revenue now present, the Federal Government cannot afford to lose any longer the $184,000,000 which the exemption is costing annually under present rates or the $225,000,000 which it would cost under the rates proposed in H. R. 7378.

[1] See opinion of Assistant Attorney General Samuel O. Clark, Jr., addressed to Randolph E. Paul, April 14, 1942, reprinted in appendix of this report.

Elimination of percentage depletion credit.

The Revenue Act of 1913 provided that operators and owners of mines and oil and gas wells might deduct from their gross income the depletion of their natural assets in production, basing it either on invested cost or property value as of March 1, 1913, divided by the estimated reserves. Such a deduction, if computed on an investment basis, is comparable to the deduction of depreciation of capital equipment allowed the usual manufacturing enterprise. This allowance was limited to 5 percent of the gross income from the property, for th eyears 1913, 1914, and 1915. Thereafter, no such limitation was applied and depletion based on actual cost or March 1, 1913, value was allowed.

In 1918, however, the law was changed ostensibly for the purpose of encouraging new discovery and production of oil and minerals. Under the new law the calculation of depletion allowances on wells or mines discovered after March 1, 1913, could be computed on the basis of "discovery value," the value determined within 30 days of discovery.

The difficulties encountered in the administration of this formula and reaching agreement on the determination of fair and proper depletion allowances for income-tax purposes when "discovery valuation" was necessarily subject more to the imagination than to any objective test finally led to a demand that a fixed percentage depletion based on gross income be established in the law. This was done in the Revenue Act of 1926 for oil and gas wells, and in the Revenue Act of 1932 for mines (metal, coal, and sulfur).

Under present law, as a consequence, the following types of producers are granted a fixed percentage of their gross income as a deduction for depletion:

	Percent
1. Oil and gas	27½
2. Sulfur	23
3. Metal mines	15
4. Coal	5

Experience has shown that these percentages far exceed the actual depletion of these various classes of properties. Most companies to which percentage depletion applies also compute their actual cost depletion for their own books and the information of their stockholders. Tax returns filed by 78 oil companies for the year 1941 show an aggregate of $30,600,000 deducted on the tax returns as percentage depletion while only $6,100,000 was deducted as depletion on their books in computing their income and surplus.

Table No. 5 demonstrates the significance of this gratuitous privilege extended under the present law.

TABLE 5.—*Net income of selected oil companies reported for income-tax purposes compared with net income on the basis of cost depletion and loss of Federal revenue from percentage depletion.*

Company	Year	Depletion claimed for income-tax purposes [1]	Cost depletion	Taxable net income reported [2]	Net income based on cost depletion [2]	Federal revenue lost through percentage depletion	
						Under 1937 act rates	Under H. R. 7378 rates as reported by Senate Finance Committee
A	1937	$9,800,000	$600,000	−$5,000,000	$4,200,000	$630,000	$1,680,000
B	1937	10,100,000	2,000,000	−5,900,000	1,300,000	195,000	520,000
C	1937	3,600,000	400,000	800,000	4,000,000	480,000	1,280,000
D	1938	5,300,000	1,900,000	6,000	3,400,000	[3] 645,000	1,358,000

[1] Under percentage depletion privileges.
[2] After deduction of 85 percent of dividends received.
[3] Under 1938 act rates.

Source: Form 1120, Corporation income-tax return.

It is fair and proper that oil and mining companies be allowed the return of their capital free of tax and that is fully provided in the allowance for cost depletion granted by law. However, percentage depletion goes far beyond the point where it can be so justified. Oil and mining companies are no more entitled to these extra concessions than any other business involving the investment of capital. It is a form of subsidy.

As a subsidy it cannot be justified on the ground that it is necessary to increase our oil production, for with the rationing of civilian demand for petroleum products the national oil supply is far in excess of war needs. The Petroleum Coordinator recommended a production rate for October of this year amounting to 4,000,000 barrels a day, nearly 200,000 barrels below daily production a year ago.

Because mining does not enjoy large net incomes comparable to those common in the oil industry, the benefits of percentage depletion are not as important to the mining industry. However, it is no more justifiable in the case of mining than in the oil industry. It is true the war effort is requiring additional production of metals, but the task of developing new supplies in modern-day, scientific mining is one of determinable cost and predictable risk which can be given due credit on its own merit.

The elimination of the percentage depletion allowances from the Federal tax law would increase revenues by $124,100,000 annually under tax rates in H. R. 7378. Of this, $98,000,000 would come from oil and gas properties alone.

Corporation taxes.

Corporate income has benefited directly and enormously from the Government's war expenditures. Since 1939 the aggregate net corporate income among corporations reporting net incomes has increased 146 percent. Some of this increase has been taken back in the form of excess profits taxes, but additional revenue is still available from this source.

The maximum combined normal and surtax rate of 55 percent proposed by the Treasury Department, in combination with the excess-profits tax, would recover an amount roughly equivalent to this increase. The 40-percent combined rate proposed by the Finance Committee falls $832,500,000 short of this objective.

In view of the fact that these increased incomes can be considered as direct consequences of Government expenditures arising out of the national emergency, it is neither unjust nor unreasonable to recover this additional net income which has accrued to corporations over and above their costs of operation and production. When the Nation is asking its soldiers to give up their normal civilian pursuits, break off family ties, and risk their lives for only a token payment of $50 a month, it is indeed a small request to make that a corporation simply relinquish the extra net income resulting from war production.

TABLE No. 6.—*Net income, income taxes, and dividends of corporations with positive net incomes 1936 through 1942*

[Money amounts in millions of dollars]

	Actual				Estimated		
	1936	1937	1938	1939	1940	1941	1942
Net income including tax-exempt interest and dividends received	9,726	9,848	6,725	9,028	11,750	17,500	19,500
Dividends received	2,504	2,515	1,625	1,779	1,900	2,000	2,300
Net income excluding dividends received	7,222	7,333	5,100	7,249	9,850	15,500	17,200
Tax-exempt interest	488	419	420	464	450	500	500
Net income excluding dividends received and tax-exempt interest	6,734	6,914	4,680	6,785	9,400	15,000	16,700
Taxes:[1]							
Income tax	1,025	1,057	854	1,216	2,150	3,650	3,900
Undistributed-profits tax	145	176	------	------	------	------	------
Excess-profits tax	------	------	------	------	340	2,900	3,600
Declared value excess-profits tax	22	43	6	16	30	50	100
Total taxes	1,192	1,276	860	1,232	2,520	6,600	7,600

[1] Estimates for 1942 based on existing rates.

Source: 1936 through 1939, Statistics of Income, pt. II.

It is contended that corporations should be allowed to enjoy their larger profits during the war years so that they will be better able to withstand the post-war adjustment. The Finance Committee's proposal of a 10-percent post-war credit on corporate excess-profits taxes, which would be made available to the taxpaying corporation after the conclusion of the war, is designed to meet this requirement. However, with an increase in surtax rates there is an opportunity for enlarging the post-war credit so as to make it amount to 10 percent of the normal tax and surtax, as well as the excess-profits tax paid under the law. This would provide a larger and really effective aid to corporations in the post-war period of adjustment. The problems of post-war adjustment are not going to be confined to only those corporations paying excess-profits taxes; neither should the post-war credit.

To give assistance that is immediately needed by the smaller corporations, it seems highly desirable that the $10,000 exemption granted corporations by the bill as passed by the House for purposes of com-

puting excess-profits tax should be retained. If the exemption is lowered to $5,000, as proposed by the Finance Committee, it will mean that approximately 8,000 additional small corporations of limited capital resources will be subjected to tax burden out of proportion to their size and ability to pay. Such a burden would unduly handicap them in developing as efficient, producing enterprises, and thereby handicap the war production program of small business.

Even after providing this additional relief to smaller corporations and extending the post-war credit feature of the law to aid all corporations paying normal tax, surtax, or excess-profits tax, an additional $168,700,000 of revenue can be secured by increasing the surtax on corporation surtax net incomes over $25,000 to 26 percent, making a maximum combined rate of 50 percent. This is 5 percent under the Treasury Department's proposed combined rate. This plan would afford a total post-war credit of $1,045,400,000, which exceeds the Finance Committee's post-war credit proposal by $473,900,000.

Of the total post-war credit provided, it is estimated $385,000,000 would be made available currently to apply on debts and $660,400,000 would go to the taxpaying corporations as refunds after the war.

Individual surtax and estate taxes.

It is possible, entirely within the ability-to-pay principle, to increase the revenue from individual surtaxes on the middle and upper income brackets by at least $208,000,000 annually. Increases in estate and gift taxes can also be made to yield $193,000,000 additional revenue.

Summary.

The additional revenue available in the foregoing recommendations is as follows:

Compulsory joint income tax returns	$300, 000, 000
Taxation of income from State and local securities	225, 000, 000
Elimination of percentage depletion	124, 000, 000
Increased corporation taxes	219, 000, 000
Increased individual income surtax rates	208, 000, 000
Increased estate and gift taxes	193, 000, 000
Total increased revenue available under above recommendations without violating ability-to-pay principle	1, 269, 000, 000

THE LIMITS OF ABILITY TO PAY

Studies of consumer income indicate that any tax program which bears down upon individuals and families receiving incomes of $1,500 or less, encroaches upon subsistence standards of living. The tax dollars collected from taxpayers of these lower-income groups are dollars that would otherwise be spent for food, shelter, and the bare necessities of life. In these income groups are to be found approximately 43 percent of the Nation's population, but in the current year it is estimated they are receiving only 16 percent of the aggregate consumer income.

The study of income and spending and saving of city families in 1941 and the first 3 months of 1942, conducted by the Bureau of Labor Statistics, indicates that the average consumer with income under $1,500 is not able to meet living costs out of current income. On the

basis of the Bureau's findings for the first quarter of 1942, this group will have an average deficit of $16 in the full year of 1942.

TABLE NO. 7.—*Average money income and outlay, city families and single persons, by money income class*

FIRST 3 MONTHS OF 1942

Annual money income class	Average money income	Average money expenditures for—			Average net saving (+) or deficit (−)
		Current consumption	Gifts and contributions	Personal tax payments	
Under $500	$75	$105	$2	$1	−$37
$500 and under $1,000	182	207	6	1	−30
$1,000 and under $1,500	312	310	10	2	−4
$1,500 and under $2,000	436	400	16	5	+24
$2,000 and under $2,500	556	480	21	8	+48
$2,500 and under $3,000	685	585	26	13	+71
$3,000 and under $5,000	932	704	34	26	+113
$5,000 and under $10,000	1,615	1,184	58	82	+298

Source: Bureau of Labor Statistics.

The reduced present exemptions from $1,500 to $1,200 for married couples, and from $750 to $500 for single persons, the reduced credit for dependents from $400 to $300, and the victory tax proposed by the Finance Committee will impose a tax burden upon those income groups below $1,500 that can only have the effect of impairing the health, strength, and morale of nearly half of the Nation's population, from which it must draw not only the soldiers for the armed forces but the workers to fight the Nation's battles of production.

Manpower has already become one of the acute bottlenecks of the war-production program, and with the shortage of manpower has come the urgent necessity of getting the utmost out of every individual worker. Man-days lost because of fatigue, accident, and sickness are of serious importance. It is estimated that 6,000,000 man-days are lost every month in war production because of sickness and injury.

The significance of proper nutrition and adequate medical care in keeping the Nation's manpower functioning at top efficiency is obvious. The relationship of income to the problem can be seen in such facts as the following:

The sickness rate in the income groups receiving $1,000 a year or less has been found to be 17 percent higher than in the groups receiving over $3,000. Disability, based on both the frequency and the length of disability, is twice as great among individuals and families with incomes of $1,000 or less as it is among those receiving over $3,000.

Malnutrition and fatigue are, without doubt, partially responsible for this difference, but another important cause is found in the fact that the lower income families have been unable to afford adequate medical care in time of sickness. Families with incomes of $1,000 or less have failed to receive physician's care in 28 percent of their cases of disabling illness.

In the emergency that now exists there are many sources of additional revenue that can be tapped without violating the basic limita-

tions of the ability-to-pay principle. Some of these have been outlined in this report. However, it is neither necessary nor wise to impose additional tax burdens on families and individuals who are already struggling under great financial handicaps. To tax health, nutrition, and medical care means wasting the precious human resources needed on the battlefield, on the farm, and in the factory to win this war.

These basic limits of ability to pay must be kept constantly in view when judging any public tax measure. They are of most vital importance today when national morale must be built upon equality of sacrifice and fighting power must come, not from a comparatively small portion of the population engaged in the armed forces, but from the total population engaged in total war.

ROBERT M. LA FOLLETTE, Jr.

APPENDIX

OPINION OF ASSISTANT ATTORNEY GENERAL SAMUEL O. CLARK, JR., ADDRESSED TO RANDOLPH E. PAUL

DEPARTMENT OF JUSTICE,
Washington, April 14, 1942.

Hon. RANDOLPH E. PAUL,
Tax Adviser to the Secretary of the Treasury,
Washington, D. C.

DEAR MR. PAUL: On June 24, 1938, Hon. James W. Morris, Assistant Attorney General in charge of the Tax Division of the Department of Justice, transmitted to the Honorable Herman Oliphant, General Counsel of the Treasury Department, a comprehensive study of the constitutional aspects of the taxation of Government bondholders and employees. Copies of this study were also made available to the appropriate congressional committees.

You have requested our opinion on the constitutionality of the proposal by your Department to subject to Federal income tax the interest received hereafter on outstanding and future issues of State and municipal bonds, with special emphasis on legal developments subsequent to the publication of our study. We are pleased to comply with your request and submit the following views.

In our earlier study we expressed the following conclusion:

"It is believed that there can no longer be found in the decisions of the Supreme Court any rule of continuing authority which would raise a constitutional prohibition against applying the Federal income tax to State bondholders, officers, and employees."

You are no doubt aware that since that time the decisions of the Supreme Court on the question of constitutional tax immunity have all served to reinforce and confirm that conclusion. The trend toward a limitation of such immunity, which had developed when we published our study in 1938, has continued without interruption to the present date.

We are, of course, no longer concerned with the power of the Federal Government to tax the income of State officers and employees. The decision of the Supreme Court in *Graves* v. *N. Y. ex rel. O'Keefe* (306 U. S. 466), and the enactment of the Public Salary Tax Act of 1939, have removed that problem from the field of controversy. Taxation by both State and Federal Governments of the salaries of public employees is now an accepted incident of our fiscal system. The only remaining question is whether the income received from State and municipal obligations may be subjected to Federal taxation. In our view, the answer is as clear and certain as the solution of any legal problem can ever be prior to a final determination of the precise issue by the Supreme Court. It is our considered opinon that the Congress does have the power to tax such income.

It is, of course, true that the Supreme Court concluded in *Pollock* v. *Farmers' Loan & Trust Co.* (157 U. S. 429, 158 U. S. 601), that a Federal tax could not validly be imposed upon income derived from municipal obligations. That decision was based upon the theory that a tax on income was a tax upon the source from which the income was derived. Thus, a tax on the income from municipal bonds was the equivalent of a tax upon the bonds themselves, and, therefore, an unconstitutional burden upon the power to borrow. However, this reasoning has been completely discredited in later opinions of the Supreme Court. With the destruction of the premise of the *Pollock case*, its conclusion must also fall.

"The theory, which once won a qualified approval, that a tax on income is legally or economically a tax on its source, is no longer tenable * * *," said the Supreme Court in March 1939, in *Graves* v. *N. Y. ex rel. O'Keefe* (306 U. S.

480). Less than a year earlier in *Helvering* v. *Gerhardt* (304 U. S. 405), the Court had sustained a Federal tax upon the salaries received by employees of the Port of New York Authority. The claimed immunity, if allowed, would in the Court's opinion (p. 424) have imposed "to an inadmissible extent a restriction upon the taxing power which the Constitution has granted to the Federal Government." The imposition of a State tax upon the salary of a Federal employee was similarly held in the *O'Keefe case* not to place an unconstitutional burden upon the employing sovereign. *Collector* v. *Day* (11 Wall. 113), another landmark decision like the *Pollock case*, was thus overruled. The express denial in the *O'Keefe case* that a tax on income was the equivalent of a tax upon the source represented no new thought but was rather a reiteration of a principle which had been applied in the Court's prior decision in *New York ex rel. Cohn* v. *Graves* (300 U. S. 308), and in *Hale* v. *State Board* (302 U. S. 95). There, too, it had been recognized that "income is not necessarily clothed with the tax immunity enjoyed by its source."

The opponents of the pending proposal urge that it would produce an unconstitutional "interference" with State governments. Translated into practical terms, the interference complained of is merely the increased cost of future public borrowing which might be occasioned by the tax. It is significant that this increased cost involves no discriminatory burden. Rather, it represents the effect of placing income from private and public sources upon the same plane of equality. The absence of any element of discrimination would be helpful in sustaining the constitutionality of the proposed tax.

Until the Supreme Court handed down its decision in *Alabama* v. *King & Boozer* on November 10, 1941 (314 U. S. 1), there was room for the view that, despite the decisions affecting public employees, a constitutional immunity from taxation might possibly be accorded to Government bondholders. Mr. Justice Stone had stated in the *O'Keefe* opinion, page 486, that there was no basis "for the assumption that any * * * tangible or certain economic burden is imposed on the government concerned as would justify" a decision that the tax upon the employee's salary was invalid. On the other hand, it is no doubt true that the issuing government would bear a part of the economic burden of an income tax imposed upon the bondholder. Nevertheless, this Department did not attach to the statement of Mr. Justice Stone the significance urged for it by those who have opposed the legislation now suggested. The recent decision in *Alabama* v. *King & Boozer* confirms our view. It is now clearly established that the validity of a tax upon bond interest will not be affected by the increased likelihood that the economic burden will in some measure be passed on to the Government.

The question in the *Alabama case* was whether an Alabama sales tax, which was to be collected from the buyer, was unconstitutional in its application to purchases made by a contractor engaged by the United States under a cost-plus-a fixed-fee contract. It was quite clear, of course, that the entire burden of the tax would be borne by the Government. In fact, the Government had agreed with the contractor that State taxes, if valid, would constitute part of the cost of the project and would be assumed and borne by the Government. Hence there was no uncertainty as to the economic effect of the tax as in the earlier case of *James* v. *Dravo Contracting Co.* (302 U. S. 134), which involved a lump sum contract. The Supreme Court nevertheless sustained the State exaction. In the course of its opinion the Court made the following observation (pp. 8–9):

"So far as such a nondiscriminatory State tax upon the contractor enters into the cost of the materials to the Government, that is but a normal incident of the organization within the same territory of two independent taxing sovereignties. The asserted right of the one to be free of taxation by the other does not spell immunity from paying the added costs, attributable to the taxation of those who furnish supplies to the Government and who have been granted no tax immunity."

Thus, the Supreme Court finally laid to rest the theory that an economic burden in terms of increased governmental costs invalidates a tax. The earlier opinions in *Panhandle Oil Co.* v. *Knox* (277 U. S. 218), and *Graves* v. *Texas Co.* (298 U. S. 393), were held untenable so far as they supported the contrary conclusion.

A decision which supports State taxation of Federal cost-plus-a-fixed-fee contractors would operate at least equally to sustain a Federal tax imposed upon State bondholders. Both relationships rest upon contract; one involves the furnishing of supplies and services, the other money. The tax in each instance would increase the cost of governmental operations: In the case of the State tax

on the Federal contractor, to the full extent of the tax exacted; in the case of the State bondholders, to some extent which is difficult of precise ascertainment. Paraphrasing the language of the Supreme Court in the *Alabama case*, we may therefore conclude that so far as a nondiscriminatory Federal income tax upon a holder of a State obligation enters into the cost of borrowing, that is but a normal incident of the organization within the same territory of two independent taxing sovereigns.

What has been said thus far as to the power of the Federal Government to impose a tax upon income received from State obligations applies with equal force to all interest hereafter received whether upon future issues or upon outstanding obligations. No constitutional question as to the validity of a retroactive tax is involved. See *United States* v. *Hudson* (299 U. S. 498), and cases cited therein. The proposed tax reaches only future income, and is therefore entirely prospective in operation. It possesses the same constitutional validity as the income tax imposed by the Public Salary Tax Act of 1939, upon the income received after 1938 by all Federal judges, irrespective of the date of their appointment to office.

The assumption, which was formerly prevalent that interest received upon State securities was immune from Federal taxation, is analogous to the assumption of many years standing that under *Evans* v. *Gore* (253 U. S. 245), an income tax upon the salaries of Federal judges would be unconstitutional as a diminution of their compensation. The salaries of some Federal judges were made subject to the income-tax laws by the Revenue Act of 1932, which required that all compensation received by judges taking office after June 6, 1932, the effective date of the act, be included in gross income. Judges who had taken office prior to June 6, 1932, were thus given a statutory tax immunity. In the case of the bondholder, express statutory exemption was included in the act of October 3, 1913, and this provision was repeated in later acts. With the realization that tax immunity of judges who had taken office prior to June 6, 1932, was not a constitutional requirement, the Congress, by the Public Salary Tax Act of 1939, took the final step to remove it. The present proposal to tax future income of all State securities is therefore consistent with the procedure and objective of the Public Salary Tax Act of 1939. A further illustration of the application of the income-tax laws to future income arising out of transactions which were closed before the particular taxing provision was adopted may be found in *Burnet* v. *Wells* (289 U. S. 670). The grantor of an irrevocable trust was there held constitutionally taxable upon the trust income although the trust had been created before the enactment of the statute imposing the tax.

There is no constitutional basis for contending that income hereafter received upon outstanding State bonds must be free from Federal taxation because the obligations were issued and purchased on that implied or expressed understanding. The Federal Government was not a party to such contracts and the power of the Congress to enact a revenue measure is not fettered by any agreement between individuals or between an individual and a State. There are many illustrations of this proposition. Thus, in *Louisville & Nashville R. R.* v. *Mottley* (219 U. S. 467), an act of Congress which prohibited the enforcement of certain contracts for transportation was upheld, although applied to a preexisting contract. In *New York* v. *United States* (257 U. S. 591), an order of the Interstate Commerce Commission which increased an intrastate railroad rate was upheld even though the State charter had provided that a lesser rate should be charged by the company. See also *Norman* v. *B. & O. R. Co.* (294 U. S. 240).

It accordingly appears that no objection on constitutional grounds can be successfully raised against the proposal to tax the income hereafter received upon outstanding State obligations. Indeed, the assistant secretary of the Conference on State Defense has admitted that if Federal taxation of income arising out of future issues of State bonds is constitutional, "there remains no constitutional bar to Federal taxation of the income received from the bonds now outstanding." (Tax Immunity and the Revenue Bond, by Daniel B. Goldberg, a printed memorandum distributed by the Conference on State Defense, March 1940.)

The Department's study of 1938, referred to above, reached a second and alternative conclusion that irrespective of the weakened vitality of the *Pollock case* and *Collector* v. *Day*, there is sound basis for a construction of the sixteenth amendment which would remove the immunity of the State bondholder and officer. We there examined at length the history of the ratification of the amendment and presented as exhibits the evidence which would support that conclusion. Accordingly, we refrain from entering into that phase of the problem in detail. One brief observation, however, seems appropriate.

At the hearings last month before the Committee on Ways and Means of the House of Representatives, reference was made to the fears expressed in 1910 by then Governor Hughes, of New York, that the proposed sixteenth amendment would authorize the taxation of interest received from State and municipal obligations. Reference was also made to the subsequent assurances of Senator Root and Senator Borah leading to the conclusion that the amendment was adopted by the legislatures of all the States with the views of the latter two in mind. The statements of Governor Hughes and of Senators Root and Borah, and of many others, were gathered and commented upon in our study. It is significant that a large number of public officials (some agreeing and others disagreeing with the construction placed upon the amendment by Governor Hughes) urged that if the Hughes construction was correct, it furnished an additional ground for the adoption of the amendment. Among these were Frederick M. Davenport, to whom Senator Root's letter had been addressed, and Senator Brown, of Nebraska, who was the father of the joint resolution submitting the amendment to the States. It is also significant that the New York Legislature rejected the amendment in 1910 after the message of Governor Hughes, but ratified it subsequently under the administration of Gov. John A. Dix, who vigorously championed the broadest interpretation of the amendment.

The foregoing and an abundance of similar evidence permitted the conclusion to be reached in our study that the preponderant understanding of the States at the time of the ratification of the sixteenth amendment was that its adoption would in all probability carry with it the power to tax the income from State and municipal bonds.

We should like to reiterate, however, that the constitutionality of the proposed legislation does not depend exclusively upon the acceptance of our construction of the sixteenth amendment, namely, that the words "from whatever source derived" mean exactly what they say, and as so interpreted clearly embrace income from Government securities. With full confidence, the validity of our conclusion may rest upon the basic proposition previously discussed that no implied constitutional immunity from Federal taxation attaches to interest received from State and municipal obligations.

Very truly yours,

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Assistant Attorney General.

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