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AMENDING CERTAIN PROVISIONS OF THE INTERNAL REVENUE CODE

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

REPORT

[To accompany H. R. 5268]

The Committee on Finance, to whom was referred the bill (H. R. 5268) amending certain provisions of the Internal Revenue Code, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. GENERAL STATEMENT

H. R. 5268 contains nine provisions which in the opinion of your committee, remove certain inequities or hardships in the present Federal tax laws. Six of the nine (all but secs. 4, 7, and 9) were in the revenue revision bill (H. R. 6712) passed by the House but not considered by your committee in the second session of the Eightieth Congress. Your committee added the last three sections of the bill and amended sections 5 and 6. The remaining sections are the same as they were in the bill as it passed in the House.

II. DETAILED DISCUSSION OF THE BILL

1. Farmers' returns

Present law does not require farmers to file a declaration of estimated tax under the current tax-payment system until January 15 of the year following the year in which the liability is incurred. The reason for this is that their income is more uncertain and subject to greater fluctuation than the income of most other taxpayers, and thus more difficult to estimate before the close of the taxable year. Also, since many farmers realize relatively little income before the latter part of the year, it would be a real financial hardship to them to require the advance payment of part of their tax in the forepart of the year.

Since the January 15 date is relatively close to the March 15 date, when final returns must be filed, many farmers have preferred to file their final returns by January 15 in lieu of making a separate declaration of estimated tax. Because farmers often insist on filing final returns, or precise estimates, by January 15, the accountants, lawyers, and other tax advisers in the towns and smaller cities who customarily aid farmers in making out their returns have been deluged with work during the first 15 days of January.

In an effort to relieve this situation, section 1 of the bill amends section 60 (a) of the Internal Revenue Code to provide that if a farmer on a calendar-year basis files his income-tax return on or before January 31 following the close of the year, and pays in full the amount computed on the return as payable, such return and payment shall also be considered as the declaration and payment of estimated tax now required to be made on or before January 15. The present right of farmers to file a declaration of estimated tax by January 15 and a final return by March 15 is unchanged. Under present law, farmers also have the alternative of filing a final return by January 15, which return is also considered as the necessary declaration of estimated tax. The bill liberalizes this alternative by extending this final filing date to January 31. Comparable treatment is also accorded farmers making returns on a fiscal-year basis.

2. Adjustment to foreign tax credit in case of refund of foreign taxes

Section 2 of the bill amends section 131 of the Internal Revenue Code relating to credits for taxes of foreign countries and possessions of the United States. Section 131 provides, subject to limitations, that there shall be credited against United States income tax the amount of any income and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States. Section 131 further provides that, if any foreign tax paid is refunded, the amount of the United States tax for the year or years affected shall be redetermined, with an adjustment in the credit to reflect the amount of the foreign tax refunded. This result in a deficiency in the United States tax payable by the taxpayer.

In some countries, however, a tax refund may itself (for reasons peculiar to the tax structure of the particular country) be subject to a tax for the year in which the refund is made. For example, assume a taxpayer has received credit against the United States tax in the year 1945 for $1,000, the income tax paid to a foreign country. In 1947 the foreign country allows a refund of the $1,000 tax paid in 1945, but imposes for the year 1947 a $300 tax on the amount of the refund. It is not clear under section 131 whether the United States foreign tax credit for 1945 should be reduced by the gross amount of the refund ($1,000) or by the net amount ($700). Section 2 of the bill clarifies the problem by providing, in adjusting the foreign tax credit, that only the net amount be considered as having been refunded.

Section 2 of this bill accordingly provides that, in this redetermination of the amount due to the United States from the taxpayer for the year or years affected by a refund, the amount of taxes refunded (for which credit has been allowed) shall be reduced by the amount of any tax imposed by the foreign country or possession on such refund. However, no foreign tax credit and no deduction for any taxable year shall be allowed with respect to the tax imposed on the refund by the foreign country or possession. This is done to prevent the double allowance of the tax paid the foreign country on the refund, since, under this provision the credit is in effect allowed for the earlier year.

Your committee's attention has also been directed to the fact that some foreign countries either do not pay interest on refunds of income and excess-profits taxes or their interest rates are lower than the rate of interest on a deficiency determined under United States law. When a refund is made by a foreign country with respect to a tax for which credit has been allowed under section 131 of the code, interest must be paid on the resulting deficiency in United States tax. This may result in the taxpayer paying more interest to the United States with respect to the deficiency than he has received from the foreign country on the refund which gave rise to the deficiency. Your committee believes that it is only equitable to limit the amount of interest due on a deficiency resulting from such refund. Accordingly, section 131 has been amended to provide that no interest shall be collected for any period prior to the receipt of the refund except to the extent interest for such period was paid by the foreign country or possession on the amount of such refund.

Section 2 also provides that both of these amendments shall be applicable to taxable years beginning after December 31, 1938, and if the application of these amendments results in a refund to the taxpayer such refund shall be made irrespective of any provision or rule of law if a claim for refund is filed within the period prescribed by section 322 of the code or within 1 year from the enactment of the bill, whichever is later.

3. Deduction of charitable contributions by corporations

Section 3 of the bill amends section 23 (q) of the Internal Revenue Code, which allows (subject to the 5 percent of net income limitation) a deduction for charitable, etc., contributions paid by corporations. Section 23 (q) of the code now allows this deduction only where payment is actually made within the taxable year.

The amendment liberalizes the rule respecting time for payment by adding a rule that any such contribution will, in the case of a corporation on the accrual basis, and at the election of the taxpayer, made at the time the return is filed, be considered as paid during the taxable year if payment is actually made on or before the fifteenth day of the third month following the close of the taxable year, and if the contribution has during the taxable year been authorized by the board of directors.

Your committee believes this amendment is desirable because corporations intending to make the maximum charitable contributions allowable as deductions have experienced difficulty in determining before the end of the taxable year what constitutes 5 percent of their net income.

Section 3 also amends section 102 (d) (1) (B) of the code (relating to sec. 102 net income); section 336 (a) (2) (relating to net income of foreign personal holding companies); and section 505 (a) (2) (relating to net income of domestic personal holding companies), so as to integrate provisions of these sections relating to charitable contributions with the amendment to section 23 (q).

The amendments made by this section are applicable with respect to taxable years beginning after December 31, 1942. In the case of any taxable year beginning before January 1, 1949, the election for such year may be made (in lieu of at the time of the filing of the return for such year) at any time within 1 year after the date of the enactment of this bill, but not unless the taxpayer consents in writing to the assessment of any resulting deficiency for any other taxable year.

4. Exemption from stock transfer taxes

Section 4 of the bill amends section 1802 (b) of the Internal Revenue Code (relating to stamp taxes on transfers of stock) to exempt from tax transfers from a corporation to a registered nominee of such corporation, or from one such nominee to another such nominee, provided the shares or certificates are held by the nominee for the same purpose for which they would be held if retained by the corporation. Transfers by the nominee back to the corporation are also exempted from tax.

The provision is considered desirable because, although the transfers described above represent changes in legal title, they do not represent a real change of interest. Corporations frequently find it convenient to make use of nominees in order to facilitate stock transfers. The use of nominees makes it unnecessary to obtain the vote of the board of directors before making a sale or transfer of stock. This method of achieving flexibility in handling investments is believed to be desirable since no real change in interest occurs.

Section 4 also provides that in the case of the death before the date of the enactment of this bill of a nominee of a corporation, no tax shall be imposed upon any transfer of stock from his executor or administrator to the corporation, if such transfer is made on or before the date of the enactment of this bill or within 1 year after such date.

5. Contributions to certain trusteed plans providing employee annuities

Section 5 of this bill as passed by the House adds a new subsection (d) to section 165 of the Internal Revenue Code to provide that contributions to certain employee annuity trusts by employers shall not be included in the income of the employees in the year in which the contributions were made, despite the fact that such trusts are not qualified under section 165 (a). The application of the provision is limited to trust agreements entered into prior to October 21, 1942, the effective date of the Revenue Act of 1942, which specified the present qualifications for employees' trusts under which contributions by employers are not taxable to employees as income in the year in which acquired by the trust. The application of the provision is further limited to trusts under which (1) the contributions are to be applied by the trustee for the purchase of annuity contracts for the benefit of employees, and (2) the employee, except with the consent of the trustee, is not entitled to any payments under the annuity contracts except annuity payments. Thus, under this provision, the employees are given essentially the same treatment as those covered by plans qualifying under section 165 (a). Your committee believes this is desirable, since these contributions are not currently available, without the consent of the trustee, to the employee (making it necessary for him to look to other sources for funds to pay the tax on the employer's contribution), and since the employee might not have been on notice at the time of entering into such a contract that employer contributions under the plan would represent income currently taxable to him.

As indicated above this section as passed by the House would have postponed the taxing to employees of contributions by employers for annuity contracts (under the conditions specified) only where the employer made the contributions to the trust, and the trustee purchased the annuity contracts for the benefit of the employees. Your committee has amended this section of the bill to extend similar treatment to amounts which the employer himself used to purchase the annuity contracts subsequently transferred to the trust. Your committee believes that there is no significant difference between these two types of cases and proposes, therefore, that the prospective annuitants in these cases be given the same tax treatment. The section was also amended to require that the employee be in the employ of the employer and covered by an agreement prior to October 21, 1942. Otherwise it would be possible to bring under this provision employees who were on notice at the time of entering into such a contract (after the passage of the Revenue Act of 1942) that employer contributions under the plan would represent income currently taxable to them. The Ways and Means Committee report indicated that this was not the intent of the House. Since your committee agrees that this is one of the principal reasons for proposing this provision, it has amended this section to limit the application of this provision as outlined above.

This section of the bill also contemplates that the employer's contributions to such a trust, or for the purchase of annuity contracts turned over to the trust, will be taxable to the employee, when received in later years, as an annuity (pursuant to sec. 22 (b) (2) of the code). To this end it is provided that the amount so contributed by an employer shall not constitute consideration paid by the employee for such annuity contract in determining the amount of annuity payments required to be included in his gross income under section 22 (b) (2). An exception to this rule will be applicable in cases where income tax for any taxable year beginning before January 1, 1949, has been paid by the employee with respect to a contribution made by the employer for such year and such tax is not credited or refunded to the employee. In such event, the amount contributed by the employer for such year shall constitute consideration paid by the employee for such annuity contract in determining the employee's tax liability under section 22 (b) (2).

The provisions of this section are applicable to taxable years beginning after December 31, 1938, but have no application with respect to amounts contributed to a trust after June 1, 1949, if the trust on that date was exempt under section 165 (a) of the code. This latter provision is to prevent employers who have plans which have been amended to meet the requirements of section 165 (a) from removing the amendments and permitting the plans to revert to their former status. In the case of employer-purchased annuity contracts which are transferred to the trustee, the time of the purchase of the annuity contract, rather than the time of transfer to the trustee, will govern the determination of whether or not the contribution was made to the trust before or after June 1, 1949.

6. *Reciprocal trusts*

Prior to 1940 certain reciprocal trusts were established with the apparent intent of minimizing estate taxes by what were then considered effective means. For example, an individual might establish a trust providing that the corpus of the trust would be payable to his children upon his death. Under the general plan followed, certain rights in the trust were also given to his wife. These rights might consist of a general power to invade the corpus, to change the beneficiaries or to change the amount which they would receive. At the same time or a short time after the husband set up the trust, his wife would also establish a trust with assets of a similar amount, vesting in him powers equivalent to those he had vested in her. By this reciprocal device it was thought that two persons could transfer property to their heirs without diminishing effective control during life but still paying the gift tax rather than the estate tax.

The acceptance by the Treasury, prior to 1939, of the gift taxes paid (and, it is claimed, the assertion of occasional deficiencies) caused some taxpayers to believe this was a legitimate device.

However, in 1940 in *Lehman* v. *Commissioner*, 109 F (2d) 99, the Circuit Court of Appeals for the Second Circuit held that where trusts are found to have been created each in consideration of the other, the nominal grantors are to be interchanged for tax purposes. Thus, in the type of case discussed above, the husband would be considered the grantor of the trust created by the wife, and vice versa. This means that the husband is considered to have reserved powers in the trust nominally set up by his wife. This, under present law, is sufficient to require inclusion of the entire trust corpus in his gross estate upon his death.

The court decisions in 1940 and subsequent years put taxpayers on notice as to the probable tax consequences of reciprocal trusts in the future. However, the situation is different with respect to trusts created before 1940, the year of the Lehman decision. If taxpayers release their powers, they become subject to the gift tax, although one gift tax may already have been paid. If they retain the powers, the trust property will be included in the gross estate upon their death, even though a gift tax may have been paid.

Section 6 of this bill removes hardship by extending relief to persons who created reciprocal trusts, vesting powers in each other, before January 1, 1940. This section amends section 1000 of the Internal Revenue Code and corresponding provisions of prior law to provide that the relinquishment of such a power on or before December 31, 1950, will not be subject to the gift tax. This section also provides that such a relinquishment is not to be considered, for the purpose of the estate tax, as having been made in contemplation of death, but only if the person who made the relinquishment died after February 10, 1939. This last date was substituted for December 31, 1939, to coincide with the date of the enactment of the Internal Revenue Code. If either grantor relinquishes his power, the other reciprocal trust created by him must, for all gift-tax purposes, be treated as a completed gift when made.

This section does not apply, however, to the assignment of a life estate or other interest (as distinguished from the relinquishment of a power) which has been created in a reciprocal trust.

This section as amended by your committee applies only to a relinquishment by a person who made a reciprocal transfer upon which gift tax was paid and not credited or refunded. This section as passed by the House also applied where the reciprocal transfer was made (1) while no gift-tax law was in effect, or (2) while a gift-tax law was in effect but no gift tax was paid because of deductions and exclusions claimed on the return. Your committee has limited the scope of the provisions to cases where a prior gift tax was paid, since only in such cases would there be a double gift tax under present law as the result of the relinquishment of the trust powers.

7. Transfers prior to March 4, 1931, with life estate retained

Section 7, which your committee has added to the House bill, amends section 811 (c) of the Internal Revenue Code (relating to the estate tax treatment of transfers in contemplation of, or intended to take effect in possession or enjoyment at or after, the decedent's death) to provide that property transferred before March 4, 1931, shall not be included in the transferor's gross estate by reason of the fact that he retained an estate for his life in the transferred property.

This amendment is made necessary by the recent decision of the Supreme Court, by a divided Court, in the case of *Commissioner* v. *Church* (335 U. S. 632 (January 17, 1949)), holding property transferred by the decedent prior to 1931 to be includible in his gross estate because he retained the income from the property for life. This result was reached by overruling *May* v. *Heiner* (281 U. S. 238 (1930)), and three per curiam opinions handed down on March 2, 1931, in which the Court had held that transfers in which the decedent retained a life estate were not taxable. The Congress in enacting a joint resolution on March 3, 1931, to overcome the effect of *May* v. *Heiner* and related cases did not intend to apply the legislation retroactively. In fact, Mr. Garner, in explaining on March 3, 1931, the joint resolution reported by the Ways and Means Committee, stated:

> We did not make it retroactive for the reason that we were afraid that the Senate would not agree to it.

The Supreme Court itself held, in *Hassett* v. *Welch* (303 U. S. 303 (1938)), that the language of the joint resolution and its subsequent reenactment was not meant to apply retroactively to transfers made before its enactment.

Despite the fact that Congress has not seen fit to limit the effect of *May* v. *Heiner* with respect to transfers before March 4, 1931, the present Supreme Court had, after eighteen years, decided that its statutory construction in *May* v. *Heiner* was incorrect. In the words of Mr. Justice Reed's dissent from the Church decision:

> In reliance upon a long settled course of legislative and judicial construction, donors have made property arrangements that should not now be upset summarily with no stronger reasons for doing so than that former courts and the Congress did not interpret the legislation in the same way as this Court now does.

In the joint resolution of March 3, 1931, Congress created a new estate tax rule with respect to transfers after March 3. It left unchanged the rule in effect for transfers before that date. It is the opinion of your committee that the old rule should have been continued in effect with respect to such transfers until changed by legislation. Since the rule has been changed by the Supreme Court in the Church opinion, your committee believes that the Congress should act to restore the estate tax law to what it was prior to the Church opinion.

Some persons might have surrendered their life estates after 1931 had they not relied on the interpretation of the estate tax law which has now been overruled and in some cases considerable hardship may result from application of the new interpretation presented in the

Church case. It is the opinion of your committee that after all of these years these persons are entitled to rely upon the long standing interpretation in *May* v. *Heiner*, and the proposed amendment is accordingly intended to assure that result. While the Treasury has proposed regulations which would relieve, in some cases, the hardship arising from application of the Church opinion, it would be beyond the power of the Treasury to alleviate the full effects of this opinion, and legislation is necessary to accomplish this.

The operation of the amendment made by this section may be illustrated by the following example: A, in 1928, transferred property in trust retaining a life estate and giving the remainder indefeasibly to B and his heirs. Since the transfer was made before March 4, 1931, and the only right or interest retained by the decedent in the property consists of an estate for his life, the transfer is not "intended to take effect in possession or enjoyment at or after his death" within the meaning of section 811 (c) as amended by this section of the bill. Hence, the property is not includible in the gross estate unless the transfer was made in contemplation of death or unless the property falls within some other subdivision of section 811.

The amendment made to section 811 (c) by this section of the bill does not, however, similarly change the estate-tax treatment of a transfer made before March 4, 1931, in case the decedent retained both a life estate and some other right or interest in the transferred property. Thus, assume that A, in 1928, transferred property in trust retaining a life estate and giving the remainder to B if living at A's death. In this case, since the property will revert to A by operation of law if he should survive B, A has retained more than a life estate. Accordingly, this section of the bill does not relieve A's estate from liability under the estate tax with respect to this property.

The amendment made by this section is applicable with respect to estates of decedents dying after February 10, 1939, the date of the enactment of the Internal Revenue Code.

8. Reverters under the estate tax

Under the present interpretation of the estate-tax law, the full value of property transferred by the decedent during his lifetime is included in his gross estate if the following two conditions coexist: (1) Possession and enjoyment of the transferred interest can be obtained only by beneficiaries who must survive the decedent; and (2) the decedent or his estate possesses a right or interest in the property. It has been held by the courts that the second of these conditions is satisfied where the decedent's interest is only a right of reverter. This is illustrated in a recent Supreme Court decision (*Estate of Spiegel* v. *Commissioner*, 335 U. S. 701). In this case Spiegel established a trust when he was 47 years old and his three children were aged 25, 15, and 13. At his death 20 years later the children were still living and there were three grandchildren. Despite the fact that the corpus of the trust would revert to Spiegel only if he survived all of his children and grandchildren, the entire value of this property was included in his gross estate. One of the justices in a dissenting opinion pointed out that, given the facts of the Spiegel case, the value to a settlor just prior to death of a reverter on a $1,000,000 trust fund (the Spiegel trust fund was about $1,140,000) would be about $70. As he phrased it: "The relation of $70 to

$1,000,000 ordinarily would be de minimis and certainly not one which would induce Congress to permit the assessment of a tax of over $450,000 because of its existence."

Section 8, which your committee has added to the House bill, further amends section 811 (c) of the Internal Revenue Code, to provide that the amount of the transferred property to be included in the gross estate shall not exceed the actuarial value of the decedent's reversionary interest immediately before his death. It applies only in case the property transferred by the decedent would not be includible under section 811 (c) in determining the value of his gross estate except by reason of the fact that he retained a reversionary interest in the property. The term "reversionary interest" is defined so as to include both a possibility that the transferred property or a portion thereof may return to the decedent or his estate and a possibility that the transferred property or a portion thereof may pass under the exercise of a power by the decedent. The latter possibility may be illustrated by assuming that A transferred property in trust to accumulate the income until his death and then to pay the accumulated fund to B if living; but if B should predecease A, then the fund is to be paid to whomsoever A shall appoint by will. Under the existing construction of section 811 (c), the entire fund is includible in A's gross estate in the event of his death during B's lifetime. The effect of this section of the bill is to limit the amount includible to the value, immediately before A's death, of the interest which he can appoint by will; except where the transfer was made in contemplation of death or where the property falls within some other subdivision of section 811.

The amendment made by this section is applicable only with respect to estates of decedents dying after the date of enactment of the bill.

9. Percentage depletion for perlite and diatomaceous earth

Section 9, which was not contained in the House bill, amends section 114 (b) of the Internal Revenue Code to provide a different basis for allowance of depletion in the case of mines or deposits of perlite and diatomaceous earth. The effect of the amendments made by this section of the bill is to add mines or deposits of perlite and diatomaceous earth to the list of nonmetallic mines or deposits which are allowed depletion in the amount of 15 percent of the gross income derived therefrom, and to make inapplicable to these mines or deposits the allowance of depletion upon the basis of discovery value. It is proposed to allow percentage depletion only with respect to perlite and diatomaceous earth in the dried crude mineral form, before grinding or any other preparation for any particular market. Perlite is a volcanic glass, and diatomaceous earth, a chalk-like, or clay-like material which is the silicified skeleton remains of colonial algae.

The Director of the Bureau of Mines reports that although the Bureau does not have a detailed statistical record which would completely define the degree of competition of these minerals with those now accorded percentage depletion, "such competition is known to exist." He further reports:

For example, diatomaceous earth is used as a heat-insulating material and as such competes with vermiculite in some applications. Diatomaceous earth is also used as a filler in a wide variety of products, and therefore competes in varying degree with other minerals that serve this market, such as china clay, bentonite, talc, and barite, all of which are allowed percentage depletion.

Similarly, perlite competes with vermiculite in the lightweight aggregate market.

Other reports indicate that perlite or diatomaceous earth, or both are also competitive with ball and sagger clay, feldspar, mica, and pyrophyllite. Since all of these minerals, as well as those mentioned above by the Director of Mines, receive percentage depletion, your committee believes that the benefits of percentage depletion should also be extended to perlite and diatomaceous earth to remove any tax differential which might prevent them from competing on an equal basis with these other minerals.

It is not proposed to allow percentage depletion with respect to the value added as the result of grinding or other special preparation because many of the extractors do not themselves carry on this process, but rather sell these minerals in crude form and let others carry on any processing required. Thus to allow percentage depletion with respect to this added value would discriminate against those selling these minerals in crude form, since percentage depletion is not allowable to processors.

The amendments made by this section are applicable with respect to taxable years beginning after December 31, 1948.

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